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Did Kaplan and Johnson get it right?

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Abstract

Purpose – This paper sets out to demonstrate a conceptual structure for the study of performance management systems which subsumes one major aspect of management accounting activity, namely performance evaluation and control.

Design/methodology/approach – The approach takes the form of a review of management accounting practices and change over the past 20 years, to give insight into how research can become more fruitful in the future.

Findings – Management accounting is argued to be an unhelpful conceptual category in developing insight and theories in the field of organizational control practices. A wider framework is proposed that has fewer limitations.

Practical implications – Many of the practical implications have already been observed in organizational practices; for academic research, the practical implication is the need to move beyond the confines of an artificial management function and seek to establish a more appropriate basis for theorisation.

Originality/value – The paper gives guidelines and criteria for evaluating the likely contribution of different research approaches. It is hoped that these will be helpful in encouraging researchers to move outside conventional boundaries in developing fresh approaches to understanding long-standing issues and practices.

Keywords Management accounting, Performance management systems, Control systems

Paper type General review

It is now 20 years since Johnson and Kaplan (1987) wrote their influential critique of management accounting, *Relevance Lost*. It therefore seems a good opportunity to assess the validity of their critique and to examine how both management accounting practice and academic research have progressed over this period. My overall conclusion is very simple: I do not believe that "management accounting" is any longer a useful conceptual category for organizing research activity. Moreover, practitioners do not appear to believe that it is a very useful distinction to be made in practice either. Rather, we need to examine organizational routines and practices to better understand the functions they serve. One category of such routines might usefully be thought of as "control" procedures, which involve the processes that organizations engage in to help ensure that their strategies, plans and objectives are attained. Thus the category of "management control systems" or "performance management systems" provides a more focussed framework for analysis. This conclusion will be shown to have far reaching implications for the practice of academic research.

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Relevance Lost

So to begin with Kaplan and Johnson. Essentially they argued that management accounting was past its sell-by date. At best, it had little usefulness or value in practice. At worst, it was counter-productive. And they gave many examples to support these conclusions. Most tellingly, they gave examples of managers promoting and expanding the sale of unprofitable products whilst neglecting to emphasize profitable products. How could the managers be so stupid? The reason, they argued, was that traditional cost and management accounting systems were sending them the wrong signals. They claimed if the costing were to be done properly (and by this they meant using activity-based costing) it would be seen that many products which traditional systems showed to be loss-making were in fact profitable, and vice-versa. The situation they identified was one where management accounting had stagnated. For many years there had been very little innovation and change; as a consequence management accounting techniques had become increasingly irrelevant to management practice.

However, the publication of their critique also marked a turning point. There has been more management accounting innovation over the past two decades than in the previous fifty years. Interestingly, the two authors followed different paths after writing their joint book. Johnson appears to have given up on management accounting and concentrated on other aspects of management, outlined in his 1992 book *Relevance Re-gained*. But the relevance he espouses does not encompass the development of new management accounting techniques; rather he concentrates on forms of organization and espouses greater degrees of decentralization, more devolution of decision-making and a greater degree of empowerment by employees. Kaplan, on the other hand, has clearly taken his own message seriously. Although not the developer of ABC, nevertheless he has become one of its greatest popularisers. More recently, he was involved in the development of the Balanced Scorecard which he has developed through various phases, represented by his two books (with David Norton) published in 1996 and 2001. In addition to these developments, other advances have included a variety of techniques summarized under the banner of “Strategic Management Accounting” which might include the more recent emphasis on Value-Based Management. Finally, the “Beyond Budgeting” movement has developed its own critique of budgetary control practices and suggested some ways forward. So there has been much apparent change in management accounting techniques over the last two decades, although it should also be noted that the role of “management accountant” seems to have significantly declined, at least if one observes the use of the title in practice. What needs to be assessed is what these new techniques have added to the management accountants” repertoire, and to what extent they are truly “new” rather than representing old wine in new bottles.

Activity-based costing

Let us look at each main group of techniques in turn, beginning with activity-based costing (ABC). Here it is clear that over-simplified methods of overhead cost allocation had led to significant problems in practice. These were most apparent in US companies who had contracts with the US Department of Defence (DOD), but also undertook normal commercial work. The DOD typically reimbursed its contractors on a cost-plus basis, but the nature of the products supplied was that they were typically low volume and subject to continual changes in specification. From the later ABC point of view, it

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is clear that this made them relatively high cost products. But the reimbursement mechanism, based on traditional methods of overhead cost allocation (at its most extreme, based on direct labour cost) would tend to under-price such products. In these companies, it became clear that their normal commercial work was being required to subsidise the defence contracts, which in a competitive commercial market place it was unable to sustain. Thus, the acceptance of ABC methods of costing by the DOD was an important milestone in the wider acceptance of ABC methods.

But how great an advance was ABC? In many ways it has substantial similarities with the detailed costing systems of the 1920s, with different allocation methods for different categories of cost. In more modern terminology, it advocates the use of "micro cost centres"; that is, a larger number of small cost centres to allow detailed costing and overhead allocation. The sales pitch of ABC, namely "more accurate product costs", also caused some problems with senior managers who, having paid for this new system then demanded instant action to eliminate the unprofitable products it identified. Accountants were required to explain that overhead costs did not vanish immediately with the elimination of some product lines, and that a longer-term plan for cost reduction was required. In addition, there was often considerable resistance from Marketing managers, who were appalled that some of the products being slated for elimination were "among our best sellers". Hardly a surprise if the company was selling them at a loss!

However, there were some novel elements in ABC practice. The terminology of "cost drivers" rather than "cost allocation rates", signalled a more proactive stance towards cost management. Further, the cruciform picture (Figure 1) distinguishing between a cost view and a process view of ABC gives an important insight into the benefits that ABC systems provided in practice. Most consultants agree that the majority of benefits from ABC do not stem from having more accurate product cost information, useful though that may be, The process view signals that it is an activity that is the focus of managerial activity. The cost driver represents the unit cost of an activity, and knowledge of unit costs is an important item of information for the management process. If we add to that some measures of the outputs that the activities generate, we have the rudiments of a management control system (i.e. a process being managed, information on inputs and their cost, and information on outputs). Thus the term activity-based management (ABM) which has been seen as an oxymoron by some

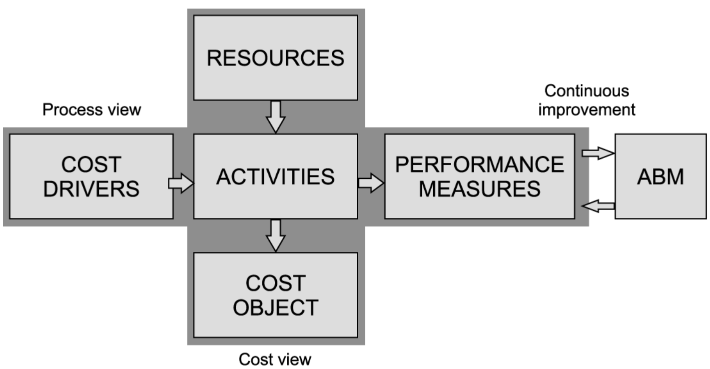

Figure 1.
Two views of ABC

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(after all, what do managers do except manage activities!), is given meaning in that it focuses on a process view of the underlying organizational activities.

Thus ABM can be seen to be taking over some of the functions originally undertaken by the budgetary control system (BCS). On a smaller scale, it attempts to measure and codify both the costs and benefits of each organizational process, with a view to assessing its viability. It is probably easier to do this on a smaller rather than larger scale. Many of the disadvantages of BCSs can be reduced to a consequence of planning horizons becoming shorter and the world becoming less predictable. Indeed, if budgets focus solely on costs, they are not a useful method of control; they require to be augmented by knowledge of the processes being managed and some assessment of the value of the outputs of such processes. Thus, in many ways, ABC is not notably new; it can be re-interpreted as a re-emergence of basic managerial principles in an environment that has changed, and which is less predictable than it may have been in the 1960s and 1970s.

Strategic management accounting

Moving on to strategic management accounting (SMA), it is first necessary to define what this umbrella term actually means. In many ways it has been used as rhetoric to promote the role of the management accountant, and to move the focus of activity from the factory floor to the boardroom table. As Bromwich and Bhimani (1989) observe, it represents " . . . a desire to release management accounting from the factory floor". But the originator of the term, Ken Simmonds (1981) perhaps formulated the definition that has best stood the test of time:

> Strategic Management Accounting can be defined as the provision and analysis of management accounting data about a business and its competitors for use in developing and monitoring the business strategy, particularly relative levels and trends in real costs and prices, volume, market share, cash flow and the proportion demanded of a firm's total resources. In no way, however, is strategic management accounting a redefinition of business planning or marketing functions in a firm.

This is a particularly wide-ranging view, the full implications of which do not seem to have been taken on by its proponents. Ken used to talk about the strategic management accountant observing the production plant of a competitor (from the outside, as he was not invited inside) and purely from observing the colour of the smoke from the factory chimney, and counting the cars in the car park, could jot down on the back of an envelope a profit and loss account for the operation. Clearly he exaggerated somewhat, but the comment gives a clue to the scope that he saw for SMA. Even now, its use is concentrated more on customers than competitors. However, the type of analysis required for effective SMA does not lead itself easily to codification; it is more about grounded creativity than a set of rules and/or techniques.

Economic value added

A more recent development that is associated with SMA lies in the plethora of three letter acronyms (TLAs) that have been popularized in the last decade that include the letter "V" for value. Thus we have shareholder value added (SVA), market value added (MVA), value-based management (VBM) and others. Most influential however has been EVA®, a registered trademark of the Stern Stewart Corporation, which refers to economic value added. This has had widespread popularity in the last decade, with

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some corporations who announced that they have engaged Stern Stewart to implement their EVA® system of management (as it has become known) experiencing a significant jump in their share price! The significance of this development is that EVA® is not actually a new technique at all. Without underestimating Stern Stewart's contribution to the refinement and operationalisation of the measure, it is based on the concept of residual income, which was the subject of an extensive debate in the accounting literature in the mid-1970s. Although it still features is management accounting textbooks (see for example, Emmanuel *et al.*, 1990), and is well-known to practitioners through their qualifying educational programmes, it had not been at all popular in practice. Surveys of uses of accounting performance measures showed it to be little used in practice before it was re-launched by Stern Stewart. Originally developed as a board level performance measure, it was argued that it was a better measure to which to calculate incentive payments to senior executives than the more common measures of the 1990s, most notably earnings per share. However, its use was extended by Stern Stewart to be applied at as many levels of an organization as possible, again with middle manager incentives being tied to it. It was also argued that it was a good surrogate for the future earning potential of an organization: improving EVA® was equivalent to creating shareholder value; failing to do so was destroying shareholder value. This seems to represent an unjustified conceptual leap. Clearly EVA® is based on an (adjusted) accounting earnings number and, as such, measures past or delivered performance. By contrast, shareholder value rests primarily on future expectations that are incorporated into share prices, and represents promised value. The two are related only in a very diffuse way. So the promises made to sell this popular technique thus appear to rest on very shaky foundations.

This is an issue with most measures of value other than those represented by current revenues. The future value of an asset, product or business unit can only be assessed quite subjectively as it depends on estimates of what will occur in the future. In addition, the value of a product to a customer also depends on subjective perceptions which will influence what a customer is willing to pay. Thus two products that may objectively be very similar may sell at very different prices in the market place because of features such as branding. Admittedly, such subjective assessments are part and parcel of the process of value creation by organizations; my point here is that I cannot see what comparative advantage the management accountant has in making such judgments over, for example, a marketing expert. Thus much of SMA falls outside the actual expertise of management accountants.

Balanced scorecards

Moving on to the topic of balanced scorecards. Again this is an area that has seen great popularity since its first launch in an HBR article in 1992. The main thrust of the BSC literature is that it is generally inappropriate to try to manage using financial measures of performance alone. Financial measures need to be supplemented by other non-financial performance measures (which may still be lagging indicators) and also by a range of leading indicators of future potential performance (which are almost always non-financial in nature). Management of an activity, not surprisingly, requires some knowledge and understanding of the activity being managed. Interestingly, the development of the BSC in the early 2000s began to stress the development of "strategy maps" which require a detailed causal understanding of the factors which a manager

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can control and their inter-relationships. What is being constructed here is essentially a predictive model of the situation being controlled (see Berry and Otley, 1980), although it is not always clear from the literature how this knowledge is to be gained and tested. Although management accountants know quite a lot about the construction, use and reporting of financial performance measures from their experience with budgetary control systems, they have often also been given the role of developing the systems required to support BSC use. Although some of their experience can be generalized into the non-financial area, there are also many new challenges in collecting and reporting non-financial data. Very often, it is difficult to design robust information gathering systems that are not susceptible to manipulation by the managers whose performance will be assessed by reference to the reported results. Again, it is not clear that management accountants currently have this expertise, although it may be an area into which they should consider diversifying.

Beyond budgeting

A further threat to the role of the management accountant in practice comes from the arguments put forward by the *Beyond Budgeting* group (see Hope and Fraser, 2003). This group clearly points out the problems that traditional methods of budgetary control are encountering in contemporary organizations. Their central argument is that traditional budgetary control is proving increasingly unsuitable for the rapidly changing environment of the modern business world. Budgets become rapidly out-dated during the course of a budget year; indeed, many organizations state the budget is already out-of-date at the start of the budget period because of the time taken to put it together. Although there have been attempts to keep budgets up-to-date by more frequent revisions (e.g rolling budgets) the general experience is that it is difficult to keep the focus on annual financial targets during the revision processes. Budgeting is proving to be a very limited management tool, and is sometimes made more rigid by tying performance bonuses to budget achievement. Two ways forward are suggested; the two "peaks" of beyond budgeting. The first is to replace the "fixed performance contracts" typified by traditional budgets by a more flexible approach. Rather than giving managers targets which are fixed in numerical terms (e.g. make £1m profit this year), it is suggested that more flexible targets could be set, benchmarked on environmental conditions or competitors' performance (e.g. perform in the top quartile of competitor performance). Although this approach has potential at the most senior levels, it may prove difficult to apply at lower levels, not least because details of competitor performance may not be available in such detail. The second "peak" is to replace traditional "command and control" techniques with devolution and empowerment of lower level employees. Again, although this may be a useful suggestion in some circumstances, it is not clear how it would apply in complex organizations requiring a great deal of planning and co-ordination. The overall recommendation is that traditional budgeting should be relegated to the "back office" and that line managers should be measured and controlled using a set of generally non-financial performance measures – if you like, a kind of balanced scorecard, although using flexible rather than fixed targets. However, what seems to be lacking in this approach is some way of maintaining the holistic overview that traditional budgeting systems provided.

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The future of management accounting

The common thread running through this review of the "new" management accounting techniques of the past two decades, is that the role of traditional management accounting is diminishing. Many of the new techniques prove to be not all that new; the developments that appear to offer most potential move into areas where the traditional skills of a management accountant are able to add little value. This is reflected in practice where even the title "management accountant" is falling into dis-use. Clearly, there will always be a role for applying financial analysis to decision-making. Yet, even here, this task is now often undertaken by line managers who have become adept at using spreadsheets and other computer-based methods to support their own decision-making. The management accountant may also have been seen as the guardian of the organizations information systems because of their role in maintaining the financial information system. Here other specialists also contend for this role, and the management accountant has not proved adept at tackling the issues that the management of non-financial performance measures raises. Even that backstop of traditional control, the budgetary control system, appears to be coming under threat, although there is little consensus over what might replace it.

At the heart of every control system lies a predictive model. That is, a means of forecasting what the outcomes of potential control actions will probably be. Without such models, control is impossible. This immediately raises a number of important research questions. For example:

(1) Where do such predictive models reside?

(2) What information is required to support and update them?

(3) Who manages the information used in control?

(4) What mechanisms exist to provide an holistic overview of the total operations of a unit or firm?

Such issues can be categorized under the more general banner of performance management systems (PMS). This is more than just a terminological change from management accounting and control systems, so well defined by Robert Anthony in 1965 (Anthony, 1965). What Anthony did was to separate out the activities of "management control" from the wider activities of "strategic planning" and the more detailed and technically diverse activities of "operational control". Somewhat inevitably (at least, with hindsight) the result was a concentration on management accounting control systems. In one sense, the move towards PMSs is involved with putting Anthony's categories back together again, as they need to operate much more seamlessly in practice. A major contribution to this task has been made by Robert Simons (1995) in his "levers of control" approach, which provides a more encompassing framework for considering a wider variety of control mechanisms. These include not only financial and non-financial performance measurement approaches, but also the more diffuse techniques inherent in his categories of beliefs systems and boundary controls. He also stresses the ways in which information is used by managers, as well as the formal systems that provide it. However, even Simons' framework does not address how overall viability can be captured in his models.

My conclusion at this point is that we need to move outside the confines of management accounting, and even management control systems, which impose

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blinkers on our thinking that need to be removed. Thinking more widely in terms of PMSs may not be a complete solution, but it at least opens the door to more inclusive ways of thinking. In short, management accounting is only one part, and a possibly diminishing part, of the ways in which we need to think about designing and using information and performance management systems for organizational control.

Studying control systems

What I have said so far may appear to have been unduly negative. However, I do think it necessary to sweep away some of the constraints that have limited our thinking in this area, and to engage with practice so that we can understand how contemporary organizations are going about tackling the important issues of achieving control and managing risk. My central research question can be formulated as follows:

RQ. How do organizations configure their control arrangements to enable them to adapt to, and survive in, a rapidly changing environment?

This immediately suggests a number of sub-issues:

(1) To what extent do organizations have an overall control "system", rather than a set of less than perfectly coordinated packages?
(2) What is the role of management accounting systems in these arrangements?
(3) How is performance measurement used in conjunction with other practices?
(4) What is the effect of different control configurations?

And the list can go on. Clearly it requires some logical structuring.

I would start from arguing that there is no such thing as "performance". It is essentially a multi-dimensional concept. Organizations have to satisfy different constituencies of people in the course of their operations, which have conventionally been termed "stakeholders", although this use of language can cause difficulties in some cultures, particularly in the USA. Measures of performance need to address different stakeholders, they may be affected by differing organizational strategies, and they will undoubtedly differ in different parts of the organization. The concept of "performance" is inherently multi-dimensional, and it is profoundly misleading to expect that there will ever be a single over-arching measure of it.

From this standpoint, I have tried to devise with Aldonio Ferreira, (Ferreira and Otley, 2005) a framework that tries to cover some of the main aspects of organizational activities that comprise an overall control "system" or "package". This is not intended to be normative; rather it provides a logical structure to help ensure that the various aspects of controls in practice are considered and their linkages identified. Neither do I believe it to be complete; it is presented as a starting point for further development, rather than as a finished work. The framework is developed around 12 questions to which organizations are observed to have developed different answers (see Figure 2). These questions are:

(1) What is the unit's vision and mission?
(2) What key success factors has it identified to achieve this vision?
(3) What strategies has it developed?
(4) What organizational architecture has it put in place?

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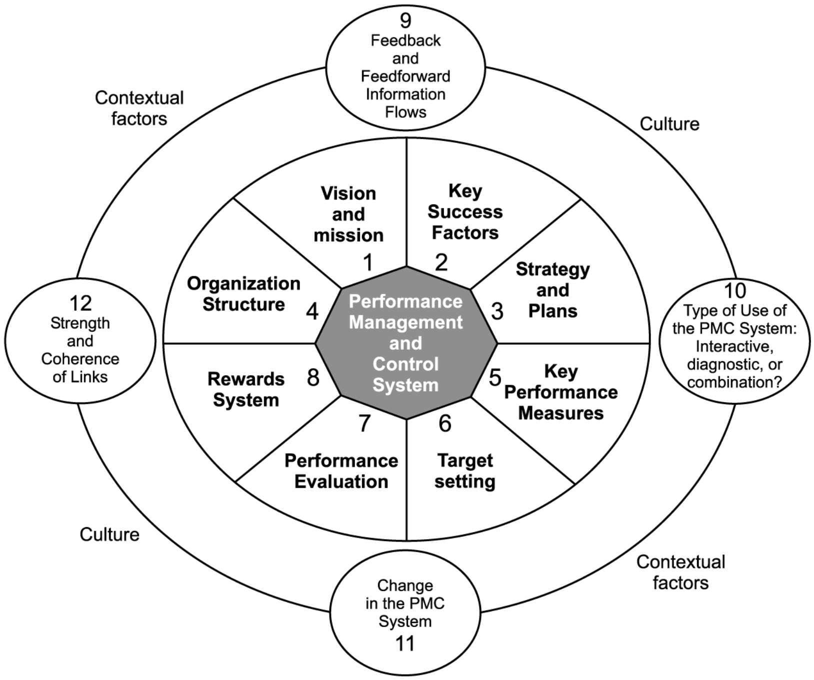

Note: The numbers assigned to each area correspond to the questions of the PMC framework

Source: Ferreira and Otley (2005)

Figure 2. An extended framework for analyzing performance management systems

(5) What key performance measures does it use?
(6) How are targets for these measures set?
(7) How is managerial and unit performance evaluated?
(8) What incentives and rewards are in place?
(9) What information systems support these activities?
(10) How is the PMS actually used by managers?
(11) What changes have been made, and what are being contemplated?
(12) How coherent are the systems identified above?

The range of these questions (which will surely be expanded as others think about them and develop the framework) will inevitably require inter-disciplinary approaches to their study. However, I believe it is important to hold on to the holistic overview that this approach entails; that is, it is fundamentally concerned with issues of organizational adaptation, survival and viability.

Implications for research

I will conclude with some brief suggestions that I believe are helpful in thinking about designing future research in this area. These are intended to be developmental rather

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than constraining, and represent some key issues that I believe need to be seriously considered in moving the research agenda forward:

- Keep hold of organizational purposes as well and individual goals and actions; the central research issue is about the viability of the overall organization or activity.
- Keep studying real organizations; practice leads theory in this area. The decline of US management accounting research can be seen as a consequence of neglecting this.
- Pluralistic perspectives are helpful; there is unlikely to be an over-arching theory for a long time, if ever.
- Avoid theory in-theory out (TITO); theoretical perspectives are a way of helping us to see things, but "a way of seeing is a way of not seeing" (Poggi, 1965).
- Interpretations and perceptions are important in affecting individual behaviour, so tapping in to this subjective area in necessary.
- Change is endemic; do not assume systems are set in concrete – they are usually in the process of being changed.
- Be ready for surprising results.

I do not normally like over-simple models, but I will indulge myself on this occasion with my eight "I's" for desirable attributes of a research project in this area. These require that a good research project should be:

(1) *Incremental* – builds on what we already know.
(2) *Interpretive* – includes individual perceptions that drive behaviour.
(3) *Integrated* – keeps an holistic focus.
(4) *Inclusive* – considers all stakeholders.
(5) *International* – not confined to a single culture.
(6) *Imaginative* – not formulaic.
(7) *Interesting* – or why do it?
(8) *Influential* – relevant to practice.

It would take another hour to deal more fully with all the issues raised in these suggestions, so I will leave that for another occasion. For the moment, I would encourage you to consider working on issues within the remit of performance management as it involves key issues for which organizations are constantly seeking better solutions. It moves our perspective away from accounting techniques towards a more integrated view of the roles of formal control systems in organizational functioning. It has certainly helped to keep me interested and occupied for the past 35 years, and I trust that it will prove to be as intellectually stimulating for you as it has been for me.

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