Finding the Right Mix

HOW TO MATCH STRATEGY AND MANAGEMENT PRACTICES TO ENHANCE FIRM PERFORMANCE

BY KIP R. KRUMWIEDE, CMA, CPA,
AND SHANNON L. CHARLES

Lara was a new division manager at a poultry products company. During her first week on the job, she asked each staff member about the strategic purpose of major reports and business practices. Often the answer was, "I'm not sure. We've just always done it." These activities probably started with a valid reason, but, like twigs on a fruit tree, they'll keep growing unless occasionally "pruned." Today, with so many business tools and fads out there, how do managers decide which practices are best? Since *best* practices aren't necessarily the *right* practices, the key is finding an appropriate match among strategy, environment, and management practices.

To find out what companies are using, we conducted a study sponsored by the

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Institute of Management Accountants (IMA®) on various management tools and practices. We'll share the results, then profile high-performing firms with different competitive strategies and introduce a five-step process to find the right management practices.

THE TOOLS

Working with IMA's Cost Management Member Interest Group, we collected data from almost 300 U.S. manufacturing and nonmanufacturing firms regarding their use of 28 popular organizational practices, information systems, and management accounting practices (see Table 1). We also collected data on their general strategic focus and self-reported firm performance relative to competitors regarding 10 key performance metrics, such as profit, market share, and customer satisfaction.

As Table 1 shows, usage varies considerably. Organizational practices are dominated by process reengineering and Just-in-Time (JIT) methods. Information systems practices are led by ERP systems and other improvements to increase system quality, and e-business is still growing, especially among nonmanufacturing companies. Costing practices are led by traditional product and customer profitability analysis, and there is a surprisingly low general use of activity-based costing (ABC). Control practices are led by traditional variance analysis and budgeting. Finally, the nonfinancial performance measurements are led by customer satisfaction and cost control.

Although some practices show generally low use, implementing them may still provide great benefits. Table 2 reports the rated benefits vs. rated usage for certain practices. Note that target costing, the balanced scorecard (BSC), and ABC are among the most highly rated practices by users, yet they have relatively low usage overall and thus have the biggest gaps between usage and benefits. More companies may need to consider these practices.

Table 1: Management Tools and Practices Used in This Study

Practice	Overall	Mfg.	Nonmfg.
ORGANIZATIONAL MANAGEMENT PRACTICES			
New processes/reengineering	4.70	4.80	4.37
JIT methods	4.43	4.52	4.17
Quality systems/teams	4.29	4.37	4.06
Downsizing	4.24	4.36	3.87
Outsourcing	4.03	4.09	3.84
Strategic planning techniques	3.78	3.81	3.73
Investing in new physical plant	3.76	3.75	3.82
Lean production systems	3.69	3.74	3.54
Value-chain analysis	2.81	2.92	2.31
INFORMATION SYSTEMS PRACTICES			
Integrated (ERP) systems	3.90	3.95	3.75
IS/CMS quality	3.80	3.88	3.56
E-business: Internet for procurement needs	3.26	3.19	3.45
E-business: Selling over the Internet	3.11	2.88	3.83
E-business: Improving product quality	2.96	2.61	4.04
COSTING PRACTICES			
Product profitability analysis	5.18	5.30	4.71
Customer profitability analysis	4.39	4.45	4.18
Target costing	3.55	3.63	3.29
Estimate cost of unused capacity	2.98	3.03	2.81
ABC/M	2.75	2.70	2.87
CONTROL PRACTICES			
Variance analysis	5.10	5.26	4.63
Budgeting	4.52	4.58	4.36
Benchmarking	3.56	3.58	3.50
NONFINANCIAL PERFORMANCE MEASUREMENT FOCUS			
Customer satisfaction	5.77	5.77	5.77
Cost control	5.26	5.24	5.36
Internal process performance	4.51	4.45	4.70
Develop new products	4.44	4.55	4.07
Employee satisfaction	4.29	4.15	4.74
Balanced scorecard	2.92	3.00	2.67

Note: Means based on scale of 1 (low) to 7 (high) usage.

STRATEGIC PROFILES

Some management tools may be more suited to one competitive strategy than another. Based on answers to questions pertaining to strategy, we classified companies into three general types of strategic focus: customer, product, and cost. We excluded companies that were hard to classify. As Michael Porter of Harvard Business School suggested,

Table 2: Benefits vs. Usage of Various Practices

Practice	Benefit	Usage	Difference
Target costing	5.29	3.55	**1.74**
Just-in-time methods	5.25	4.43	0.82
Balanced scorecard	5.05	2.92	**2.13**
Activity-based costing	4.96	2.89	**2.07**
ERP	4.92	3.90	1.02
Benchmarking	4.77	3.56	1.21
Quality practices	4.65	4.29	0.36
E-business	3.97	3.11	0.86
Costing unused capacity	3.92	2.98	0.94
Activity-based management	3.80	2.60	1.20

Note: Means based on scale of 1 (low) to 7 (high).

Table 3: High-Performance Profiles

		Strategic Focus		
		CUSTOMER	PRODUCT	COST
	NO. OF FIRMS	23	16	13
CATEGORY	PRACTICE			
Org. Mgt.	New processes/reengineering		**.4954**	**.7811**
	Investing in new physical plant		**.7804**	
	Outsourcing		.2779	.4445
	Quality systems/teams	**.4621**	**.8790**	**.5177**
	Downsizing			
	Value-chain analysis	.2963	**.8218**	
	Lean production systems	.3996	**1.0012**	
	Just-in-time (JIT) methods	**.3972**	**.7013**	
	Strategic planning techniques	**.5534**	**.8228**	.4464
IS Practices	Integrated (ERP) systems		**.8141**	.3970
	Information/Cost mgt. system quality	.3387	**.6992**	.4310
	E-business: Internet for procurement needs		.5298	
	E-business: Selling over the Internet		.2969	
	E-business: Improving product quality	.2619		
Costing	Activity-based costing/mgt. (ABC/M)		.4217	.5031
	Target costing		**.6337**	
	Product profitability analysis	.3335	**.6027**	.3901
	Customer profitability analysis	**.5598**	.3453	
	Estimate cost of unused capacity		**.7091**	
Control	Budgeting	.2797	**.9424**	.4595
	Variance analysis		.3178	.4893
	Benchmarking	**.4242**	**.7906**	**.7507**
PM Focus	Cost control		**.5817**	**.7042**
	Develop new products		**.6640**	
	Customer satisfaction	**.2903**	**.4892**	
	Employee satisfaction	**.4297**	.5797	
	Internal process performance	.3396	.5144	**.6084**
	Balanced scorecard	.3340	**.8110**	

Note: High-performing firms have mean performance scores (based on self-reported ratings on 10 financial and nonfinancial metrics) in the top 25% for their strategic focus group. Scores have been standardized to have an overall mean of zero and variance of one. Means below 0.25 have been deleted. ***Means in bold*** *are statistically greater than zero (less than 5% probability of being below zero).*

companies with mixed or no real strategic focus tend to have lower corporate performance than those with a strategic focus. On a scale of 1 (low) to 7 (high), average group performance was as follows: product focus (5.03), cost focus (4.65), customer focus (4.56), and mixed/none (4.04).

We then determined the most common practices for the highest-performing companies, defined as those in the top 25% for overall mean scores on the 10 performance metrics. The resulting profiles represent a particular subset of the 28 practices that successful companies within these strategy groups use most often to carry out their strategic plans. The results show some common practices among the strategic profiles and some practices linked more to certain strategies.

Table 3 lists the three strategic profiles. Some practices tend to be used by high-performing firms in all three profile groups: quality systems and teams, strategic planning, high-quality information systems, product profitability analysis, budgeting, benchmarking, and internal process performance measurement. Most companies should probably consider extensive use of these practices. On the other hand, downsizing hasn't been used extensively by any of the high-performing groups.

Customer-focused companies

Successful customer-focused companies try to give customers what they want. They focus heavily on quality (as defined by the customer) and the practices that go with it (e.g., teams, lean production, JIT, benchmarking). High-quality information systems are important for gathering and tracking information on customer needs and avoiding mistakes. These companies perform extensive customer profitability analysis to ensure efforts to please customers are still profitable. Finally, they have relatively strong performance measures for employee satisfaction, which respondents often mentioned as an important leading indicator of customer satisfaction.

Product-focused companies

High-performing product-focused companies differentiate themselves through innovation and flexibility, so they tend to use most of the practices in the study. This suggests that firms successful with this strategy spend considerable time and resources analyzing how to differentiate their products from competitors and using a measurement system that encourages product innovation and improvement. Product-focused groups also have highly integrated and high-quality information systems to enable communication and innovation.

Complementing these management practices and systems is a costing system that emphasizes target pricing and costing, product profitability analysis, budgeting, and capacity planning to avoid producing unprofitable products. These companies also use ABC fairly strongly to help achieve more accurate product cost analysis.

Table 4: Identify Your Strategic Priorities (Step 1)

Step 1. Rank the following from 1 (highest priority) to 9 (lowest priority).

NO.	PRIORITY	RANK
1.	Provide high-quality products or services	
2.	Provide unique product features or services	
3.	Pursue cost reductions through product/process design and standard offerings	
4.	Low price	
5.	Provide fast and dependable deliveries	
6.	Make rapid volume and/or product mix changes	
7.	Low cost of production or service	
8.	Provide effective after-sale service and support	
9.	Make changes in design, and introduce new products quickly	

Add your ranks as follows (lowest score is your strategic focus)

NOS.	TOTAL	STRATEGIC FOCUS	EXAMPLES
1, 5, 8		Customer focus	Home Depot, IBM
2, 6, 9		Product focus	Johnson & Johnson, 3M
3, 4, 7		Cost focus	Southwest Airlines, Costco

Cost-focused companies

Since successful cost-focused companies must provide their product or service at prices relatively lower than their competition, they emphasize streamlining their processes. For example, they look for new processes and use reengineering to do things more efficiently, which means standardizing product design and offerings and outsourcing production if it's cheaper to do so. As with the other strategy groups, they rely on quality practices and teams, only their motivation is more to reduce waste and save money. Performance measures focus on internal process performance and cost control. They also have good cost information systems to help keep the organization running smoothly. Activity-based costing is most prevalent for this group, mostly to identify cost drivers and nonvalue-added activities to help reduce costs.

Organizations that link their management practices to their strategy and environment tend to have better performance than those that don't. Like Boy Scouts paddling a canoe in the same direction, resources are used more optimally in achieving the goal. Let's look at the five-step process that can achieve this linkage.

FIVE-STEP PROCESS

The following five steps can help a company find the right mix of management activities:

1. Identify your strategy and environment.
2. Identify current practices.
3. Research what practices make sense for your strategy and environment.
4. Propose an "ideal" set of practices.
5. Develop an implementation plan.

Table 5: Identify Current Practices

Step 2. Rate your usage of each practice from 1 (not used) to 7 (highly used). Later (Step 4), you will identify the "Ideal Practices" for your firm.

ORGANIZATIONAL MANAGEMENT PRACTICES

- ◆ Implementing new processes/reengineering
- ◆ Investing in new physical plant
- ◆ Outsourcing manufacturing or services
- ◆ Quality systems (cross-functional teams, ISO 9000 certification, employee teams, rewards for quality improvement, process experiments, statistical process control)
- ◆ Downsizing the organization
- ◆ Value-chain analysis
- ◆ Lean production systems (cross-training and job rotation, flexible manufacturing cells, production halted if defective work is produced, setup times frequently reduced)
- ◆ Just-in-time methods (establish supplier relationships, materials delivered as needed, firm oriented toward eliminating inventory)
- ◆ Strategic planning (formal, long range)
- ◆ Other

INFORMATION SYSTEMS

- ◆ Integrated (ERP) systems across functions (e.g., sales and operations), within operations, and with suppliers or distributors
- ◆ Information system/cost management system quality (high level of user-friendliness, wide array of cost and performance data available, data updated "real time," etc.)
- ◆ E-business: Internet for procurement needs (e.g., online suppliers, electronic invoices).
- ◆ E-business: Selling products or services over the Internet.
- ◆ E-business: Improving product quality through the Internet (e.g., faster service, research, etc.)
- ◆ Other

COSTING PRACTICES

- ◆ Activity-based costing/management (ABC/ABM)
- ◆ Resource consumption accounting (RCA)
- ◆ Target costing
- ◆ Product profitability analysis
- ◆ Customer profitability analysis
- ◆ Estimate cost of unused capacity
- ◆ Other

CONTROL PRACTICES

- ◆ Budgeting (used for evaluating performance, planning cash flows and financial position, and controlling costs; also, full participation of all levels of management in budgeting process)
- ◆ Variance analysis
- ◆ Benchmarking (track product characteristics and internal processes with other companies)
- ◆ Other

PERFORMANCE MEASUREMENT FOCUS

- ◆ Cost control
- ◆ Develop new products
- ◆ Customer satisfaction
- ◆ Employee satisfaction
- ◆ Internal process performance
- ◆ Balanced scorecard
- ◆ Other

STEP 1: Identify your strategy and business environment. You must first articulate your organization's competitive strategic focus, which could include customer focus, product leadership, low-cost provider, high quality, specific market niche, etc. Michael Porter suggests first determining your core competencies. Which of your products or services are the most distinctive? Which are the most profitable? Which of your customers are the most satisfied? Which customers, channels, or purchase occasions are the most profitable? Which activities in your value chain are the most different and effective? This is also a good time to analyze the value chains your firm competes in and consider how your firm fits in with your competitors. What are their strengths? Weaknesses?

After identifying your core competencies, you're better able to identify your strategic priorities. Table 4 provides a list of nine strategic priority statements. Rank the items from 1 (highest priority) to 9 (lowest priority), then add certain statements' ranks together to total your customer-focused score, product-focused score, and cost-focused score. As in golf, the lowest score wins. For instance, our poultry producer scored 10 for cost focus, 14 for customer focus, and 21 for product focus. This result suggests the company has a primary strategic focus on cost leadership and a strong secondary focus on meeting customer needs.

At this stage, you should identify your company's internal business environment. What major initiatives are occurring in your company? Articulate the company's resources, culture, and financial situation.

STEP 2: Identify current practices in different categories. Table 5 provides a list of potential practices in organizational management, information systems, costing, control, and performance measurement. The list consists of commonly used practices, plus resource consumption accounting (RCA), which has been generating much interest recently. (For more on RCA, see "Relevance Added: Combining ABC with German Cost Accounting" by Gunther Friedl, Hans-Ulrich Küpper, and Burkhard Pedell in the June 2005 issue of *Strategic Finance*. The October 2004 issue of *Strategic Finance* and the Fall 2004 issue of *Management Accounting Quarterly* also feature articles on the topic.)

Table 5 isn't intended to be a complete list. You can add other potential practices as needed. The goal of step 2 is to rate your company's use of these practices on a scale of 1 (not used) to 7 (highly used).

As an example, let's go back to our poultry producer. Under organizational management practices, quality practices and cross-functional teams are strong and are considered a critical part of the continuous improvement philosophy. The company is also quick to invest in new physical plants and equipment if customers request some new product requiring a new production line or process. Information systems are excellent. Their ERP system links every process, which management considers a competitive advantage, because if there's a quality issue, the company can tell within a couple of minutes where every case of product was shipped from and its destination.

Costing practices are geared toward meeting customer price expectations. Target costing and customer and product profitability analysis are practiced heavily. For control purposes, the company relies heavily on benchmark data from a poultry industry benchmarking company, especially data related to costs of raising a chicken. In addition to weekly profit-and-loss estimates and product cost information, performance measurements also include nonfinancial ones related to developing new products, customer satisfaction, product output, quality metrics, employee turnover, and absenteeism.

STEP 3: Research what practices make sense for your strategy and environment. Through the Internet you can find out what practices successful firms are using, especially those with a similar strategy. Internet research options include ProQuest (ABI/INFORM), LexisNexis, Google, IMA's website, and numerous others.

Use phrases to narrow the search and provide articles matching as closely as possible to your firm's situation. For example, our poultry producer might start with "poultry industry," although it might limit the search to peer-reviewed articles only. Reviewers who are generally qualified to assess the objectivity of research have screened peer-reviewed articles. To narrow the search, future ones might include "poultry industry and cost management," "poultry industry and quality," and "poultry industry and benchmarking." To broaden it, change "poultry industry" to "food industry."

STEP 4: Propose an "ideal" set of practices. After doing some research on various practices, go back to Table 5 and decide what mix of practices makes the most sense. Consider several factors: your competitive strategic focus, industry, firm size, culture, and financial situation.

First, for each current or potential practice, ask the following questions: Is it feasible for your firm? What does or will it cost? What specific decision support benefits will it provide? How will it support other tools and the competitive strategy? What would happen if you didn't use it?

For example, our poultry producer might consider using more strategic planning. Higher use is common in all high-performing groups, regardless of strategic focus. The company might also consider implementing a balanced scorecard because it already has good measures in all the BSC categories. Assembling key measures will help the firm manage the business in line with its strategic focus. Regarding information systems, it might expand its use of the Internet to improve product quality by researching quality practices, new processes to improve cost and quality, etc. Finally, activity-based costing might be helpful to use to get more accurate product costs, which are essential to product profitability and "what if?" analyses.

Now consider your company's business environment, including common industry practices, company resources, culture, and financial situation. For instance, one of the authors worked for a manufacturing plant that seemed ideal for activity-based costing. The plant produced a wide variety of parts in different batch sizes and relied on product costing for most pricing decisions, but because of the plant's culture (e.g., lack of interdepartmental communication and top-management support for improving the costing system), ABC wasn't even considered.

Companies should also consider the country's culture. For instance, firms in Japan tend to use the most quality practices (e.g., benchmarking and market research), while U.S. firms tend to have more management meetings to discuss quality, according to Chris Ittner and David Larcker in the 1997, Issue 3-4, edition of *Accounting, Organizations and Society*.

STEP 5: Develop an implementation plan. The last step to "rightsizing" a firm's management practices may be the hardest because changing an organization is always tough, even from the top. Top-management support is usually key for any organizational change.

Here are some ways to improve your chances of changing management tools:

◆ Develop a plan, and identify specific action items.

◆ Decide in what order to implement the new practices and which practices you will give up and when.

◆ Try to make sure the changes will work with the incentive system. Getting an organization to change its management tools is hard enough, but getting it to change its incentive system is much more difficult.

In the March 2001 issue of *Strategic Finance*, Michael Latimer suggests that firms trying to align their activities with their strategy perform strategic audits to identify unnecessary costs. He classifies activities into three categories: strategic, obligatory, and elective. We could apply the same approach for a firm's management practices and perform a "strategic" audit. Strategic tools are those that directly support the overriding strategic focus. For example, a product-focused firm may want to encourage invention using new product development performance measures. Obligatory tools are those mandated by customers, stakeholders, and regulators (e.g., environmental studies), while self-imposed elective tools are mostly procedural or infrastructural in nature (e.g., training and supervision). The goal of strategic audits is to identify unnecessary practices and shift resources from elective activities to strategic ones. Latimer suggests companies use the following methods to help make this shift:

◆ Automate or eliminate tasks.

◆ Change incentive plans to encourage strategic activities.

◆ Place dependable people who require minimal front-end support in positions to manage the business.

◆ Establish an innovation fund in the budget to encourage innovation initiatives without disrupting everyday business operations.

In addition, companies wanting to "try out" a new practice, such as ABC or RCA, without incurring major implementation costs might consider a pilot study at one or two locations.

FIND THE RIGHT MIX

The role of the management accountant has evolved from one that reports the numbers to one that affects the numbers. By helping your company find the right mix of management tools and practices—and getting rid of others—you will help to implement its strategy and use its resources more effectively. ■

Kip R. Krumwiede, CMA, CPA, Ph.D., is an assistant professor of management accounting at Boise State University in Boise, Idaho. You can reach him at (208) 426-2288 or kipkrumwiede@boisestate.edu.

Shannon L. Charles, Ph.D., is an assistant professor of management accounting at Brigham Young University in Provo, Utah. You can reach her at scharles@byu.edu.