Old Meets New

CHINESE COMPANIES ARE BLENDING SOME OF THEIR TRADITIONAL TECHNIQUES WITH SOME NEW ONES FROM THE WEST TO ACHIEVE GOOD WORKING MANAGEMENT ACCOUNTING PRACTICES THEY CAN USE.

This is the second of three articles based on the recently completed study by the Institute of Management Accountants (IMA®) of the state of management accounting in China. The study included both field studies as well as an extensive survey of 209 companies; in conducting it, we were given access to companies that was unprecedented for Westerners. The research team consisted of Dr. Raef Lawson, IMA vice president of research and Professor-in-Residence; Jiliang Yang, retired professor from Hong Kong University of Science and Technology; and Pinzhun Ding, IMA senior China advisor, formerly of the PRC Ministry of Finance and the Chinese Institute of Certified Public Accountants (CICPA).

The first article discussed the evolution of the finance and accounting (F&A) function in Chinese companies; this one discusses the management accounting techniques they employ; and the third article discusses these companies' costing practices. To obtain a copy of the study, visit **www.imanet.org/china_studies_request.asp?id=1&from=research_costing_practice.asp.**

By Raef Lawson, CMA, CPA

Last month I described how the "opening" of the People's Republic of China (China) to the West has led to an expanded role for Chinese companies' finance and accounting (F&A) functions. How are they handling these additional responsibilities? What tools and techniques are they using? To what extent has Western practice influenced Chinese practice? IMA's recent study of Chinese management accounting practices, on which this article is based, answers these questions.

The answers are important because, by examining the tools and techniques Chinese management accountants employ, we have an opportunity to enrich our understanding of how to better design performance management systems for firms with varying corporate cultures and who are operating in a variety of economic environments.

Background of Accounting in China

China has a long accounting history that extends back more than 3,000 years, reflecting its position as one of the world's oldest civilizations. This history includes the development of various forms of bookkeeping systems.

After the People's Republic of China was established in 1949, the Chinese government developed several systems for planning and managing the operations of organizations under a planned economy. The three most important ones were the economic accountability system, which defined the economic relationship between the state and the enterprise; the comprehensive annual planning system, which included the cost planning/budgeting system; and the norm management system for setting the technical and economic targets for enterprises. As part of the implementation of these systems, companies were required to follow a uniform accounting system designed by the Accounting Affairs Department of the Ministry of Finance.

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Many of the techniques developed in China under the planned economy were based on the concept of "mass line," a term used by the Chinese Communist Party (CCP) to denote its policy of relying on "the people." This philosophy was one of Mao Zedong's key principal beliefs, and the CCP has traditionally believed that its ability to directly mobilize workers is its source of strength and power.

The mass line philosophy is still strongly evident even though China has shifted from a planned economy to a market-based one. In our visits in 2006 to a dozen Chinese enterprises, both state-owned and privately owned, we witnessed the practice of this philosophy in the display of billboards throughout the workshops and factories that showed the performance of the grassroots work teams and workers rather than just the performance of the managers. This philosophy of the power of the masses is a significant characteristic of Chinese business management and is different from traditional Western command-and-control management (although it is now being adopted in the West as well).

Management Accounting Tools and Techniques

As noted in last month's article, management accounting as a profession didn't exist under China's planned economy, yet tools and techniques that you would associate with management accounting evolved during this period of isolation from the West. Chinese companies faced similar problems of industrial organization and control as companies in market-oriented economies did, so they developed their own unique management accounting techniques, including "mass line accounting." But this wasn't a period of consistent progress in the development of the field of management accounting. Accounting—with its focus on cost and profits—was at times viewed as being capitalistic and as being inconsistent with socialism. As a result, accountants endured several periods of persecution, which included many of them being sent to indoctrination camps for their capitalistic ways of thinking.

A cursory analysis of the costing and budgeting systems many Chinese companies employ today would lead you to think that, in general, Chinese companies have outdated cost accounting systems. For example, major Western developments in the area of cost management from the 1950s on haven't been adopted (such as absorption costing, activity-based costing, balanced scorecard). Yet this conclusion would be a gross oversimplification of the situation. As just noted, during the period of isolation from the West, Chinese companies faced comparable planning and control challenges. In many cases, they developed similar tools to meet these challenges based on their practice (see Table 1). Differences between the practices they developed and those developed in the West often reflect then-existing differences in political and economic climates. A challenge going forward for these companies is to integrate exist-

Table 1: Parallel Development of Costing and Control Techniques

WESTERN TECHNIQUE	CHINESE TECHNIQUE
Responsibility accounting	Responsibility cost control system
Cost/profit centers	Cost control center
Dashboards/scorecards	Utilization of a mixture of financial and nonfinancial key performance metrics for performance evaluation
Market-based transfer prices	Transfer prices based on overall cost target for value chain
Beyond Budgeting	Delinking of budget for planning and control purposes; use of "league tables"
Target costing	Basics of a similar concept

ing Chinese planning and control practices with Western best practices to fit the unique operating environment and culture of China.

Accounting Standards

With the opening of China to the West in 1979 and the country's transition from a planned to a market economy, Chinese accounting standards were largely unsuitable for managing companies in the emerging market environment. As a result, the PRC has adopted a series of accounting standards with the goal of making financial reporting by Chinese companies more consistent with international standards.

Just as the financial reporting standards in other countries (such as U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS)) affect costing practices by specifying which costs are period costs and which are product costs, so, too, has the reporting of costs by Chinese companies been affected by the evolution of external reporting standards. Beyond this change, however, an even greater change is taking place in the arena of management accounting.

Cost Management in China Today

The practice of management accounting in China has continued to evolve since the beginning of the country's transition to a market economy. Companies have had to shift from an economic system in which the cost of their input and output were fixed and where their most important measure of performance was quantity of output to one in which control of costs and concern for profit maximization have become the primary concerns. In order to cope in this changed environment, planning and systems have had to be redesigned, performance evaluation systems have had to be reexamined, and the role played by the accounting function has had to expand.

Planning and Control

As mentioned previously, the early 1950s saw the development of the economic accountability system, the annual planning system, and the norm management system. These systems were implemented and refined over the next 30 or so years.

While the transition to a market economy has changed the economic and social environment in which companies operate and the tools they need to use in such an environment, evidence of the prior systems remains strong. All the companies we visited as part of our field study employed a budgeting system as a primary means of operational planning and control, as did most of the companies surveyed. In many instances, especially at the state-owned enterprises, these budgeting systems were very similar to the cost planning/budgeting system previously employed under the planned economy. One difference is that while the department formerly responsible for preparation of this plan, the Planning Department, remained in a few companies, this function has largely been transferred to new finance and accounting (F&A) departments.

Many Chinese companies are looking to the West for best-practice management accounting tools. Some have adopted these techniques "as is," others have adapted them to their unique operating environments, and others

Table 2: Importance of Various Cost Management Techniques

(Table numbers denote percentage of respondents in the given category for each technique.)

	IMPORTANT/ VERY IMPORTANT	NEUTRAL	UNIMPORTANT/ VERY UNIMPORTANT
Activity-based costing	100	0	0
Benchmarking	100	0	0
Value chain costing	88	6	0
Standard costing	85	15	0
Theory of constraints	83	17	0
Operational budgeting techniques	80	18	2
Incentive compensation	80	19	1
Responsibility accounting	78	18	3
Performance measurement	78	14	8
Fixed-variable cost analysis, breakeven analysis, etc.	77	20	0
Target costing	74	18	6
Capital budgeting techniques	73	27	0
Flexible budgeting	72	28	0
Life-cycle costing	67	33	0
Economic Value Added (EVA®)	60	40	0
Internal transfer pricing	55	43	3
Traditional overhead allocation	55	35	0

Note: Percentages for each technique may not add up to 100% due to "Do not know" or "Not applicable" responses and due to rounding.

are developing their own unique management accounting techniques. Two companies that have implemented innovative techniques in the area of budgeting are Hongdou Group and Shangdon Huijin Stock Company. Hongdou Group first goes through a traditional budgeting process on a calendar-year basis. Then it encourages employees to optimize company performance in the third month of the year (March), using all available means. It then reestablishes its budget for the rest of the year based on this performance. Shangdon Huijin has developed a "cost target control" management system that divides all costs based on key links (processes) and cost elements and then bases cost control on these relationships.

Despite this innovation by some companies, the use of production, technological, and economic targets—required under the planned economy—remains very strong, especially with regard to raw material usage. Most companies track raw material usage and compare it to preestablished quotas on a frequent basis.

Systemic differences in practices between most Western companies and Chinese companies exist with regard to the costing of raw materials, direct labor, and overhead. All companies we visited utilized a "quota" system (similar to a standard costing system) in operational planning. Unlike under a standard costing system, however, there was typically no linkage between the standards and the cost accounting system: Direct materials, direct labor, and overhead were allocated to a period's production based on the actual cost, which is contrary to prevalent practice in the West.

Two of the companies we visited use the "Backward Cost Analysis" method frequently attributed to Handan Steel. This methodology, similar to target costing, is a relatively sophisticated technique for establishing cost standards that employs a pull (backward-working) approach in order to introduce market forces into the standard-

Table 3: Percent of Utilization of Management Accounting Techniques by Ownership

	STATE-OWNED ENTERPRISES	PUBLICLY OWNED LISTED	PRIVATELY OWNED UNLISTED
Operational budgeting techniques	84 (26)	91 (10)	89 (59)
Flexible budgeting	25 (5)	43 (3)	29 (8)
Capital budgeting techniques	50 (10)	50 (3)	48 (14)
Fixed-variable cost analysis, breakeven analysis, etc.	43 (9)	43 (3)	77 (33)
Value chain costing	6 (1)	43 (3)	34 (11)
Target costing	28 (5)	40 (2)	55 (21)
Responsibility accounting	68 (15)	89 (8)	81 (34)
Incentive compensation	72 (18)	80 (80)	84 (38)
Performance measurement	67 (18)	40 (2)	78 (32)
Standard costing	11 (2)	20 (1)	36 (9)
Internal transfer pricing	35 (6)	80 (4)	67 (20)
Traditional overhead allocation	42 (8)	60 (3)	64 (21)
Activity-based costing	6 (1)	0 (0)	12 (3)
Life-cycle costing	17 (3)	40 (2)	14 (3)
Benchmarking	11 (2)	20 (1)	9 (2)
Theory of constraints	12 (2)	0 (0)	19 (4)
Economic Value Added (EVA®)	6 (1)	0 (0)	18 (4)

Note: Figures in table indicate number of firms with a given ownership type responding affirmatively and, in parentheses, the percentage of firms.

setting process, resulting in reduced production costs and increased profitability. Use of this methodology is an indication of the progress Chinese companies have made in developing new cost management techniques.

Performance Management and Employee Compensation

During the 1950s, Chinese firms developed an intracompany economic accountability system in which performance targets were set for the various layers of an enterprise. Under this system, a diverse set of performance metrics was employed, including measures of production, efficiency, quality, cost, and safety, among others, rather than just measures dealing with costs and profitability. This was necessary so that, under the planned economy, each factory could be viewed as part of a large "conglomerate" where the output of one factory was the input of another. Thus there was a heavy emphasis on maximizing production (or at least in achieving production quotas) in order to ensure the smooth operation of the economy.

With the current transition to a market economy, the emphasis on the various performance metrics has changed. Costs and profit, often disregarded or of little importance in the past, are now key measures. Yet the use of a diverse set of performance metrics on workers' scorecards persists to this day: Each of the companies we visited evaluated workers' performance using a performance scorecard containing a diverse set of performance metrics including production, productivity, safety, costs, and profitability.

This is interesting in that this relatively old practice is similar to a new, popular Western approach—the balanced scorecard. This latter technique emphasizes the use of a diverse set of performance metrics in order to obtain a "balanced" view of organizational performance. While most of the field study companies didn't tie their scorecards explicitly to organizational strategy, as is advocated when using balanced scorecards, you can argue in most cases that there's an implicit linkage of the two. Thus we see an area that would be considered "leading edge" in the West in which Chinese companies have amassed great experience. Now the challenge to Chinese companies is finding the right balance of metrics to reflect their new operating environment as (hopefully) reflected in their new organizational strategies.

All of the companies we visited indicated that they use a comprehensive performance evaluation system with appropriate measures employed at each level of their organization. Most of the companies have a bonus system that links employee compensation to job performance, but there's a great diversity in these bonus plans that reflects the varied history, unique circumstances, and differing management philosophies of these organizations.

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Management Accounting Techniques

What management accounting tools and techniques do PRC firms use to cope in an increasingly competitive business environment? The introduction of "new" Western management techniques to PRC companies has been widely noted and advocated, but traditional Chinese techniques can also help organizations compete. Table 2 provides a ranking, based on our survey results, of the importance of various (mainly Western) techniques in achieving organizational objectives.

Given the high level of importance attributed to some recently introduced Western techniques, such as activity-based costing (ABC) and value chain costing, it might be concluded that they are also widely utilized. This isn't the case.

The three most widely used management accounting techniques are operational budgeting techniques, incentive compensation, and responsibility accounting. These techniques have roots that go back to the days of the planned economy. Also widely used are fixed-variable cost/breakeven analysis and performance measurement. These relatively simple techniques help provide companies with insight into their cost structure and its impact on their profitability.

Table 3 lists the rate of utilization of the various cost management techniques, For none of the techniques was there significant difference in the utilization rate among the various forms of company ownership. (For further statistical details, see the full IMA study.) This finding indicates that state-owned enterprises use management accounting techniques similar to those that privately owned firms use and that their poorer financial performance stems from other causes, such as differing organizational objectives.

Additional statistical analysis of the commonalities in the use of these management accounting techniques found three significant factors. The first factor had the greatest loadings (or weightings) on benchmarking, theory of constraints, activity-based costing, life-cycle costing, and value chain costing but none on flexible budgeting. It can be interpreted as dealing with obtaining an understanding of costs, generally on a long-term horizon, to assess a firm's competitive position. The second factor, with its greatest loading on fixed-variable cost analysis, target costing, and internal transfer pricing, can be interpreted as dealing with obtaining an understanding of cost behavior to enhance operational performance. The third factor, with large loadings on incentive compensation, performance measurement, and responsibility accounting, deals with the traditional performance measurement and control function of accounting.

What's Next?

Chinese management accountants face unique challenges. While they are able to learn management accounting techniques from the West, Chinese firms are unlikely to find an entirely satisfactory management accounting framework in the West because of their unique operating environment. They must combine their accumulated experience with the best of Western management accounting techniques to devise management tools that will be effective in their environment. In doing so, they have the opportunity to advance the entire field of management accounting. **SF**

Raef Lawson, CMA, CPA, Ph.D., is the vice president of research and Professor-in-Residence at the Institute of Management Accountants (IMA®). You can reach him at rlawson@imanet.org.