CMAs: Role in Corporate Governance

Manas Kumar Thakur
Vice President
Institute of Cost Accountants of India,The

1. Introduction

"Corporate governance" was broadly defined by the Organisation for Economic Co-operation and Development (OECD) (1999) as the system by which business corporations are directed and controlled. The ideal corporate governance structure ought to specify the acquisition and distribution of inputs (e.g. assets) and responsibilities among different participants in the organisation, such as the board, managers, shareholders and other stakeholders.

Major concerns about the need for good corporate governance came about after large scale corporate scandals involving fraud and financial irregularities such as those experienced by Enron and Parmalat (Kenny, 2005). There is now a realisation that compliance to corporate governance guidelines alone does not guarantee success of an organisation. The underlying objective of good corporate governance is to create, maintain or enhance value for the respective stakeholders. Corporate governance therefore, may only be effective if it ultimately creates value for its stakeholders. The stakeholders may inevitably need management accounting to measure and monitor the value created(or destroyed) in order to continuously assess the effectiveness of a corporate governance system.

The Companies Act, 2013, in India, also intends to improve corporate governance by requiring disclosure of nature of concern or interest of every director, manager, any other key managerial personnel and relatives of such a director, manager or any other key managerial personnel and reduction in threshold of disclosure.

An effective governance system may need board of directors (executive and non-executive) with the majority having at least sufficient knowledge of the organisation's activities and that of the industry within which it operates. The board should be able to fulfil the following five responsibilities as pointed out by Kaplan and Nagel (2004) are (i) approve and monitor organisation strategy (ii) approve major financial decisions (iii) select the CEO, evaluate the CEO and senior executive team and ensure executive succession plans (iv) provide counsel and support to the CEO (v) ensure compliance.

Hence, there is a need for competent management accounting function to be implemented and practised by the board to facilitate its operations.

2. Management Accounting for Corporate Governance:

Management accounting, which was traditionally intended for internal use in organisations, has, through its ability to measure value and to present both current and forward-looking information, developed into a key instrument to organisations for delivering effective corporate governance to stakeholders. It is the practical science of creating value within organisations. To create and manage a successful business, accounting, finance and management are combined with leading edge techniques and management accountants fulfil financial and non-financial roles in their organisations. Hence, management accountants are equipped with an exceptional insight into how their organisations function.

Management accounting is the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management accounting also involves the preparation of financial reports for groups such as shareholders, creditors, regulatory agencies and tax authorities which are not involved in the management of the organisation. From this it can be stated that management accounting may assist the board of directors in providing a realistic measurement of the organisation's current value, taking into account all aspects of costs and values, therefore showing where the company is at a particular time.

For the directors to execute their duties efficiently, they may need to regularly use management accounting reports to facilitate their decision making processes. Management accounting reports may therefore need to go beyond the senior management level up to the board level. Sir Adrian Cadbury (2002) indicated that directors may consider that lack of timely relevant information, or the way in which debates are handled and decisions are made, made it difficult for them to contribute in a useful manner. In fact Epstein and Birchard (2000) observed that many companies turned to their management accounting systems to bypass the limitations of financial accounting. This may be because for every decision the board has to make, there is a need for timely and relevant management accounting reports to support it.

To approve and monitor an organisation's strategy, some of the management accounting reports the board may require (Hulbert and Fitzroy, 2004) are:

- A report on economic values of opportunities available for the company e.g. the expected revenues.
- A SWOT (Strength, Weakness, Opportunities and Threats) analysis - summarises the key issues from the business environment and the strategic capability of an organisation that are most likely to impact on strategy development.

3. MANAGEMENT ACCOUNTING, STRATEGY FORMULATION AND CONTROL

Management Accounting when effectively applied facilitates in corporate governance. Decisions that directors may be expected to make in formulating and controlling corporate strategy and it reviews the management accounting information upon which corporate governance decisions can be made.

3.1 Management Accounting and Organisational Strategy

Management accounting comprises a set of tools and techniques to support planning, decision making and control in business organisations. Hence, management accounting may be of value to the board of directors in formulating and controlling the strategy of the organisation.

3.2 Strategy Formulation

The Board is responsible for the strategy of the business and for harmonising the operating plans and targets required to turn the strategy into action. For the board to fulfil the corporate governance recommendations regarding strategy, it should, according to Kaplan and Nagel (2004), understand the strategy and should be able to judge that the strategy is capable of delivering long term shareholder value at acceptable levels of business, financial and technological risk. Some of the management accounting tools which may be employed for strategy formulation includes:

- SWOT analysis,
- PESTEL framework and
- Porter's five competitive forces model

Each of the above is briefly discussed as :

3.2.1 SWOT Analysis

A SWOT analysis identifies strengths and weaknesses from within the organisation by an internal environment analysis while the opportunities and threats are identified by looking at the external environment. Management accounting may play a very important role in making meaningful forecasts and quantifying the effects of changes to the organisation.

Internal Environment Analysis includes deploying its strength to maximum advantage, minimise its vulnerability to its weaknesses and develop to meet challenges of the future. External Environment Analysis should include selecting key variables that can affect the organisation, forecast the nature and pace of these changes and estimate the potential of these changes on the organisation. A Management Accountant facilitates in identification of the relevant variables which can affect the organisation and assigning values to such variables in order to assist the board to make a decision based on optimisation of stakeholder value.

3.2.2. PESTEL Framework

The PESTEL framework may be employed by management accountants, categorising the environmental factors into six main types : (i) Political (ii) Economic (iii) Social (iv) Technological (v) Environmental and (vi) Legal. Using various costing and valuing techniques the management accounting report may put values and weights to the factors identified above, hence highlighting the key drivers of change i.e. the forces likely to affect the structure of an industry, sector or market to facilitate the board in deciding how much of the organisations resources to allocate to help address the respective factors.

3.2.3 Porter's Five Forces Model

A management accountant can employ Porter's five forces model to provide an analytical report. The forces are the (i) power of suppliers (ii) power of customers (iii) threat of substitutes to its offering (iv) threat of competition from its peers, and (v) threat of new entrants into its market domain. The management accounting reports issued to the directors using the model may attach costs and values to the powers and threats of the various elements so that the board can decide whether to ignore them or to dedicate time and funds to address them.

3.3. Monitoring and Controlling Strategy

Management Accounting reports, in form of variance analyses, are presented to show when and where there are control lags which may lead to divergence from the expected results. It also recommends that the board should include a statement that they have established formal policies and frameworks for the design and implementation of the system of internal financial controls.

3.4 Variance Analysis

Variance analysis helps to identify variances comparing actual results with some type of benchmarked standard and investigating the reasons why they occurred and can be used to monitor and control strategy. Variance analysis can be a very strong tool in compliance reporting and be effectively used to improve future operating plans. Management accounting would facilitate to identify the critical factors and develop standards from there. Then, using variance analysis, periodical reports may be generated identifying divergences and reasons thereof. This information would facilitate Board for corrective action for improving operating performance.

3.5 Balanced Scorecard

Kaplan and Norton (1996) indicated that the process of building a balanced scorecard clarifies objectives and identifies the critical few drivers of strategic objectives. The balanced scorecard translates mission and strategy into objectives and measures. It is organised into four different perspectives, namely: (i) Financial (ii) Customer (iii) Internal business process (iv) Learning and growth.

A management accounting report using the balanced scorecard approach may be like a panoramic view of the entire organisation and its environment as it demonstrates values created and/or destroyed in all aspects of the organisation, enabling the board to make timely and quality decisions.

The Balanced Scorecard provides some major benefits which includes (i) to track progress for achievement of strategic goals (ii) to implement strategy on relevant critical success factors (iii) to determine each manager's compensation and advancement (iv) acts as a framework that coordinates efforts within the organisation to achieve critical success factors by enabling managers to see how their activity contributes to success and motivates team work.

3.6 Management Accounting for Financial Decisions

Management Accounting would help to review the company's internal financial controls and to monitor the integrity of the financial statements on the company's financial performance. The company's financial management is an integral part of its business strategy. The major financial decisions that the board is expected to reserve for itself includes financing or divestment decisions, acquisitions, borrowings and its cost, opportunity cost of retained earnings, cash flow analysis.

3. 7 Management Accounting for Directors and Board's Performance Evaluation

Performance measurement is the process of quantifying the efficiency and effectiveness of past actions. Most corporate governance codes recommend that there should be continuous evaluation of the performance of the board of directors both as a whole and at individual director level. The boards can only carry out proper performance evaluations if they are provided with the relevant information to base their assessment upon. The management accounting tool of Economic Value Added (EVA) can be employed for production of the reports which will help ensure that they operate in a manner consistent with maximising shareholders wealth.

3. 8 Management Accounting Information for Support

Information retrieved from Management Accounting Reports would facilitate management in proper decision-making. They can contribute specifically based on the knowledge of the industry, functional and management expertise, and guidance based on the company's history and competitive position.

Management accounting can support the board in this aspect by making reports available using tools such as (i) benchmarking, and (ii) the balanced scorecard

3.8.1 Benchmarking

Benchmarking is a continuous process of measuring performance gaps, establishing where best practices are, and introducing change capable of closing identified gaps. From the benchmarking reports, different functional comparisons may be prepared and measures as appropriate be taken for sustainable growth and development.

3.8.2. The Balanced Scorecard

In addition to previous discussion, the authors of Balanced Score Card, Kaplan and Norton (2006), suggested a three-component balanced scorecard to address the evaluation and performance issues of the board and its directors namely: (i) Organisation balanced scorecard - to manage entire organisation, describing the organisational strategy, measures and targets (ii) Board balanced scorecard to manage performances of the board its committees - defining theirs strategic contributions (iii) Executive balanced scorecard - to assess and reward performance of executives by defining theirs specific contributions.

3.9 Management Accounting Facilitating Compliance to Corporate Governance Requirements

Compliance to relevant laws, regulations and codes of business practice is one of the cornerstones of good corporate governance. Management accounting may provide non financial reports which may enumerate the principles and practices of the board while highlighting the variance, if any, from best practices in the industry hence assist the board in making an informed decision on the way forward or assist the stakeholders to appreciate the board's efforts in compliance.

3. 10 Exceptional Reporting on Compliance

Management accounting reports will assist the board to track compliance using exceptional reporting to highlight any divergences from the recommendations. Directors may be able to take corrective action using a system called management by exception.

3.11 Cost Benefit Analysis for Compliance

The management accountant will be able to present a report to the board which will identify and quantify costs and weigh them against benefits of compliance and a comparative analysis of costs and benefits of non compliance.

3.12 Responsibility Accounting

Under responsibility accounting, controllable costs are assigned to managers and reports the cost and expenses a manager is responsible for as well as the budgeted amounts (Wild, 2005). Using responsibility accounting, a management accounting report may be used to differentiate between group performance and/or economic performance and that of the particular individual being assessed.

3.13 Activity Based Costing (ABC)

Among the methods used by a management accountant to arrive at more realistic and relevant costs for decision purposes is activity based costing. Activity based costing accumulates overhead costs into activity cost pools and then uses activity rates to allocate those costs to products, based on identified and related cost drivers. This is a major departure from Traditional Costing and makes a logical assessment of costs.

4. Role of Cost & Management Accountants (CMAs) in achieving Corporate Governance

Corporate Governance starts and ends with strict adherence to discipline and compliance of legal requirements. Yet the question arises, whether adherence to corporate governance would result in sustainable growth and development. CMAs contribute in optimum and effective utilisation of available scarce resources, within the given constraints and challenges. The strict adherence to the provisions of the Companies Act, 2013, through Generally Accepted Cost Accounting Principles (GACAP), Cost Accounting Standards (CASs), Cost Audit and Assurance Standards (CAASs) issued by our Institute helps to meet the required compliance. Guidance provided by CMAs increases both the qualitative and quantitative yield of organization. The prime objective of meeting economic, social and national objectives are achieved besides adhering the strict governance and compliance. There is a shift from 'Corporate Governance' to 'Enterprise Governance' which includes both (i) conformance or corporate governance and (ii) performance or business governance. Necessity is the mother of invention or innovation. Reports and analysis from CMAs help organisations to innovate and invent path for success. Some of such path-breaking concepts includes - Lean Management, Target Costing, Kaizen Costing, Product Life Cycle Costing. Even there are several efforts to achieve six-sigma in managing resources based on management accounting reports and guidance. CMAs, when effectively engaged, would be the preferred source of professionals for reaping positive yields under 'Make in India' mission besides attaining the prescribed statutory provisions on corporate governance. CMAs have a greater role to spread cost consciousness amongst mass, which would also support the financial literacy and financial inclusion missions of the Government. CMAs are engaged in specifically engaged under different taxation provisions, recognized under the Companies Act, 2013 in various authentication functions and Foreign Trade Policy 2015 certifications. Failures within organizations occurs due to non-implementation or wrong-implementation of Management Accounting reports and recommendations. I also dream a day when 'Cost information would be effectively utilised for making assessment under tax laws in India'. This would increase transparency and fairness in assessment, stem-tide the increasing degree of litigation, address tax-evasion issues and also meet desired expectation of tax-stakeholders. We are all Management Accountants in our own capacity, irrespective of whether we have a formal qualification or not. The efficiency varies on how well a person manages its resources and yields benefits. India needs skilled professionals. Acquiring a formal CMA qualification through its structured education would help YOU to achieve your dreams and goals at a very low cost. Through this esteemed column, I urge all to pursue the CMA Course, be a ambassador for performing social good too. Remember, the role of a CMAs ranges from womb (idea germination/ imagination) to tomb (effective execution/implementation and resulting success) as we all know Behind every successful business decision, there is always a CMA.