Aim of the thesis

Although many accounting firms try to meet their customers’ varied demands for independent advice, the provision of that advice is not a logical extension of the accountant’s basic task. Whereas the field of accountancy focuses specifically on compiling, evaluating and auditing historical financial figures, the provision of useful commercial advice requires the time horizon to be shifted to the future.

The following factors limit the usefulness of accountants’ financial reports for providing strategic advice:

1. the figures available are often dated, i.e. at least several months old;
2. they are rarely standardised, so that variance analyses are not possible;
3. they often lack non-financial information. Moreover, the figures are hardly ever related to business processes. They do not indicate, for example, costs per hour, the relationship between direct and indirect costs, and capacity utilisation at any particular point in time.

This thesis aims to make a contribution to a system designed to improve the advice accountants give to entrepreneurs running small and medium-sized enterprises (SMEs). In developing this system, which we call the Management Compass System (MCS), we have the following objective:

*to support SME entrepreneurs in their decision-making on the basis of financial and non-financial information, focusing on the integration of decisions at strategic and operational levels.*

Development of the MCS has some further underlying goals:

1. to arrive at a working method for the auditor/consultant that is recognisable and distinctive to others;
2. to offer the adviser a solid foundation for his work that enables him to deliver a quality service as efficiently and effectively as possible;
3. to develop a way of guiding and educating employers based on a clearly defined concept.

Study approach

The study consists of two parts. The first part is the development of the MCS and the second is the use of the MCS in two industry sectors. The two parts are described separately.
Development of the MCS
The first step in developing the MCS was to research the literature. The aim here was to:
1 form an impression of the existing models developed for strategy formation and information provision in general and for SMEs in particular;
2 establish which elements of the existing models could contribute to the development of a system for use in SMEs;
3 give direction to the development of the MCS and to the empirical study that would be conducted later.
The strategy planning and information provision models discussed below emerged from the literature research.

Two strategic planning models are discussed: the traveller’s model and the hiker’s model. Their characteristics are described, together with the consequences these characteristics have for internal information provision. Several schools of thought based on these models are considered. This is followed by discussion of four models designed to facilitate systematic development of a strategic plan for SME’s: the Bontje model, the strategic Y-model, the Durham model and the SME entrepreneurship plan model. This is followed by identification of some of these models’ main features with firm input to our own model.

The resulting model can be used by a company to determine its present competitive position and the implications this has for its future competitive position. The analysis includes a customer survey. Internal analysis is also discussed, with company comparison and cost analysis as important elements. The cost analysis is based partly on Cooper and Kaplan’s ABC cost analysis and partly on the cost centre method.

Two models of internal information provision are then examined: the Bennik System and the Balanced Scorecard. These provide the basis for a model that has been developed for internal information provision within the MCS. We call this model the profit-and-loss tracking system. It provides management with a weekly up-date on the most important company information. The MCS relates strategy and internal information provision, based on:
1 the quantity and nature of the information included in internal reports;
2 the standardisation of this information.

Practical application of the MCS
Once the MCS model was developed, the system was put into practice in two case studies.

As mentioned earlier, the MCS project was about developing a system for use in SMEs that establishes a relationship between strategic and operational policy and a link between financial and non-financial information. The relationships between these various factors were therefore treated as an integrated whole. This had two consequences for the empirical work that was carried out:
In relation to strategy, an external and an internal analysis were required. The external analysis had to reveal the most important developments in those factors that had a significant influence on the size and nature of the market in which the company operates. It also had to identify the factors that were critical for success, based on the customer’s requirements and expectations. In the internal analysis it was relevant to identify distinctive competitive factors. Since these are relative with regard to competitors, we used a comparative company survey.

In order to produce an information system in which there is a relationship not only to the strategy that is implemented, but also to the business processes, these processes had to be thoroughly analysed. In doing so, it was important to analyse the relative and absolute costs of the processes as well as the factors that affect those costs.

The development and testing of the MCS required a comprehensive, integrated empirical study of an industry sector. We decided on a practical study of two sectors: the compound feed and the engineering industries.

**Exploratory study**

An exploratory study was carried out prior to the empirical study. The aim was to:

1. assess in more detail whether the sector was suitable for MCS development;
2. establish priorities and important issues for follow-up study;
3. develop a plan that could be used as a basis for the later development and implementation of the MCS;
4. get an idea of the important issues when applying the various parts of the MCS to a compound feed company.

The exploratory study was based on literature research, interviews with experts and the study of data from some compound feed companies.

**Comparative company survey**

The exploratory study formed the basis for a comparative survey involving 14 companies.

The aim of the survey was to:

1. profile the sector in terms of market developments and competition;
2. establish how returns varied between one company and another, and to try to determine the reasons for these variations;
3. identify specific problem areas in the sector as well as the specific problems experienced by the participating companies.

This study attempted to obtain both quantitative and qualitative information. The results were then used as input in the development of the MCS. At this stage a telephone survey of customers was conducted. The 600 companies approached were selected at random from lists of addresses with a coverage of 90%. The companies selected had to derive
their main income from the livestock industry. Of the companies approached, 157 were willing to cooperate. The survey questions focused mainly on the criteria that customers use when buying feed and selecting suppliers. In view of the fact that this was not a ‘stand-alone’ study but would be related to in-depth interviews with customers, and the fact also that its results could be compared to figures obtained from compound feed companies, a response of 26% was considered sufficient to give a reasonably accurate insight into customers’ most important requirements and wishes.

Use of the MCS in an individual company
The final part of the empirical study consisted of integrated development and implementation of the MCS in an individual company. This was a company involved in the compound feed industry (Feed B.V.). We opted for a single case study which attempted a high degree of MCS penetration.

Parts of the MCS were also applied to several companies in the engineering field. The differences between MCS as applied to the engineering and the compound feed industries are largely explained by two factors: firstly, the primary process in the engineering industry differs greatly from that in the compound feed industry and, secondly, the structure and dynamic of the sales markets differ considerably between these sectors.

Results

The MCS
The integrated MCS, developed as described above, consists of ten steps:
1 orientation
2 business mission/company philosophy
3 objectives
4 diagnosis
5 strategic choices
6 planning
7 long-range estimates
8 annual plan
9 profit-and-loss tracking system
10 interim figures

These steps are elaborated in order:

Step 1: Orientation
During this phase the consultant’s aim is to acquaint himself with the company that is the subject of MCS implementation. This orientation step involves three tasks. Firstly, an analysis of the company in overall financial terms (Gibb, 1992). In the MCS this is called an initial figures analysis. With existing companies this can be based on the annual accounts of
the last few years, possibly supplemented by interim figures. Secondly, determining the reason for MCS implementation: what is the entrepreneur’s motive for introducing the MCS, and is this motive preventive or project-based? And lastly, global marketing research.

During this first step, the adviser gets an initial indication of the company’s potential and limitations. He also begins to become aware of special issues that may be important when implementing the MCS.

**Step 2: Business mission/company philosophy**

During this phase one is looking for answers to the following questions:

1. What are the main products/services?
2. Who are the main customers?
3. What are the company’s core activities?
4. What are the main factors that contribute to future success?
5. Where is the company located?
6. What is the management’s basic philosophy?
7. In which areas does the company want to fulfil its social responsibilities?
8. What is the attitude to employees?

The answers to these questions form the framework in which the following MCS steps have to be placed.

**Step 3: Objectives**

In determining objectives, the consultant tries to bring out the objectives the entrepreneur has in mind when drawing up the strategic plan. A distinction is made here between the entrepreneur’s personal objectives and the company’s commercial objectives.

**Step 4: Diagnosis**

The aim of this phase is, on the one hand, to determine the company’s strengths and weaknesses, and, on the other, to identify external developments. An assessment is then made of the extent to which these match each other. In determining the company’s strengths and weaknesses, the consultant makes use of, for example, information gathered from comparative company research. The consultant also carries out a strategic cost analysis.

**Step 5: Strategic choices**

During this phase the company’s future strategy is decided. This is done by formulating a number of strategic options based on the results of the diagnosis (step 4) and by analysing the risks attached to each option.

**Step 6: Planning**

The decisions taken in step 5 are translated into a plan. This means working out strategic choices in terms of objectives, strategic plans/plan components, and the points for improvement that emerged as a by-product of step 4.
**Step 7: Long-range estimates**
The long-range estimates involve a quantitative conversion of the strategic choices made in step 6. There are three reasons for making these estimates: firstly, to have a standard on which an analysis of actual figures can be based; secondly, to provide a means of control; and finally, to be able to gauge the financial consequences of the proposed policy.

**Step 8: Annual plan**
The annual plan is derived from steps 6 and 7 of the MCS: planning and long-range estimates. The annual plan has to set tasks for the coming year. The tasks set will be shown quantitatively (annual budget) as well as qualitatively (action plan). The annual plan in the MCS includes the principles and the targets for the profit-and-loss tracking system as well as additional elements. In the annual plan we also see the critical factors for success and the distinctive competitive factors that were analysed in step 4, the diagnosis. The annual plan also contains a summary of proposed actions, those responsible for them and when they are scheduled to occur.

**Step 9: Profit-and-loss tracking system**
The profit-and-loss tracking system offers the entrepreneur a weekly information update on his company that is relevant to him. This includes financial information on turnover, costs, the result and the most significant balance positions, and non-financial information on distinctive competitive factors and critical factors for success. The most important functions this information performs are to give the entrepreneur an insight into his operation and to provide a means of control, motivation and communication.

**Step 10: Interim figures**
Interim figures are drawn up periodically, based on information produced by the financial accounting system. These figures can be used to do the following: give management an interim picture of results achieved; enable actual results to be compared with the results of previous periods and the estimates, making interim analysis of results possible; facilitate control of information generated by the profit-and-loss tracking system; and report on variables for which weekly reporting is too frequent and annual reporting not frequent enough. Interim reporting also enables a company to see whether targets are indeed being achieved. If they are not, then either the policy or the targets need to be adjusted.

**The use of the MCS in a compound feed company (Feed B.V.)**
Once the MCS was developed, the system was put into practice. Its initial application was in a compound feed company, and following this first practical trial we can say that all the elements of the MCS are applicable in practice. The cost analysis component had to be adjusted during the trial to the specific requirements of a compound feed company. This was carried out without factoring the cost of raw materials.

The company, Feed B.V., believes that the comparison of similar companies has enhanced it’s understanding, certainly if this is seen against the background of the SWOT analysis as
a whole. According to Feed B.V. management, the comparison supplements the SWOT analysis in two ways: firstly, the strengths and weaknesses of the company are identified more or less objectively and, secondly, the adviser is able to make his sessions with management more meaningful through his knowledge of the sector. Deadlocked disputes between departments can often be resolved by the adviser with reference to company comparisons and his own specialist knowledge.

At Feed B.V., internal reporting based on the profit-and-loss tracking system is a weekly event. The management requires the report on any particular week to be finalised and available by the following Tuesday. Feed B.V.’s management feels that reporting based on this system offers the following advantages:

1. It gives them a good idea of the extent to which profit and other targets are actually being achieved.
2. It tightens discipline within the organisation: tasks in accounts and elsewhere that are lagging behind schedule are exposed in the weekly report (or the lack of a weekly report).
3. The link between specific financial and non-financial indicators becomes immediately apparent – the link, for example, between production and the capacity result.
4. Each part of the weekly report is the result of various other indicators. Recognising this relationship raises awareness. Feed B.V. puts it this way: ‘Behind every benchmark there is a story. By running through the report each week, we are also following the weekly instalments of the story behind the reports, including the basic principles we’ve formulated and the assumed relationships between our company’s various performance criteria. This helps to add to our understanding of the company.’
5. The application of the tracking system puts much greater pressure on them to think about targets and the results achieved.

The company estimates the differences between the tracking system and the monthly and quarterly figures at no higher than 25% of the result. For the purposes of the tracking system, the management finds this sufficiently accurate.

The management says that determining actual fixed costs can be done accurately, which is why there will only be very minor differences between the estimated and the actual figures.

They estimate the time required to draw up a weekly report at 15 minutes a week.

According to Feed B.V.’s management, the integration of strategic and operational information is absolutely essential for the proper overall functioning of the MCS. The profit-and-loss tracking system is of little or no use if it is not preceded by an accurate estimate. The company says that the relationship between strategy and operational information becomes clear and fully comprehensible through the application of the MCS as a whole. The management would have been able to discover these relationships themselves, but this would have been much more time-consuming. This makes the MCS into a kind of ‘educational’ experience for the entrepreneur.
Feed B.V.’s management finds weekly reporting of a bare minimum of non-financial indicators quite sufficient. Nevertheless, they find that working with non-financial indicators in the MCS offers some distinct advantages. In this connection, they cite continuous attention to the cost-drivers and an understanding of the relationship between what incurs costs and the costs themselves.

**Use of the MCS in an engineering company**

Besides the case study in the compound feed company, a case study was also undertaken in various types of engineering companies. The results showed that the MCS concept is just as applicable in an engineering company as it is in a compound feed company. Specific adaptations, however, were required in relation to the external analysis, the cost analysis and the profit-and-loss tracking system.

The use of the MCS in the engineering sector differs from its use in the compound feed sector in the following ways:

1. The engineering industry has a great number of product/market combinations, which makes it impossible to identify crucial factors for success for the market as a whole. Some product/market combinations are offered by a single company; in these cases, the crucial factors have to be determined on a company-by-company basis.

2. The considerations referred to in the first point make it hard to compare companies. Because companies are unique, they are impossible to compare or only to a very limited extent.

3. The production process in engineering involves job production, whereas in the compound feed sector it is a matter of process production, so cost analysis is used differently in the two sectors.

4. The engineering sector has relatively large movements in the stock work in process. The compound feed sector does not have this characteristic, because production charges are completed each day. The movements of work in process in the engineering sector require a specific information column in the profit-and-loss tracking system.