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# Management Accounting for Strategic Alliances

By

**Tomoaki Sonoda**

## Abstract

This article discusses management accounting for contractual strategic alliances. When two companies lack the enough managerial resources to individually implement their own objectives perfectly, strategic alliances are adopted. Each company provides its own resources and conducts the business affairs in partnership to achieve both objectives at the same time. There are two characteristics of strategic alliances. The first characteristic of strategic alliances is that there is not a master and servant relationship between two companies. So one company's objectives do not have any priority over the other's objectives. Moreover, strategic alliances do not allow one company to pursue profits at the expense of the partner. The second characteristics is that the negotiation process is significant.

The decision making process of strategic alliances is divided into five steps. This article discusses management accounting problems of the fifth step. In this step, companies negotiate the contents of strategic alliances. Profits will be divided according to the rate of managerial resources provided by each company. Therefore, the most important management accounting information is one which is associated with the allocation of managerial resources. I discuss the following four problems.

- ① Decision making when the managerial resources are qualitative
- ② The influence of corporate expenses on decision making
- ③ Disclosure of the premise of management accounting information
- ④ Possibility of changes of capacity costs

## Key Words

managerial resources, strategic alliances, objectives, negotiation, contractual alliances, decision making process, qualitative, corporate expenses, attributable costs, committed costs

## 1. Introduction

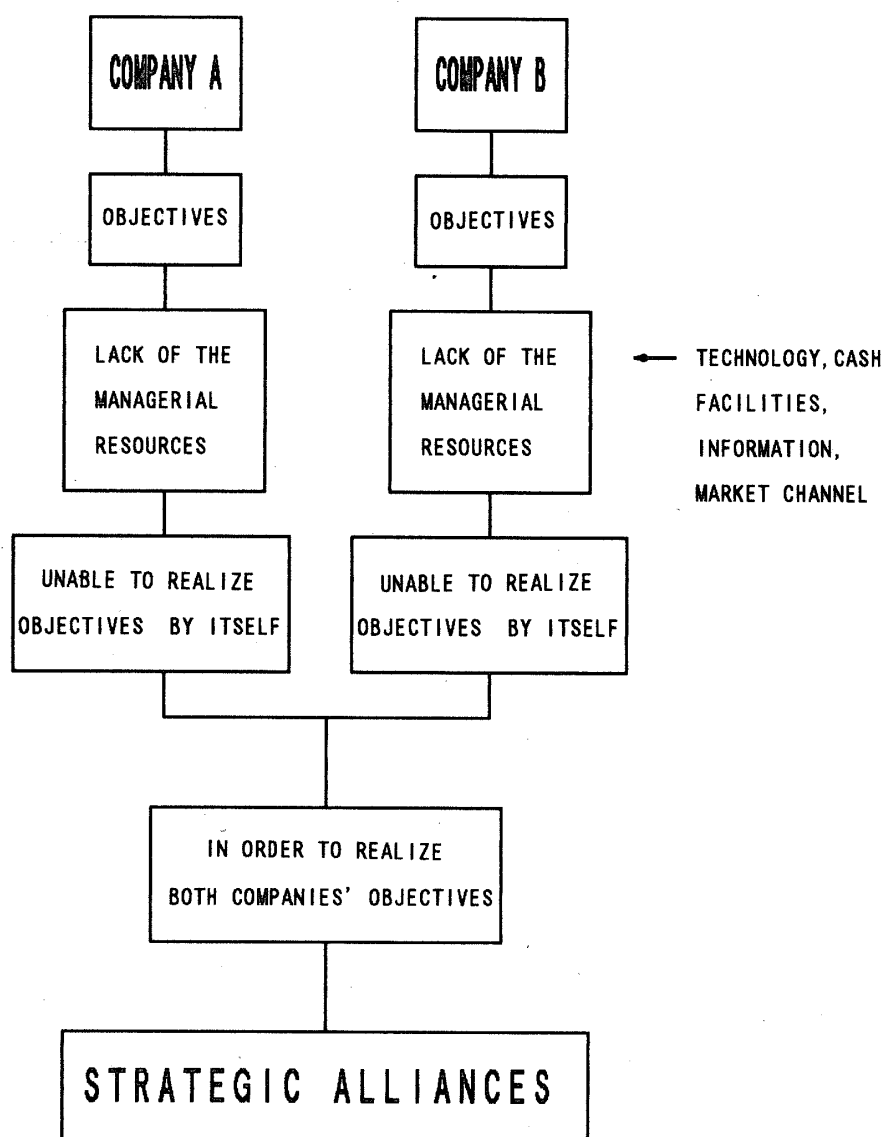
The companies need a variety of managerial resources to conduct their business affairs, for example, able personnel, facilities, cash and technology. But they are unable to possess all of the resources they need, so they sometimes join forces with other companies in order to use other's resources. Recently as for the relationship between companies, we have noted the new concept of "strategic alliances" which are gaining an increasingly important position within the competitive strategy. In strategic alliances, effective influence on the partner company is the most essential factor to succeed. This article considers management accounting for strategic alliances<sup>1</sup>.

## 2. The definition of strategic alliances

### (1) The definition of strategic alliances

Although there are many explanations for strategic alliances, we do not have a fixed definition. So in this article, I temporarily define the strategic alliances as the following<sup>2</sup>. In figure 1, both Companies A and B have their own objectives but lack

Figure 1 The Concept of Strategic Alliances



<sup>1</sup>Strategic alliances are mainly stated in management literature and there are very few management accounting articles on this subject (Cellini, 1993, is one example of them). So I summarized the concept of strategic alliances by referring to management literature and found out the problems of management accounting.

<sup>2</sup>Lewis (1990), Webster, Jr., (1992) and AGF Ryutu Academy Kenkyukai (1994) define strategic alliances in a similar way.

the managerial resources to individually implement their own objectives perfectly. Strategic alliances are adopted when they intend to solve this problem. Each company provides its own managerial resources<sup>3</sup>, and conduct the business affairs in partnership to achieve both objectives simultaneously.

In this definition, strategy has two meanings. Firstly, it means that companies change their management structures drastically to carry out the important activities with the partner company. Secondly, the range of partner companies becomes more extensive, with the inclusion of competitors (Lewis, 1990, pp.70-75)<sup>4</sup>.

## **(2) The characteristics of strategic alliances**

The above definition informs us that there are two characteristics of strategic alliances. This article distinguishes strategic alliances from the simple type of business tie-up, and considers them as different concepts. These characteristics show the difference between two concepts.

① The first characteristic of strategic alliances is that there is not a master and servant relationship between Company A and Company B. Theoretically in strategic alliances, one company does not have the sole right to make decisions by itself or to take advantage of the other. I will examine this characteristic from the two views of the objectives and profit allocation.

### **1) objectives**

When we consider strategic alliances from Company A's viewpoint, Company A thinks of Company B as the partner in order to implement Company A's objectives. But Company B also thinks of Company A as the partner in order to realize Company B's objectives. Therefore, one company's objectives do not have any priority over the other's objectives. In strategic alliances, both companies' objectives should be realized at the same time. There is no relationship where one company uses the other. Two companies unite their efforts and create a new value.

### **2) profit allocation**

Strategic alliances do not allow one company to pursue profits at the expense of the partner. Spiegel, Jr. (1993, p.30) state:

“we're sure we really have a commonality of interest and no one party dominates.”

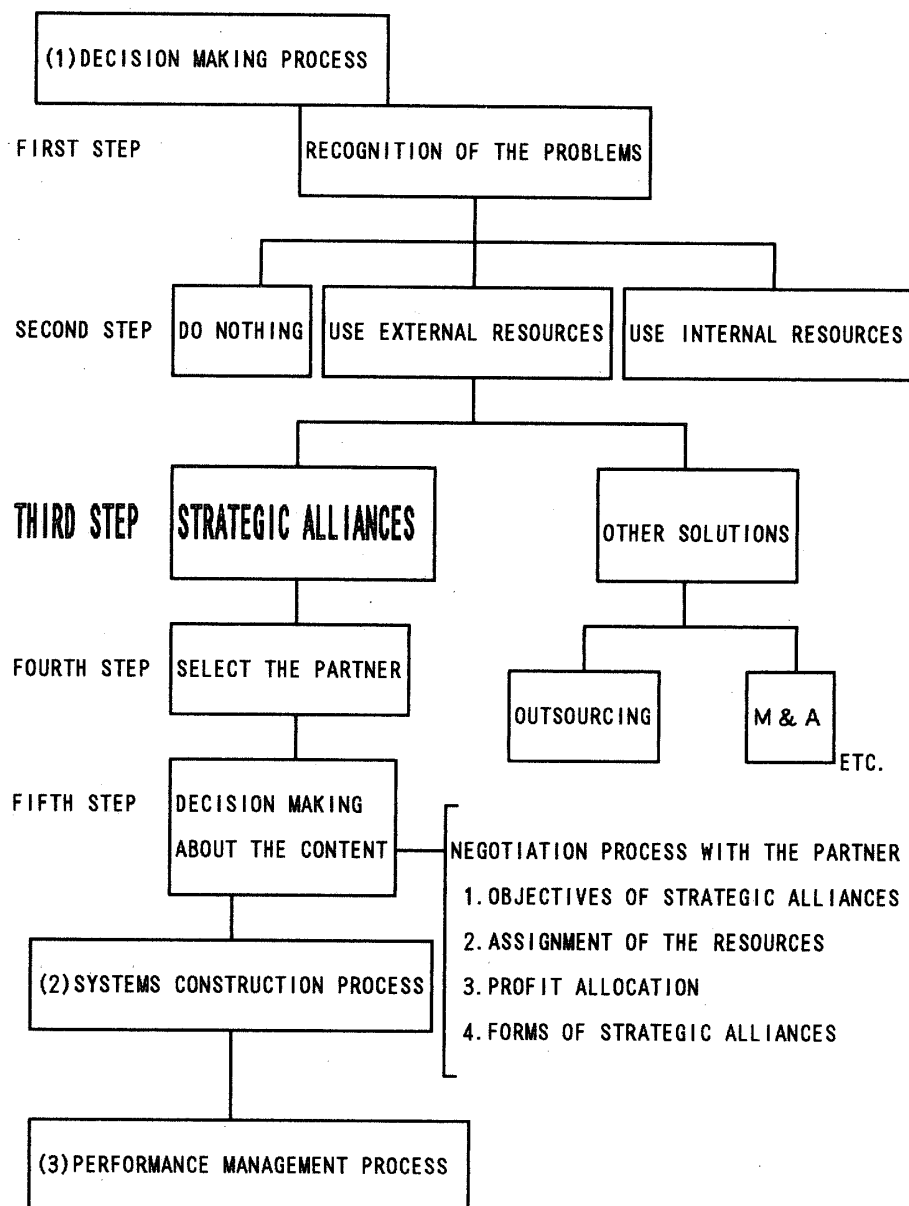
Respecting profits of both companies will ensure that they can earn optimum profits. Of course, profit allocation is not always 50:50. It will be divided according to the rate of managerial resources provided. Then one company will not have excessively bigger or smaller profits compared with the managerial resources it provided. Therefore, the most important management accounting information is one which is associated with the allocation of managerial resources.

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<sup>3</sup>For example, according to Spiegel Jr., who is the executive vice president of Merck, the managerial resources his company needed were research, scientists, productivity, and internationalization of the partner companies (Spiegel Jr., 1993, p.29).

<sup>4</sup>For example, Merck has carried out strategic alliances with Astra and Johnson&Johnson which are the same pharmaceutical companies as Merck. (Spiegel Jr., 1993, pp.28-29)

Figure 2 Management Process of Strategic Alliances



②The negotiation process is significant. As I will state later, we can divide the decision making process of strategic alliances into five steps. In the fifth step, which is the most important step, we make decisions about the details of strategic alliances through the negotiation of both companies. Because of the characteristic ①, one company cannot ignore the partner company's intention and make decisions by itself. Before decision making, we should understand and agree the details through negotiation in order to succeed with strategic alliances.

### (3) The forms of strategic alliances

Although there are a variety of forms of strategic alliances<sup>5</sup>, I consider the following two forms to be typical. One is establishing a joint venture for strategic alliances, the other is that two companies make a contract for strategic alliances, without establishing a joint venture (contractual alliances).

Joint ventures can make the strong relationship between the two companies because they establish a new corporate organization. On the other hand, contractual alliances make the less stable relationship, so when they make decisions, management accounting is increasingly more important. This article mainly examines management accounting for strategic alliances by contract.

## 3. The process of strategic alliances

I divide the management process of strategic alliances into the following three processes (figure 2 shows this process<sup>6</sup>).

- (1) decision making process
- (2) systems construction process
- (3) performance management process

Furthermore, I divide the decision making process into five steps as showed in figure 2. In the first step, we recognize the problems. In each following step, we search for, estimate and select the alternatives. We need different management accounting information in each step. Moreover, we use non-accounting information along with management accounting information and make decisions by judging them synthetically.

In the second step, we make decisions about whether to solve the problems using external resources, or internal resources such as reinforcing production equipment. We might decide to do nothing although we recognize the existence of the problems (Gordon et al., 1978, p.120). In the third step, we make decisions about whether to solve it by strategic alliances, or by other methods (for example, outsourcing or M&A etc.). In the second and third steps, we use incremental profit analysis in order to compare the alternatives.

In the fourth step, we examine more than one company in principal and select one of the best companies to realize strategy as the partner of strategic alliances. The fifth step is the process where we make decisions concerning the contents of strategic alliances through negotiation with the partner company. As stated on the previous page, this step is the most important in the decision making process of strategic alliances.

Following these 5 steps of the decision making process, the systems construction

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<sup>5</sup>For example, Lewis classified strategic alliances into eight categories (Lewis, 1990, p.232 and p.318).

- ①informal alliances
- ②contractual alliances
- ③minority investments alliances
- ④joint ventures
- ⑤strategic networks
- ⑥alliances with universities
- ⑦franchises
- ⑧business cooperatives or consortia

<sup>6</sup>Actually management is not always carried out according to the procedures of figure 2. Each process may progress at the same time, or decision making may start at a later stage during the process. I showed the basic management process pattern in figure 2.

process exists. In this process, we construct the organization, invest the equipment and arrange the personnel etc. After that, we operate daily business affairs and performance management process exists to manage these activities.

#### **4. Management accounting for strategic alliances**

Because of limited space, this article discusses the fifth step of the decision making process of strategic alliances, which is the most significant step and causes many new management accounting problems. In this step, we negotiate the contents of strategic alliances with the partner company selected in the fourth step and plan concretely. The main contents are;

- 1)objectives of strategic alliances
- 2)assignment of the managerial resources
- 3)profit allocation
- 4)forms of strategic alliances

Within these four clauses, we mainly require management accounting to provide useful information about 2) and 3). We can assume that in principle each company receives profit, which is allocated according to the managerial resources it has provided. Therefore, I limit the problems of management accounting information to the assignment of managerial resources. (As mentioned in 2(3), I also limit the form of the strategic alliances to the contractual alliances in this article.)

##### **①Decision making when the managerial resources are qualitative**

When we assign the managerial resources to the two companies, resources should be represented by means of useful forms to make decisions; that is that we should use monetary unit. There are no problems when the managerial resources are only cash. On the other hand, there may be qualitative resources. Typical examples of these are technology or expertise. In this case, management accounting must provide information concerning the qualitative resources because financial accounting does not provide it. Spiegel, Jr. (1993, p.30) state:

“we had to calculate a value for those contributions and then persuade the other party that those values were reasonable.”

One solution is that we can use monetary unit to represent the qualitative factors and assume that each company provides an equivalent sum of cash. Even if we adopt this method, another problem may exist. We should choose a better estimation method between research and development costs incurred, and the probable future benefits. If we select the latter choice, some companies might offer a larger probable amount to the partner company than the reasonable estimated amount and get an unfair advantage. This deception could result in preventing adequate decision making and could also damage a good relationship between the two companies concerned.

##### **②The influence of corporate expenses on decision making**

There are indirectly used resources in addition to directly used resources. Corporate expenses are indirectly used resources. I will examine the influence of corporate expenses on decision making, using some examples.

We can classify corporate expenses into two types:

(A) expenses not to be changed by strategic alliances

(B) expenses to be increased by strategic alliances

Corporate expenses type (B) are attributable costs. Attributable costs will be used only in ④ of table 1. All corporate expenses will be considered as only type (A) from ① to ③ of table 1.

Taking one company into consideration, the department which carries out strategic alliance is one segment and receives a lot of support service from the indirect management departments.

Now, we imagine a contractual strategic alliance between Company A and B, which will develop a new product. We suppose that both companies will be charged with costs equally, and cash payable within the costs is ¥500<sup>7</sup>. We must decide how to allocate the ¥500. Without corporate expenses, the premise of equal allocation leads

Table 1 The Influence of Corporate Expenses

①	CASH ASSIGNMENT	COMPANY A	COMPANY B	S U M
		250	250	500
②	ALLOCATED CORPORATE EXPENSES	COMPANY A	COMPANY B	S U M
		100	50	150
	CASH ASSIGNMENT	225	275	500
	S U M	325	325	650
③	CASH ASSIGNMENT	COMPANY A	COMPANY B1	S U M
		250	250	500
	ALLOCATED CORPORATE EXPENSES (FREE SERVICES)	+	+	
		(100)	(50)	(150)
④	ATTRIBUTABLE COSTS	COMPANY A	COMPANY B	S U M
		0	40	40
	CASH ASSIGNMENT	270	230	500
	S U M	270	270	540
	ALLOCATED CORPORATE EXPENSES (A) (FREE SERVICES)	+	+	
		(100)	(10)	(110)

<sup>7</sup>We consider that all cash payable becomes expenses in order to make the example simple.



us to the decision that both companies should pay ¥250 respectively as shown in ① of table 1.

As for the case where allocated corporate expenses exists, there are three decisions about the assignment of cash which will be provided as resources. They depend on the ways to deal with corporate expenses.

②~④ of table 1 are the cases where there are corporate expenses to be allocated to each company's segment which carries out strategic alliance. Allocated corporate expenses are:

Company A – ¥100

Company B – ¥50

The first method allocates them to the departments which carry out strategic alliance because the joint venture would have to pay cash which corresponds to corporate expenses in contractual alliances.

② of table 1 is the first method's example. Two companies are equally charged with the sum (¥650) of allocated corporate expenses ( $¥150 = ¥100 + ¥50$ ) and cash (¥500). So, each companies' costs are equally ¥325 ( $¥650 \div 2$ ). Company A will pay ¥225 ( $¥325 - ¥100$ ) in cash, and Company B will pay ¥275 ( $¥325 - ¥50$ ) in cash.

The second method does not take into account corporate expenses in the decision making. Indirect management departments' activities are considered to be free services. One reason is that corporate expenses will accrue without strategic alliances. Moreover, if we include corporate expenses in the managerial resources, some companies may calculate the higher allocated corporate expenses in order to lessen their cash payable. ③ of table 1 shows the decision that both companies should pay ¥250 in cash respectively. (Although this result is same as ①, the processes are different.)

The third method takes only attributable costs (corporate expenses type (B)) into consideration in the decision making. Attributable costs are traceable to the segment carrying out strategic alliance. For example, when the computer department's expenses increase by strategic alliance, although the computer department is not directly associated with strategic alliance, they are counted as attributable costs.

In ④ of table 1, we suppose that Company B's attributable costs are ¥40 among corporate expenses (¥50). Both companies' costs are equally ¥270, which is half of the sum (¥540) of attributable costs (¥40) and cash (¥500). So, Company A pays ¥270 ( $¥540 \div 2$ ), and Company B pays ¥230 (adding attributable costs ¥40, it becomes ¥270). The corporate expenses type (A) mentioned previously are not considered in the third method because they are free services, and not associated with strategic alliance.

We can therefore conclude that the last method (④ of table 1) is appropriate. In applying the last method, we have to recognize corporate expenses attributable to the segment which implements strategic alliance.

If we would like to make the allocated costs visible, we should establish the joint venture instead of contractual alliance. Then, the allocated corporate expenses would become visible because they are cash payable in the joint venture. Joint ventures does not have the problems of allocation of corporate expenses.

### ③Disclosure of the premise of management accounting information

In the fifth step of the decision making process of strategic alliances, decisions are made through negotiations between partner companies. The premise of management accounting information used in this step may not always be the same between two companies. So, each Company should take care not to mislead its partner company. Cellini (1993, p.57), who has experience of strategic alliances in Hoffmann-La Roche, state:

“It is important to make sure that all necessary financial terms are defined, are explained, and are consistent.”

If there are differences in the calculation methods, a consensus should be reached.

We need a variety of management accounting information in this negotiation process. Much of it is long-term information about this future, for example, probable future revenues, expenditures and capital investment. They are not definite because of possible later changes, but once they are shown as the accounting information, the partner company may misunderstand that they are definite.

Firstly, we should improve the accuracy of forecast, but we cannot expect it to be foolproof. Then, it is desirable that we should disclose how we interpreted the non-accounting information in compiling that of management accounting. For example, when forecasting future sales, we should judge the market, economic, and exchange rate trends and the activities of competitors etc.. We should specify these judgements in addition to management accounting information, and that they are the result of considerable speculation and not definitive.

### ④Possibility of changes of capacity costs

Some capacity costs may change in nature from managed costs to committed costs. R&D costs are generally considered to be managed costs. On the other hand, when carrying out research collaboration in strategic alliance, there may be the obligation to pay cash which is decided by the contract. In this case, one company cannot change the amount payable by itself and the nature of R&D costs change to committed costs. Committed costs are likely to increase by the contract of strategic alliances, and decision making becomes more important in order to manage committed costs.

## 5. Conclusion

I have examined management accounting for strategic alliances. We can divide the management process of strategic alliances into the decision making process, the systems construction process and the performance management process. The decision making process is further divided into five steps. This article has discussed the problems of the fifth step in the decision making process.

In the fifth step, we need the management accounting information in order to make decisions about the allocation of managerial resources and profit. These decisions are made through negotiation with the partner company. I have discussed the following four problems of the fifth step:

- ①Decision making when the managerial resources are qualitative
- ②The influence of corporate expenses on decision making

③Disclosure of the premise of management accounting information

④Possibility of changes of capacity costs

Strategic alliances will be increasingly carried out in the future. Therefore, management accounting is going to be required to provide useful information about strategic alliances.

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