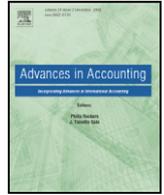




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The relationship between business strategy, management control systems and performance: Evidence from China

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A B S T R A C T

Over the past two decades, China has emerged as a global economic power, ranking behind only the USA, Japan and Germany. China's continuous global economic power has therefore prompted a surge in interest in understanding Chinese business practices. This paper reports on the results of a survey on the contingent relationship between business strategy, management control systems (MCS) and performance in Chinese Enterprises. The analysis is based on data gathered from 215 enterprises operating within the Xinjiang autonomous region of China. For those firms that were classified as pursuing differentiation strategy, the use of more non-financial based MCS has a positive effect on performance and this finding is consistent with the literature. We also found that for those firms classified as pursuing a low cost strategy, the use of more financial based MCS had a positive effective on performance as suggested in the literature. Our research has implications for understanding management accounting practices in Chinese enterprises.

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1. Introduction

This study presents survey evidence on the contingent relationship between business strategy, Management Control Systems (MCS) and performance in a sample of Chinese enterprises. The increasing importance of China in the global economy cannot be downplayed. The Chinese economy now ranks behind only the USA, Japan and Germany. China also accounts for the majority of the world's foreign direct investment and its entry into the World Trade Organisation (WTO) in 2001 and unabated economic reforms have far reaching implications for Chinese enterprises.

Before the advent of the economic reforms in the early 1980s, for instance, Chinese enterprises faced limited competition, as the economy was centrally planned. The types and quantity of production, the source of raw materials and customers were all determined by the government, as most enterprises were state-owned (Rawski, 1997). There was less pressure than there is now on these enterprises to design competitive strategies. The economic reform has, however, introduced competition which has led to fundamental and wide-ranging changes to the formal and informal rules and structures of organisations (Peng, 2003; Peng & Luo, 2000). This necessitates that

firms are more proactive and search for strategies in order to be able to compete, especially in a global economy (Giner & Giner, 2004; Su, 2005). Management education in China has also changed over the years to accommodate the changes in the Chinese business environment. Western concepts of strategic management and management controls have become important parts of the management education curriculum. Popular Western management and accounting texts are translated and used in Chinese universities and colleges (Nie, 2005).

Prompted by these changes, researchers are beginning to show interest in understanding management accounting practices in Chinese enterprises (Bromwich & Wang, 1991; Chalos & O'Connor, 1998; Chalos, O'Connor, & Zijian, 1999; Firth, 1996; Lin & Yu, 2002; O'Connor, Chow, & Wu, 2004; O'Connor, Deng, & Luo, 2006; O'Connor, Luo, & Lee, 2001; Skousen & Yang, 1988; Xiao, Chow, Duh, & Zhao, 2007; Zheng, 1999). The evidence so far points to Chinese firms increasingly adopting western management accounting practices. For example, Firth (1996; p. 561) notes that "The existence of market competition stirs Chinese firms to implement detailed accounting systems that can potentially aid decision making". He further observes that "as China moves towards a free enterprise market structure it seems likely they will move towards capitalist style accounting information systems" (Firth, 1996, p. 640). This observation has recently been confirmed by Xiao et al. (2007) who found an increase in the adoption of western management accounting techniques by Chinese firms.

Despite this evidence of Chinese firms adopting western management accounting systems, one line of research which has not been explored is the extent to which the adopted techniques contribute to improved performance of the firms (see for instance Xiao et al., 2007).

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This paper explores this issue by investigating how MCS supports the strategic orientation of a sample of Chinese firms.

There is evidence to suggest that strategy has become an important issue in Chinese organisations given the increasing competitive environment they now operate in (Li, 2000; Li, Zhang, & Chan, 2005; Lukas, Tan, & Hult, 2001; Peng, 2003; Peng & Luo, 2000; Pyke, Farley, & Robb, 2002; Robb & Xie, 2001, 2003; Tan & Litschert, 1994; Wang, Lo, & Yang, 2004; Zhao, Sum, Qi, Zhang, & Lee, 2005). The Chinese government is also now requesting State-Owned Enterprises (SOEs) to formulate their own strategic plan (Szirmai & Ruoan, 2000; Zhang, Zhang, & Zhao, 2002). To achieve better performance and competitive advantage, these firms must ensure that their strategies are aligned with their MCS (Auzair & Langfield-Smith, 2005; Cadez & Guilding, 2008; Chenhall, 2005; Collins, Holmann, & Mendoza, 1997; Cooper, 1996; Govindarajan, 1988; Govindarajan & Gupta, 1985; Jermias & Gani, 2004; Kald, Nisson, & Rappt, 2000; Simons, 1987, 1990). This paper aims to provide empirical evidence on the contingent relationship between MCS, business strategy and performance in Chinese enterprises.

2. Theory and development of hypotheses

Over the past two decades, there has been a growing interest in understanding the contingent relationship between strategy and MCS (Auzair & Langfield-Smith, 2005; Cadez & Guilding, 2008; Jermias & Gani, 2004; Kald et al., 2000; Langfield-Smith, 1997; Simons, 1990). This interest emanates from the increasingly competitive environment in which firms now operate (Simons, 1990; Langfield-Smith, 1997) and also developments of methods such as the balanced scorecard, strategic management accounting, and value-based management (Kald et al., 2000).

There is agreement among researchers that to achieve better performance and competitive advantage, firms must not only have appropriate strategies but they must also ensure that such strategies are aligned with their MCS (Collins et al., 1997; Cooper, 1996; Govindarajan, 1988; Govindarajan & Gupta, 1985; Jermias & Gani, 2004; Kald et al., 2000; Simons, 1987, 1990). Business strategy has therefore become an important contingent variable in the study of how MCS can be used to improve organisational performance (Langfield-Smith, 1997). The importance of strategy in MCS research has been summarised by Chenhall (2003, p. 150) as: “The role of strategy is important as it addresses the criticism that contingency-based research assumes that an organisation’s MCS is determined by context and that managers are captured by their operating environment”. The contingent relationship between business strategy, MCS and performance is discussed in the remainder of this section.

2.1. Business strategy

Strategy can be emergent and complex (see for instance, Archer & Otley, 1991; Coad, 1996; Hoque & Alam, 1999; Lord, 1996; Roslender & Hart, 2003; Tuomela, 2005) but it can also be formalised or deliberately planned (Bruggeman & Van der Stede, 1993; Govindarajan & Gupta, 1985). However, it is unlikely that a purely emergent or a purely deliberate form of strategy will be found in practice. Mintzberg and Waters (1985, pp. 258–259) argued that “we would expect to find tendencies in the directions of deliberate and emergent strategies rather than perfect forms of either. In effect, these two form the poles of a continuum along which we would expect real-world strategies to fall”.

A significant number of empirical studies are, however, based on the deliberate variant of strategy. For example, in a recent study of UK organisations, Bhimani and Langfield-Smith (2007, p. 24) found that: “strategy development and implementation were relatively structured and formal activities in the companies investigated”. In line with this argument, this paper examines strategy as a deliberate or a formal plan of activity undertaken to enhance the competitiveness of a firm.

From this rational perspective, different strategy typologies have been adopted in analysing the relationship between strategy and MCS. For example, some studies have adopted Govindarajan and Gupta’s build–hold–harvest strategies (see for instance, Collins et al., 1997; Govindarajan & Gupta, 1985) and Simons’ prospector–analysers–defender strategies (see for instance Cadez & Guilding, 2008; Simons, 1987). However, Porter’s (1980) generic strategies of low cost and differentiation have remained the dominant typology used in the MCS literature (see for example, Auzair & Langfield-Smith, 2005; Bruggeman & Van der Stede, 1993; Govindarajan, 1988; Jermias & Gani, 2004; Langfield-Smith, 1997). Our analysis is based on Porter’s generic strategies for several reasons.

Apart from being the most empirically tested and proven to be a relevant description of how successful organisations operate (Kald et al., 2000), Porter’s generic strategy is also the most widely taught strategy option in China. Nie (2005) notes in this context that:

Michael Porter’s three generic business strategies ... are very popular and highly recommended in China. Indeed, this is reflected in the several repeated translations of Porter (1980, 1985) that are widely read by Chinese managers. The Chinese even call it the ‘competitive trilogy’...(p. 93).

We wanted to select a concept that the participants can easily understand (see Auzair & Langfield-Smith, 2005 for a similar argument) hence our choice of Porter’s typologies of low cost and differentiation.³ Porter (1980) argues that firms compete on the basis of pursuing either a low-cost (cost leadership) strategy or a differentiation strategy. Although Porter also identifies broad focus as a strategy, there is confusion as to whether this is a separate strategic option on its own: it has been argued that broad focus is not an explicit strategy. Thus, a firm pursuing a low-cost or differentiation strategy could decide either to focus on a particular segment of the market or to serve the broad market. Because of this confusion, researchers have tended to examine only the cost leadership strategy and the differentiation strategy as the main strategic options. As a result, the analysis in this paper focuses on the cost leadership and differentiation strategies.

A firm that adopts a cost leadership strategy sets out to become the low-cost producer in its industry and must find and utilise all sources of cost advantage (Porter, 1985). Cost advantage can come from different sources, such as the pursuit of economy of scale, proprietary technology, preferential access to raw material, etc. and will depend on the structure of the industry (Auzair & Langfield-Smith, 2005; Govindarajan, 1988). On the other hand, a firm adopting a differentiation strategy seeks to be unique in its industry along some dimensions that are widely valued by buyers. This firm must select one or more attributes that many buyers see as essential, and uniquely position itself to meet those needs. Differentiation may be based on several factors, such as the product itself, the delivery system, the marketing approach, etc. (Dess and Davis, p. 198). The characteristics of cost leadership and differentiation strategies are shown in Table 1.

Porter has been criticised for suggesting that cost leadership and differentiation strategies are alternatives (see for instance, Cooper, 1996). Porter (1985) had cautioned against a firm pursuing both strategies simultaneously on the grounds of competitive advantage

³ Auzair and Langfield-Smith (2005) also defended the use of Porter’s typology on the ground that there are similarities between the generic strategies and the prospector/defender typologies of Miles and Snow and the strategic mission of build and harvest (see also Kald et al., 2000 for a similar argument). For example, a cost leadership strategy has a similar attribute as defenders, and harvest strategies in that they have a conservative orientation and a differentiation strategy has a similar attribute as prospectors and build strategies in that they have an entrepreneurial orientation (see for instance Chenhall, 2003).

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