1.1 Introduction

Management control is important for organizations because failures in management control can lead to large financial losses, reputation damage, and possibly even to organizational failure.

Despite the importance of having good management control systems (MCSs), management critics have argued that adding controls does not always lead to better control and that the MCSs in common use cause managers to be excessively short-term oriented or are prone to stifle creativity and initiative.

An old narrow view of a MCS is that of a simple regulating system, involving a single feedback loop. This book takes a broader view and recognizes that some management controls are proactive rather than reactive. Proactive means that the controls are designed to prevent problems before the organization suffers any adverse effects on performance. The benefit of management control is that the probability that the firm’s goals will be achieved increases.

1.2 Management and control

Management literature includes many definitions of management. All relate to the processes of organizing resources and directing activities for the purpose of achieving organizational objectives. There are different functions, resources and processes of management:

|  |  |  |
| --- | --- | --- |
| Functions | Resources | Processes |
| Product/service development  Operations  Marketing/sales  Finance | People  Money  Machines  Information | Objective setting  Strategy formulation  Management control |

To focus on management control we must distinguish the concept objective setting and strategy formulation:

1. Objective setting: objectives do not have to be quantified and do not have to be financial. Employees must have some understanding of what the organization is trying to accomplish.
2. Strategy formulation: defines how organizations should use their resources to meet their objectives. It can be specified formally or left largely unspecified. Interaction between management and employees is important. Strategy can b0e intended or emergent.

Control systems have two basic functions:

1. Strategic control: the process of monitoring as to whether to various strategies adopted by the organization are helping its internal environment to be matched with the external environment. It allows managers to evaluate a company's program from a critical long-term perspective. (external focus)
2. Management control: include processes for planning, organizing, directing, and controlling program operations. (internal focus)

Management controls are necessary to guard against possibilities that people will do something the organization does not want them to do or fail to do something they should do (behavioral orientation).

1.3 Causes of management control problems

The causes can be classified into three main categories:

1. Lack of direction
   1. Employees do not know what the organization wants from them.
2. Motivational problems
   1. Individual and organizational objectives do not naturally coincide: individuals are self-interested.
   2. Employee fraud and theft are the most extreme examples of motivational problems.
3. Personal limitations
   1. They may be caused by a lack of requisite intelligence, training, experience, stamina, or knowledge for the task at hand.
   2. Some jobs are not designed properly.

1.4 Characteristics of good management control

Good control means that management can be reasonably confident that no major unpleasant surprises will occur. It must be future driven and objectives driven.

Out of control describes the situation where there is a high probability of poor performance.

Perfect control would require complete assurance that all physical control systems are foolproof and all individuals on whom the organization must rely always act in the best way possible. Control loss is the cost of not having a perfect control system. Optimal control can be said to have been achieved if the control losses are expected to be smaller than the cost of implementing more controls. Assessing whether good control has been achieved must be future oriented (no unpleasant surprises in the future)and objectives driven (because the goals represent what the organization wants). But still it is difficult and subjective to determine control as ‘good’.

1.5 Control problem avoidance

There are four avoidance strategies (to eliminate the possibility of control problems):

1. Activity elimination

Managers can sometimes avoid the control problems associated with a particular entity or activity by turning over the potential risks, and the associated profits to a third party. Transaction Cost Economics: whether specific activities (transactions) can be controlled more effectively through markets or internally.

1. Automation

The use of computers, robots, expert systems, and other means of automation to reduce their organization’s exposure to some control problems. Automation can provide only a partial control solution at best. Limitations are: feasibility, cost and the replacement of control problems with others.

1. Centralization

Centralize decision-making in some areas of their companies at specific points in the histories to improve control.

1. Risk sharing

Sharing risks with outside entities can limit the losses that could be incurred by inappropriate employee behaviors. Risk sharing can involve buying insurance to protect against certain types of large, potential losses the organization might not be able to afford. Or share risks with an outside party is to enter into joint venture agreement.

1.6 Control alternatives

If control problems cannot be avoided, management controls must be implemented. These are what is addressed in this book.

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CHAPTER B

Results controls are an indirect form of control because they do not focus explicitly on the employees’ actions.

Pay for performance is an example because it involves rewarding employees for generating good results. It is difficult to define what are ‘good’ results. However, they may create greedy and short-termism cultures. Results controls create meritocracies; the rewards are given to the most talented and hardest working employees. Results controls influence actions because they cause employees to be concerned about the consequences of the actions they take.

2.1 Prevalence of results controls

These controls are used for controlling the behaviors of employees at many organizational levels. But especially for professional employees with decision authority. Decentralization and the design of the incentive system are two critical organizational design (organizational architecture) choices in a results control context.

2.2 Results controls and the control problems

It is important that the results inform employees as to what is expected of them and encourages them do what they can to produce the desired results. Results controls are effective in addressing motivational problems and they can also address personal limitation problems and they can encourage all employees to address their limitations and to develop their talents to position themselves to earn the results-dependent rewards. The performance measures also provide some non motivational benefits of a cybernetic (feedback) nature. Management-By-Exception is investigating and intervening when performance is deviating from expectations (common in large firms).

2.3 Elements of results controls

The implementation requires four steps:

1. Defining performance dimensions

The goals that are set should be congruent with the measurements that are made and are important to shape employees’ view of what is important

1. Measuring performance

At higher organizational levels, most of the key results linked to rewards are defined in financial terms.

Lower-level managers are evaluated in terms of operational data that are more controllable at the local level.

In the middle of the organization, managers must translate financial goals to operational goals.

If more than one resulted is expected, weightings should be added.

1. Setting performance targets

Targets should be specified for every performance dimension that is measured. They affect behavior in two basic ways:

* Improve motivation by providing clear goals
* They allow employees to assess their own performance.

1. Providing rewards

The rewards can be in the form of anything employees’ value: salary increases, bonuses, promotions, job security, power and so on. Punishments are the opposite of rewards.

An extrinsic reward is an external reinforcement, which takes the form of a tangible item such as a trophy or money, or something intangible such as praise and public recognition.

An intrinsic reward gives an individual internal (personal) satisfaction such as that derived from a job well done.

The expectancy theory states that individuals’ motivational force is a function of (1) their expectancies or their belief that certain outcomes will result from their behavior and (2) their valences or the strength of their preference for those outcomes.

The motivational effects of the various reward forms can vary widely depending on individuals’ personal tastes and circumstances.

2.3 Conditions determining the effectiveness of results controls

Results controls work best only when all of the following conditions are present:

* Organizations can determine what results are desired in the areas being controlled
* The employees whose behaviors are being controlled have significant influence on the results for which they are being held accountable
* Organizations can measure the results effectively

1. Knowledge of desired results

Organizations must know what results are desired in the areas they wish to control, and they must communicate those desires effectively to the employees working in those areas.

Results desirability means that more of the quality represented by the results measure is preferred to less, everything else being equal. Different needs and tradeoffs are present in different parts of the organization. It is important that the combination of results and measures is congruent with the organization’s true objectives.

1. Ability to influence desired results (controllability principle)

The employees whose behaviors are being controlled must be able to affect the results in a material way in a given time period. Results measures are only useful if they provide information about the desirability of the actions that were taken. Uncontrollable factors hinder efforts to use results measures for control purposes and they are not effective.

1. Ability to measure controllable results effectively

The measure must evoke the right behaviors in a given situation. Results measures should be (next to congruent, controllable and cost efficient):

* Precise: the amount of randomness in the measure. Without it the measure loses much of its information value, it measures the risk of misevaluating performance.
* Objectivity: the freedom from bias.
* Timeliness: the lag between the employee’s performance and the measurement of results. Important because employees need consistent, short-term performance pressure to perform at their best (motivation reason). Second it increases the value of interventions that might be necessary.
* Understandability: the employees must understand what they are being held accountable for. This requires communication. They must also understand what they must do to influence the measure.

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CHAPTER C

Action controls involves ensuring that employees perform certain actions known to be beneficial to the organization. They are not effective in every situation. They are feasible only when managers know what actions are desirable and have the ability to ensure that the desirable actions occur.

Personnel controls are controls to make it more likely that employees will perform the desired tasks satisfactorily on their own because employees are experienced, honest, and hard working.

Cultural controls are controls to shape the organizational behavioral norms and to encourage employees to monitor and influence each other’s behaviors.

3.1 Action controls

This is the most direct form of management control because it involves taking steps to ensure that employees act in the organization’s best interest by making their actions themselves the focus of control.

There are four basic forms:

1. Behavioral constraints

This is a negative form of action control. These controls make it impossible, or at least more difficult, for employees to do things that should not be done.

A psychical constraint is for example a lock on a desk, passwords, and limits to areas.

An administrative constraint can be used to place limits on an employee’s ability to perform all or a portion of specific acts. An example is the restriction of decision-making authority or separation of duties (so that one person cannot perform the entire task). Separation of duties is required for good internal control but cannot prevent collusion (between different persons)

A poka-yoke is a step built into a process to prevent deviation from the correct order of steps; that is, where a certain action must be completed before the next step can be performed.

1. Preaction reviews

This involves the scrutiny of the action plans of the employees being controlled

1. Action accountability

This control involves holding employees accountable for the actions they take. For the implementation there are four things important:

* Defining what actions are acceptable or unacceptable
* Communicating those definitions to employees
* Observing or otherwise tracking what happens
* Rewarding good actions or punishing actions that deviate from the acceptable

Action controls are most effective if the desired goals are well communicated. The actions for which employees are to be held accountable can be communicated either administratively (rules, policies, contracts, codes of conduct) or socially. Actions can be tracked directly (supervision or monitoring) or by examining evidence.

1. Redundancy

This control involves assigning more employees (or machines) to a task than necessary. It increases the probability that a task will be satisfactorily accomplished.

3.2 Action control and the control problems

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Control problems | |  |  |
| **Type of action control:** | **Lack of direction** | **Motivational problems** | | **Personal limitations** |
| **Behavioral constraints** |  | X | |  |
| **Preaction reviews** | X | X | | X |
| **Action accountability** | X | X | | X |
| **Redundancy** |  | X | | X |

Action controls address one or more of the three basic control problems (see table)

3.3 Prevention versus detection

Controls that prevent the undesired errors and irregularities from occurring are, when they are effective, the most powerful form of control because none of the costs of the undesirable behaviors will be incurred. Detection controls are applied after the occurrence of the behavior. Most action controls are used for prevention. However, accountability controls are designed to motivate employees to behave appropriately, it cannot be verified whether the appropriate actions were taken until evidence of the actions is gathered.

3.4 Conditions determining the effectiveness of action controls

They are only effective when both of the following conditions exist to some extent:

1. Organizations can determine what actions are (un)desirable

2 ways: analyzing the actions/results patterns in a specific situation to learn what actions produce the best results or be informed by others.

1. Organizations are able to ensure that the (un)desirable actions (do not) occur

They must have the ability to ensure or observe that the desired actions are taken. The effectiveness of behavioral constraints and preaction reviews varies directly with the reliability of the physical devices or administrative procedures. ‘Management override’ is when management overrides otherwise effective controls and is one of the reasons of undetected fraud. Refer to the previous chapter for precision, objectivity, timeliness and understandability.

3.5 Personnel controls

This type of control builds on employees’ natural tendencies to control and/or motivate themselves.

Three basic purposes:

* They help ensure that each employee understands what the organization wants
* Some of them help that each employee is able to do a good job
* Some of the personnel controls increase the likelihood that each employee will engage in self-monitoring.

Self-monitoring pushes most employees to want to do a good job. It’s effective because most people have a conscience that leads them to do what is right.

Three major methods of implementing personnel controls:

1. Selection and placement of employees

Finding the right people to do a particular job and giving them both a good work environment and the necessary resources can increase the probability that a job will be done properly.

1. Training

This can provide useful information about what actions or results are expected and how the assigned tasks can best be performed.

1. Job design and provision of necessary resources

Make sure that the job is designed to allow motivated and qualified employees a high probability of success.

3.6 Cultural controls

This type of control is designed to encourage mutual monitoring; a powerful form of group pressure on individuals who deviate from group norms and values. They are most effective where members of a group have emotional ties to one another.

Cultures are build on shared traditions, norms, beliefs, values, ideologies, attitudes and ways of behaving.

A code of conduct is a set of rules outlining the responsibilities of or proper practices for an individual or organization. These formal, written documents provide broad, general statements of organizational values, commitments to stakeholders, and the ways in which management would like the organization to function.

Group rewards are rewards based on collective achievement. This also encourages cultural control. Examples are bonus, profit-sharing, or gain-sharing plans that provide compensation based on corporate or entity performance in terms of accounting returns, profits, or cost reductions. They are different from individual accomplishment (result controls) because the link between individual efforts and the results begin rewarded is weak.

Other common approaches to shape organizational culture:

* Intraorganizational transfers: help transmit culture by improving socialization of employees throughout the organization.
* Physical arrangements: office plans, architecture, social arrangements
* Tone at the top: their statements should be consistent with the type of culture they are trying to create and their behaviors should be consistent with their statements. Management can also set the wrong tone

3.8 Effectiveness of personnel/cultural controls

Personnel and cultural controls, which are sometimes referred to as soft controls, have become more important in recent years. Organizations have become flatter and leaner. They have several important advantages over results and action controls.

* They are usable in almost every setting
* Their costs is often lower than more obtrusive forms of controls
* They usually produce fewer harmful side effects

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CHAPTER D

The benefit of any MCS is derived from the increased probability that the firm’s goals will be achieved relative to without the MCS. Tighter MCSs should provide a higher degree of certainty that employees will act as the organization wishes. A firm can have tight or loose controls. Effective implementation of tight control requires that management has detailed and reasonably certain knowledge about how one or more of the control objects are related to the overall organizational objectives.

4.1 Tight results controls

The achievement of right results control depends on:

1. Definitions of desired results

For management control to be considered tight in a results control system, there are some requirements:

* Congruence: The results dimensions must be congruent with true organizational objectives
* Specificity: The performance targets must be specific
* Communication and internalization: The desired results must be effectively communicated and internalized by those whose behaviors are being controlled
* Completeness: The measures must be complete: only if good control is affected exclusively, or at least extensively, through results controls.

1. Performance measurement

Tight results control also depends on the effectiveness of the measures of performance that are generated. Results controls are likely to be tighter if rewards (or punishments) are directly and definitely linked to the accomplishment (or nonaccomplishment) of the desired results.

4.2 Tight action controls

Action controls systems should be considered tight only if it is highly likely that employees will engage consistently in all of the actions critical to the operation’s success and will not engage in harmful actions.

Behavioral constraints can produce tight control in some areas of the organization. Physical constraints usually cost more if there is more of them. Administrative constraints provide widely varying degrees of control. Restricting decision authority to higher levels provides tighter control if it can be assumed that higher-level personnel will make more reliable decision than lower-level personnel. Good separation of duties makes the control system tighter.

Preaction reviews are sometimes considered to be tight if the reviews are frequent, detailed, and performed by diligent, knowledgeable reviewers. They are typically tight in areas involving large resource allocations because many investments are not easily reversible and can, by themselves, affect the success or failure of an organization.

The amount of control generated by action accountability controls depends on:

* The characteristics of the definitions of desirable actions:

to achieve tight action accountability control, the definitions must be congruent, specific, well communicated and complete. Tight action control depends on the understanding and acceptance on the part of those whose behaviors are being controlled.

* The effectiveness of the action-tracking system:

Control can also be made tighter by improving the effectiveness of the action-tracking system. Employees who are certain that their actions will be noticed will be affected more strongly by an action accountability control system than will those who feel that the chance of being observed is small.

* Action reinforcement

Control can be made tighter by making the rewards and punishments more significant to the employees affected.

4.3 Tight personnel/cultural controls

In a few situations, MCS’s dominated by personnel/cultural controls can sometimes be considered tight. This is in charitable and voluntary organizations and in small family-run companies. Most of the time, the degree of control provided by the personnel/cultural controls is less than tight. Managers often use multiple forms of controls. Cultural controls are often more stable and strong because they derive from deeply held and widely shared beliefs and values.

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CHAPTER E

Direct cost in MSC’s are the cost of investing in MSC’s in return for one primary benefit: a higher probability that employees will both work hard and direct their energies to serve to organization’s interest.

Indirect costs are many times greater than their direct costs. Some are created by negative side effects others are caused by a poor MCS design or by an implementation of the wrong type of control for a give situation.

5.1 Direct/ out-of-pocket costs

This type of costs refers to the direct, monetary costs of implementing an MCS. These costs should affect decisions about whether the benefits of a particular type of control justify the costs and whether one or another form of control should be implemented.

5.2 Indirect costs

These include the following:

1. Behavioral displacement

This is a side effect that can subject organizations to significant indirect costs. It occurs whenever the MCS produces, and actually encourages, behaviors that are not consistent with the organization’s objectives. It is most common with results or action accountability where the specification of the results or actions desired is incongruent. But some forms of personnel/cultural control can also produce behavioral displacement.

In a results control system, behavioral displacement occurs when an organization defines sets of results measures that are incongruent with the organization’s true objectives. This happens when:

* managers have a poor understanding of the desired results
* managers over rely on easily quantified results: they concentrate on results areas that are concrete and quantifiable, rather than intangible, difficult-to-quantify results areas that may be even more important for organizational success. Employees then concentrate on the results that are rewarded by the control system.

A form of action control-related displacement is often referred to as means-end inversion. This means that employees pay attention to what they do while losing sight of what they are to accomplish. Action control-related displacement can occur because the defined actions are incongruent or because the action controls promote compliant but rigid, nonadaptive behaviors. The latter often happens in bureaucratic organizations. Action controls and bureaucratization can be good in stable environments with considerable centralized knowledge about what actions are desired because they help establish good, efficient work habits.

Behavioral control can also occur with personnel/cultural controls. It occurs when organizations recruit the wrong type of employees or provide the wrong training.

1. Gamesmanship

Gamesmanship refers to the actions that employees take to improve their performance indicators without producing any positive economic effects for the organization. There are two forms:

* Creation of slack resources:

Slack is the consumption of resources by employees that cannot be justified easily in terms of its contribution to organizational objectives. This often takes places when tight controls are in use. Budget slack is negotiating highly achievable targets that are deliberately lower than their best-guess forecast in the future. It protects managers against unforeseen contingencies and improves the probability that the budget target will be met. Slack is feasible only where there is information asymemetry.

Advantages:

* slack can reduce manager tension
* it can increase organizational resiliency to change
* can make available some resources that can be used for innovation

Disadvantages:

* slack obscures true underlying performance
* it distorts the decisions based on the obscured information
* Data manipulation:

It involves an effort on the part of the employee being controlled to look good by fudging the control indicators. Two basic forms:

* falsification: reporting erroneous data
* data management: any action designed to change the reported results.

Accounting methods are interventions in the measurement process and operating methods involve the altering of operating decisions.

1. Operating delays

Operating delays are an often-unavoidable consequence of the preaction review types of action controls and some of the forms of behavioral constraints. Where fast action is important, decisions delays can be quite costly. Bureaucracy can cause operation delays.

1. Negative attitudes

* Negative attitudes produced by action controls:

Most people react negatively to the use of action controls. Preaction reviews can be particularly frustrating if the employees being reviewed do not perceive the reviews as serving a useful purpose.

* Negative attitudes produced by results controls

They can also produce negative attitudes. Lack of employees’ commitment to the performance targets defined in the MCS can be a cause. Negative attitudes can also be caused by the measurement system (accountable for things they cannot control) or the rewards (not equitable).

Table: control types and possible harmful side effects

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CHAPTER F

6.1 Understanding what is desired and what is likely

A better understanding of objectives and strategies:

\* yields a larger set of feasible control alternatives

\* provides a better chance of being able to apply each alternative tightly

\* reduces the chance of creating behavioral displacement problems

What is desired is defined in terms of the actions desired. Knowledge of what is desired is most useful for management control purposes if it can be translated into knowledge of the specific demands on the roles of employees in the organization.

It is important to identify the key actions that must be performed in order to provide the greatest probability of success. Key results are the things that must go right for the business to succeed.

6.2 Decision 1: choice of controls (see table previous page)

The different types of management controls are not equally effective at addressing each of the management control problems.

In deciding among the many management control alternatives, managers should also consider on the personnel or cultural controls. These controls have relatively few harmful side effects and relatively low out-of-pocket costs. These controls are sufficient only if employees:

\* understand what is required

\* are capable of performing well

\* are supported by the requisite organizational structures and systems

\* are motivated to perform well without additional reinforcements provided by the organization

Advantages of action controls

* they are the most direct form of control
* they tend to lead to documentation of the accumulation of knowledge as to what works best
* they are an efficient way to aid organizational coordination
* they increase the predictability of actions and reduce the amount of interorganizational information flows required to achieve a coordinated effort

Disadvantages of action controls

* there is a severe feasibility limitation
* there is a tendency to focus on known or established actions of lesser importance that are easy to monitor, thereby potentially causing behavioral displacement
* they often discourage creativity, innovation, and adaptation because employees react to action controls by becoming passive.
* Action accountability, in particular, can cause sloppiness.
* They can cause negative attitudes
* Some action controls, particularly those that require preaction reviews, are costly.

Advantages of results controls

* feasibility, they can provide effective control even where knowledge as to what actions are desirable is lacking.
* Employees' behaviors can be influenced even while they are allowed significant autonomy.
* Usually yields greater employee commitment and motivation because higher-level personal needs are brought into play
* Can also provide on-the-job training. Employees can learn by doing and by making mistakes.
* They are often inexpensive

Disadvantages of results controls:

* results measures usually provide less than perfect indications of whether good actions had been taken because the measures failed to meet one or more of the qualities of good measures.
* When results are affected by anything other than the employee's own skills and efforts, results controls shift risk from owners to employees.
* The performance targets set as part of result control systems often fulfill two important, but competing, control functions:
* motivation to achieve: it is best for the targets to be challenging but achievable
* coordination: the targets should be a best guess to make sure they are achieved and no overcommitments of resources take place
* Not all employees like being empowered to produce results as they best see fit.

6.3 Decision 2: choice of control tightness

Should controls be tight or loose? Depends on three questions: what are the potential benefits of tight controls? What are the costs? Are any harmful side effects likely? Tight control is most beneficial in the most critical areas. The potential benefits of right controls is higher when performance is poor. Tight action controls would likely cause behavioral displacement and stifle creativity. Tight results controls would likely cause problems to select the right results measures and set adequately challenging targets.

Simultaneous tight-loose controls are also found to work. Tight control should then be used over the few key actions or results that have the greatest potential impact on the success of the organizations.

6.4 Adapting to change

Organizational growth pushes management controls in the direction of increased formalization of procedures for action accountability purposes and/or development of more elaborate information systems for results control purposes.

6.5 Keeping a behavioral focus

The benefits and side effects of management controls are dependent on how employees will react to the controls that are being considered. No one form of control Is optimal in all circumstances.

6.6 Maintaining good control

There are several causes of failures of MCS:

* An imperfect understanding of the setting and/or the effect of the management controls in that setting. This is often associated with rapid growth.
* Management inclination to subjugate the implementation of good management controls to other business demands.
* Some MCSs that are seemingly inadequate may actually be quite effective because they minimize some harmful side effects.

Controls that seem quite loose have some benefits: high creativity, a healthy spirit of cooperation or low cost.

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CHAPTER G

In financial results control systems, results are defined in monetary terms (revenues, costs, profits and returns). They have tree core elements:

1. financial responsibility: apportioning of accountability for financial results within the organization
2. planning and budgeting systems: used for control-related purposes
3. incentive contracts: the links between results and various organizational rewards.

Financial results control systems rely on internal controls, which ensure the reliability of the organization's information.

7.1 Advantages of financial results control systems

* financial objectives are paramount in for-profit firms
* financial measures provide a summary measure of performance
* most financial measures are relatively precise and objective.
* the cost of implementing financial results control is often small relative to that of other forms of management control.

7.2 Types of financial responsibility centers

These are responsibility centers in which individuals' responsibilities are defined at least partially in financial terms. Responsibility accounting is a reporting system that classifies accounting information about an organization's activities according to the managers who are responsible for them.

There are four basic types:

1. Investment centers

Managers are held accountable for the accounting returns on the investment made to generate those returns.

1. Profit centers

Managers are held accountable for profit, which is a measure of the difference between the revenues generated and the costs of generating those revenues. They are not accountable for the investments made to generate them. The financial goal of many profit centers is to break even.

1. Revenue centers

Managers are held accountable for generating revenues, which is a financial measure of output. Revenue, rather than profit, provides a simple and effective way to encourage sales and marketing managers to attract and retain customers. Most revenue centers are also held accountable for some expenses. Not a profit center because there is no profit calculation relating outputs and inputs.

1. Cost centers

Managers are held accountable for some elements of cost. Costs are financial measures of the inputs to, or resources consumed by, the responsibility center. In standard cost centers, the outputs are relatively easy to measure, and the causal relationship between inputs and outputs is direct and relatively stable. Control can be exercised by comparing standard cost with the cost that was actually incurred. In discretionary cost centers, the outputs produced are difficult to value in monetary terms. Control is usually exercised by ensuring that the cost center adheres to a budgeted level of expenditures while successfully accomplishing the tasks assigned to it.

A gross margin center is a variation of a profit center. The managers may be quite low-level salespeople who happen to sell products of varying margins. The profit measure gives them an incentive to sell higher margin products, rather than merely generating additional, possibly unprofitable, revenues.

The incomplete profit center managers do not have authority for all of the functions that affect the success of their products. Complete profit managers are accountable for all aspects of the worldwide performance of major business segments.

7.3 Choice of financial responsibility centers

See the tables on page 263 and 266 for the different responsibilities of the managers.

Decisions about an organization's structure do not necessarily precede decisions about the type of responsibility centers that should be used: the responsibility structure decision may come first.

7.4 The transfer-pricing problem

Transfer pricing refers to the pricing of transferred within an organization. It directly affects the revenues of the selling profit center, the costs for the buying profit center and the profits for both entities.

Purposes of transfer pricing (may be conflicting):

* provide the proper economic signals so that the managers affected will make good decisions.
* The transfer prices and subsequent profit measures should provide information that is useful for evaluating the performances of both the profit centers and their managers.
* They can be set to purposely move profits between firm locations. Managers might be motivated to use transfer prices to move profits between jurisdictions to minimize taxes.

These multiple transfer-pricing purposes often conflict. Transfer pricing interventions undermine the benefits of decentralization. They reduce profit center autonomy and cause decision-making complexity and delay.

Types of transfer pricing:

* based on market price:

this price could be the listed price of an identical product or service, the actual price the selling entity charges external customers, or the price a competitor is offering. Optimal in a perfectly competitive market. The selling profit centre should shut down if it cannot function using the market price and the selling profit centre should shut down i fit cannot function by paying the market price.

* Based on marginal costs:

Marginal costs approximated as the variable or direct costs of production. It provides poor information for evaluating the economic performance of either the selling or buying profit centers.

* based on the full costs

Costs of providing the product or service. Several advantages:

* they provide a measure of long-run viability
* full-cost transfers are relatively easy to implement
* they are not as distorting for evaluation purposes since the selling profit center is allowed to recover at least the full cost of production.
* Full cost plus a markup.

They allow the selling profit centers to earn a profit on internally transferred products and services. Not responsive to changes in market conditions.

* Negotiated price

Allow the selling and buying center managers to negotiate between themselves. Both profit centers have some bargaining power. Several problems:

* negotiation of the prices of a potentially large number of transactions is costly in terms of management time
* negotiation often accentuates conflicts between profit center managers.
* The outcome depends on the negotiating skills and bargaining power of the managers.

One other variation is to transfer at marginal costs plus a fixed lump-sum fee. The lump-sum fee is designed to compensate the selling profit center for tying up some of its fixed capacity for producing products that are transferred internally.

Advantages:

* it preserves goal congruence because additional unit transfers are made at marginal cost.
* It preserves information for evaluation purposes because the selling division can recover its fixed costs and a profit margin through the lump-sum fee.
* It stimulates intra-firm planning, coordination and communication because the selling and buying entities must discuss the bases for the lump-sum fee.

The major problem: managers involved must predetermine the lump-sum fee based on an estimate of the capacity that each internal customer will require in the forthcoming period. If this is incorrect the capacity will not be assigned to the most profitable uses.

In dual transfer prices the selling profit center is credited with the market price but the buying profit center pays only the marginal cost of production

Advantages:

* the managers of both the selling and buying profit centers receive proper economic signals for their decision-making.
* It almost ensures that internal transactions will take place

However, it can destroy the internal entities' proper economic incentives.

It is impossible to use two different multiple transfer-pricing methods and simultaneously serve both the decision-making and evaluation purposes because managers make decisions to produce the numbers for which they are being evaluated.

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CHAPTER H

Planning and budgeting systems produce written plans that clarify where the organization wishes to go (goals), how it intends to get there (strategies), and what results should be expected (performance targets).

8.1 Purposes of planning and budgeting systems

They serve four main purposes:

1. *Planning*: a powerful form of action control forcing managers to think about the future and make decisions in advance.
2. *Coordination*: forces the sharing of information across the organization
3. *Top management oversight*: occurs in the form of preaction reviews, as plans are examined, discussed, and approved before actions are taken at successively higher levels in the organization.
4. *Motivation*: plans and budgets become targets that affect manager motivation because the targets are linked to performance evaluations

8.2 Planning cycles

Three cycles:

1. Strategic planning:

the relatively broad processes of thinking about the organization's missions, objectives, and the means by which the missions and objectives can best be achieved. It involves analyzing the past and forecasts of the future. A complete, formal strategic planning process leads to definitions of the corporate diversification strategy and the strategies of all the strategic business units.

1. Capital budgeting:

Identification of specific action programs or projects to be implemented over the next few years and specification of the resources each will consume. The outcomes are almost always dependent on the track record, preparation, arguing skill, and political power of the managers involved.

1. Operating budgeting

Preparation of a short-term financial plan, a budget, usually for the next 5 years.

8.3 Performance target setting

Reviews that compare actual performance with plans and budgets can lead to improved understanding of what is and what is not working well. They also improve coordination and they provide important motivational benefits.

Types of financial performance targets:

1. model-based, historical, or negotiated:

engineered targets.◊Model-based targets: provide a prediction of the performance that should ensue in the upcoming measurement periods. When they are used in areas where activities are programmable (direct and stable causal relationship between inputs and outputs)

Historical targets: derived directly from performance in prior periods.

Negotiated targets: negotiated between superiors and subordinates.

Tight control is easiest to implement when targets are engineered because the link between effort and results is direct.

1. fixed or flexible

Fixed targets do not vary over a given time period. Flexible targets are changed according to the conditions faced during the period. Most of financial targets: fixed, at lower organizational levels: flexible.

1. internal versus external targets

Internally focused: managers consider what is possible within the organization and focus on period-over-period, continuous improvements. Externally focus: organization benchmarks its performance and practices with those of other organizations.

Two of the most important financial performance target issues are related to:

* the optimal amount of challenge in a target
* the proper amount of influence to allow subordinates in setting targets

Targets must be challenging, but achievable. Advantages of highly achievable budget targets:

* They increase managers' commitment to achieve the targets.
* It protects the organization against the costs of optimistic revenue projections.
* They are motivating; they make most managers feel like winners.
* They reduce the costs of organizational interventions by superiors.
* They reduce the risk of gameplaying.

How much influence should subordinates have in setting their financial targets?

Allowing them to participate in, and to have influence on, the process of setting their performance targets can have benefits:

* commitment to achieve the targets: they understand why the targets were set
* information sharing: sharing information about business possibilities and corporate preferences and resources.
* Cognitive: thinking about how best to achieve the targets.

Top-down target setting when:

* an activity or operation is programmable. No need to negotiate targets through some form of bottom-up process.
* Superiors have an excellent understanding; they exert greater influence on the final decisions about performance targets.
* Top-level managers have the information available for evaluating performance on a relative basis.
* Lower-level managers are not good at budgeting
* Lower-level managers are prone to impart biases into the budgets that cannot be controlled.

Managers must be careful that their subordinates commitment to achieve the targets is still there.

8.4 Variations in practice

Planning and budgeting system variations:

* planning horizon: number of years
* planning content: quantitative versus qualitative.
* Length and timing of planning processes:
* Planning updates
* Planning guidance

8.5 Criticism of companies' planning and budgeting processes

They claim that planning and budgeting processes:

* are rife with politics and gameplaying
* produce only incremental thinking, minor modifications to the plans and budgets prepared in the preceding periods, and are not responsive to changes in today's fast-moving economy
* centralize power in the organization and stifle initiative
* focus on cost reductions, rather than value creation
* separate planning from execution
* cause too many costs for too few benefits

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CHAPTER I

Incentive systems are important because they inform and remind employees as to what result areas are desired and motivate them to achieve and exceed the performance targets.

9.1 Purposes of incentives

Three types of management control benefits:

1. informational:

the rewards attract employees' attention and inform or remind them of the relative importance of often competing results areas. Effort-directing purpose.

1. motivational:

some employees need incentives to exert the extra effort required to perform tasks well. Effort-inducing purpose.

1. Attraction and retention of personnel:

Performance-dependent rewards are an important part of many employees' total compensation package.

Incentive systems also serve noncontrol purposes:

1. decreasing cash outlays when performance is poor
2. smoothing earnings – compensation expense is lower when profits are lower

9.2 Monetary incentives

Three main categories:

1. performance-based salary increases
2. short-term incentive plans: provide higher rewards for employees who make the largest contribution to the company. Cash payments based on performance measured over periods of one year or less: annual incentive pay, bonuses.
3. Long-term incentives: based on performance measured over periods greater than one year. Objective is to reward employees for their role in maximizing the firm's long-term value. Multiple forms:

* Stock option plans: the right to purchase a set number of shares of company stock at a set price during a specified period of time.
* Restricted stock plans: they eligible employees do not have to spend cash to acquire the stock, but selling the stock is restricted for a specified period of time contingent upon continued employment.
* Performance stock plans: to provide stronger incentives to maximize shareholder value by raising the bar for stock price improvements before the options become exercisable.
* Stock appreciation plans

9.3 Incentive system design

- Formula

It is important for incentive systems to have an incentive formula. Also a part can be subjective. Superiors sometimes leave contract terms implicit because they may not know how to describe the bases for the rewards or the weigthenings of importance. They want to keep the contract flexible, also to ensure that employees do not stop when the target is reached.

Employee risk can be decreased if it allows adjustments for factors outside of the employee’s control but increased if evaluation is based on different factors than assumed, if the evaluators are not trusted and if employees try to influence their evaluation.

* Shape of incentive

When the reward promises are formulaic, the link between rewards and the bases on which they are awarded is often determined by a rewards-results or incentives-performance function.

Lower cutoff / threshold: below some significant fraction of targeted performance, managers are promised no incentive compensation for performance.

Upper cutoff / cap: no extra rewards are provided for any additional performance above the cutoff.

- size of incentive

Variable pay should motivate and is likely to attract employees who are confident about their abilities. A risk premium (at-risk pay) should be offered if outcomes are not totally controllable by employees.

9.4 Criteria for evaluating incentive systems

For ideal motivation, a system of performance-dependent rewards:

1. The rewards should be valued.
2. The rewards should be large enough to have impact.
3. The rewards should be understandable.
4. The rewards should be timely.
5. The rewards should be durable.
6. The rewards should be reversible.
7. the rewards should be cost efficient

9.5 Group rewards

Group rewards are good when the tasks are mutually connected. However they can also create the free rider effect. Group rewards can produce a beneficial form of cultural control. Team members may monitor and sanction each other's behaviors and produce improved results.

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CHAPTER J

10.1 Value creation: the primary goal of for-profit organizations

The value concept is important for management control purposes because it indicates that employees can increase the value of the firm or entity in which they work by increasing the size of the future cash flows, by accelerating the receipt of those cash flows or by making them more certain or less risky. Economic value is the change in firm value over any given period.

10.2 Market measures of performance

Market measures of performance are based on changes in the market value of the firm or, if dividends are also considered, return to shareholders. You can measure the value created directly for any period as the sum of the dividends grated to shareholders in the measurement period +/- the change in the market value of the stock.

These measures are attractive because they provide direct indications of the amount of value that has been created or destroyed.

Advantages of market measures, if they are measured in terms of recent transaction prices: the values are:

* available on a timely basis (for publicly traded firms)
* accurate
* can be measured precisely
* usually objective and not manipulable
* understandable
* cost effective, they do not require any company measurement expense.

There are also some limitations of market measures:

* feasibility constraint, not available for privately held firms or wholly-owned subsidiaries or divisions and nonprofit organizations
* controllability problems, they can be influenced by only the top managers
* they are not always reflective of realized performance.
* Potential congruence failure, they cannot reflect information that is not available to it.

Basing rewards on stock market valuations if employees cannot influence those values will have no effect on the employees' behaviors. Stock market valuations are affected by many factors that the managers cannot control. For example: macroeconomic activity, interest rates, factor prices, exchange rates and the actions of competitors.

Relative performance evaluations are used to improve market measures to make them more reflective of the controllable elements of performance.

10.3 Accounting measures of performance

2 basic forms:

- residual measures (accounting profit measures): net income, operating income, EBITDA, residual income

- ratio measures (accounting return measures): ROI, ROE, return on net assets, risk adjusted return on capital.

Advantages, accounting measures:

* can be measured on a timely basis relatively precisely and objectively. Short-term performance
* compared to other quantities, accounting measures are relatively congruent with the organizational goal or profit maximization. They are designed to provide a better matching of cash inflows and outflows. Correlations between accounting profits and changes in stock prices are positive.
* are largely controlled by the managers whose performances are being evaluated
* are understandable
* are inexpensive

Accounting income does not reflect economic income perfectly, because accounting measures:

* correlations between annual accounting profits and stock price are positive, but small
* meaningless in start-up firms.
* Accounting profit is highly dependent on the choice of measurement method.
* Accounting profit is derived from measurement rules that are often conservatively biased.
* Profit calculations ignore some economic values and value changes that accountants feel cannot be measured accurately and objectively.
* Profit ignores the costs of investments in working capital.
* Profit reflects the cost of borrowed capital but ignores the cost of equity capital.
* Accounting profit ignores risk and changes in risk
* Profit focuses on the past.

Accounting measures do not reflect well changes in entities’ economic values, particularly in shorter measurement windows.

* 1. Investment and operating myopia

Investment myopia is the fact that holding managers accountable for short-term profits and returns induces managers to reduce or postpone investments that promise payoffs in future measurement periods, even when those investments clearly have a positive NPV.

Operational myopia: making operational decisions to shift income across periods, even when harmful long-term

It comes from two problems with accounting measures: their conservative bias and their ignoring of intangible assets with predominantly future payoffs.

Managers are motivated to produce accounting profits and returns and to make no investments. They reduce expenses in the current period and do not suffer the lost revenue until future periods.

Channel stuffing is a trick whereby near-term sales are boosted by extending lower prices to distributors encouraging them to load up while potentially hurting later sales.

Investment myopia occurs only in businesses where investments are being made in the future.

10.5 Return-on-investment measures of performance

Managers in divisionalized organizations are held accountable for profit of some form of accounting return on investment (ROI). An organization is decentralized when authority for making decisions is pushed down to lower levels in the organization. All divisionalized organizations are decentralized. Not all decentralized organizations are divisionalized. When decentralization is effected along functional lines of authority, the responsibility centers are usually cost and revenue centers, not profit or investment centers.

Advantage of divisionalization: Local managers become experts in their specialized markets, and they are able to make good decisions more quickly. They are highly motivated because they control their own success to a significant extent.

ROI is a ratio of accounting profits earned by the division divided by the investment assigned to the division.

Advantages ROI:

* They provide a single, comprehensive measure that reflects the tradeoffs managers must make between revenues, costs and investments
* They provide a common dominator that can be used for comparing returns on dissimilar businesses.
* Because they are expressed in percentage terms, they give the impression that ROI figures are comparable to other financial returns. (sometimes false)
* All managers understand both what the measures reflect and how they can be influenced because ROI measures have been in use for so long in so many places

Problems with ROI:

* The numerator in the ROI measure is accounting profit. (all the limitations of profit measures)
* Tendency for the measures to induce suboptimatization. It encourages managers to make investments that make their divisions look good even though those investments are not in the best interest of the corporation.
* They provide misleading signals about investment centers’ performance because of difficulties in measuring the fixed asset portion of the denominator. The asset values reflected on the balance sheet do not represent the real value of the assets available to mangers for earning current returns. ROI measures create incentives for managers to lease assets, rather than buying them. Leased assets accounted for on an operating-lease basis are not recognized on the balance sheet, so they are not included in the ROI denominator.

10.6 Residual income measures as a possible solution to the ROI measurement problems.

The use of a residual income measure overcomes the suboptimatization limitation of ROI. It is calculated by subtracting from profit a capital charge for the net assets tied up in the investment center. The capital is charged at a rate equal to the weighted average corporate cost of capital.

Residual income measures solve the suboptimization problem because the charge can be made equal to the corporate investment cutoff rate of return.

Economic value added (EVA) = modified after-tax operating profit – (modified total capital x weighted average cost of capital).

Modified after-tax operating profit: reflects the capitalization and subsequent amortization of intangible investments.

Modified total capital: fixed assets, working capital and the capitalized intangibles.

Weighted average cost of capital: reflects the weighted average cost of debt and equity financing.

EVA reflects the results of a summation of transactions completed during the period and focuses on the past, while economic income reflects changes in future cash flow potentials.

EVA measurement limitations:

* Accuracy problems
* Does not solve any of the controllability problems
* Understandability problems
* Quite expensive

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CHAPTER K

Myopia is a dysfunctional side effect of financial results control systems, it is the tendency to focus on the short term.

11.1 Pressures to act myopically

Managers must be made to understand how the stock market reacts to earnings announcements. Managers believe that the stock market reacts forcefully to every public earnings announcement, even quarterly disclosures. That’s why managers try to maintain a smooth, steady earnings growth pattern. The two most common forms of earnings management:

* Myopia
* Gamesmanship

The stock market is generally not short-term oriented. The stock market is not myopic. The stock market’s horizon is relatively long.

There are six remedies to the myopia problem:

11.2 Measure a set of value drivers: combination-of-measures systems

Focus also on other performance measure that are more future-oriented and use also nonfinancial performance measures.

Most widely-publicized combination-of-measurement system: balanced scorecard. It proposes a combination of short-term measures and leading indicators framed in four perspectives:

1. Financial perspective: how do we look to shareholders? Measured by: operating income, ROE
2. Customer perspective: How do our customers see us? Measured by: on-time delivery and percentage of sales from new products
3. Internal perspective: what must we excel at? Measured by: cycle time, yield, efficiency
4. Innovation and learning perspective: can we continue to improve and create value? Measured by: time to develop next generation, new product introductions vs. competition.

Market measures are best suited for use at top management levels of publicly traded firms only.

11.3 Measure changes in shareholder value directly

Try to measure economic income or shareholder value creation directly by estimating future cash flows and discounting them to the present value.

Measurement precision and objectivity are still significant stumbling blocks to the use of direct measures of economic income.

11.4 Control investments with preaction reviews

Use financial result controls to reward improvements in short-term operating performance only.

The cost of longer-term investments are considered below the income statement line for which the managers are held accountable, so managers have no pressure to cut these investments to boost short-term profits.

Distinguish operating expenses, necessary to produce current period revenues, and developmental expenses, incurred in order to generate revenues in future periods.

Distinguish today businesses, managers are charged with making their business lean, efficient and profitable while they defend it against competitors, and tomorrow businesses, managers are charged with inventing new businesses that will augment or replace the existing today businesses.

Today businesses: controlled through tight financial result controls. Tomorrow businesses: controlled with a combination of nonfinancial performance indicators and action controls.

Two major limitations:

* No clear distinction exists between operating expenditures and developmental expenditures.
* It passes final decisions about which developmental expenditures to fund to corporate management.
  1. Use improved accounting profit measures

Make the accounting income measures more congruent with economic income.

* Adjust depreciable lives of fixed assets, adopt current value depreciation, charge depreciation for older assets
* Capitalize expenditures related to long term investments
* Recognize profits more quickly
* Impute a cost of equity on income statement
* Put leases on the balance sheet

These improvements are not without their costs. There are added processing, reporting, and reconciliation costs and possible costs of confusion that might not be inconsequential.

* 1. Extend the measurement horizon (use long-term incentive plans)

The longer the period of measurement, the more congruent are the accounting measures of performance with economic income. Long-term incentive plans can be a solution.

Basing incentives on stock market valuations can lengthen mangers’ decision-making horizon if managers believe that the stock market is forward looking: if the stock market considers performance beyond a quarter or a year.

Extending the period of measurement can avoid some of the congruence problems of accounting measures of performance. The payoffs must be potentially quite lucrative for the individual. To provide a better short-term/long-term balance, and thus to reduce a myopia problem, the rewards based on long-term performance must be much larger than those based on short-term performance.

* 1. Reduce pressure for short-term profit

Relax the pressure for generating short-term profits. The reductions in pressure can be communicated in two ways:

* The weighting placed on the profit targets can be reduced.
* The short-term profit targets can be made easier to achieve.

The danger is that managers lose the concentration on short-term results without focusing more on longer term targets.

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CHAPTER L

The controllability principle: people should held accountable only for what they control. Employees should not be penalized for bad luck or given extra rewards for good luck. Many important result measures are only partially uncontrollable.

12.1 The controllability principle

When employees are hold accountable for uncontrollable factors, the organization bears the costs of doing so because the vast majority of employees are risk averse. Employees like their performance-dependent rewards to stem directly from their efforts and not be affected by the vagaries of uncontrollables.

Risk aversion is the basis for the primary argument supporting the controllability principle. Owners are risk neutral because they can diversify their portfolios through elaborate financial markets set up for exactly that purpose. The owners’ rewards stem directly from the risk-bearing function they perform.

12.2 Types of uncontrollable factors.

Types of factors:

1. Economic and competitive factors.

Profit is affected by many factors that change and every other results measure can be affected by multiple, uncontrollable factors. Most evaluators do not buffer managers completely from changes in economic and competitive factors, although they might take steps to have the organization share some of the risk with the managers.

1. Acts of nature:

These are large, unexpected, one-time, totally uncontrollable events, such as hurricanes, earthquakes, floods.

1. Interdependence

It signifies that an organization’s or an individual’s area is not completely self-contained, and thus, the measured results are affected by others within the organization. Three types:

* Pooled interdependencies: where a firm’s entities use common resources or resource pools. Low when entities are relatively self-contained.
* Sequential interdependencies: when the outputs of one entity are the inputs of another entity. High: vertically integrated firms.
* Reciprocal interdependencies: organizational entities both produce outputs used by other entities and use inputs from them.

Interventions from higher-level management: higher-level managers can force a decision on a lower-level manager and in so doing significantly affect a results measure linked to one or more forms of rewards.

12.3 Controlling for the distorting effects of uncontrollables

Managers can reduce some of the distorting effects by either of both of two complementary approaches.

* Before the measurement period begins, they can define the results measures to include only those items that employees can control or at least influence.
* After the measurement period had ended, they can calculate and adjust for the effects of any remaining uncontrollable factors.

Controlling for uncontrollables before the measurement period:

* Purchasing insurance
* Design of responsibility structures: hold employees accountable for the performance areas you want them to pay attention to.

Controlling for uncontrollables after the measurement period:

* Variances analyses:

A technique developed to explain how and why two numbers are different. They are used to explain why actual results are different from predetermined standards, budgets or expectations. They have two purposes:

* Segregate some uncontrollable factors form the controllable factors causing actual results to be different from plan.
* Isolate certain controllable performance factors from others so that specific individuals can be held accountable for them.
* Flexible performance standards:

The performance that employees are expected to achieve given the actual conditions faced during the measurement period.

* Relative performance evaluation:

Employees’ performances are evaluated not in terms of the absolute levels of the results they generate, but in terms of their results relative to each other or relative to those of their closest outside competitors.

* Subjective performance evaluations:

They take into consideration all the logic embodied in the objective methods of adjusting for uncontrollables. They can correct for flaws in the results measures. Popular with evaluators because they provide a significant source of power over their subordinates. However, it is likely to be biased and often leads to inadequate feedback about how performance was evaluated. Employees often do not understand or trust them. Subjective performance evaluations are expensive in management time.

12.4 Other uncontrollable factor issues

Issues when considering adjustments for uncontrollables:

* The purpose for which adjustments are made.
* Direction of adjustments. Only protect employees from suffering from bad luck, but not to protect the owners from paying out undeserved rewards for good luck.

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CHAPTER M

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed.

Corporate governance is broader than management control, also covering control over top management. Corporate governance focus is on controlling the behaviours of top management, and through their direction, those of all the other employees in the firm.

Two corporate governance orientations:

* Anglo-American system: focuses on the primacy of shareholders as the beneficaries of fiduciary duties
* Continental European/Japanese system: a broader concern for the rights of other stakeholders.

13.1 The Sarbanes-Oxley act of 2002

Sarbanes-Oxley is the most significant piece of legislation affecting corporate governance practices to be passed in the US since the Securities Act of 1934, and it has control implications beyond US borders.

The goal was to improve the transparency, timeliness, and quality of financial reporting. Regulation of auditing, independence of audit committees, in-control rules (related to effectiveness of these controls)

It will increase control costs, but is not a safeguard to failures (day-to-day ethical behaviour is a management matter).

Section 404 mandated an evaluation of the effectiveness of a company’s internal controls by both management and the company’s external auditor and formal written opinions about the effectiveness of those controls.

13.2 Boards of directors

Boards of directors have a fiduciary duty to foster the long-term success of the corporation for the benefit of shareholders, and also sometimes for debt holders. Elements:

1. Duty of care – duty to make/delegate decisions in an informed way
2. Duty of loyalty – duty to advance corporate over personal interests
3. Duty of good faith – duty to be faithful and devoted to the interests of the corporation and its shareholders
4. Duty not to waste – duty to avoid deliberate destruction of shareholder value.

Boards must be independent and accountable to shareholders, and they must exert their authority for the continuity of executive leadership with proper vision and values.

Two main control responsibilities:

* Safeguard the equity investors’ interest, particularly by ensuring that management seeks to maximize the value of the shareholders’ stakes in the corporation.
* Protect the interests of other corporate stakeholders by ensuring that the employees in the corporation act in a legally and socially responsible manner.

Most boards have at least the following standing committees: audit committee, compensation committee, and nominating and governance committees.

13.3 Audit committees

They provide independent oversight over companies’ financial reporting processes, internal controls, and independent auditors. They enhance a board’s ability to focus intensively and relatively inexpensively on the corporation’s financial reporting-related functions.

Audit committees must be comprised of at least three independent members. An audit committee charter must specify the scope of the committee’s responsibility and how it carries out those responsibilities. They must be directly responsible for the appointment, compensation, retention and oversight of the work of the external auditors.

13.4 Compensation committees

They deal with issues related to the compensation and benefits provided to employees, and particularly top executives. They have fiduciary responsibilities for ensuring that the company’s executive compensation programs are fair and appropriate to attract, retain, and motivate managers and that they are reasonable in view of company economics and the relevant practices of comparable companies.

Those committees rely on the company’s HR function for staff support.

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CHAPTER N

Controllers and auditors serve roles within the firm, such as corporate, group, and division controllers and internal auditors. They have two important roles:

1. Management service: helping line managers with their decision-making and control functions, to create value for the owners.
2. Oversight: ensuring that the actions of everyone in the organization, and especially the managers, are legal, ethical, and in the best interest of the organization and its owners.

14.1 Controllers

In large firms, the finance/accounting related functions are typically divided between two roles:

* Treasurer: deals primarily with raising and managing capital. This function is highly centralized.
* Controller: deals primarily with financial record keeping, reporting and control. May be centralized but often decentralized.

Controllers play key roles in line management and in the design and operation of a MCS. They are the financial measurement experts within their firm.

Roles controllers must play:

* highly involved in helping managers make good business decisions
* entity’s chief accountant: prepare performance reports and fulfill financial, tax, and government reporting obligations. They establish and maintain internal control systems that help ensure both the reliability of information and the protection of the company’s assets.
* Must stay independent of their entity’s managers.
* Fiduciary responsibility: ensure that the information reported from their operation unit, is accurate and that the unit’s internal control systems are adequate.
* Management oversight responsibility to inform others in the organization if individuals in their organization are violating laws or ethical norms.

Organizational features that can be implemented to ensure that controllers fulfill their management oversight and fiduciary duties effectively:

* Audit committees of boards of directors and internal auditors can be used to oversee the controller function.
* Controllers behaviors can be shaped through personnel or cultural controls. Training programs can be used to remind controllers of their multiple responsibilities and to give them the interpersonal skills useful in maintaining the proper balance between their management service versus management oversight and fiduciary roles.
* Designing incentive systems that do not create temptation
* Solid-line reporting: the business-unit controller’s primary reporting relation is to the corporate controller. This is designed to reduce the emotional attachment between business-unit controllers and the operating units to which they are assigned.

14.2 Auditors

An audit is a systematic process of:

1. objectively obtaining and evaluating evidence regarding objects of importance,
2. judging the degree of correspondence between those objects and certain criteria
3. communicating the results to interested users

External auditors are independent of management because they are employed by professional service firms.

Internal auditors are employees of the company they are auditing.

*Common audit types*

In a *financial audit*, independent, external auditors are asked to express an opinion as to whether the financial statements prepared by the management are fairly presented in accordance with GAAP. It provides a tool by which outside regulators can enforce standards for the preparation and presentation of accounting information to interested parties who are outside the organization.

In a *compliance audit*, the auditors are asked to express an opinion only as to whether actual activities or results are in compliance with the established standards. Many frauds and irregularities are uncovered by compliance audits.

*Performance audits* are used to provide an overall evaluation of the general performance, or some specific aspect of the performance of an activity, department, or company, and its management.

Audits create value in two ways:

* the audit report adds credibility to the information provided to user groups.
* The anticipation of the audit. Everyone performs better if they know someone is looking over their shoulder.

The greater the potential consequences, the greater the potential value of the audit. Audits are also potentially more valuable where other control mechanisms are not feasible.

Limitations and disadvantages:

* They are done only on a periodic basis and thus provide little protection against problems occurring in the interim except to the extent that they provide a deterrent effect.
* Audits can create negative reactions.
* Audits are costly.

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CHAPTER O

Ethics seeks to address questions about morality; that is, about concepts like good and bad, right and wrong. Ethics is important for managers involved with MCSs because ethical principles can provide a useful guide for defining how employees should behave.

Ethics is a difficult subject for managers to understand: most managers’ basic discipline training is in economics. Rational people should act to maximize their own self-interest and the primary purpose of employees in for-profit organizations is to maximize shareholder value.

15.1 The importance of good ethical analyses

Unethical behaviors are costly to individuals, organizations, markets and societies. They create a need for extra laws and standards from governments and regulatory agencies, and extra rules, reviews, or supervision within organizations.

To control unethical behaviors within an organization, managers need well developed ethical reasoning skills. Managers need moral expertise to make good ethical judgments. Training sessions, codes of conduct, and credos help employees identify and think through ethical issues. Managers should serve as moral exemplars: role models.

15.2 Ethical models

Four common cited ethical models:

1. Utilitarianism

The rightness of actions is judged solely on the basis of their consequences. An action is morally right if it maximizes the total of good in the world; that is, if it produces at least as much net good as any other action that could have been performed.

Limitations:

* Quantifying net good is difficult because the benefits of some actions or decisions are difficult to measure, aggregate, and compare across individuals.
* Using utilitarian-type thinking makes it easy to sacrifice the welfare of a few individuals for the good of a larger number.

1. Rights and duties

Every individual has certain moral entitlements in virtue of their being human. Every right that an individual has creates a duty for someone else to provide, or at least not to interfere.

Limitations:

* Difficult to get agreement as to what rights different individuals or groups of individuals should have because rights can proliferate, and they can conflict.

1. Justice/fairness

People should be treated the same way except when they are different in relevant ways.

Limitations:

* It is easy to ignore effects on both aggregate social welfare and specific individuals.

1. Virtues

Integrity, loyalty, and courage. Individuals with integrity have the intent to do what is ethically right without regard to self-interest. Loyalty is faithfulness to one’s allegiances. Courage is the strength to stand firm in the face of difficulty or pressure.

15.3 Analyzing ethical issues

Good ethical behavior needs to be guided by more than people’s opinions, intuitions, or good feel. The following steps should be present in any ethical analysis:

1. Clarify the facts
2. Define the ethical issues
3. Specify the alternatives
4. Compare values and alternatives
5. Assess the consequences
6. Make a decision

15.4 Why do people behave unethically?

There are four basic reasons:

1. Some people are just basically dishonest.
2. Moral disengagement: no foundation in ethics.
3. Some people who recognize ethical issues develop rationalizations to justify their perhaps unethical behaviors.
4. Some people who are well trained in ethics and who know they are doing something wrong are not able to stop because they lack moral courage; the strength to do the right thing despite fear of the consequences.

15.5 Some common management control-related ethical issues

Four common management control-related ethical issues:

* Creating budgetary slack:

Managers negotiate about performance targets and they want to distort their positions in order to be given more easily achievable targets. Managers at all levels of the organization negotiate for slack in their budgets, and everyone is aware of the behavioral norm.

* The ethics of managing earnings

Any action that changes reported earnings while providing no real economic advantage to the organization and, sometimes, actually causing harm. They are designed to:

* Boost earnings
* Smooth earnings: to give the impression of higher earnings predictability and, hence, lower corporate risk.
* Reduce earnings: save profits for a future period when they might be needed or to lower the stock price to facilitate a management buyout.

Unethical because:

* Most of the actions are not apparent to either external or internal users of financial statements. Those engaging in earnings management may be deriving personal advantage through deception.
* Many people believe that professional managers and accountants have a duty to disclose fairly presented information.
* Distortions can be interpreted as not being consistent with managers’ and accountants’ integrity obligations to be honest, fair and truthful.
* The rewards earned from managing earnings are not fair when the reported performance is only cosmetic, not real.
* The ethics of responding to flawed control indicators

When the targets and prescriptions are not defined properly, they can actually motivate behaviors that employees know are not in the organization’s best interest.

* The ethics of using control indicators that are ‘too good’

15.6 Spreading good ethics within an organization

Corporate specialists develop lists of specific standards, rules, and regulations embodying good ethical principles. They communicate these lists either through corporate policies and procedures manuals, corporate codes of conduct, or less formal sets of memoranda.

Managers have to make sure that the employees follow the rules. Top-level managers must set a good tone at the top, and they must endeavor to maintain a good internal MCSs so that potential violators know there is a high probability they will be caught.

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CHAPTER P

There are no universal best control systems that apply to every situation in all organizations.

Figuring out the relevant aspects of the situational context and their effects on MCS elements is difficult because:

1. Many of the factors are related
2. Many of the factors interact with each other to produce MCS-related effects

16.1 Environmental uncertainty

Environmental uncertainty refers to the broad set of factors that, individually and collectively, make it difficult or impossible to predict the future in a given area. It can stem from changes in natural conditions, the political and economic climate, or the actions of competitors, customers, suppliers, and regulators.

It has some powerful effects on MCSs: it makes action controls difficult to use: These controls are effective only if there is knowledge as to which actions are desirable and if those actions are consistently desirable. Results controls can be used even in highly uncertain settings, as employees can be rewarded for generating more of what is known to be desirable.

Also difficulties for results control:

* results controls are not effective when employees do not understand how to generate the desired results. Uncertainty often hinders their abilities to know.
* Even when employees know ho to do better, results controls will not be optimally effective unless properly challenging performance targets are set. In uncertain situations it's almost inevitable that targets will be too easy or too difficult.
* Uncertainty combined with the use of results controls causes employees to bear business risk.
* High uncertainty tends to have some broad effects on organization structures and decision-making and communication patterns, and these effects increase the complexity of the management task.

16.2 Organizational strategy

Two levels of strategy:

1. Corporate diversification strategy

Determines what businesses it wants to be in and how resources should be allocated among those businesses. Viewing them from related to unrelated diversification:

* related diversification: operational synergies based on a common set of core competencies
* unrelated diversification: connection between businesses is purely financial.
* Single business firms: one line of business

|  |  |  |  |
| --- | --- | --- | --- |
|  | | **Single/related business** | **Unrelated diversified** |
| **Budgets** | Control of SBU manager over budget formulation | Low ? | High |
| **Budgets** | Importance attached to meeting the budget | Low ? | High |
| **Incentives** | Bonus criteria | Financial and nonfinancial criteria | Primarily financial criteria |
| **Incentives** | Bonus determination | Primarily subjective or discretionary | Primarily formula-based |
| **Incentives** | Bonus basis | SBU + corporate performance | Primarily SBU-performance |

1. Business competitive strategy

Defines how a firm or entity within the firm chooses to compete in its industry and tries to achieve a competitive advantage relative to its competitors. Two primary competitive strategies:

* cost leadership: This strategy emphasizes efficiency. By producing high volumes of standardized products, the firm hopes to take advantage of economies of scale and experience curve effects. The product is often a basic standardized product that is produced at a relatively low cost and made available to a very large customer base.
* Differentiation: the creation of a product or service that customers perceive as uniquely differentiated from competitor's offerings.

Competitive strategy should be directly related to the results measures included in a results control system.

Cost leadership: control employees' behaviors through relatively tight, formal financial controls and standardized operating procedures.

Differentiation: a more informal control system, a participative decision-making environment, and they should reward employees and managers based on any of a number of forward-looking, nonfinancial performance indicators.

16.3 Multinationality

Multinational organizations (MNOs) operate in more than one country. They must understand how they must adapt their management practices to make them work in each of their international locations.

Problem with MNOs: they are organized not only by function and product line, but also by geography.

Three sets of factors that affect MCS choices or outcomes across countries in a systematic manner:

1. National culture

The collective programming of the mind that distinguishes the members of one group or society from another.

People's tastes, norms, values, social attitudes, religions, personal priorities and responses to interpersonal stimuli differ across nations.

Hofstede four cultural dimensions:

* individualism vs collectivism: incentives based on individual vs group performance. Degree of engaging in myopic, self-centered behavior.
* power distance: degree of centralization in decision-making, degree of participation in setting performance targets.
* Masculinity: degree of performance-based rewards.
* Uncertainty avoidance: degree of subjectivity in performance evaluations, degree of formality in planning / budgeting processes.

1. Local institutions

Social, government, and legal institutions vary significantly across nations. Accounting regulations differ dramatically across countries.

1. Local business environments

Business environments also differ significantly across countries. Elements of these environments can affect:

* environmental uncertainty: risk differs across countries because of the stage of economic development. Government activities also affect business risk.
* Inflation: affect the relative values of currencies, create financial risk.
* Personnel availability, quality and mobility (talent): when employees are not highly educated, decision-making structures are usually more centralized, and MCSs tend to be more focused on action controls, rather than results controls.

1. Foreign currency translation:

Local managers bear foreign currency translation risk if their performance is measured home-country currency.

Can subsidiary managers control this risk?

* they have the authority to make significant cross-border investments, product sourcing, or marketing decisions.
* Authority to write purchasing of sales contracts denominated in one currency or another.
* Authority to make foreign exchange transactions (hedging, swaps or arbitrage)

If the managers of their foreign entities should not bear the foreign exchange risk:

* evaluate manager in local currency
* treat foreign exchange losses and gains 'below' the line
* calculate foreign exchange variance and treat is as uncontrollable
* flex the budget to end-of-year currency rates.

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CHAPTER Q

17.1 Differences between for-profit and nonprofit organizations

Purpose of a nonprofit organization: to provide some kind of public service. They have to generate revenues to fund their operations.

17.2 Goal ambiguity and conflict

MCSs should be designed to enhance the probability that the organization's goal will be achieved, and assessments about MCS effectiveness should be predicated upon judgments of the likelihood goal achievement.

No goal clarity in many nonprofit organizations: their values and interests conflict. Without clarity it is difficult to judge how well the MCS is performing.

17.3 Difficulty in measuring performance

The degree of achievement of the organization's overall goals cannot be measured in financial terms.

17.4 Accounting differences

Nonprofit organizations use other accounting standards than profit organizations. Most nonprofit organizations use fund accounting: it separates resources restricted for different purposes from each other. Each fund has its own set of financial statements.

17.5 External scrunity

Nonprofit organizations have to answer to a number of external constituencies.

17.6 Legal constraints

Many nonprofit organizations face legal constraints that are more extensive than those faced by for-profit organizations. Specific laws and conditions attached to the revenues they raise and also disclosures, regulatory oversight, and legislation regarding the compensation of their executives and employees.

17.7 Employee characteristics

The size of the compensation packages of employees in nonprofit organizations are not competitive with those offered at for-profit organizations: can cause control problems if employee quality is diminished.

Many non-profit organizations tend to attract employees who are highly committed to their organization's goals. This minimizes the other control problems: lack of direction and lack of motivation.