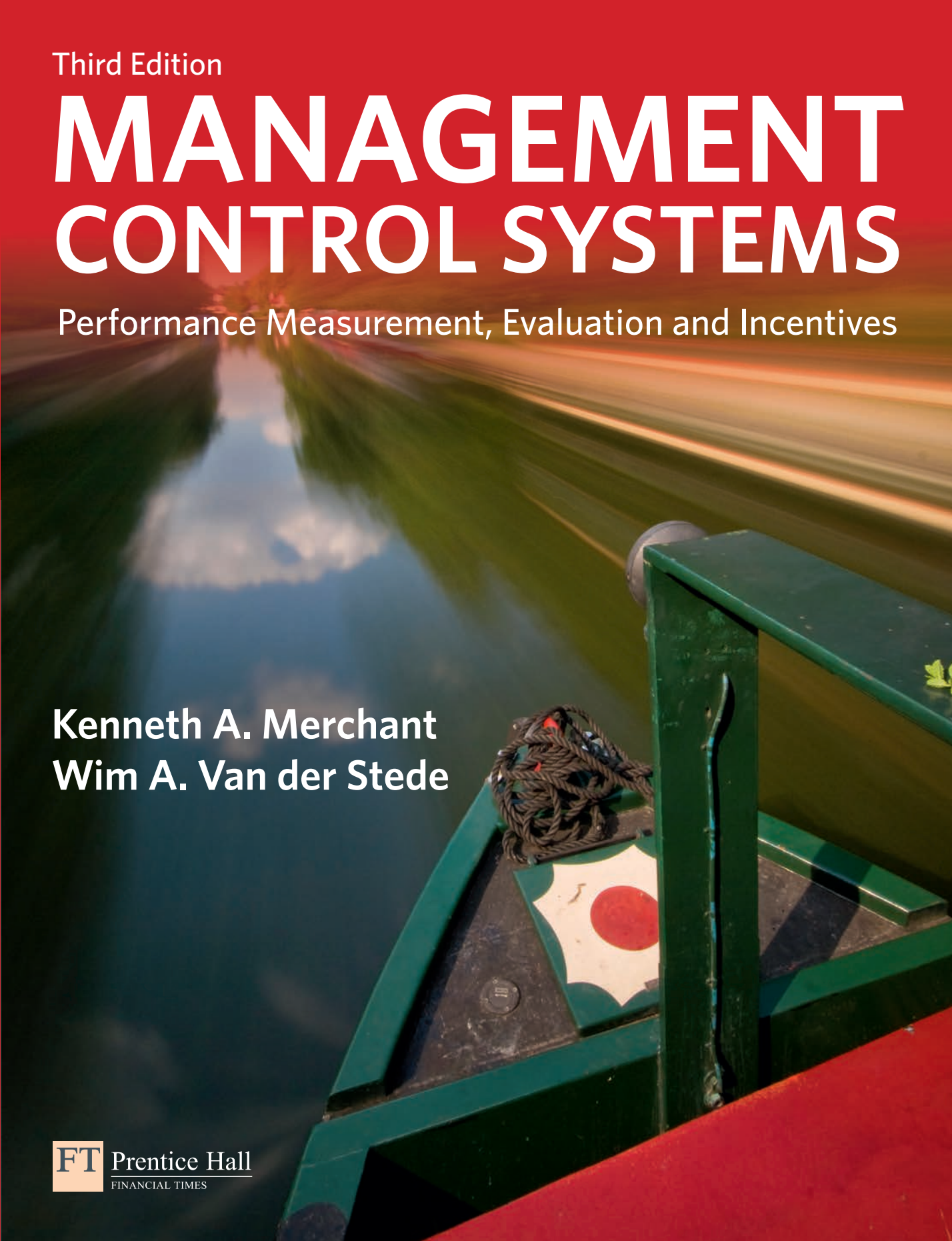
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MANAGEMENT CONTROL SYSTEMS

Performance Measurement, Evaluation and Incentives



Kenneth A. Merchant
Wim A. Van der Stede

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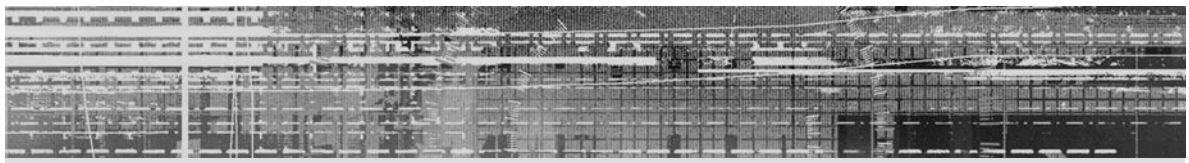
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Performance Measurement, Evaluation and Incentives

Third Edition

Kenneth A. Merchant
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PREFACE

This book provides materials for a comprehensive course on management control systems (MCSs). MCSs are defined broadly to include everything managers do to help ensure that their organization's strategies and plans are carried out or, if conditions warrant, that they are modified. Thus, the book could be used in any course that focuses on topics related to strategy implementation or execution.

While the treatment of the MCS subject is broad, the primary focus of the book is on what we call *results controls*, which involve motivating employees to produce the outcomes the organization pursues. This type of management control, which requires performance measures and evaluations and the provision of incentives, dominates in importance in the vast majority of organizations. When we use the word *incentives*, we are not referring solely to monetary incentives, such as bonuses and stock options, we are also referring to any of a variety of non-monetary incentives, such as praise, recognition, and autonomy.

Because management control is a core function of management, all students interested in business or management can benefit from this book. However, courses based on the materials in this book should be particularly useful for those who are, or aspire to be, managers, management consultants, financial specialists (for example, controllers, financial analysts, auditors), or human resource specialists (for example, personnel directors, compensation consultants).

This book includes 71 cases for classroom use. The cases have been selected because of their interest and educational value in stimulating useful class discussions. Some of them are also suitable for use in examinations. We view these cases as an essential part of the textbook. Case studies that stimulate learning through the analysis of often complex situations in the "real world" are generally recognized to be the best pedagogical conduit for teaching a MCSs course. Because MCSs, the contexts in which they operate, and the outcomes they produce, are complex and multi-dimensional, simple problems and exercises cannot capture the essence of the issues managers face in designing and using MCSs. Students must develop the thinking processes that will guide them successfully through decision tasks with multiple embedded issues and large amounts of relatively unstructured information. They must learn to develop problem-finding skills, as well as problem-solving skills, and they must learn how to articulate and defend their ideas. Case analyses, discussions, and presentations provide the best method available for simulating these tasks in a classroom.

The discussions in this book assume a basic level of knowledge of financial accounting (for example, how financial statements are put together), management accounting (for example, variance analysis), and core MCS elements (for example, budgeting). The book was designed primarily for use by graduate students and practicing professionals. It can also be used successfully by undergraduate students who have had a prior management accounting course, but it should be recognized that some of the cases in this book might be too challenging for undergraduate students. Cases for use in an undergraduate course have to be chosen judiciously.

This book is different from other MCS texts in a number of important ways. First, the basic organizing framework is different. The first major module of the book discusses management controls based on the object of control: results, actions, or personnel/culture.

The object-of-control framework has considerable advantages over other possible organizing frameworks. It has clean, clearly distinguishable categories. It is also relatively all-inclusive in the sense that the reader can relate many management controls and other control classifications and theories (for example, proactive vs. reactive controls, prevention vs. detection controls, and agency theory concepts such as monitoring vs. incentives) to it. It is also intuitive; that is, students can easily see that managers must make choices from among these categories of management control. Thus, using the object-of-control focus, the overall structure of the book can be summarized as being organized around a framework that describes

the core management control problems that need to be addressed, the MCSs that can be used to address those problems, the most important situational factors that can cause managers to choose one set of management controls over another, and the outcomes that can be produced, both positive and negative.

Second, the book's treatment of management control is broad. Like all MCS textbooks, this book focuses intensively on the use and effects of financial performance measures, which dominate in importance at managerial levels in most organizations. However, this book also provides a broader treatment of management controls (organized around the object-of-control framework) to put the financial results controls in proper perspective. For example, the book describes many situations where financial results controls are not effective and discusses the alternatives that managers can use in those situations (such as nonfinancial performance indicators, centralization of authority, management audits, or the creation of a team-oriented culture).

Third, the book provides considerable discussion on the causes and remedies of the most common and serious management control-related problems, including myopia, suboptimization, uncontrollability, and gameplaying.

Fourth, the book provides a whole chapter of ethics coverage. This makes it perhaps unique among accounting and control textbooks. There are many management control-related ethical issues, and the recent debacles at, for example, Enron, WorldCom, Parmalat, Lehman Brothers, and Bear Stearns, clearly suggest the need to develop managers' and prospective managers' ethical reasoning skills more fully. Related to this is coverage of corporate governance, to which we devote another whole chapter.

Fifth, the important concepts, theories, and issues are not discussed just in abstract terms. They are illustrated with a large number of real-world examples, far more than typically included in any other MCS textbook. The examples make the textual discussion more concrete and bring the subject to life.

Finally, the mix of cases included in this book is different from those included in other MCS textbooks in four important ways:

- A high proportion of the cases are real and undisguised (that is, they describe the facts of the actual situations and use the companies' real names). Reality and lack of disguise enhance student interest and "secondary" learning (that is, about named industries, companies, and individuals).
- Most of the cases include rich descriptions of the context within which the MCSs are operating. The rich descriptions give students opportunities to try to identify and address management control problems and issues within the same multi-dimensional situations that practicing managers face.
- Most of the cases are of relatively recent vintage, and the set of cases has been chosen to ensure coverage of the latest MCSs topics and issues, such as how to stress test budgets; how to minimize management myopia; how to motivate all employees to create sustainable value; and whether to use the EVA™ or Balanced Scorecard measurement approaches, just to name a few.
- The cases are descriptive of the operations and issues faced by companies located in many different countries and regions around the world, including Asia, Europe, Latin America, as well as North America.

The cases in this book permit the exploration of the management control issues in a broad range of settings. Included in the book are cases on both large and small firms, manufacturing and service firms, domestic-focused and multinational firms, and for-profit and not-for-profit organizations. The cases present issues faced by personnel in both line and staff roles at corporate, divisional, and functional levels of the organization, as well as by members of boards of directors. Instructors can use this set of cases to teach a management control course which is broad in scope or one which is more narrowly focused (for example, MCSs in service organizations by focusing on the cases from the healthcare, education, financial, and other service sectors).

The cases provide considerable scheduling flexibility. Most of the cases cut across multiple topic areas because MCSs are inherently multi-dimensional. For example, the classroom focus for the new Statoil case in Chapter 11 might be on performance measurement, as Statoil uses a key-performance-indicator (KPI) structure that is Balanced Scorecard-like. Or it could be on Statoil's planning and budgeting system, which separates the functions of target setting, forecasting, and resource allocation using the principles of "Beyond Budgeting". Students also have to consider the industry characteristics, the organization structure, the characteristics of the people in key positions, and the company's history (for example,

a recent merger), so instructors can choose to use this case when they wish to focus on the effects of one or more of these factors on the design of MCSs. As a consequence, the ordering of the cases in the book is not intended to be rigid. Many alternatives are possible. A case overview sheet in the accompanying Instructors Manual to this textbook provides a matrix that helps instructors disentangle the various relevant topics for which each case could be fruitfully used.

In this third edition of the book, we made a number of substantive updates, most obviously in those areas where the world has been moving fast during the past few years, particularly since the 2008–2009 financial crisis and subsequent economic recession. This includes changes in incentive systems (Chapter 9) and corporate governance (Chapter 13). Throughout the book, we incorporated discussions of some of the most important recent research findings and updated the survey statistics and examples provided. We also added some new, exciting cases. Eleven of the 71 cases included in this edition are new, and an additional three were revised or brought up to date. Some of the new cases cover cutting-edge topics, such as stress testing (scenario budgeting) (VisuSon, Inc.), enterprise risk management (Entropic Communications, Inc.), and "Beyond Budgeting" (Statoil). Others were intended to address the topics in new and different settings, such as Raven Capital LLC (a hedge fund), Family Care Specialists Medical Group, Inc. (a medical group), and Game Shop, Inc. (a billings system "scorecard").

In developing the materials for this third edition of our book, we have benefited from the insightful comments, helpful suggestions, and cases of many people. Ken owes special thanks to the two professors who served as his mentors at the Harvard Business School: William Bruns and Richard Vancil. Ken also appreciates the valuable research assistance from David Huelsbeck, Sahil Parmar, and Michelle Spaulding, and useful suggestions from Jong Hwan Kim, all currently or formerly at USC. Wim is especially grateful to Renuka Fernando for her capable assistance with updating the many examples throughout this book. We also appreciate the punctual administrative assistance from Ingrid McClendon and Linda Ramos at USC, and Justin Adams and Liz Venning at LSE. At Pearson Education, we are indebted to Katie Rowland (Acquisitions Editor, Accounting) and Gemma Papageorgiou (Assistant Editor, Higher Education Division). David Hemsley made helpful suggestions in copy-editing the manuscript.

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In closing, we wish to acknowledge that there is certainly no one best way to convey the rich subjects related to MCSs. We have presented one useful framework in the best way we know how, but we welcome comments about the content or organization of the book, or regarding specific errors or omissions. Please direct them to us.

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