Management Control Systems

Performance Measurement, Evaluation and Incentives

Kenneth A. Merchant & Wim A. Van der Stede



Second Edition

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MANAGEMENT CONTROL SYSTEMS



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Kenneth A. Merchant
University of Southern California

Wim A. Van der Stede
London School of Economics

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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 wants. 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 nonmonetary 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, controller, financial analyst, auditor), or human resource specialists (for example, personnel director, compensation consultant).

This book includes 66 cases suitable 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. The case method, which stimulates learning through the analysis of actual (or sometimes hypothetical) events, is generally recognized to be the best method for teaching an MCSs course. Because MCSs, the contexts in which they operate, and the outcomes they produce, are complex and multidimensional, 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 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 with graduate students and practicing professionals. It can also be used successfully with 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 carefully.

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 readers can relate many management controls and other control classifications and theories to it (for example, proactive vs. reactive controls, prevention vs. detection controls, and agency theory concepts such as monitoring vs. incentives). And it is 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. 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 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, Royal Ahold, and Global Crossing, clearly suggest the need to develop managers' and prospective managers' ethical reasoning skills more fully.

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 is included in any other MCS textbook. The examples make the textual discussion more concrete and bring the subject to life.

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

- A vast majority of the cases are real (not "armchair" cases). Further, a high proportion of the cases are undisguised (that is, they use the companies' real names and describe the facts of the actual situations). Reality and lack of disguise enhance student interest and "secondary learning" (that is, about companies, industries, and specific people).
- 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 multidimensional situations within which practicing managers have to deal with them.
- 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 minimize management myopia, how to motivate all employees to maximize shareholder value, and whether to use the EVA™ or Balanced Scorecard measurement approaches.
- 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, and Latin America, as well as North America. This is different from the case selection in most other MCS textbooks, which are heavily US-focused.

The cases included 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. And the cases present issues faced by personnel in both line and staff roles at corporate, divisional, and functional levels of the organization. Instructors can use this set of cases to teach an MCSs course that is broad in scope or one that is more narrowly focused (for example, MCSs in service organizations).

The cases provide considerable scheduling flexibility. Most of the cases cut across multiple topic areas because MCSs are inherently multidimensional. The focus of a given case (for example the HCC Industries case placed in Chapter 8) might be on, for example, the setting of performance targets. But such a case must also describe the organization structure, the characteristics of the people in key positions, the planning processes,

performance measures, and incentive systems. As a consequence, the ordering of the cases in the book is not intended to be rigid. Many alternatives are possible.

In this second edition of this book, we made a number of substantive changes. One was to add a new chapter titled "Corporate Governance and Boards of Directors" (Chapter 13). This chapter takes the control topic to a higher level of analysis – control of top management. It also allows us to discuss the significant overlaps among various corporate governance regulations, particularly the US Sarbanes-Oxley Act of 2002, a broad range of corporate governance elements, internal control systems, and MCSs.

We significantly restructured the measurement chapters, Chapters 10 and 11. These chapters discuss more clearly the three major measurement alternatives used at management organization levels: market measures (e.g. total shareholder return), summary financial measures (e.g. return on assets), and combinations of measures, which typically include both summary measures and nonfinancial measures and which are sometimes arrayed in complex forms such as Balanced Scorecards. These alternatives are discussed in the context of the set of measurement-evaluation criteria that were introduced in Chapter 2.

We augmented the ethics chapter, Chapter 15. We included a more complete discussion of some of the common ethical reasoning models (e.g. utilitarianism). Instructors can use the cases included in this chapter to show students that different conclusions are possible depending on which ethical reasoning model they (or their critics) use. We also added a section describing the reasons why people behave unethically.

Throughout the book, we incorporated discussions of some of the most important recent research findings and updated the survey statistics and examples provided. We attempted to improve the explanations and eliminate redundancies where possible, such as by having just one chapter focused on planning and budgeting and associated performance target setting (Chapter 9). And we added some new, exciting cases. Nineteen of the 66 cases included in this edition are new. Some of the new cases cover new topics, such as the MCS implications of complying with Section 404 of the Sarbanes-Oxley Act, various aspects of corporate governance, and cross-national differences in performance measurement and incentive systems. Others were intended to address the topics in different settings to give instructors more course-design flexibility, or to replace cases that had become dated.

In developing the materials for this book, we have benefited from the insightful comments, helpful suggestions, and cases of many people. Ken Merchant owes special thanks to the two professors who served as his mentors at the Harvard Business School: William Bruns and Richard Vancil. The authors wish to thank the authors of cases included in this book, including George Baker, Christopher Bartlett, Norman Berg, Brian Hall, Paul Healy, Robert Kaplan, Lynn Sharp Paine, and Tatiana Sandino. Valuable research assistance was provided by Xiaoling (Clara) Chen, Fei Du, Sung-Han (Sam) Lee, and Liu Zheng, all currently or formerly at USC. We also appreciate the punctual administrative assistance from Ingrid McClendon and Linda Ramos, both at USC. At Pearson Education, we are indebted to Matthew Smith (Publisher – Accounting) and Joe Vella (Senior Editor, Higher and Professional Education).

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Finally, 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.

Kenneth A. Merchant
Deloitte & Touche LLP Chair of Accountancy
Leventhal School of Accounting
Marshall School of Business
University of Southern California
Los Angeles, CA 90089-0441
USA

Phone: 213-821-5920
Fax: 213-747-2815
E-mail: kmerchant@marshall.usc.edu

Wim A. Van der Stede
Professor of Management Accounting
London School of Economics
Department of Accounting and Finance
Houghton Street
London WC2A 2AE
UK

Phone: 020-7955-6695
Fax: 020-7955-7420
E-mail: w.van-der-stede@lse.ac.uk

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