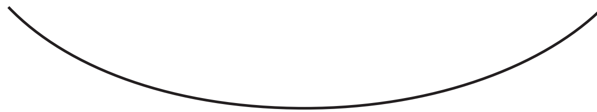
MANAGEMENT SUP

ACCOUNTING – MANAGEMENT CONTROL

Performance Management and Control



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Véronique Malleret, Jérôme Méric, Yvon Pesqueux

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Introduction: what is management control?

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SECTION 1 Management control: a process
SECTION 2 No management control without objectives
SECTION 3 Incentives
SECTION 4 Management control: a mode of control among others
SECTION 5 Structure of the book

What is management control? Why should management be controlled? These are the questions that this introduction, and to a more general extent, this book, will answer. Firstly, we recall what management control is not: management control is not what the management controller does. This conviction forms the key foundation for the way that management control is viewed and taught in this book. A large part of our book is devoted to management control as a discipline, as a management mode and as a daily task carried out by managers in companies, generally the operational managers. We feel that it should be clearly separated from the practice and the profession of controller or management accountant. Of course the controller must give impetus to control and maintain it within the company; however, the controller also has other roles and must develop skills and expertise without any direct relation to the act of management. For this reason, a whole section is devoted specifically to the controller's ways of thinking, roles and challenges.

This book is primarily aimed at a wide public interested in management, wanting to understand control as one of the characteristic features of management. It is intended for non-specialists, academics, engineers, students and teachers in business schools, who are not necessarily aiming to become specialists in management control (in other words, management controllers) but who would like to have a better understanding of a key corporate process, that of managing performance.

In this introductory chapter, we will describe the key process by which the company is "controlled". Throughout the book, we emphasise how the men and women in the company experience this process and, in return, maintain their tools and give them impetus. It is only in chapters 5 and 6 that we analyse the role that the management accountant plays in running this control process.

In terms of control, specific questions are raised: Who controls management in the company? Who will buy appropriately, process efficiently and sell wisely? The group of people within a company who are able to make the right decisions goes beyond – one hopes – the management control team. In the same way that we need more than a quality department to "deal with" quality, or more than a risk department to eliminate risk, we need more than a management control function or a controller to control management! The controller's function is therefore not to replace the operational managers, since each one remains responsible for his or her own management.

In this introduction, we describe management control as a management process. The definition of management control proposed in 1965 by R.N. Anthony, the first person to have expressed a theory on the discipline, has become the conventional definition:

> "Management control is the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's objectives" (R.N. Anthony, 1965).

What does such a definition tell us? It stresses three characteristics or essential components of management control in its capacity as a performance management device or the means by which operational managers control management:

1. management control is not an isolated act, but a process;
2. this process refers explicitly to the concept of objectives;
3. it highlights the behavioural nature of control – incentives form part of management control in order to motivate managers.

The purpose of management control is to create and develop organisational coherence, consistent decision-making, and convergence of the different business unit goals. In this introduction, we consider management control as a process. We emphasise the target-based nature of the control process and the existence of associated incentives. We also view management control as a way of better aligning an organisation's strategy with its implementation.

Section 1 MANAGEMENT CONTROL: A PROCESS

Management control can be seen as a process, a "loop" that assumes iterative learning, and a cycle made up of four main stages:

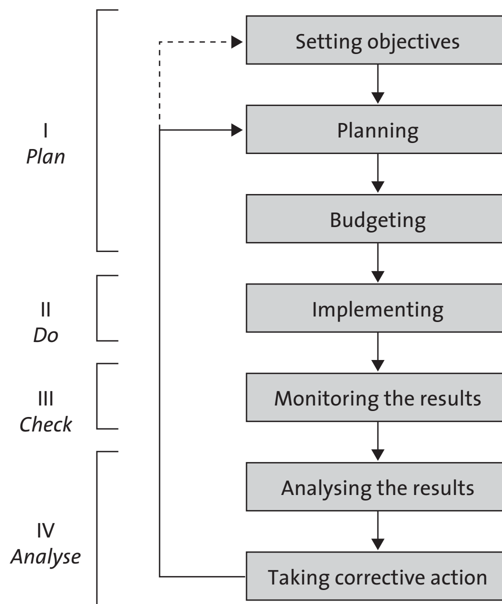

Figure 0.1 – The four states of management control: a learning process

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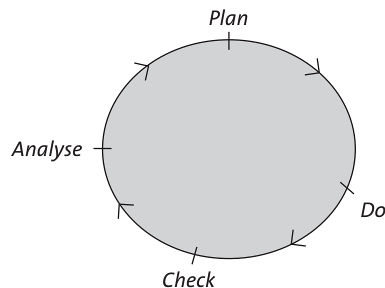
This figure is very close to work based on cybernetic approaches. In particular, it takes inspiration from quality specialist W.E. Deming, well known for his quality cycle (see Figure 0.2).

The planning stages, which involve setting objectives and forward planning, are followed by an implementation phase. The results of the actions are then carefully recorded and analysed. Consequently, corrective actions are incorporated into the planning for the following cycle as a basic element in the "loop" learning process. These "corrections" frequently concern actions to be carried out, as well as the resources to be used and how to use them; however in rare cases, they may call into question the objectives themselves.



Source: W. E. Deming, *Quality, the management revolution*, Economica, 1988, p.116.

Figure 0.2 – The control cycle

A very brief diagnosis of a company's control process will ensure that the process "does not miss any steps" or "skip" any stage. Certain companies, for instance very creative and entrepreneurial SMEs that are expanding and growing, may typically concentrate on phases I and II (*plan-do*) to the detriment of the analysis and hindsight required for enrichment and learning: there is a risk of the same errors being repeated. On the other hand, in some very large public companies there might be a tendency to omit phase II (*do*), while the planning, diagnosis and analysis stages are very well run. In all cases where a stage is omitted in this way, the management control process becomes unbalanced and it is debatable whether management is controlled at all.

Recent theory has seriously challenged the relevance of an exclusively cybernetic mode of management control, which is considered to be a closed circle. Companies are exposed to a large number of events, rarely foreseeable, and the model representing the management control process should take this into account: all stages must open up to external influences and information. The planning phase (from setting objectives to the budget) should take the environment and external phenomena - more or less foreseeable - into account and change planning into proactive simulation. The implementation phase is subject to the environment and must remain

sufficiently flexible so that it can be adapted. Implementations can no longer be followed up and analysed without an external benchmark or without any understanding of what is happening, not only inside, but also outside the company. The concepts of process and learning are at the core of performance management. At the same time, individual commitment and responsibility have been revived in recent years, as a tangible contribution to collective objectives.

Section 2 NO MANAGEMENT CONTROL WITHOUT OBJECTIVES

The second idea to emphasise is that management control can only be understood in an organisation that has a purpose and **goals,** and in which an objective-setting process has been devised for the organisation's entities and individuals. The concept of **objectives** has generated significant theoretical work in management control: a guidance system is only required if there is a purpose, if there are clear objectives and if people are stretched to achieve such objectives.

Difficulties in control may arise if there are a large number of, sometimes conflicting, objectives and if they are ambiguous (more or less explicit in nature).

Example – The mayor's town council management

– *Multiple and sometimes contradictory objectives:* opening new nurseries, improving social housing, setting up new sports facilities or infrastructures, caring for and assisting elderly people, balancing the council budget, and stabilising or reducing local taxes.
– *Dominant, non-explicit objective compared with explicit objectives*: being re-elected!

An objective (unlike a weather forecast!) is proactive. It is accompanied by an action plan, which ensures that the declared intention is implemented, and which gives details of the means used to achieve the objective. This may be summarised by the following equation:

Objective = Commitment + Action plan

In other words, an objective without an action plan is merely wishful thinking. We examine the concept of objectives in detail in this introductory chapter as well as the process for setting them and for choosing appropriate targets.

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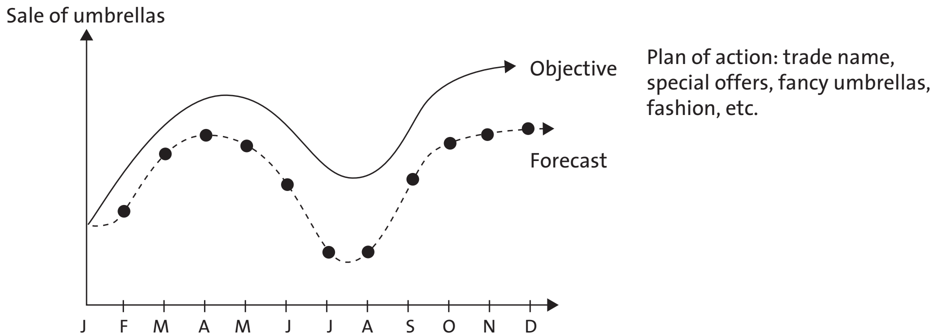
EXAMPLE – The umbrella merchant

- Objective: sell 10% more umbrellas this year, in terms of turnover and units.
- Forecast: sell 2% more umbrellas.
- Action plan: develop trade name, give special offers, sell fashionable umbrellas, change location, etc.



In addition to the concept of objectives, two more elements are of importance for management control: **resources** and **results**. A manager's activity can be thought of as linking these three elements: the objectives to be achieved, the resources available and the results obtained. This gives rise to three assessment criteria for the manager:

- relevance (resources used in relation to the objectives);
- effectiveness (the ability to achieve the objective, in other words, to arrive at a result in line with the objective); and
- efficiency (using the minimum resources required to achieve the desired objective).

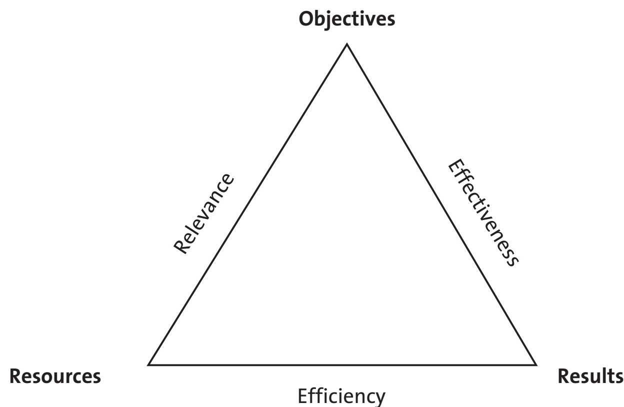


Figure 0.3 – The management control triangle

Section 3 INCENTIVES

The purpose of management control is to increase managers' motivation and to create greater goal convergence within an organisation. A company is made up of people, however there is nothing to indicate that they will spontaneously try to achieve their organisation's objectives. Why should everyone in the company want to make an enormous effort to generate a 10% pre-tax profit for shareholders? How will individuals' behaviour converge with the organisation's objectives? The *raison d'être* of management control is to encourage employees, particularly managers, to support the organisation in its objectives.

To achieve this aim, management control generally relies on an incentive system, in other words a reward (or punishment) system. Rewards or incentives might be financial – extrinsic rewards – but they might also be intrinsic, based on recognition and enhancement of professional or social standing.

The issue of control is related to decentralisation: **delegation creates the need for control**. Consequently, the issue of management control arises as organisations increase in size. A small entrepreneurial business or an SME does not require a complex incentive system. Assuming that my local baker is of sound mind, he will try to achieve his own objectives. If he is lucky, his spouse and few employees will share this aim. As **organisations grew in size** at the beginning of the twentieth century, the need emerged to develop tools and managerial systems to prevent these structures from breaking up. After the Second World War, towards the 1950s, management control expanded with the development of MNEs (multinational enterprises), which brought an increased need for delegation.

Example

A simple comparison illustrates the degree to which delegation creates the need for control:

– If parents give €2 a week to their child, what degree of control will they have over their child's spending? Probably none.

– What degree of control will the same parents have over their child if they now give him or her €100 at the beginning of the year?

Last but not least, management control is a practice essentially aimed at corporate middle management. Parallel to his definition of management control, R.N. Anthony developed a typology with three levels of control:

– **strategic control** concerns executives and examines the company's long-term strategy and objectives to assess their relevance;
– **management control** is aimed at middle management and assesses the impact of their decisions on the achievement of objectives. It is the balance between the use of resources and the strategy under study; and

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– **operational control,** which is the daily monitoring, in the very short term, of operations to ensure that they run smoothly. It mainly concerns operational staff and is largely automated.

The relationships between these three levels of control are crucial in a company. From this point of view, management control has a key role to play in ensuring that the company's strategy and major orientations are compatible with operations on the ground, i.e. with "those who do". Management control plays a key role in ensuring that the deployment of the organisation's strategic objectives cascades down and that management and employees are aligned with strategic objectives. Conversely, for a long time certain managers were criticised because they did not connect strategic orientations, such as customer satisfaction, or the need to compete externally, with the actions carried out in the factory or in the field. As a consequence, management control mainly focused on problems of cost and was not particularly open to new performance criteria.

To summarise, management control systems are composed of two dimensions:

– **a monitoring system**, which implements key performance actions and measures and is based on learning processes ("control loop", open to external information and impacts) and the implementation of strategic objectives; and;
– **an incentive system**, intended to create or to reinforce goal convergence within the organisation. Conventional management control is not, however, the only mechanism used within organisations to change individuals' behaviour and to push them towards the company's objectives.

Section 4 MANAGEMENT CONTROL: A MODE OF CONTROL AMONG OTHERS

M. Fiol (1991) identified and analysed four historical modes of control used to ensure goal convergence. Management control is one of them. The four modes of control that contribute to achieving the organisation's objectives are as follows.

1 Bureaucratic controls: control by means of regulations and procedures

Bureaucratic control appeared at the beginning of the twentieth century in the works of F. Taylor and H. Fayol. It was used in the Ford factories and in organisations described as "Weberian bureaucracies", which developed manuals describing

standard processes and procedures. To a large degree it still persists today in companies, in the sophisticated form of standards (quality assurance, ISO, etc.) or standardised processes, as well as in the development of shared services centres, lean management, and other "six sigma" approaches.

This mode of control, apart from being extremely mechanistic and potentially dehumanising, is limited in that it is rigid and poorly adapted to uncertain situations. In this respect, it is not a particularly relevant mode for managers, who often need to react rapidly, and independently, to unforeseen situations.

2 Human controls by means of satisfaction

This control type is based on the concept devised by the School of Human Relations according to which good working conditions, particularly material and financial, motivate and encourage people to make substantial efforts. This approach is based on the Hawthorne experiments carried out in the General Electric workshop by E. Mayo in the 1930s. However, no empirical findings have ever actually demonstrated that good working conditions increase motivation.

It seems that satisfaction factors are a necessary, but not sufficient, condition: they do not guarantee that goals will converge. The lack of minimum material conditions is negatively expressed but it has not been proven (even with the Hawthorne experiment) that an improvement in these conditions, beyond a certain level, would create a positive incentive. Moreover, this approach remains theoretical.

3 Output controls: decentralised control or management control by results

This is the subject of the present book and what management control is all about. First developed during the 1950s and 1960s, it is based on the idea of delegating decision rights together with the resources allocated, with a contract that sets objectives for the manager and monitors results to ensure that objectives are achieved. Extensively used in practice, this control mode has spread to the majority of companies sufficiently large to justify it. However, since the late 1980s, it has come in for a great deal of criticism. Among these criticisms are:

– it is an exclusively financial measure and an exclusively economic approach to motivation. Many authors have emphasised the high risk of failure incurred by such a system of control if there is no corporate culture to support the tools;
– it performs poorly in service industries or in an environment where "doing it right the first time" is essential. Control by results is retrospective control, which responds badly to the needs of service activities and, more recently, of industrial

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activities. In a service-based or a just-in-time management system, when results are assessed and they are poor, it is too late to act; the damage is done. This control mode is therefore criticised for not being anticipative;

– it induces myopia (short-term vision) in managers. Output controls have a tendency to accelerate their reporting frequency in a failed attempt to compensate for being "after the fact". This can lead to very short-sighted managers, whose eyes are riveted on the next short-term results on which their career depends; in too much of a hurry and too mobile to incorporate the company's longer-term objectives and requirements (investments, quality, sustainability, etc.).

4 Social control or clan control: control by supporting common values

This mode of control is anticipative. Instead of controlling after the event, it involves selecting people first by recruiting them, and then encouraging them, through training, to behave as the organisation expects. This mode of control, in practice very ancient, tends to reinforce values already held by members of the organisation and to lead employees to act or to make decisions in the way that top management would have done. This is one of the current modes of functioning in religious organisations, and was also used by colonial administrations when they operated in Africa, India or other countries. This approach was only brought into management literature theory in the 1980s, however, at which point the limitations of this mode of control became clear.

Firstly, it is difficult to "use" corporate culture as a tool. Organisations cannot change their culture as one would change a screwdriver or a computing system. It often takes quite a long time to adapt and the culture often proves to be extremely stable. Secondly, this mode of control has been criticised for its conformist drift, which leaves no place for people "out of tune" with the organisation. In the end, an organisation that is too standard in terms of values and attitudes runs the risk of lacking in creativity and innovation.

In practice, in corporate life, as in daily life, a combination of the four modes of control can be seen. It is rare (and often short lasting) to encounter a situation where a single mode of control exists, even if one of them is dominant.

Example

> We can take family life as an illustration. Parents usually lay down rules and procedures for their children, give them drivers of satisfaction (material and affective), motivate them to achieve results with rewards (pocket money linked to marks, permission to go out etc. dependent on school achievements of the "if you pass your exam…" type) and instil in them values derived from family tradition.

It would seem that in companies, as in the family, a medley is a guarantee of success. Fiol (1991) has shown that an organisation cannot survive with one single mode of goal convergence. Management control by results alone cannot endure without a minimum consensus on values as a moral contract underlying delegation. Similarly, corporate culture will go nowhere if it is not supplemented by a direction and a concern for results. The historical alternation between more economic (1. and 3.) and more social (2. and 4.) modes of control highlights the need for a balanced mix.

Section 5 STRUCTURE OF THE BOOK

Chapters 1 and 2 emphasise that **management control cannot work independently of organisational structure, on which control practices depend**. During the past two decades, a large number of companies have restructured one or more times, sometimes after significant changes in scope or ownership (mergers, acquisitions, external growth, sale of upstream or downstream activities, etc.), and sometimes with the aim of being more effectively organised on their markets. So-called matrix structures, with two, or sometimes three, reporting lines, became widespread. These structures recognise that it is essential for the organisation, for commercial performance purposes, to manage cross-disciplinary dimensions that deliver value for the customer, such as processes and projects. Companies in the digital economy have often opted for types of organisation that are even more radical, for instance in a network or star form. The first chapter of this book takes these observations as its starting point. It firstly recalls the traditional, vertical and hierarchical structures that are used as the bedrock for decentralisation and management control. Such organisational structures rely on delegating decision rights and allocating responsibilities down the chain of command, with different types of responsibility centre being established depending on the degree of autonomy allowed. The chapter also recalls the principles and applicability conditions relating to responsibility accounting. It then emphasises that new organisational structures are emerging and are creating strong interdependencies inside, and even outside, the organisation. This diminishes individual controllability and calls into question the traditional foundations of management control. The second chapter is devoted to the specific problems created by internal transactions between responsibility centres and the common answers to the issues of interdependence between autonomous entities in the same organisation. A large number of examples support our presentation of transfer pricing theory.

Chapters 3 and 4 are devoted to **management control tools**. These tools have undergone substantial changes since the turn of the century. Potentialities have increased tenfold as a result of the new capabilities offered by integrated information systems (data warehouses, ERP, etc.). ERPs, once installed, mean that the

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accounting language in the company can be standardised and information processed from all angles desired – offering what is called a panoptic view of information. In parallel, recent organisational structures presented in chapter 1 have played a role in the development of new performance management tools, enabling transversality to be better managed. Confronted with increasing quantities of information, information systems must focus on priorities and strategic uncertainties in order remain relevant, proactive and flexible. Both internal and external benchmarking have developed in companies over the last two decades. More than ever, control tools are used not only to implement strategy, but also to shape further strategic objectives, which emerge and evolve through action.

Chapter 3 introduces **the tools used to measure and manage financial performance**: the budget and budgetary control, and economic return indicators such as EVA(TM) (Economic Value Added, or residual profit) or ROCE. Chapter 4 then goes on to present **strategic and operational performance measurement and management systems (PMMS)**, such as strategic *tableaux de bord* or balanced scorecards. These systems stress the link between strategy, management control in its role of "measuring to manage better", and the implementation action plans. The tools presented in Chapter 3 correspond to the increasing influence of shareholders and investors in the economy in the 2000s, while the tools in Chapter 4 are more of a response to managerial needs within the company in terms of controlling increasingly complex organisations. In both chapters, the theory and methods are presented and illustrated, through exercises or case studies, and the implementation issues in companies or organisations are considered. When we observe organisational practices, certain limitations or potentially dysfunctional effects become apparent. The control tools may become counterproductive when they are used in isolation or implemented mechanically without taking the context into account, or without prior reflection on their purpose.

Chapters 5 and 6 are devoted to the management accountant. It notes the **current debates around the function and the profession of management accountant** in the company. What has changed in management accountants' profiles? What are the qualities of a management accountant in the twenty-first century? What is expected of him or her? What are the characteristics of an outstanding management control function? Chapter 5 is devoted to the profiles and roles of the management accountant. Chapter 6 covers the management control function in the organisation and its relation to the other support functions, particularly the finance function, internal control and internal audit. The core issues in terms of the role of the management accountant and the person to whom he or she reports remain.

In each chapter, inserts sometimes offer illustrations or examples, or sometimes a more advanced reflection on a specific subject ("*Taking a closer look…*"). "*Key points*" and "*Questions*" asked at the end of a chapter (or a section) allow readers to easily and systematically check that they have understood the main ideas.