MANAGEMENT CONTROL SYSTEMS

Performance Measurement, Evaluation and Incentives

Kenneth A. Merchant & Wim A. Van der Stede

Fourth Edition

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Performance Measurement, Evaluation, and Incentives

Kenneth A. Merchant
University of Southern California

Wim A. Van der Stede
London School of Economics

Fourth edition

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To our families

Gail, Abbidee, Madelyn (KM)

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PREFACE

This text 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, are modified. Thus, the text could also be used in any course that focuses on topics related to the back end of the management process, such as strategy implementation or execution.

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

This edition includes 70 cases for classroom use. Case studies that stimulate learning through the analysis of complex situations such as those often faced in the "real world" are generally recognized to be perhaps 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 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, incomplete information, and large amounts of relatively unstructured information. They must learn to develop problem-finding skills as well as critical thinking and problem-solving skills, and they must learn how to articulate and defend their ideas. Case analyses, discussions, and presentations provide an effective method for simulating these tasks in a classroom.

Although the text was designed primarily for use with graduate students and practicing professionals, it can be, and has been, used successfully with undergraduate students who have had a prior management accounting course. All that should be recognized when using this material with pre-work experience students is that some of the cases might be too challenging. That said, there are several suitable candidates to select from among the set of cases at the end of each chapter to tailor to various audiences and/or to achieve various course objectives (see also below).

This text is different from other MCS texts in a number of important ways. First, the basic organizing framework is different. The first major module 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 adverse selection and 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 text is structured 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, and the outcomes that can be produced, both positive (intended) and negative (unintended).

Second, the treatment of management control is broad. Like all MCS textbooks, this text focuses intensively on the use and effects of financial performance measures and associated *results controls*, which are in common use at managerial levels in many organizations. However, it 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 text 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 or greater reliance on stronger cultures).

Third, the text provides considerable discussion on the causes and remedies of the most common and serious management control-related problems, including the implications of issues of uncontrollability on manager's behaviors; the tendency of managers to adopt a short-term horizon in their decision-making; and managers' and employees' propensities to engage in distortive "gameplaying" evidencing misalignment with organizational objectives.

Fourth, the text provides a whole chapter of ethics coverage. There are many management control-related ethical issues, and both erstwhile and recent scandals across industries, including the automobile and banking sectors, but also the public and not-for-profit sectors, 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 also devote a 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 provided here is different from those included in other MCS textbooks in four important ways:

- Nearly all of the cases are real (that is, they describe the facts of an actual situation) although some of them are disguised (that is, they do not use the company's real name and/or use scaled figures/data to avoid identification or to protect data confidentiality). The relatively small number of cases that do not describe the (disguised) facts of an actual situation are "vignettes" that are, even so, almost always based on an observed situation but do not describe all of it. Instead, they focus on a particular (narrower) issue. Reality (and lack of disguise where possible) enhance student interest and learning about, for example, types of industries, companies, and organizational roles.
- Most of the cases (except the vignettes) include rich descriptions of the context within which the MCSs are operating. The descriptions give students opportunities to try to identify and address management control problems and issues within the multidimensional situations within which practicing managers cope 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 MCS topics and issues, such as related to stress testing of budgets; mitigating management myopia; balancing sustainable value creation; motivating ethical behaviors; and using the EVA™ or Balanced Scorecard measurement systems or alternative budgeting 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, Oceania, as well as North America.

The cases permit the exploration of the management control issues in a broad range of settings. Included 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 that is broad in scope or one that is more narrowly focused (for example, MCSs in service organizations by focusing on the cases from the retail, financial, healthcare, education and other service sectors).

The cases provide considerable scheduling flexibility. Most of the cases cut across multiple topic areas because MCSs are inherently multidimensional. For example, the classroom focus for the 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." To illustrate the latter further or in more depth, Statoil could be followed (or preceded) by the Mainfreight case, which offers ample opportunity for students to discuss and critically challenge the idea of beyond budgeting. In that context, both cases could be taught related to the subject matter in Chapter 8 on planning and budgeting instead of with Chapter 11. Yet, there are still sufficient cases listed with Chapter 11 to focus on remedies to the myopia problem, such as the new Johansen's case that describes a retail company that has adopted a balanced scorecard-based performance evaluation system. Students also have to consider the industry characteristics, the organization structure, the characteristics of

the people in key positions, and the company's history (e.g. a recent merger), so instructors can choose to use the Statoil case, say, 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 is not intended to be rigid. Many alternatives are possible. A case overview sheet in the accompanying Instructors Manual to this text provides a matrix that helps instructors disentangle the various relevant topics for which each case could be fruitfully used.

In this fourth edition, we made various 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), corporate governance (Chapter 13), and also ethics-related concerns (Chapter 15). Throughout the text, we incorporated recent research findings and updated the survey statistics and examples provided. We also added some new, exciting cases. Twenty-one of the 70 cases included in this edition are new, and an additional 12 were revised or brought up to date. Some of the new cases cover relatively recent and/or perennially pivotal topics, such as "mobile monitoring" of employees (Witsky and Associates, Inc.); planning and budgeting flexibility (Wessanen N.V.); alternatives to traditional budgeting (Mainfreight); project management (The Stimson Company); comprehensive multi-criteria performance evaluations (Johansen's); "hands-on" relative performance evaluations using real-world data (Fine Harvest Restaurant Group); as well as crucial ethical considerations (Ethics@Cisco). Others were intended to address the topics in new and different settings, such as King Engineering Group (an ESOP, or "employee stock ownership plan," company), or in relevant control-related roles, such as corporate risk officers (Andrew G. Scavell, CRO).

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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 text, or regarding any 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
U.S.A.

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

Wim A. Van der Stede
CIMA Professor of Accounting and Financial Management
London School of Economics
Department of Accounting
Houghton Street
London WC2A 2AE
U.K.

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

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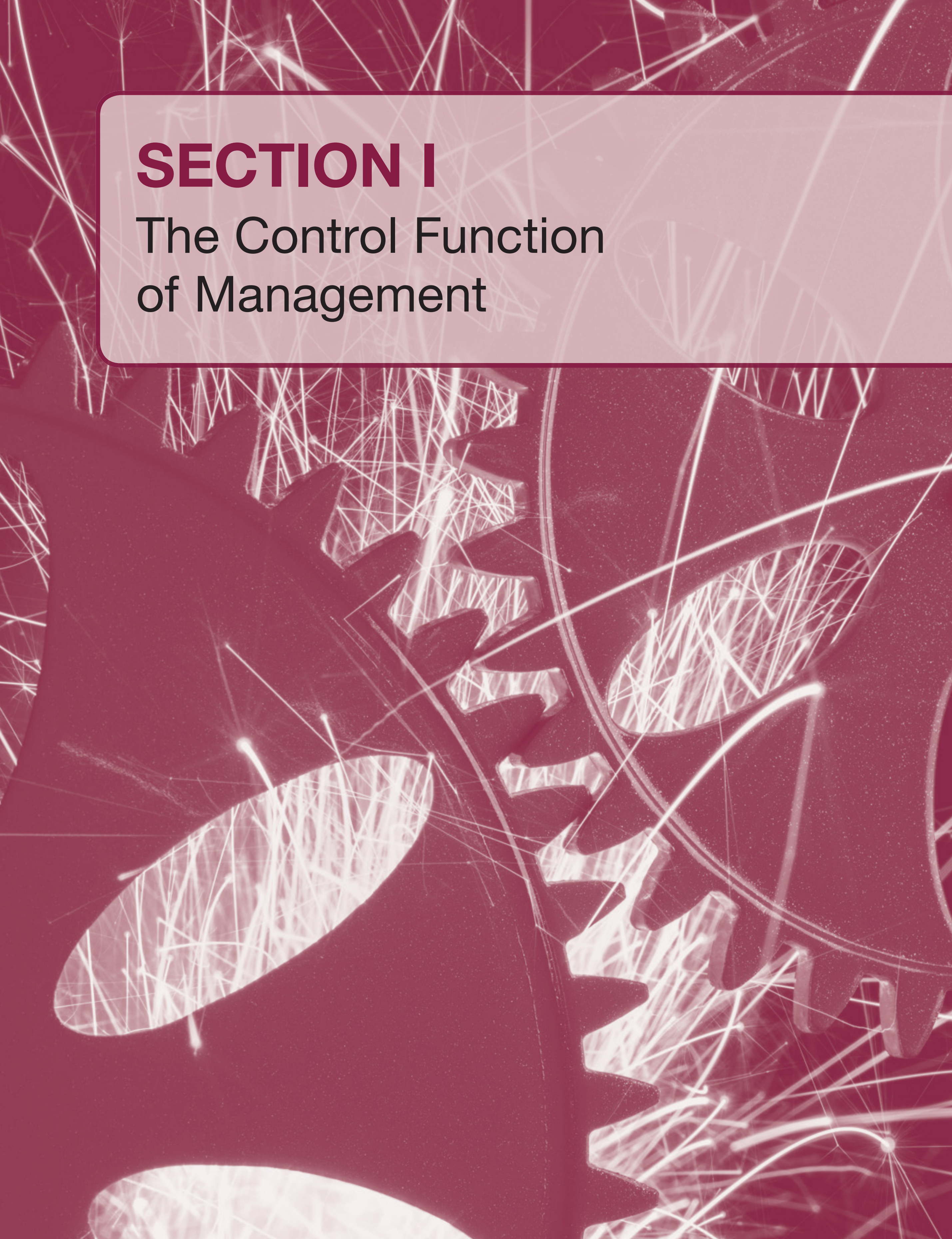

SECTION I

The Control Function of Management

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CHAPTER 1
Management and Control

Management control is a critical function in organizations. Management control failures can lead to large financial losses, reputation damage, and possibly even organizational failure. To illustrate this, let us start with some examples in the financial services sector that, since the financial crisis have been beset by a raft of control failures related to rusty information systems;[1] misconduct related to misselling financial services such as pay-protection insurance stemming from aggressive sales-based tactics;[2] allegations that financial services companies helped their clients evade taxes;[3] manipulation of interest rates, such as the venerable LIBOR (the benchmark inter-bank rate that is used to calculate interest rates on major financial transactions throughout the world);[4] faults in internal controls surrounding the reporting of commodity prices by banks' trading desks; more isolated but crippling unauthorized "rogue trades";[5] and anti-money-laundering violations,[6] just to name the most striking ones.

To provide some more detail about one particular case to demonstrate its relevance to management control systems (MCSs) and the significant risks when they fail, the Financial Services Authority (FSA) fined UBS, a Swiss-based global bank, £29.7 million (discounted from £42.4 million for early settlement) for systems and controls failings that allowed an employee (Kweku Adoboli) to cause substantial losses totaling US$2.3 billion as a result of unauthorized trading. In particular, UBS' failings included the following:[7]

- The computerized system operated by UBS to assist in risk management was not effective in controlling the risk of unauthorized trading.
- The trade capture and processing system had significant deficiencies, which Adoboli exploited in order to conceal his unauthorized trading. The system allowed trades to be booked to an internal counterparty without sufficient details, there were no effective methods in place to detect trades at material off-market prices, and there was a lack of integration between systems.
- There was an understanding amongst personnel supporting the trading desk that the operations division's main role was that of facilitation. They focused mainly on efficiency as opposed to risk control, and they did not adequately challenge the front office.
- There was inadequate front office supervision. The supervision arrangements were poorly executed and ineffective.
- The trading desk breached the risk limits set for their desk without being disciplined for doing so. These limits represented a key control and defined the maximum level of risk that the desk could enter into at a given time. This created a situation in which risk taking was not actively discouraged or penalized by those with supervisory responsibility.

- Failing to investigate the underlying reasons for the substantial increase in profitability of the desk despite the fact that this could not be explained by reference to the end-of-day risk positions.
- Profit and loss suspensions to the value of $1.6 billion were requested by Adoboli, and these were accepted without challenge or escalation. The combined factors of unexplained profitability and loss suspensions should have indicated the need for greater scrutiny.

The FSA report concluded that these failings were particularly serious because:[8]

- Market confidence was put at risk, given the sudden announcement to the market and size of the losses announced. Negative announcements, such as this, put at risk the confidence which investors have in financial markets.
- The systems and controls failings revealed serious weaknesses in the firm's procedures, management systems and internal controls.
- The failings enabled Adoboli to commit financial crime.

Global regulators have similarly exposed flaws in banks' internal control systems that allowed traders to manipulate interest rates, such as LIBOR, around the world.[9] To add, Stuart Gulliver, the chief executive of HSBC, the largest financial institution in Europe, admitted that "our anti-money-laundering controls should have been stronger and more effective, and we failed to spot and deal with unacceptable behavior."[10]

The press headlines to which these examples are selectively referenced speak for themselves. Of course, not all banks have been entangled in each and every issue. However, that the list of those being caught in these nets has been so long, sparing few, is surprising for organizations whose reputations are among their most valuable assets. Failures of this type and magnitude also damage the integrity of the wider market and financial system on a global scale. But these failures have also been costly money-wise, where the wave of fines and lawsuits that has swept through the financial sector since the financial crisis has cost big banks a whopping $260 billion, according to research from Morgan Stanley. The report also suggests that "actions taken by banks to prevent future litigation issues include everything from changing remuneration [compensation] policies [which we discuss under the rubric of *results controls* in Chapter 2 and *incentive systems* in Chapter 9] to a greater focus on 'non-financial metrics' [Chapter 11], adding compliance staff [Chapters 3 and 14], to elevating chief risk officers to boards [Chapter 13] and using 'robo-surveillance' in trading rooms [a form of *action controls* which we discuss in Chapter 3]" (brackets added).[11] Clearly, the issues illustrated here touch on, and cut across, many of the issues we discuss in this text.

To add, though, here is a quote from a *Financial Times* columnist that builds nicely on the above but extends it to other sectors:

> It turns out that bankers may not be alone. The traders who rigged Libor and foreign exchange rates cheated clients out of money. Volkswagen, we now know, deliberately polluted our air. The carmaker had a choice: install additional emissions cleaning equipment; admit that its diesel cars were not very fuel efficient; or spew out illegal amounts of nitrogen oxide. It chose the last of these options, and covered it up by designing software to deceive the US regulators. [...] This round-the-world tour of fraud also takes in Toshiba. The nuclear-to-semiconductor conglomerate was hit by a record fine from Japan's stock exchange and ordered to improve its governance and internal controls, in the wake of a $2bn accounting scandal. [...] Not even the tech industry has proved immune. European researchers revealed this week that Google has been charging advertisers for having their ads seen on YouTube, even when fraud-detection systems discover that the 'viewer' is a robot. That practice is clearly not in the same league as rate-rigging,

> years of accounting fraud or emission test deceit. But the disclosure reinforces a growing sense that companies around the world are pushing ethical boundaries [which we discuss in Chapter 15].[12]

Another article commented that the issues at VW were predictable because of VW's lax boardroom controls (which we discuss in Chapter 13) and its peculiar corporate culture (Chapter 3): "The scandal clearly also has to do with structural issues at VW … There have been warnings about VW's corporate governance for years, but they didn't take it to heart and now you see the result," says Alexander Juschus, director at IVOX, the German proxy adviser.[13]

Effective cultures, structures, and controls are quintessential as the above examples suggest, but not only in the for-profit sector, as the next example illustrates (we discuss non-profit organizations in Chapter 16). Consider the case of an award-winning teacher who at the time headed Atlanta's public schools, and who had been praised by the American Association of School Administrators for the significant gains in student achievement she had overseen, where Atlanta's schoolchildren made sizable gains on the standardized tests used to determine yearly progress. At one school, for instance, the share of 13-year-olds who passed the test's maths section rose from 24% to 86%, and the share of those who "exceeded expectations" rose from 1% to 46% – both in a single year. However,

> […] the state of Georgia alleges that those remarkable leaps rested on neither pedagogy nor determined study, but something far more invidious: cheating. A report by a special investigative team […] found widespread evidence of cheating […]. Sometimes teachers gave pupils the correct answers. Sometimes they erased pupils' answers after the test and filled in the correct ones themselves. The investigative team ferreted out cheating by analyzing erasure marks on test sheets. They flagged classrooms with an average number of wrong-to-right erasures more than three standard deviations above the state average. The chance of that occurring randomly is one in 370. More than half of Atlanta's elementary and middle schools had such classrooms, and many had erasures more than 20 to 50 standard deviations above the norm. Of the 178 teachers accused of having taken part in the cheating, 82 confessed. [The head], said the report, either knew or should have known what was going on. […] Prosecutors did not charge [the head] with taking part in the cheating, but with *putting "unreasonable pressure" on principals and teachers to do well, and for creating "an environment where achieving the desired end result was more important than the students' education."*[14]

This is an example of results controls (Chapter 2) and, clearly, not only the functional but also the behavioral displacements that they can create (Chapters 5 and 11), in part due to target pressure (Chapter 8), but also employees' and organizations' moral failures (Chapters 3 and 15).

Excessive target pressure was also identified as a culprit in the accounting scandal at Toshiba that was mentioned in passing earlier:

> In April 2015, an improper accounting scandal came to light that inflated profits by well over $1bn at Toshiba, the Japanese industrial conglomerate, which makes laptops, memory chips and nuclear reactors. A panel of external lawyers and accountants that was appointed to investigate was said to have uncovered emails showing that Hisao Tanaka, chief executive, and Norio Sasaki, former chief executive and then vice-chairman, "instructed employees to delay the booking of costs to make the financial figures look better" […] and that "the problems were worsened by reporting procedures for projects that were time-consuming and old-fashioned. Some of the paperwork was being done by junior employees in their first few years at the company." Experts further commented that "the accounting issues at Toshiba also exposed concerns around Japanese corporate governance practices [which we discuss in Chapter 13], including the weak role of external

directors and the extensive power that many former chief executives continue to exercise."[15] The scathing panel report also detailed what it said "were 'institutional' accounting malpractices [Chapter 5] and a corporate culture [Chapter 3] in which employees were afraid to speak out against bosses' push for increasingly unachievable profits [Chapter 8]. [...] Pressures to meet aggressive, short-term profit targets [Chapter 11] – known as 'the challenge' – existed from the presidency of Atsutoshi Nishida, who headed the company from 2005 to 2009 and remained an adviser. Those pressures escalated as the company's earnings deteriorated in the wake of the global financial crisis and [...] the Fukushima nuclear accident. The panel declared that Mr. Tanaka and Mr. Sasaki were aware that profits were being inflated and did not take any action to end the improper accounting. In some instances, the report added, top executives pressured employees to achieve their targets with suggestions that the company may withdraw from underperforming businesses if they were not met. But the panel found no evidence any of the three current and former chief executives had given specific instructions to division chiefs to inflate profit figures."[16] They described a corporate culture – one of exerting pressure on employees to meet aggressive, short-term profit targets spanning three generations of chief executives – in which employees were afraid to speak out against bosses when they pushed for unrealistic earnings targets.[17]

The consequences of failures of organizational control (which we define more precisely in the later sections of this chapter) can reach far and wide beyond the organizations in which they take place. As mentioned above, the banking failures have undermined the integrity of the wider market and financial system on a global scale. But there are other major impacts:

Shareholders and customers are obvious victims of the current flood of bad news. They are seeing their investments shrink, having their cars recalled and paying too much for goods and services. But there is another set of losers: the employees and shareholders of the companies that try to play fair. Back in the early 2000s, a company called WorldCom upended the telecommunications industry by repeatedly posting profit margins that its rivals simply could not match. Five big groups, including AT&T, responded by slashing about 5 per cent of their combined workforces – more than 20,000 jobs. In 2002, WorldCom was exposed as the US's largest accounting fraud and its chief executive sentenced to jail. However, the employees who were laid off at rival companies did not get their jobs back.[18]

And in the case of Atlanta's schools:

[...] the scandal's real casualties are Atlanta's schoolchildren. Schools that cheated their way to false improvements lost federal funds which could have been used to make actual improvements. Because of their apparently high test scores, struggling pupils were denied the help they needed and deserved. A generation of Atlanta's students have, in fact, been left behind.[19]

We discuss these impacts in the light of organizations' *corporate social responsibility* and their concerns about *sustainability* and the wider stakeholder communities in Chapter 16.

Not all control failures are as consequential, or of similar magnitude, as the examples listed above; yet they can, and do, inflict costs and/or embarrassment. For example,

[...] this happened when Deutsche Bank paid $6 billion to a hedge fund client by mistake in a 'fat finger' trade, where a junior member of the bank's forex sales team, while his boss was on holiday, processed a gross value instead of a net value, meaning that the trade had 'too many zeroes'. Whereas the bank recovered the money from the U.S. hedge fund the next day, the incident was "an embarrassing blow to the bank" and it also "raised fresh questions about Deutsche's operational controls and risk management." The $6bn error

> **also raised questions about why it was not spotted under the bank's 'four eyes principle' [an *action control* discussed in Chapter 3], requiring every trade to be reviewed by another person before being processed.[20]**

Other examples of this type also occur in the public sector and do not always involve money being inadvertently wired. This happened at the Bank of England (BoE), where its head of press mistakenly sent an email to the media revealing that officials were quietly researching the impact of Britain's exit from the European Union, a major blunder given the secrecy of this study. What had caused this mistake? The "auto-complete" tool in BoE's internal email service. The BoE confirmed that following this incident, it had switched off auto-complete from its email system – that is, staff now have to write the full name of the recipient of their email messages rather than being automatically proposed through the Outlook auto-complete functionality – "to preserve the security of its data."[21]

Employees do not always have to steal or engage in fraudulent activities to cause harm. Sometimes it suffices to just "fall asleep." This happened when a bank teller was making a payment of €64.20, but as he fell asleep, he left his finger on the number 2 key, accidentally putting through a payment of €22,222,222.22. The payment almost went through when the supervisor who was supposed to be looking out for such mistakes allegedly failed to notice and approved the transaction. The mistake was spotted only by another colleague who managed to correct it before it was too late.[22] As we will see, this is an example of a rather simple *internal control* procedure. We discuss internal controls as one type of what we call *action controls* in Chapter 3, and we discuss how tightly they should be applied in Chapter 4. The example further illustrates that not every control problem involves fraud, yet adequate control systems must also be able to prevent mistakes. Furthermore, when there are irregularities or control breaches, money or *incentives* like bonuses are not always the motive for the wrongdoing. For example,

> **[…] two clerical workers at the Laguna Niguel, California-based service center of the U.S. Immigration and Naturalization Service (INS) were accused of destroying thousands of immigration documents, including visa applications, passports, and other papers. According to the probe, the clerks started shredding unprocessed paperwork after an inventory revealed a processing backlog of about 90,000 documents. A month later, the backlog was reported to be zero. The shredding allegedly went on for about another month to keep the backlog at zero, until INS officials discovered the shredding spree during an evening shift.[23]**

Although it is not entirely clear what the clerks' motives were, there were no bonuses involved here, and maybe they were concerned about keeping their job and/or also not doing their job well or being lazy and cutting corners. Nonetheless, their actions were completely inappropriate, and thus proper control systems are needed to mitigate such undesirable behaviors.

However, *more* controls should not always be equated with *better* controls. When copious MCSs are stifling, they can exacerbate rather than mitigate control problems. We discuss this further in Chapters 4 and 5, where we consider not only direct, explicit, more easily quantifiable, out-of-pocket costs, but also various types of *indirect*, *implicit* costs of tightening the controls. For example, when financial irregularities were discovered at Eurostat, the European Commission's statistical service, it was not immediately clear whether these had occurred for the personal enrichment of those involved; instead, some argued that the "secret accounts" may at least initially have been set up to give Eurostat a way to pay for research quickly without going through the Commission's cumbersome procedures. Ironically, then, while the Commission had elaborate procedures to prevent financial fraud, these procedures may not only have proved insufficient (because they clearly could be circumvented), they may actually have made

the problem worse. Because tortuous form-filling was required to request funds, requesters had to jump through a number of bureaucratic hoops to get anything approved, and funds delivery was notoriously slow, commission officials and staff may have taken to cutting corners and finding "creative" ways to expedite the process. Of course, these "work-arounds" should be a red flag for possible exploitation and potential improprieties, too.[24]

By this point, it should be no surprise that we are claiming, but also that it is widely accepted, that good MCSs are important. Comparing the books and articles written on management control is difficult, however, because much of the MCS language is imprecise. The term "control" as it applies to a management function does not have a universally accepted definition. An old, narrow view of a MCS is that of a simple *cybernetic* or *regulating* system involving a single feedback loop analogous to a thermostat that measures the temperature, compares the measurement with the desired standard, and, if necessary, takes a corrective action (turn on, or off, a furnace or air conditioner). In a MCS feedback loop, managers measure performance, compare that measurement with a pre-set performance standard, and, if necessary, take corrective actions.[25]

In this text, however, we take a broader view. Many management controls in common use, such as direct supervision, employee selection and retention, and codes of conduct, do not focus on measured performance. They focus instead on encouraging, enabling, or sometimes forcing employees to act in the organization's best interest. This is consistent with the observation that all the above examples have one key question in common: how can organizations of all types ensure that their employees up and down the hierarchy carry out their jobs and responsibilities properly? Moreover, 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. Examples of proactive controls include planning processes, required expenditure approvals, segregation of duties, and restricted access. Management control, then, includes all the devices or systems that managers use to ensure the behaviors and decisions of their employees are consistent with the organization's objectives and strategies. The systems themselves are commonly referred to as *management control systems* (MCSs).

Designed properly, MCSs influence employees' behaviors in desirable ways and, consequently, increase the probability that the organization will achieve its goals. Thus, the primary *function* of management control is to influence behaviors in desirable ways. The *benefit* of management control is the increased probability that the organization's objectives will be achieved.

Management and control

Management control is the back end of the management process. This can be seen from the various ways in which the broad topic of management is disaggregated.

Management

The literature includes many definitions of management. All relate to the processes of organizing resources and directing activities for the purpose of achieving organizational objectives. Inevitably, those who study and teach management have broken the broad subject into smaller, more discernable elements. Table 1.1 shows the most prominent classification schemes. The first column identifies the primary management functions of the value chain: product or service development, operations (manufacturing products or performing/delivering services), marketing/sales (finding buyers and making sure the products and services fulfill customer needs), and finance (raising money). Virtually every management school offers courses focused on only one, or only part of one, of these primary management functions.

Table 1.1 Different ways of categorizing the broad area of management

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

Source: K. A. Merchant, *Modern Management Control Systems: Text and Cases* (Upper Saddle River, NJ: Prentice Hall, 1998), p. 3.

The second column of Table 1.1 identifies the major types of resources with which managers must work: people, money, machines, and information. Management schools also offer courses organized using this classification. These courses are often called human resource management, accounting and finance, production and operations management, and information systems, respectively. These are sometimes also referred to as the support management functions.[26]

The term *management control* appears in the third column of Table 1.1, which separates the management functions along a *process* involving objective setting, strategy formulation, and management control. Control, then, is the back end of the management process. The way we use the term management control in this text has the same meaning as the terms *execution* and *strategy implementation*. In most organizations, focusing on improving MCSs will provide higher payoffs than will focusing on improving strategy. A *Fortune* study showed that 7 out of 10 CEOs who fail do so not because of bad strategy, but because of bad execution.[27] The above examples reinforce this, too.

Many management courses, including business policy, strategic management, and management control systems, focus on elements of the management process. To focus on the control function of management, we must distinguish it from objective setting and strategy formulation.

Objective setting

Knowledge of *objectives* is a prerequisite for the design of any MCS and, indeed, for any purposeful activities. Objectives do not have to be quantified and do not have to be financial, although that is how they are commonly thought of in for-profit organizations. A not-for-profit organization's primary objective might be to provide shelter for homeless people, for example; but even in these organizations, there have been calls to express the achievement of these objectives in financial or *quasi*-financial terms, such as social return on investment.[28] However, many for-profit organizations also have nonfinancial objectives, such as related to sustainability or personnel development and well-being (see Chapter 16). In any organization, however, employees must have a basic understanding of what the organization is trying to accomplish. Otherwise, no one could claim that any of the employees' actions are purposive, and no one could ever support a claim that the organization was successful.

In most organizations, the objectives are known. That is not to say that all employees always agree unanimously as to how to balance their organizations' responsibilities to all of their stakeholders, including owners (equity holders), debtholders, employees, suppliers, customers, and the society at large. They rarely do.[29] That said, organizations develop explicit or implicit compromise mechanisms to resolve conflicts among stakeholders and reach some level of agreement about the objectives they will pursue. As Jason Luckhurst, managing director of Practicus, a UK-based project-management recruitment firm, argues:

> [To achieve organizational success], it takes a clear vision around which the entire business [can] be designed, [and I] think it is something you should be able to communicate