

**Management Control Systems**

Develop the links between strategy, management control systems, organization structure, and accounting information.

Benefits and costs of centralized and decentralized organization structures

**Organization Structure**

**Decentralization**

minimum constraints and maximum freedom for managers at the lowest levels of an organization to make decisions.

**Centralization**

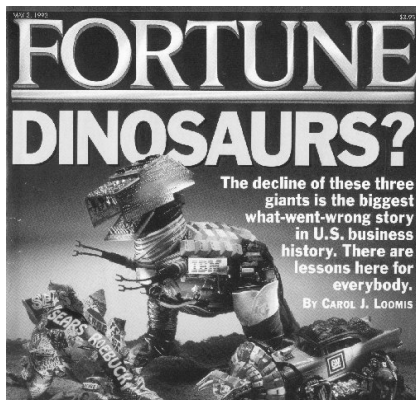
maximum constraints and minimum freedom for managers at the lowest levels of an organization to make decisions.

**Benefits of Decentralization**

- ❖ Creates greater responsiveness to local needs
- ❖ Leads to gains from quicker decision making
- ❖ Increases motivation of subunit managers
- ❖ Aids management development and learning
- ❖ Sharpens the focus of subunit managers

**Costs of Decentralization**

- ❑ Results in duplication of activities
- ❑ Leads to suboptimal decision making (incongruent or dysfunctional decision making due to loss of control)
- ❑ Focuses manager's attention on the subunit rather than the organization as a whole; decreases loyalty
- ❑ Increases costs of gathering information



**Responsibility Centers**

Four types of responsibility centers:

**Cost center**

– the manager is accountable for costs only.

**Revenue center**

– the manager is accountable for revenues only.

**Profit center**

– the manager is accountable for revenues and costs.

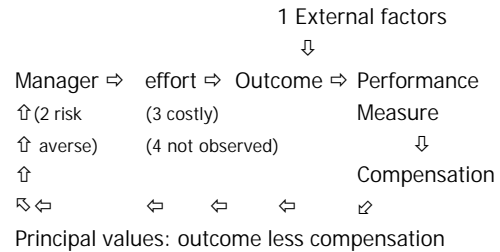
**Investment center**

– the manager is accountable for investments, revenues, and costs.

**Responsibility Centers**

Each of these responsibility units can be found in either centralized or decentralized organizations. Profit centers can be coupled with a highly centralized organization, and cost centers can be coupled with a highly decentralized organization.

**The Principal Agent Model**



**Agency theory: factors**

- ❖ Uncertainty in output given effort
- ❖ Managers risk averse
- ❖ Managers effort averse (costly effort)
- ❖ Effort not observable

The benefit to the principal is lesser if **all four** factors are present

**Uncertainty in output given effort**

- ☹ Otherwise judge effort by looking at effort which output which reveals effort
- ☹ Adjust output for observable factors inflation, price variances, market return
- ☹ Relative performance evaluation

**Benchmarks  
 Uncertainty in output given effort**

- ❖ Owners can use benchmarks to evaluate performance.
- ❖ Benchmarks representing best practice may be available inside or outside the organization.
- ❖ Measuring performance against benchmarks (either internal or external to the organization) can reduce the impact of uncontrollable factors and provide better performance information.

**Effort not observable**

- ☹ Otherwise Pay for observed effort
- ☹ More monitoring, supervision

**Managers effort averse**

- ☺ Otherwise they will work hard without incentives
- ☹ Better working conditions.

**Managers risk averse**

- ☺ Otherwise sell or lease the firm e.g. taxicabs, sharecropping
- ☹ Evaluate in teams
  - Reduces individual risk exposure
 Giving individuals incentives based on team performance encourages cooperation among individuals toward a common goal.  
 Management buy outs or leveraged buy outs.

**The Basic Trade-off**

Managers may face risks because factors beyond their control may also affect performance.  
 Managers – risk averse  
 Principals – risk neutral  
 So the best risk sharing arrangement is to impose no risk on the managers  
 Trade off the incentive benefit against the cost of imposing risk.


**The Basic Trade-off**

How large should the incentive component be relative to the salary component?  
 A key question to ask is "How well does the performance measure capture the manager's ability to influence the desired result?"

**Intensity of Incentives**

Preferred performance measures are ones that are sensitive to, or change significantly, with the manager's performance and do not change much with changes in factors that are beyond the manager's control.  
 The salary component dominates when only weak measures of performance are available.

**Trade - offs**

	Motivation	Risk sharing
Fixed Salary		
Rental or all bonus		

**"Managing" performance measures**

**Examples**

- ❖ year-end sales promotions with liberal payment terms - borrowing sales from the next year,
- ❖ speeding shipments at year-end,
- ❖ sales of fixed assets or investments with understated carrying values,
- ❖ deferring routine maintenance and discretionary expenditures at year-end,
- ❖ pressuring consultants under contract to defer invoicing until after year- end, and
- ❖ changing accounting estimates or methods.

**Moral hazard**

describes contexts in which an agent is tempted to put in less effort than would be expected by the owner. Important aspects of moral hazard include

- ❖ the two parties may have dissimilar interests.
- ❖ there are two parties and the actions of one affects the benefits received by the other
- ❖ the affected party cannot monitor and enforce the other party's actions.

**Environmental and Ethical Responsibilities**

- ❖ Corporate cultural integrity begins with a firm commitment at the top towards ethical behavior by accountants and managers.
- ❖ Managers often cite pressure to manipulate earnings via operating and accounting decisions.

**Executive Performance Measures and Compensation**

Executive compensation plans consist of base salary, annual incentives, long-term incentives (stock options), and fringe benefits.

Executive compensation plans emphasize three factors:

1. the achievement of organizational goals,
2. administrative ease, and
3. the likelihood that managers will perceive plan as fair.

**Management Control Systems**

- is a means of gathering and using information to aid and coordinate planning and control decisions
- guides the behavior of managers and employees.

**Financial data:**

net income, materials costs.

**Nonfinancial data:**

the time taken to respond to customer requests,  
absenteeism rates  
accidents

**Management Control Systems**

The term management control systems refers to both formal and informal control systems.

The formal control system consists of several systems, including:

- Management accounting system
- Human resource system

**Management Control Systems**

The informal management control system includes:  
Shared values among members of the organization  
Organization culture  
Unwritten norms about acceptable behavior for managers and employees

**Decentralization in Multinational Companies**

Multinational corporations are often decentralized

- ❖ centralized control with subunits in different continents is often physically and practically impossible.
- ❖ Decentralization enables country managers to make decisions that exploit their knowledge of local business and political conditions.

**Decentralization in Multinational Companies**

- ❖ - often rotate managers between foreign locations and corporate headquarters.
- ❖ - helps develop managers' abilities to operate in the global environment.
- ❖ drawback - the lack of control.

**Evaluating Management Control Systems**

**Motivation**  
is the desire to attain a selected goal combined with the resulting drive or pursuit toward that goal.

**Goal congruence**  
exists when individuals and groups work toward achieving the organization's goals.

**Effort**  
is exertion toward a goal.

**Evaluating Management Control Systems**

Management control systems motivate managers and employees to exert effort toward attaining organization goals through a variety of rewards tied to the achievement of those goals.

Monetary



Nonmonetary



**Performance measures**

⚡ are a central component of management control systems.

Making good planning and control decisions requires information about how different subunits of the organization have performed.

**Financial and Nonfinancial Performance Measures**

Many widely used performance measures, such as operating income, rely on internal financial information.

Companies are supplementing **internal financial** measures with measures based on:

External financial information

Internal nonfinancial information

External nonfinancial information

**Financial and Nonfinancial Performance Measures**

Some organizations present financial and nonfinancial performance measures for their subunits in a single report –

**the balanced scorecard.**

Most scorecards include:

Profitability measures

Customer-satisfaction measures

**Financial and Nonfinancial Performance Measures**

Internal measures of efficiency, quality, and time

Innovation measures

Some performance measures have a long-run time horizon.

Other measures have a short-run time horizon.

**Measuring**

Other issues in evaluating performance are:

- ❖ Designing performance measures for activities that require multiple tasks
- ❖ Executive performance measures and Compensation
- ❖ Environmental and ethical responsibilities