

Introduction to Management Control Systems

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Agenda

1. Review syllabus
2. Why Accounting is so Important
3. What is Management Accounting?

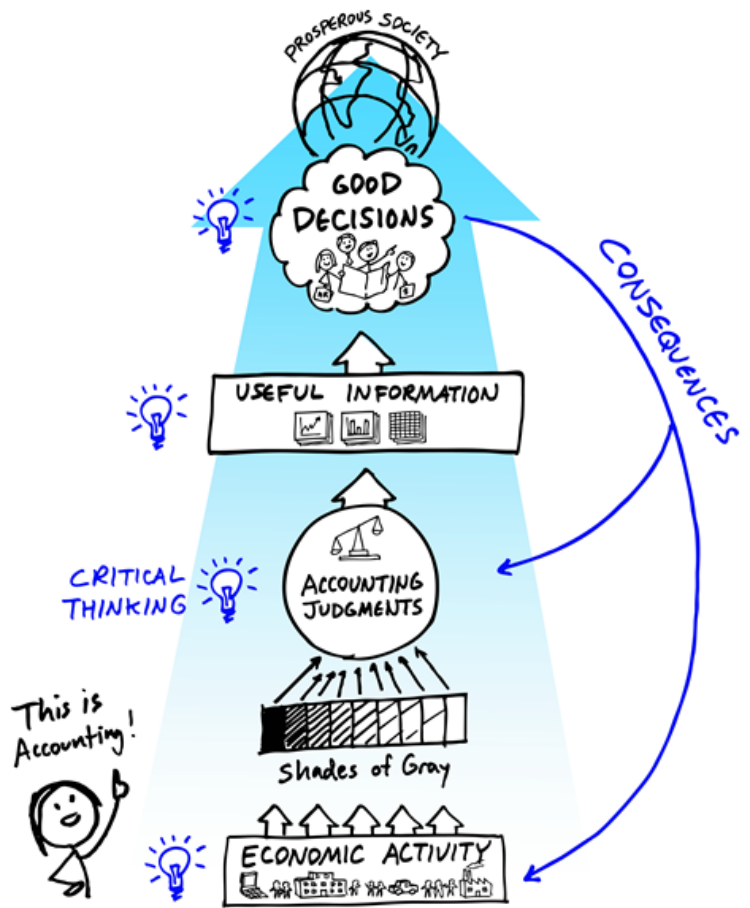
Teaching Philosophy

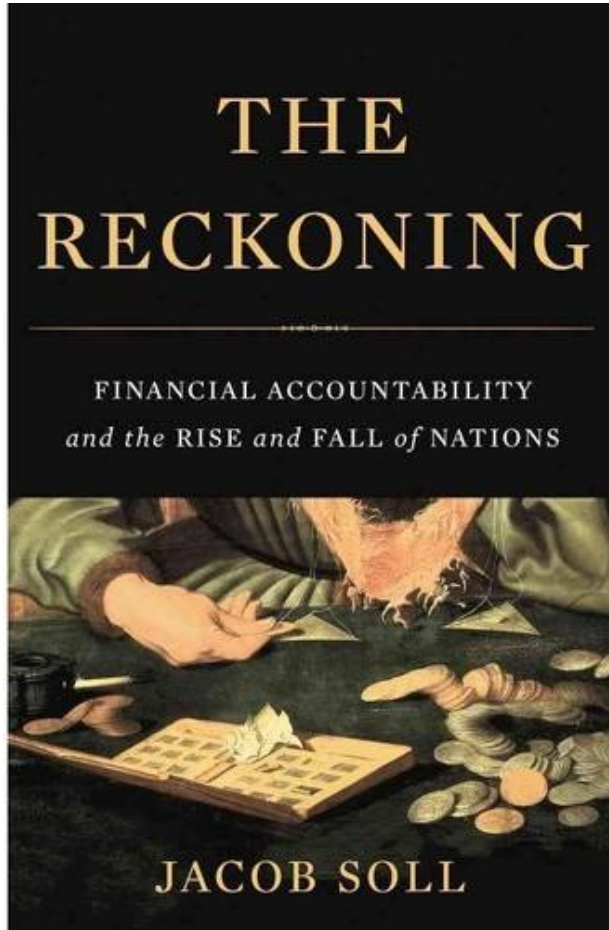
1. Active Learners
2. Peer-to-Peer Learning
3. Accounting is more than #'s
4. Exams are learning opportunities, not just knowledge assessments
5. Do everything with Integrity

Review Course Syllabus and Schedule

Why Accounting is so Important

What is Accounting?





“People built countries with accounting. Benjamin Franklin was obsessed with it. He kept account books. He wrote his autobiography in a ledger on the debit side. He wrote a book about moral accounts. He wrote about how important accounting was and came up with a scheme to teach accounting to all Americans. America was built on accounting.”

Jacob Soll, USC Trojan Family
magazine, Summer 2015

“Countries that have clear accounting, like Britain, have better long-term prospects. The U.S. does not have good accounting. And the American economy has been destabilized twice in the last 20 years by accounting scandals—the Enron, WorldCom and Arthur Anderson scandal in 1999, and the economic crash in 2007-2008, which had a lot to do with how mortgage bundles were valued and with individuals who were taking out mortgages they couldn’t understand or afford.”

“No one wants to talk about accounting, because that’s where the books are, that’s where the secrets are. But we need some clarity. Everyone gets audited—you figure out what is wrong and then you fix it. If you want to have an economy that grows and works, you need competent financial management mixed with transparency, competent bookkeeping mixed with auditing. If you want to reform yourself, the tool you use is accounting.”

Jacob Soll, USC Trojan Family
magazine, Summer 2015

“There are not accounting leaders, and there should be. Accountants need to be involved in culture, they need to read, and they need to explain to people what accounting is. They can’t just keep the books. Benjamin Franklin saw accounting as part of a leadership culture. It should be on everyone’s lips when there’s a problem.”

Jacob Soll, USC Trojan Family
magazine, Summer 2015

The What and Why of Managerial Accounting

What is Management Accounting?

Management Accounting

Definition from the IMA:

“Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization’s strategy.”

What is a Management Control System?

Management Control System

Management control includes all the devices and mechanisms managers use to ensure that the behavior of employees is consistent with the organization's objectives and strategies

Think of words like:

- Encourages
- Guides
- Incentivizes
- Enables
- Forces

Management Control System

Control Issues

1) Do employees understand what we expect of them?

Lack of direction

2) Will they work consistently hard and do what is expected of them?

Lack of motivation

3) Are they capable of doing what is expected of them?

Personal limitations

Management Control System

What motivates employees?

**Perspective from Economic Theory known as
Agency Theory → Principal-Agent Model**

Two fundamental Assumptions:

- 1) Information Asymmetry
- 2) Moral Hazard

Management Control System

Management Control Types:

- **Personnel Controls**
- **Action Controls**
- **Results Controls**

This course will explore the choice of control (or combination of control) and related issues.

Ability to measure results on important performance dimensions

Excellent	<p>Action Control and/or Results Control</p>	<p>Action Control (e.g., large projects)</p>
Poor	<p>Results Control (e.g., movie director, entity manager)</p>	<p>People Control (e.g., research lab)</p>
	High	Low

Knowledge of which specific actions are desirable

Get Certified!

Certified Management Accountant (CMA)

- From the Institute of Management Accountants (IMA)

Chartered Global Management Accountant (CGMA)

- From the American Institute of Certified Public Accountants (AICPA) and the Chartered Institute of Management Accountants (CIMA)

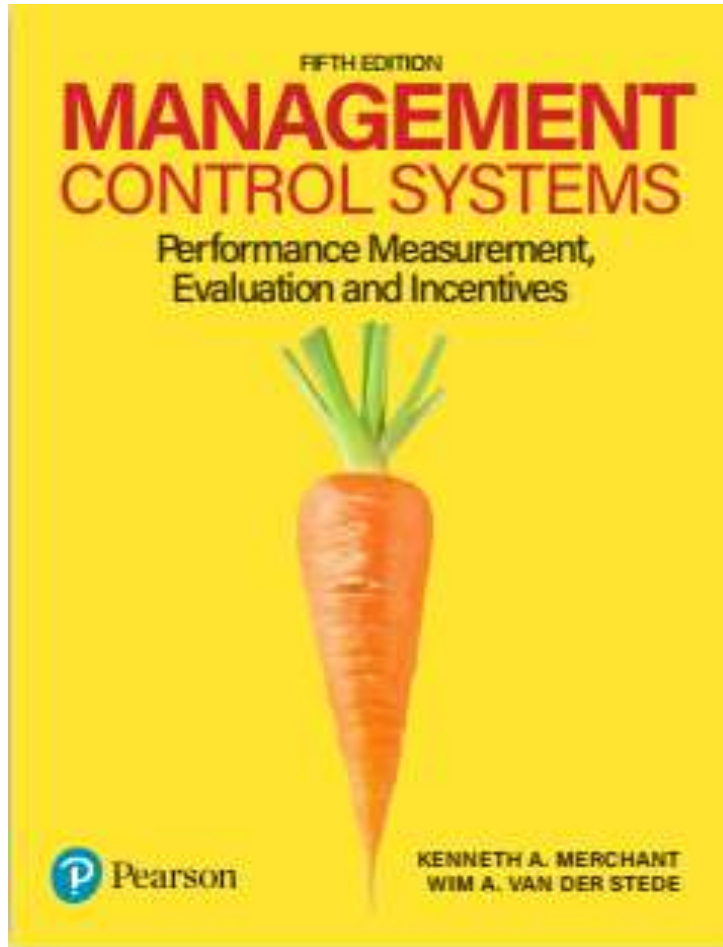
To Do Before Next Class

- Review syllabus and course schedule carefully
- Read and review textbook chapter
- Review PPT from textbook chapter
- Read and prepare assigned case
- Read articles and turn in *reading* quiz

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Section 1

The control function of management

Chapter 1

Management and control

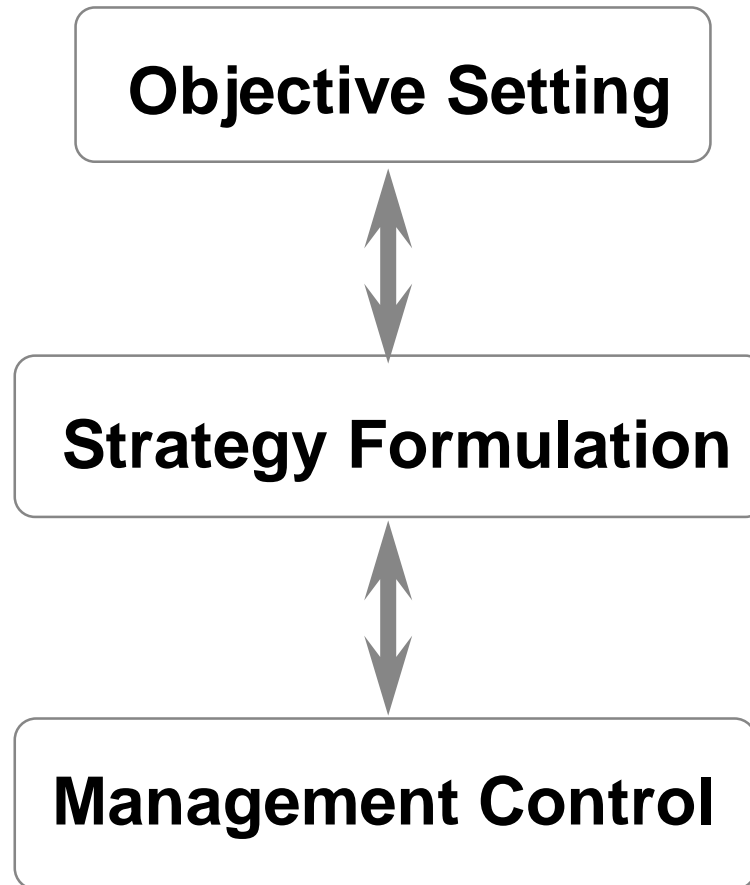
Management control

- The process by which management
 - ... ensures that people in the organization carry out organizational objectives and strategies
 - ... **encourages, enables, or, sometimes “forces” employees to act in the organization’s best interests**
- Management control includes all the devices/mechanisms managers use to ensure that the behavior of employees is consistent with the organization’s objectives and strategies

Function and benefit

- Purpose/function
 - Get done what management wants done
 - Influence behavior in desirable ways
- Benefit
 - Increased probability that the organization's objectives will be achieved

Management and its components



Objective setting

- Objectives are a necessary prerequisite for any purposeful activities
- **Without objectives, it is impossible ...**
 - to assess whether the employees' actions are purposive;
 - to make claims about an organization's success.
- Objectives can be:
 - financial vs. non-financial
 - quantified, explicit vs. implicit
 - economic, social, environmental, or societal

Strategy formulation

- An organization must select any of innumerable ways of seeking to attain its objectives
- Strategies define how organizations should use their resources to meet their objectives
- Hence, strategies put constraints on employees to focus activities on what the organization does best or areas where it has an advantage over competitors

Key questions

- Are our employees likely to behave appropriately?
 - Do they understand what we expect of them?
 - Will they work consistently hard and try to do what is expected of them?
 - Are they capable of doing what is expected of them?

The basic control problem

- Management control is about encouraging PEOPLE to take desirable actions
 - That is, it guards against the possibilities that employees will do something the organization does not want them to do, or fail to do something they should do
- Hence, management control has a ...
... BEHAVIORAL ORIENTATION
- If all personnel could always be relied on to do what is best for the organization, there would be no need for a management control system

Basic control issues

- Three issues
 - Do they understand what we expect of them?
 - **Lack of direction**
 - Will they work consistently hard and try to do what is expected of them?
 - **Lack of motivation**
 - Are they capable of doing what is expected of them?
 - **Personal limitations**

Lack of direction

- Employees do not know what the organization wants from them
- When this lack of direction occurs, the likelihood of the desired behaviors occurring is small

COMMUNICATION + REINFORCEMENT

Motivational problems

- When employees “choose” not to perform as their organization would have them perform
 - **Lack of goal congruence**
 - Individual goals do not coincide with organizational goals
 - **Self-interested behavior**
 - Generally, individuals are prone to being “effort averse” ...
 - For example, take long lunches, overspend on things that make life more pleasant, use of sick leaves when not sick, etc.
 - More extreme examples of motivational problems:
 - Employee crime (fraud and theft)

Personal limitations

- Sometimes, people are “unable” to do a good job because of certain personal limitations they have
- Some examples/causes:
 - lack of requisite knowledge, training, and experience
 - employees are promoted above their level of competence
 - some jobs are not designed properly etc.

TRAINING
JOB ASSIGNMENT
JOB DESIGN

However ...

- Management controls do not always involve a simple cybernetic system like a thermostat
 - **Detector** → measure performance
 - **Assessor** → compare with pre-set standard
 - **Effector** → take corrective action
- Many controls don't focus on **measured performance**
 - For example, direct supervision, employee hiring standards, and codes of conduct
- Many controls are **proactive** rather than **reactive**
 - That is, they are designed to prevent control problems before the organization suffers any adverse effects on performance

Control alternatives

- Control problem avoidance
- **Management control systems**
 - Action controls
 - Result controls
 - People controls

Control problem avoidance

- **Activity elimination**
 - For example, subcontracts, licensing agreements, and divestment
- **Automation**
 - Computers/robots eliminate the human problems of inaccuracy, inconsistency, and lack of motivation
 - Only applicable for “programmable” decision situations
- **Centralization**
 - Superiors reserve the most critical decisions for themselves

Control alternatives

- Controls can focus on:

- the actions taken → **ACTION CONTROLS**
- the results produced → **RESULT CONTROLS**
- the types of people employed and their shared values and norms → **PEOPLE CONTROLS**

Or any combination

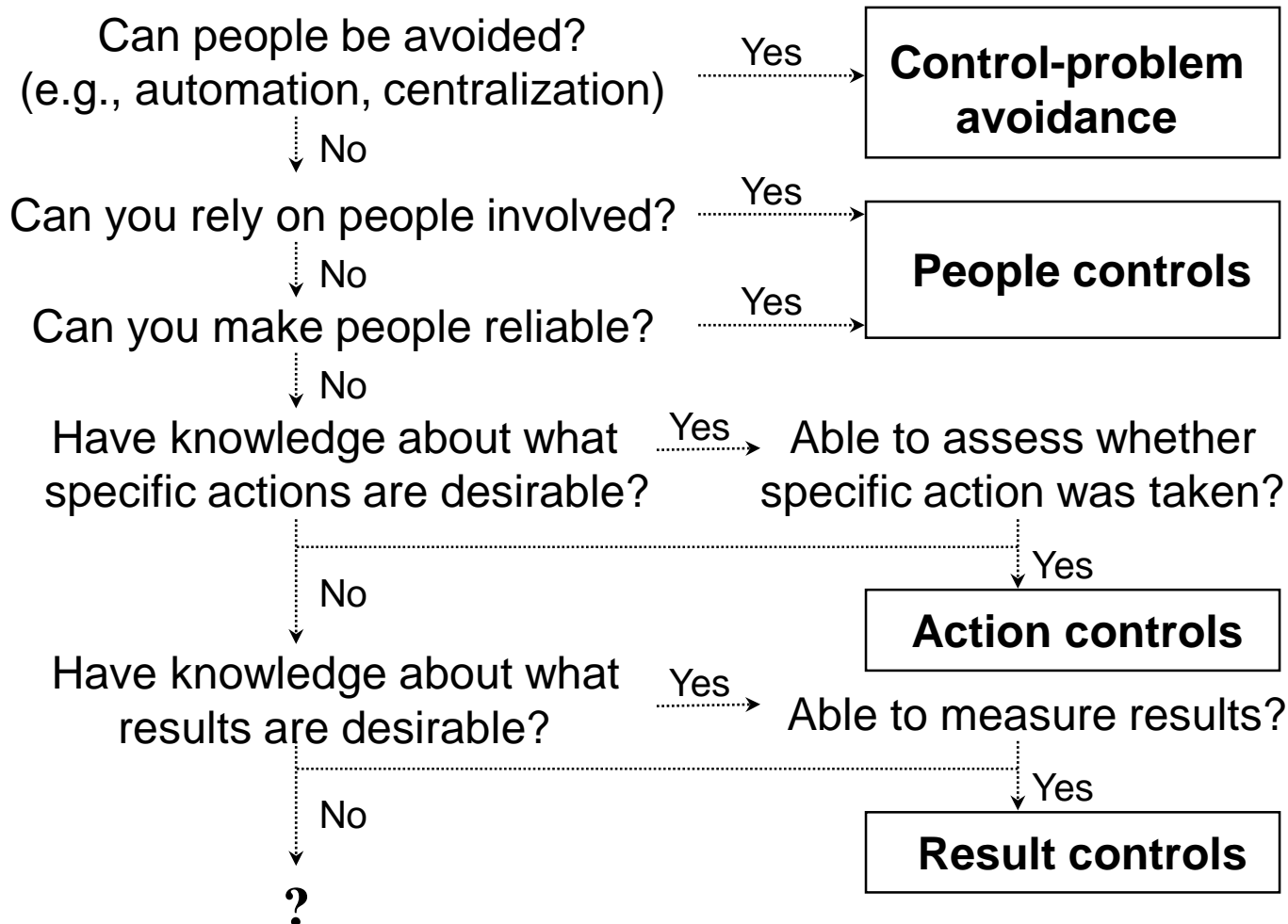
Depending on ...

Ability to measure results on important performance dimensions

Excellent	Action Control and/or Result Control	Action Control (e.g., large projects)
Poor	Result Control (e.g., movie director, entity manager)	People Control (e.g., research lab)
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Knowledge of which specific actions are desirable

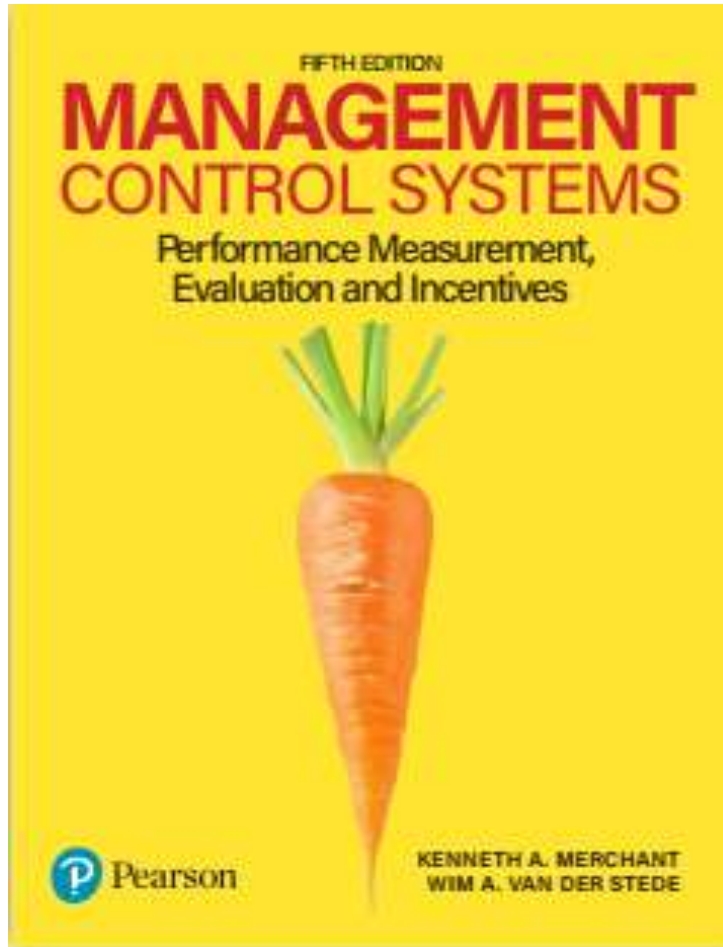
Overview



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Section 2

Management control alternatives and their effects

Chapter 2

Result controls

Result controls

- Involves rewarding individuals for generating good results (or punishing them for poor results)
 - **Result accountability**
- It influences *actions* because it causes employees to be concerned about the *consequences* of the actions they take
 - However, employees' actions are **not constrained**
 - On the contrary, employees are **empowered** to take whatever actions they believe will best produce the desired results

Key result control elements (1 of 2)

- **Defining the performance dimensions**
 - *What you measure is what you get*; hence,
 - If not congruent with the organization's objectives, the controls will actually encourage employees to do the wrong things!
- **Measuring performance on these dimensions**
 - Objective > financial > market-based: for example, stock price
 - > accounting-based: for example, return on assets
 - > non-financial: for example, market share, customer satisfaction
 - Subjective: for example, managerial characteristics (“being a team player”)

Key result control elements (2 of 2)

- **Setting performance targets**
 - Motivational effects
- **Providing rewards (or punishments)**
 - “Incentives” – monetary and non-monetary

Conditions for effective result control

- Result controls work best only when *all* of the following three conditions are present:
 - Superiors/managers must know what results are desired in the areas being controlled
 - The individuals whose behaviors are being controlled must have significant influence on the results in the desired performance dimensions
 - Superiors/managers must be able to measure the results effectively

Ability to influence results

- The person whose behaviors are controlled must be able to affect the results in a material way in a given time span
 - **Controllability principle**
- Result controls are useful only to the extent that they provide information about the desirability the actions of that were taken
 - If the results are uncontrollable, the controls tell us little about the actions that were taken:
 - Good actions will not necessarily produce good results
 - Bad actions may similarly be obscured

Ability to measure results effectively

- The effectiveness of the result measures must be judged by their ...
 - **Ability to evoke the desired behaviors**
- Measurement properties
 - Congruence
 - Controllability
 - Precision
 - Objectivity
 - Timeliness
 - Understandability
 - Cost efficiency

Pros and cons of result controls

PRO

- Behavior can be influenced while allowing significant autonomy
- They yield greater employee **commitment** and **motivation**
- They are often “inexpensive”
 - For example, performance measures are often already collected for reasons not directly related to management control (e.g., financial reporting)

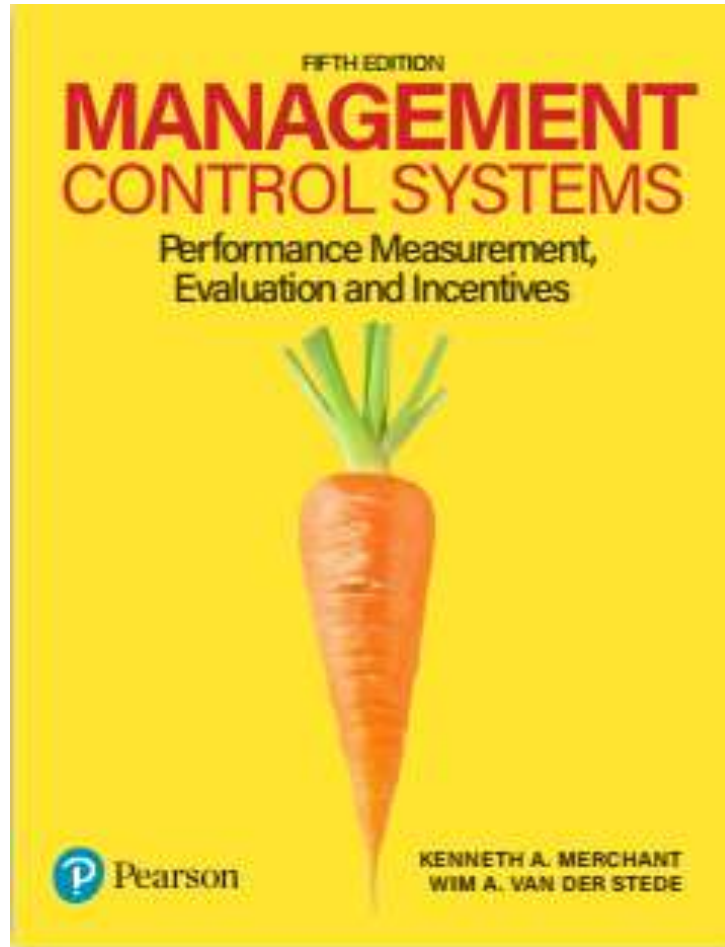
CON

- Often less-than-perfect indicators of whether good actions have been taken
- They shift **risk** to employees (due to uncontrollable factors); hence, they often require a *risk premium* for *risk averse* employees
- Sometimes conflicting functions:
 - **Motivation to achieve**
 - targets should be “challenging”
 - **Communication among entities**
 - targets should be conservative

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Chapter 3

Action, personnel, and
cultural controls

Action controls

- Ensure that employees perform (or do not perform) certain actions known to be beneficial (or harmful) to the organization
- **Prevention/detection**
 - Most action controls are aimed at preventing undesirable behaviors

Effectiveness of action controls

- They are usable and effective only when managers:
 - **Know what actions are desirable**
 - Difficult in highly complex and uncertain task environments
(e.g., research engineers or top-level managers)
 - **Have the ability to make sure that the desirable actions occur**
 - For example, effectiveness of organizational procedures

Behavioral constraints

- **Physical**
 - Locks, passwords, limited access, etc.
- **Administrative**
 - Restriction of decision-making authority
 - Separation of duties, etc.

Preaction reviews

- **Scrutiny of action plans, investment proposals, and budgets**
 - Review and approval
 - Common in (capital) budgeting processes, which are otherwise mainly a *results control* mechanism

Action accountability

- **Holding employees accountable for the actions they take**
- It requires:
 - Defining what actions are (un)acceptable
 - Communicating these definitions to employees
 - For example, work rules, policies and procedures, codes of conduct
 - Observing or otherwise tracking what happens
 - Direct observation/supervision
 - Periodic tracking (e.g., mystery shoppers)
 - Evidence of actions taken (e.g., activity reports)
 - [Rewarding good actions, or] punishing actions that deviate

Redundancy

- **Assigning more people (or machines) to a task than necessary**
 - For example, “backup” people or facilities

Pros and cons of action controls

PRO

- The most direct form of control
- Tend to lead to documentation of the accumulation of knowledge as to what works best
 - Organizational memory
- An efficient way of coordination
 - That is, they increase the predictability of actions and reduce the amount of inter-organizational information flows to achieve a coordinated effort

CON

- Only for “routine” jobs
- May discourage creativity, innovation and adaptation
- May cause sloppiness
- May cause negative attitudes
 - For example, little opportunity for creativity and self-actualization
- Sometimes very costly

Personnel/cultural controls

- “*People controls*” (for short) ensure that employees:
 - Will control their own behaviors
 - **Personnel control**
 - **Self-monitoring**
 - Will control each other
 - **Cultural controls**
 - **Mutual monitoring**
- People controls are part of virtually every management control system

Personnel controls

- Personnel controls build on employees' natural tendencies to control themselves, because most people...
 - have a conscience that leads them to do what is right
 - find self-satisfaction when they do a good job and see their organization succeed
- Labels ...
 - Self-control
 - Intrinsic motivation
 - Ethics and morality
 - Loyalty

Implementing personnel controls

- Generally, it is about ...
“... finding the right people, giving them a good work environment and the necessary resources”
- **Selection and placement**
 - Finding the right people to do a particular job
- **Training**
 - Give employees a greater sense of professionalism
 - Create interest in the job by helping employees to understand their job better
- **Job design + provision of necessary resources**
 - So that motivated and qualified employees have a high probability of success (e.g., equipment, staff support, freedom from interruption)

Cultural controls

- **Cultural controls** or mutual monitoring tap into *social pressure* and *group norms and values*
- Cultural controls are effective because members of a group have *emotional ties* and a *sense of responsibility* to one another
- Cultures are built on shared ...
 - traditions
 - norms
 - beliefs
 - ideologies
 - trust
 - ways of behaving

Ways to shape culture (1 of 2)

- **Codes of conduct**
 - Codes of ethics, corporate credos, mission statements, etc.
 - Formal written documents with broad statements of corporate values, commitments to stakeholders, and the ways in which top management would like the firm to function
 - Fundamental guiding principles of the company
- **Group-based rewards**
 - For example, profit-sharing, employee ownership of company stock

Ways to shape culture (2 of 2)

- **Intra-organizational transfers**
 - Improve the socialization of individuals in an organization and alleviate the formation of incompatible goals and perspectives
 - Improve identification with the organization as a whole as opposed to subunit identification
- **Physical and social arrangements**
 - For example, office plans, interior decor, dress codes and vocabulary, etc.
- **Tone at the top**
 - Top management statements must be consistent with the culture they are trying to create, and importantly, their behaviors should be consistent with their statements

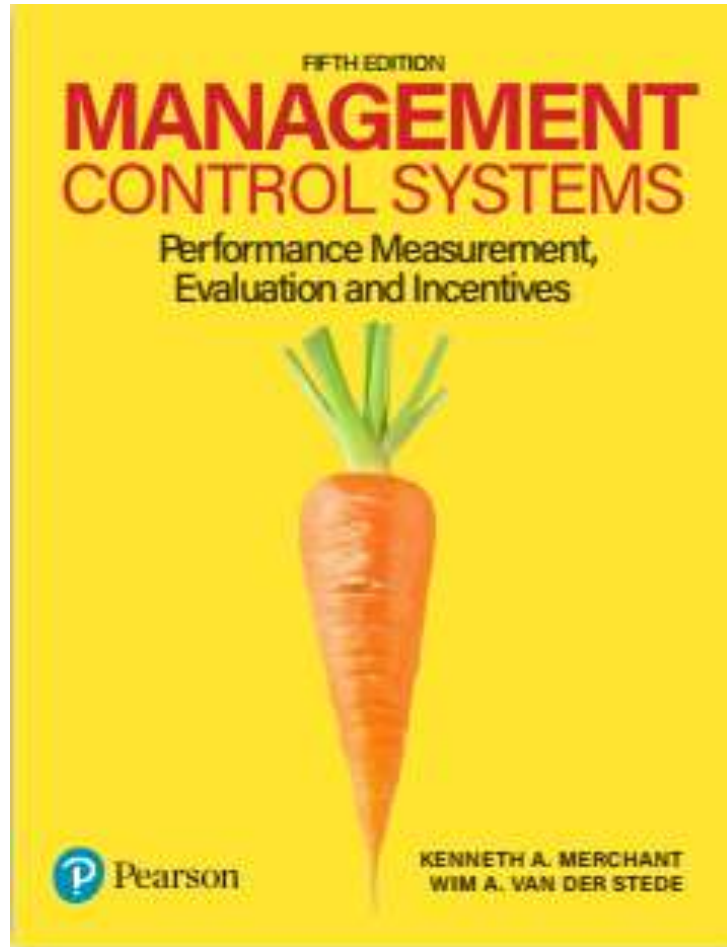
Start with people controls

- **People controls ...**
 - Must always be relied on to a certain extent
 - Have relatively few harmful side-effects
 - Involve relatively low out-of-pocket costs
- However, it is rare that people controls will be sufficient; hence, in most cases, it is necessary to *supplement* them with ...
 - Action controls
 - Result controls

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Chapter 4

Control system tightness

Control and “good” control

- “**Good control**” is said to take place when there is ...
 - a “high” probability that the firm’s objectives will be achieved
 - a “low” probability that major unpleasant surprises will occur
- In this respect, **tight control** is “good” because it provides a *high degree of certainty that people will act as the organization wishes* (assuming away harmful side-effects)

Tight action controls (1 of 2)

- **Behavioral constraints**
 - **Physical**
 - Extra protection usually costs more
 - **Administrative**
 - Restricting decision-making to higher organizational levels provides tighter controls if:
 - Higher-level personnel can be expected to make more reliable decisions
 - Those who do not have authority cannot violate the constraints
- **Preaction reviews**
 - Become tighter if the reviews are frequent, detailed, and performed by diligent and knowledgeable persons

Tight action controls (2 of 2)

- **Action accountability**
 - The amount of tightness of control generated by action accountability depends on:
 - **The definition of (un)desirable actions**
 - Definitions must be specific, yet complete
 - For example, “act professionally” vs. “obtain three competing bids before releasing a purchase order”
 - Definitions must be understood and accepted
 - **The effectiveness of the action-tracking system**
 - Employees should feel that their actions are noticed, and noticed relatively quickly
 - **The reinforcement provided**
 - That is, the significance of the rewards or punishments

Tight result control (1 of 2)

- The achievement of tight result controls depends on:
 - **The definitions of the desired result areas**
 - **Congruence and completeness**
 - Choosing measurable performance dimensions that reflect an organization’s “true” objectives
 - For example, *# visitors* for the success of a museum?
of patents for the success of R&D departments?
Annual profits for a firm with significant growth prospects?
 - **Specificity**
 - Disaggregation + quantification
 - For example, “*keep customers happy*” vs.
“*less than 1% customer complaints*”

Tight result control (2 of 2)

- **The performance measures**
 - **Precision** (amount of “noise”)
 - **Objectivity** (amount of “bias”)
 - **Timeliness** (“lag” between occurrence and measurement)
 - **Understandability**
- **The reinforcements provided**
 - Are the links between results and rewards:
 - **Direct** (no ambiguity)
 - **Definite** (no excuses)

Tight people controls

- The tightness of **personnel controls** depends a great deal on the overlap *between individual and organizational objectives*
 - Selection and training
- **Cultural controls** are often more stable
 - For example, strong “company cultures”

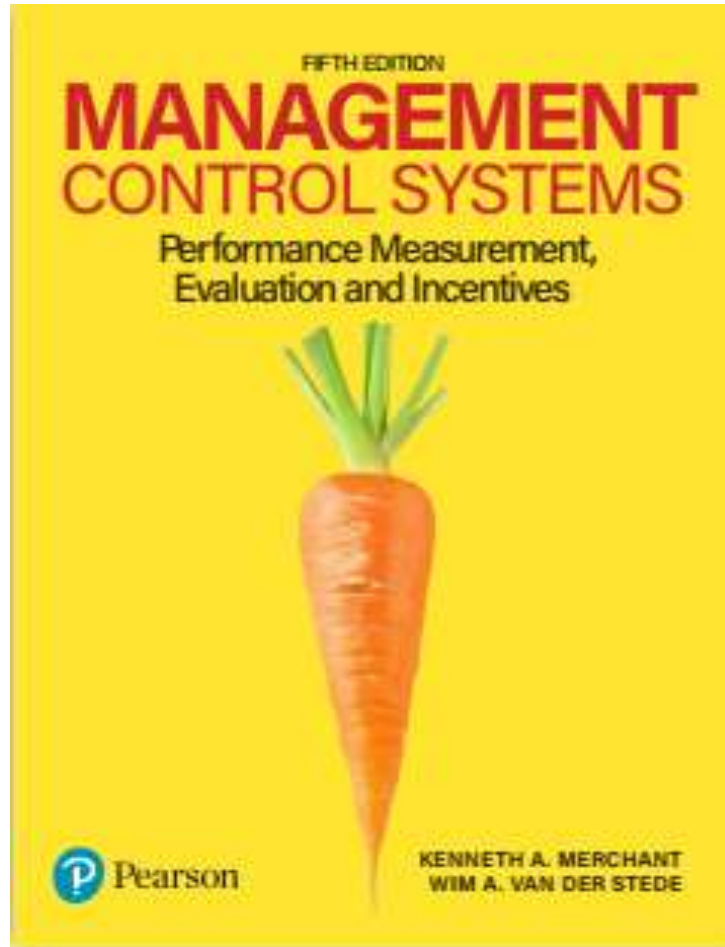
Control combinations

- In order to achieve tighter control, managers often use **multiple forms of controls** that can either *reinforce* each other or *overlap*
 - To achieve (tighter) control over **all the factors** critical to the entity's success, including those that are, say, hard to measure (by means of *results controls*) or “proceduralize” (by means of *action controls*)

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Chapter 5

Control system costs

Cost of control

- **Control benefits**
 - A higher probability that people will both work hard and direct their energies to serve the organization's interests
- **Control costs**
 - ***Direct out-of-pocket costs***
 - Quantifiable: cost of cash bonuses, internal audits
 - Difficult to quantify: time spent on planning and budgeting activities, on pre-action reviews, etc.
 - ***Harmful side-effects***
 - Behavioral displacement
 - Gamesmanship
 - Operating delays
 - Negative attitudes

Behavioral displacement

- Behavioral displacement occurs when the control system encourages behaviors that are not consistent with the organization's objectives
- With **result controls**, it occurs when the result measures are *incongruent* with the organization's *true* objectives, often due to:
 - **Poor understanding of the desired results**
 - **An over-emphasis on “measured” results**
 - Not all of what counts is countable!
- With **action controls**, it can be manifested by:
 - **Means-ends inversion**
 - Employees are induced to pay more attention to what they do and lose sight of what they try to accomplish
 - **Rigid, non-adaptive, and bureaucratic behavior**

Gamesmanship

- Refers to the actions employees take to improve their performance indicators without producing any positive economic effects
 - **Data manipulation**
 - Trying to “look good” by fudging the control indicators
 - **Data management**: affecting the reported results through *accounting methods* (e.g., reserves) or *operating methods* (e.g., delaying expenses)
 - **Falsification**: reporting erroneous data
 - **Creation of slack resources**
 - Consumption of resources in excess of what is required

Operating delays

- Mostly associated with **action controls**, notably, delays caused by:
 - Lengthy review processes
 - Cumbersome authorization layers
 - **Bureaucratic organizations**
- When *responsiveness* is important, operational delays can be quite costly

Negative attitudes

- Job tension, conflict, frustration, resistance
 - Often **coincident with many harmful behaviors**, such as gaming, lack of effort, absenteeism, and turnover
- **Action controls** often “irritate” employees
 - It is difficult for people to enjoy following a strict set of procedures for a long period of time
- **Result controls**
 - When there is a lack of employee **commitment** to the performance targets
 - For example, when targets are too difficult, not meaningful or uncontrollable
 - When performance evaluations are perceived as being **unfair**

Adaptation costs

- Factors that affect MCSs across countries
 - **National culture**
 - People's tastes, norms, values, social attitudes, religions, personal priorities, and responses to interpersonal stimuli
 - **Local institutions**
 - Government agencies, banking systems, labor unions, financial markets, accounting rules, regulations, etc.
 - **Local business environments**
 - Stage of economic development, political risk, inflation, labor availability, labor quality, labor mobility, etc.

National culture differences

- National culture has a direct effect on MCS because control problems are behavioral problems
 - **Individualism** potentially affects ...
 - Incentives based on individual vs. group performance
 - Propensity of engaging in myopic, self-centered behavior
 - **Power distance** potentially affects ...
 - Degree of centralization of decision-making
 - Degree of participation in setting performance targets
 - **Uncertainty avoidance** potentially affects ...
 - Degree of subjectivity in performance evaluations
 - Degree of formality of planning and budgeting processes
 - **Masculinity** potentially affects ...
 - Degree of performance-based rewards

Local institutions

- **Labor unions**
 - Use of performance-based rewards (merit-based vs. seniority-based)
- **Financial markets and stock market valuations**
 - Frequency of profit measurement
 - Use of short-term incentives
 - Likelihood of myopic behavior
- **Accounting regulations**

Local business environments

- **Risk and uncertainty-related factors**
 - **Business risk**
 - Military conflicts, terrorism, corporate espionage, etc.
 - **Political risk**
 - Adverse: forced production, prohibition of layoffs, price controls
 - Protective: tariff barriers, subsidies, research support, etc.
 - **Stage of economic development**
 - Age and size of corporations, degree of computerization, degree of development of accounting, information, and control systems
- **Inflation**
 - **Financial risk** (e.g., use of flexible budgeting)
- **Labor availability, quality, and mobility**
 - Use of action controls, personnel controls, and long-term incentives

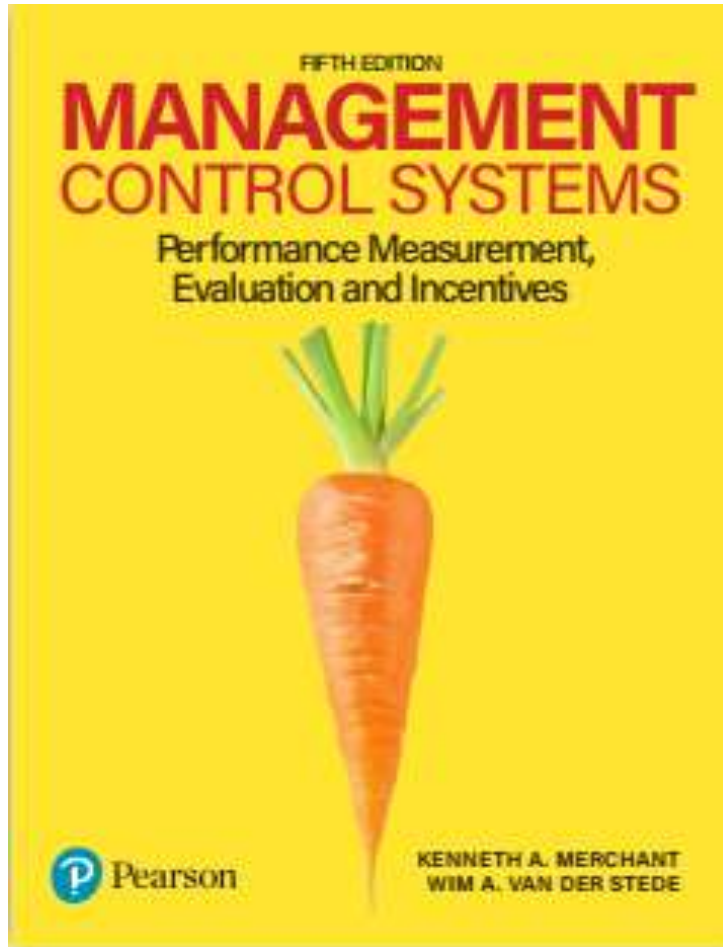
Keep a behavioral focus

- There is no “one best” form of control
 - **What works best in one company (or area within a company), may not work in another**
 - For example, accounting personnel vs. design engineers
- Therefore, it is important to keep the focus on the people involved, because ...
 - It is their *response* that will determine the success or failure of the control system
- ***The benefits of controls are derived only from their impacts on behaviors***

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Chapter 6

Designing and evaluating
management control
systems

Designing control systems

- Two basic questions
 - **What is desired?**
 - **What is likely to happen?**
- If what is likely is different from what is desired, then two basic MCS-design questions must be addressed
 - **What controls should be used?**
 - **How tightly should each be applied?**

What is desired?

- Start from objectives and strategies
 - They should be important guides to the actions that are expected, especially if they are **specific**
 - For example, “*Become a leader in the industry*”
vs. “*15% ROI and 20% sales growth*”
 - Identify the **key actions** (KA)
 - Actions that must be performed to provide the greatest probability of success
 - Identify the **key results** (KR)
 - Key areas where things must go right (or cannot go wrong) for the business to flourish

What is likely?

- Three questions
 - Do employees understand what they are expected to do (*key actions*) or to accomplish (*key results*)?
 - **lack of direction**
 - Are they properly motivated?
 - **lack of motivation**
 - Are they able to fulfill their desired roles?
 - **personal limitations**
- The discrepancy between what is desired and what is likely will determine the **choice** and the **tightness** of the management control systems

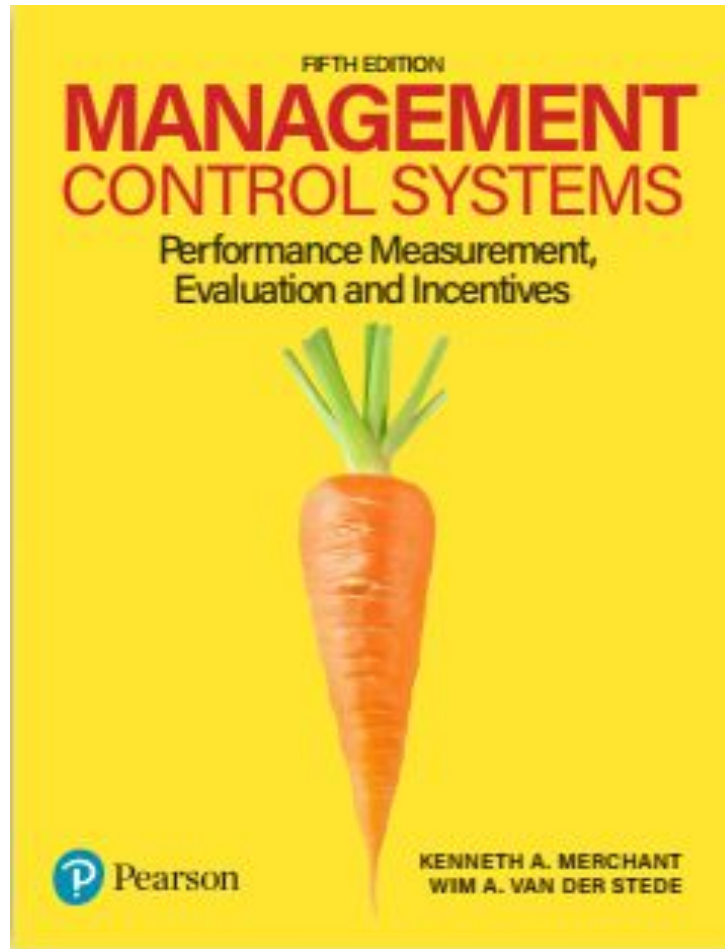
Control system change

- As firms grow, their controls evolve usually toward:
 - **Increased formalization of procedures**
 - for action accountability purposes
and/or
 - **Development of more elaborate information (“accounting”) systems**
 - for result control purposes

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Section 3

Financial result control systems

Chapter 7

Financial responsibility centers

Financial result controls

- Three core elements
 - **Financial responsibility centers**
 - The apportioning of accountability for financial results within the organization
 - **Formal management processes** (planning and budgeting)
 - To define performance expectations and standards for evaluating performance
 - **Motivational contracts**
 - To define the links between results and various organizational incentives

Responsibility centers

- **Responsibility center**
 - An organization unit (entity) headed by a manager with responsibility for a particular set of inputs and/or outputs
- ***Financial* responsibility center**
 - A responsibility center in which the manager's responsibilities are defined primarily in financial terms

Revenue centers (RCs) (1 of 2)

- **Managers of revenue centers are held accountable for generating revenues** (a financial measure of outputs)
 - For example, sales departments in commercial organizations
 - For example, fundraising managers in not-for-profit organizations
- **No formal attempt is made to relate inputs (measured as expenses) to outputs**
 - However, most revenue center managers are also held accountable for **some expenses** (e.g., salespeople's salaries and commissions)

Revenue centers (RCs) (2 of 2)

- But, still they are ***not*** profit centers because:
 - Such costs are only a small fraction of the revenues generated
 - Revenue centers are not charged for the costs of the goods they sell
- **If sales are not “equally endowed,” then revenue responsibility will not necessarily lead to the most profitable sales**

Expense centers (ECs) (1 of 2)

- **Managers of expense (cost) centers are held accountable for expenses** (a financial measure of the inputs consumed by the responsibility center)
 - **“Standard” or “engineered” expense centers (EEC)**
 - Inputs and outputs can be measured in monetary terms
 - There is a “causal” relationship between inputs and outputs
 - For example, manufacturing departments

Expense centers (ECs) (2 of 2)

- **“Managed” or “discretionary” expense centers (DEC)**
 - Outputs produced are difficult to measure
 - Relationship between inputs and outputs is hard to establish
 - For example, R&D and human resources departments

Control in expense centers

- **Engineered expense centers**
 - **Standard cost vs. actual cost**
 - Analysis of the cost of inputs that *should have been* consumed in producing the output vs. the cost that was *actually incurred*
 - **Additional controls**
 - Volume produced, quality, etc.
- **Discretionary expense centers**
 - Ensuring that managers adhere to the budgeted expenses while successfully accomplishing the tasks of their center
 - Subjective, non-financial controls
 - For example, quality of service provided
 - Personnel controls

Profit centers (PCs) (1 of 2)

- **Managers of profit centers are held accountable for generating profits** (a financial measure of the difference between revenues and costs)
- As a measure of performance, profit is ...
 - **Comprehensive**
 - That is, it incorporates many aspects of performance
 - **Unobtrusive**
 - That is, the profit center manager makes the revenue/cost tradeoffs

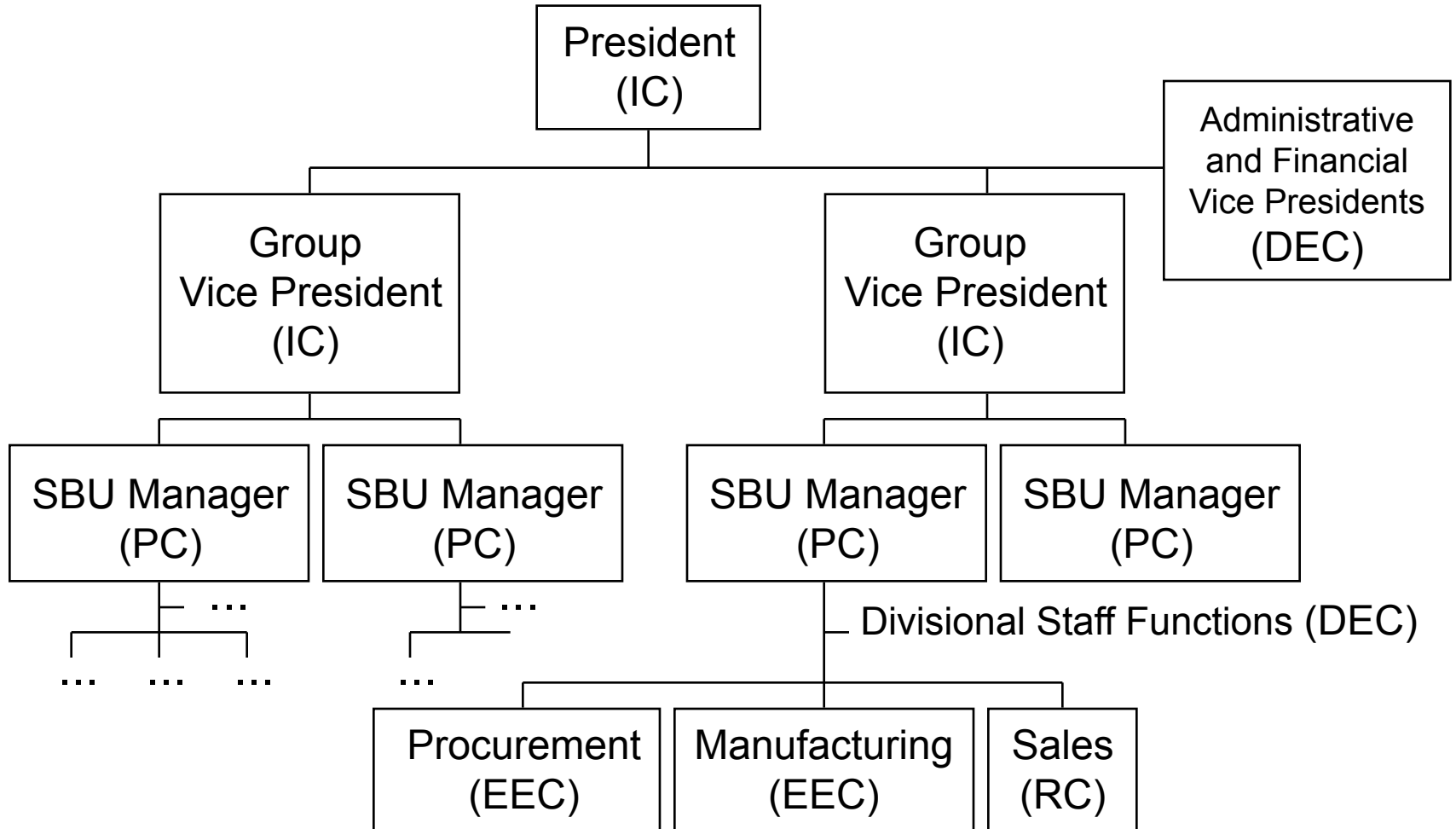
Profit centers (PCs) (2 of 2)

- **Has the manager significant influence over both revenues and costs?**
 - Charge standard cost of goods sold to **sales-focused entities**
 - *Pseudo* or *quasi* or *hybrid* profit centers

Investment centers (ICs)

- **Managers of investment centers are held accountable for the accounting returns (profits) on the investment made to generate those returns**
 - Objective = return on capital
 - Absolute differences in profits are not meaningful if the various organizational entities use different amounts of resources
- **In fact, managers have two performance objectives**
 - Generate maximum profits from the resources at their disposal
 - Invest in additional resources only when such an investment will produce an adequate return

Organization structure



Transfer pricing

Definition

- **The price at which products or services are transferred between profit centers within the same firm**
 - It affects the revenues of the producing profit center (PC), the costs of the buying PC, and, hence, the profits of both entities
- **Purposes**
 - Provide proper economic signals so that PC managers make good economic decisions from a corporate standpoint
 - Provide information for evaluating PC performance
 - Purposely move profits between company entities/locations
 - For example, for tax purposes or in joint-ventures

Market-based transfer prices

- Where a (“perfectly” competitive) external market exists
- Managers of both the selling and buying PC will make decisions that are optimal from a corporate perspective, and reports of their performances will provide good information for evaluation purposes
- **Actual price**, which is charged to external customers, **listed price** of a similar product, or the price a competitor is offering (**bid price**)
 - **Deviations** can be allowed that reflect differences between internal and external sales:
 - Savings in marketing, selling, and collecting costs
 - Differences in quality standards, special features, or special services provided

Marginal-cost transfer prices

- It excludes upstream fixed costs and profits and, hence, the marginal costs remain visible for the PC that finally sells to outside customers
- It provides poor information for evaluation purposes
 - The selling PC incurs a loss
 - The profits of the buying PC are overstated
- **Rarely used in practice**
- Variation: **Marginal cost + lump-sum fee**
 - The marginal cost of the transfer remains visible
 - The selling PC can recover its fixed cost and a profit margin through the lump-sum fee
 - Problem: estimation of capacity to “reserve” for internal sales

Full-cost transfer prices

- **Popular in practice**
- **Relatively easy to implement**
 - Firms have cost systems in place to calculate the full cost of production
 - But, full costs rarely reflect actual, current costs of producing the products because of **financial accounting conventions** (e.g., depreciation) and arbitrary **overhead cost allocations**
- There is **no incentive** for the selling PC to transfer internally since there is no profit margin
- The profit of the selling PC is understated

Full cost + markup

- **It allows the selling PC to earn a profit on internally transferred products/services**
- Crude approximation of the market price in cases where no competitive external market price exists
 - Such transfer prices, however, are **not** (quite) **responsive to market conditions**

Negotiated transfer prices

- Transfer prices are negotiated between the selling and buying PC managers themselves
 - Both PC managers should have some **bargaining power** (i.e., some possibilities to sell or source outside)
 - The outcome is often not economically optimal, but rather depends on the **negotiating skills** of the managers involved
- It is **costly** (management time), accentuates **conflicts** between PC managers, and often requires **corporate management intervention**

Dual-rate transfer prices (1 of 2)

- **Method**

- The selling PC is credited with the outside sales price
- The buying PC is charged the (marginal) cost of production only
- The difference is charged to a corporate account and eliminated at the time of financial statement consolidation

- **Advantages**

- It provides proper economic signals for decision-making
- It maintains proper information for evaluation purposes
- It ensures that internal transactions will take place

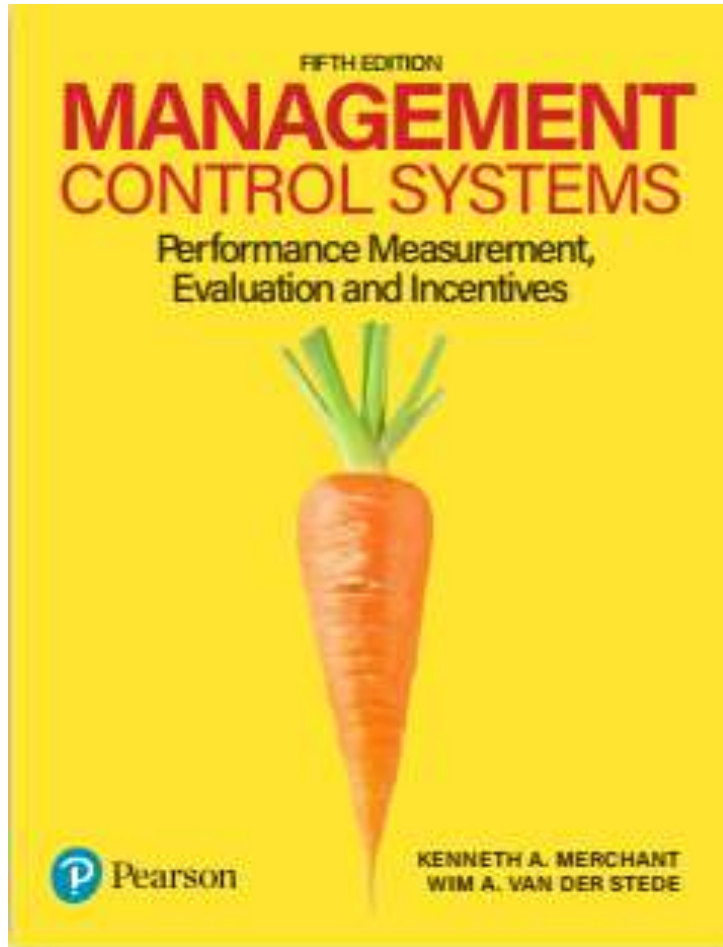
Dual-rate transfer prices (2 of 2)

- **Disadvantages**
 - It destroys incentives to negotiate favorable outside prices for supplies (buying PC now only pays the marginal cost)
 - It destroys incentives to improve productivity (selling PC finds “easy” sales inside)

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Chapter 8

Planning and budgeting

Financial result controls

- Three core elements
 - **Financial responsibility centers**
 - The apportioning of accountability for financial results within the organization
 - **Formal management processes**
 - Planning and budgeting to define performance expectations and standards for evaluating performance
 - **Motivational contracts**
 - To define the links between results and various organizational incentives

Planning and budgeting

- Produce **written plans** that specify:
 - Where the organization wishes to go
 - How it intends to get there
 - What results should be expected
- **Purposes** of planning and budgeting processes
 - To enhance management control
 - To engage in long(er)-term thinking
 - To achieve coordination (top-down, bottom-up, sideways)
 - To establish “challenging-but-achievable” performance targets

Planning cycle



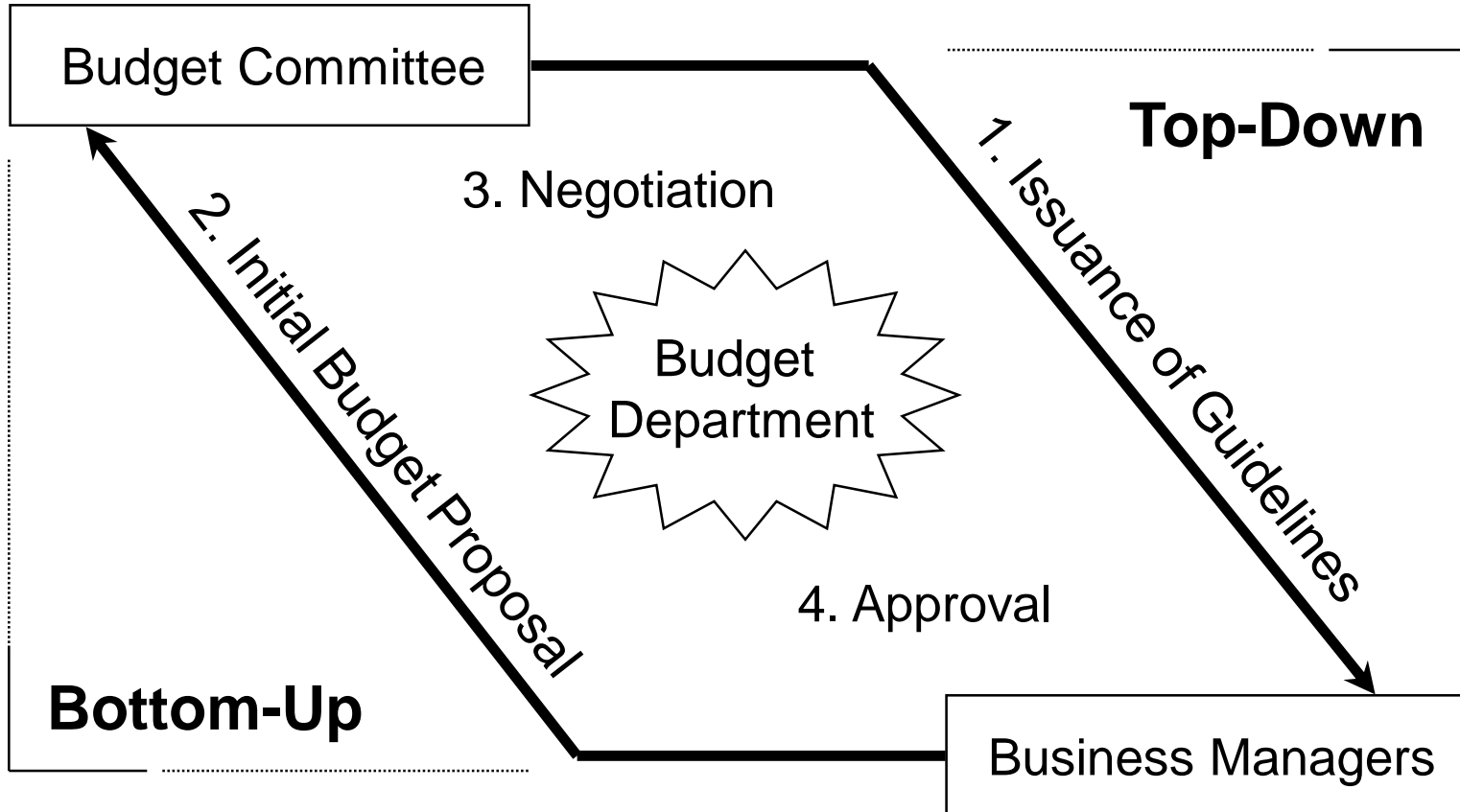
Characteristics of a budget

- It is usually stated in **monetary** terms
- It generally covers a period of **one year**
- It contains an element of **management commitment**, that is, the managers agree to accept the responsibility for attaining the budgeted objectives
- The budget is **approved** by an authority higher than the budgetee
- Once approved, the budget can be **changed** only under specified conditions
- Periodically, actual financial performance is compared to budget and **variances** are analyzed and explained

Budgeting and management control

- Budgeting involves setting targets that are commonly used as standards against which to evaluate performance – **result controls**
- Planning and budgeting processes involve formal reviews of plans and include the actions that are felt to be good for the organization to take – **action controls**
- Planning and budgeting processes provide the needed information for decision-making to the relevant managers – **personnel controls**

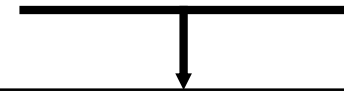
The budget preparation process



The budgeting process takes about 4 months in most firms

Types of financial performance targets

- **Model-based (engineered)/historical/negotiated**



Information asymmetry

- **Internally/externally-derived**

- Target costing
- Benchmarking

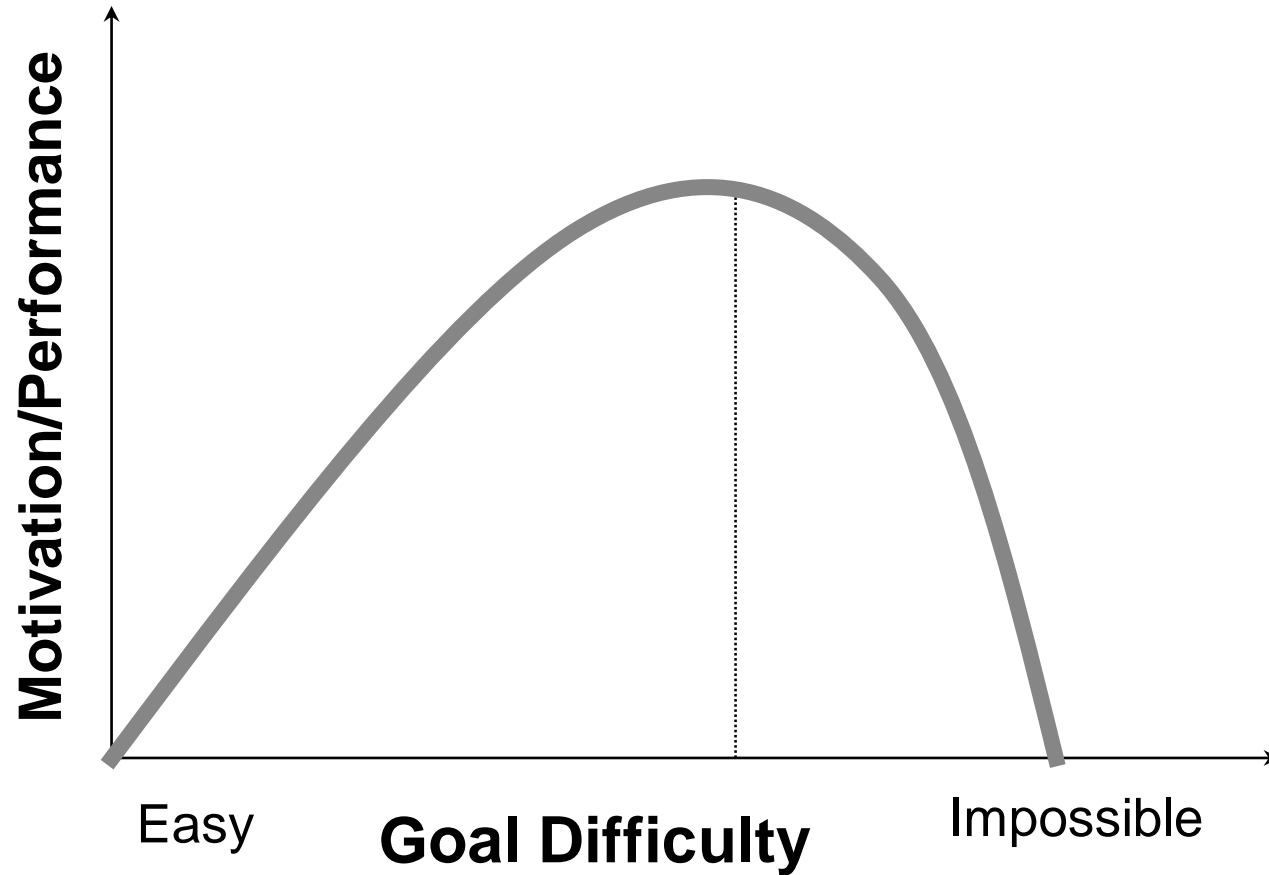
- **Fixed/flexible**

- Should managers be held accountable for achieving their plans regardless of the business conditions they face?
- Relative performance targets

Budget participation

- **Top-down/bottom-up budgeting**
 - The budgetee is both **involved** and has **influence** over setting the budget
 - Leads to better acceptance of budget targets, and hence, **commitment** to achieve them
 - Is an effective way of **information sharing** bringing together corporate priorities and constraints with lower-level insights about business potentials and risks
 - But, potential for slack, **bias**, conservatism, ...

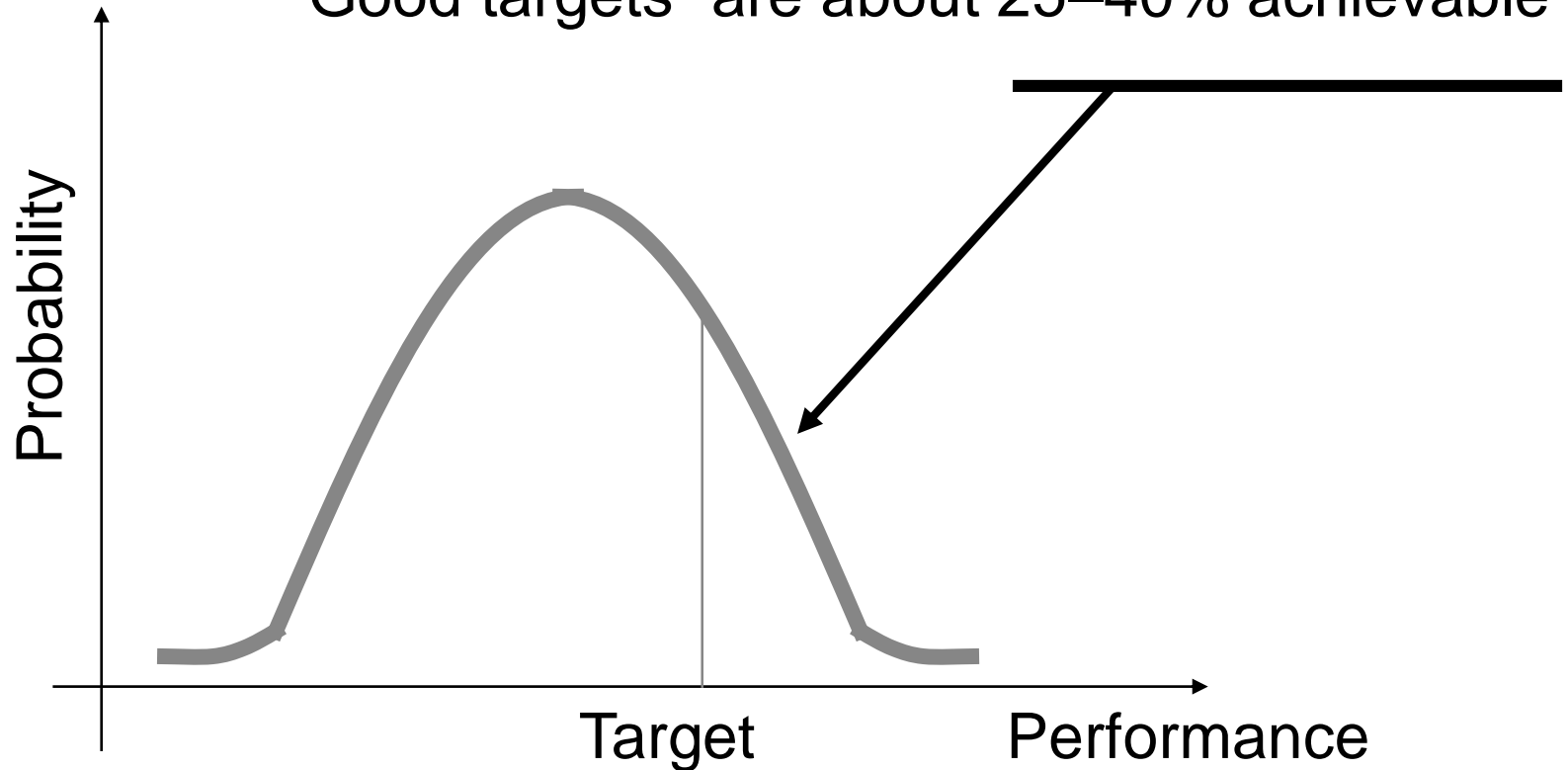
Budget target difficulty (1 of 5)



Budget target difficulty (2 of 5)

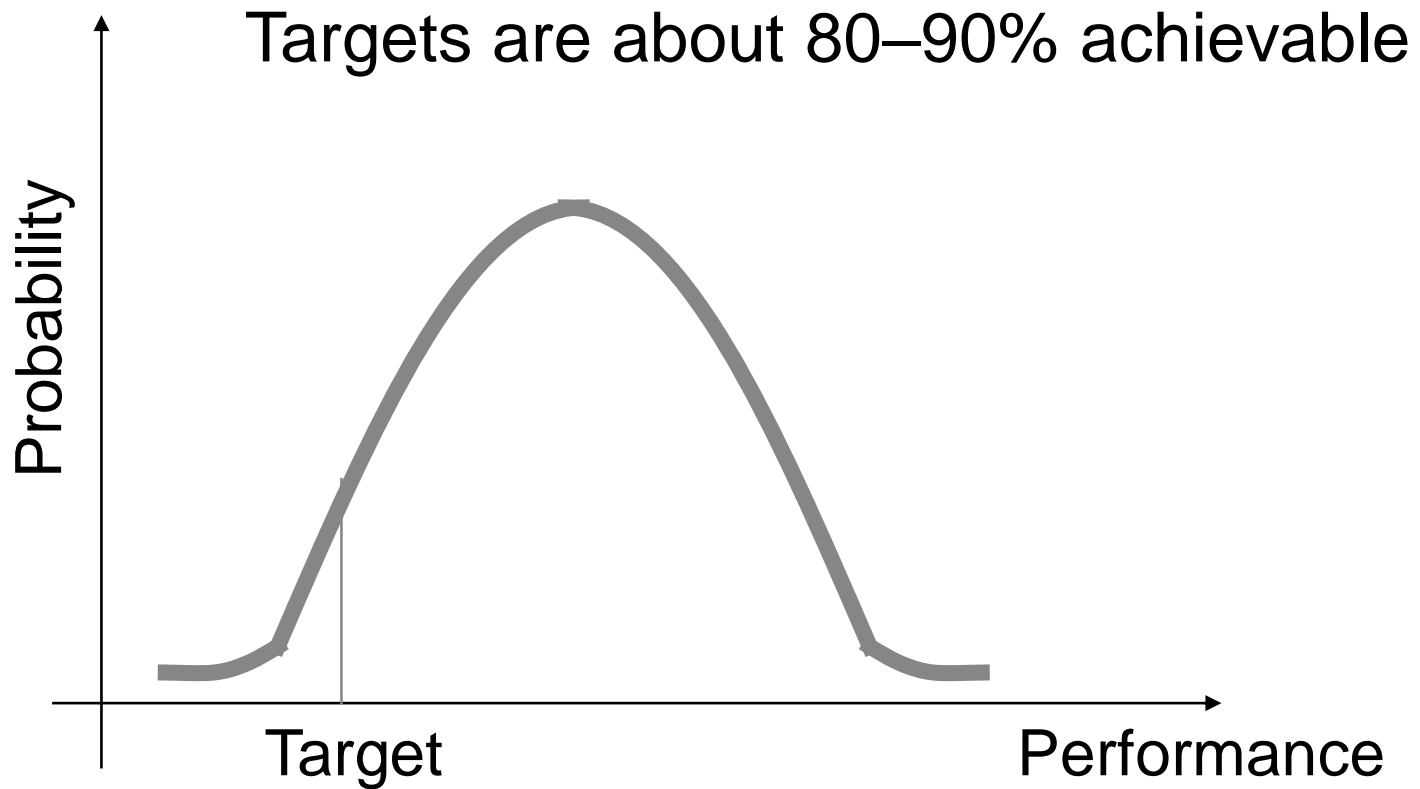
In theory (lab experiments):

“Good targets” are about 25–40% achievable



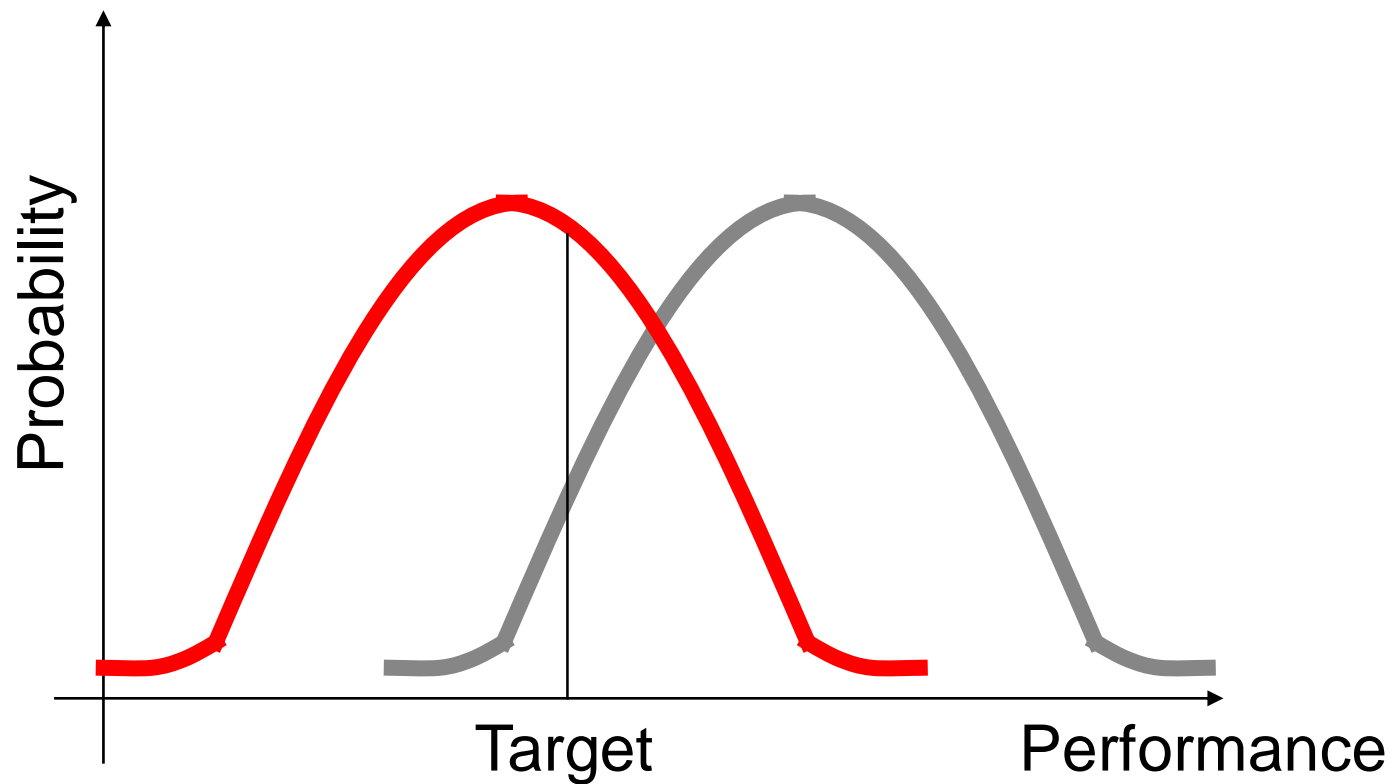
Budget target difficulty (3 of 5)

In practice (field research)



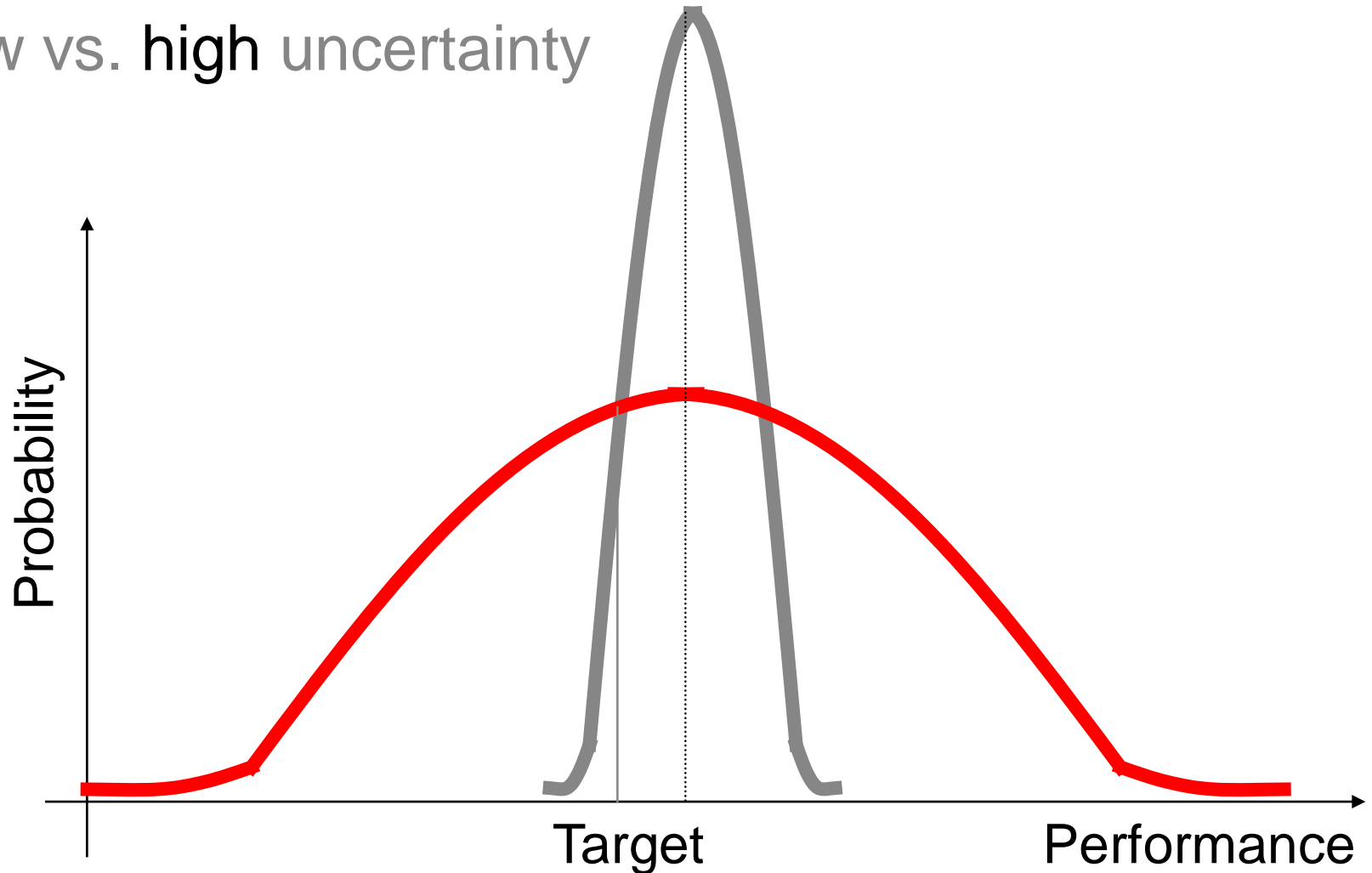
Budget target difficulty (4 of 5)

Effective vs. ineffective management teams



Budget target difficulty (5 of 5)

Low vs. high uncertainty



Challenging but achievable ...

- To minimize dysfunctional management actions
 - Myopic behavior, data manipulation
- To increase manager's commitment to budget targets
- To reduce the cost of organizational interventions
 - Management-by-exception
- To protect against the cost of optimistic revenue projections
 - Over-commitment of resources
- To create a “winning” atmosphere and positive attitude

What is a “good” budget target?

Purpose of Budgeting

- Motivation
- Planning
- Coordination
- Cost control
- Evaluation

Target Difficulty

- ◆ Conservative
- ◆ Best guess
- ◆ Optimistic

Target should be after-the-fact assessment of what could have been accomplished, not any of the three choices listed

“Beyond Budgeting”? (1 of 2)

- Some “principles”
 - **Goals**
 - Set relative goals for continuous improvement; **not fixed performance contracts**
 - **Rewards**
 - Reward success based on relative performance; **not on meeting fixed targets**
 - **Planning**
 - Make planning a continuous and inclusive process; **not a top-down annual event**
 - **Coordination**
 - Coordinate interactions dynamically; **not through annual planning cycles**

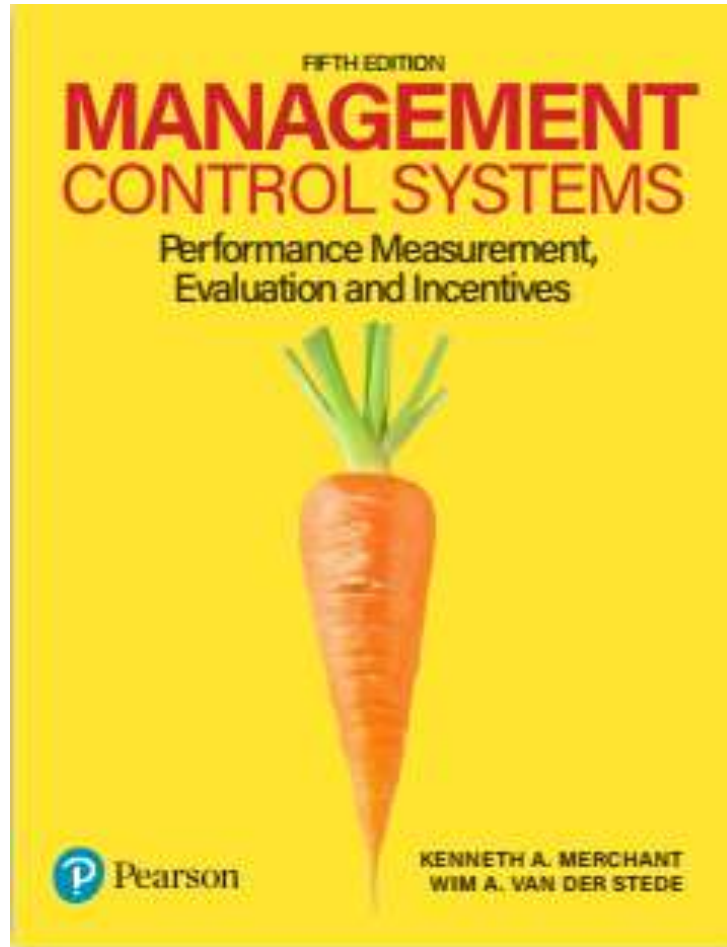
“Beyond Budgeting”? (2 of 2)

- **Resources**
 - Make resources available as needed; ***not through annual budget allocations***
- **Controls**
 - Base controls on relative indicators and trends; ***not on variances against plan***
- Applicability in practice? Effectiveness? Problems?

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Chapter 9

Incentive systems

Financial result controls

- Three core elements:
 - **Financial responsibility centers**
 - The apportioning of accountability for financial results within the organization
 - **Formal management processes**
 - Planning and budgeting to define performance expectations and standards for evaluating performance
 - **Motivational contracts**
 - To define the links between results and various organizational incentives

Positive and negative incentives

- **Positive incentives** → *“rewards”*
 - Things employees value
- **Negative incentives** → *“punishments”*
 - Things employees like to avoid
- Individuals are believed to be more strongly motivated by the potential of earning rewards than by the fear of punishment

Forms of rewards and punishments

- **Rewards**

- Monetary
 - Salary increases
 - Bonuses
 - Benefits
 - Perquisites
 - Club memberships
 - Vacation trips
- Non-monetary
 - Promotion
 - Autonomy
 - Recognition
 - Participation in decisions
 - Office assignments
 - Preferred parking places
 - Titles

- **Punishments**

- Monetary
 - No raise
 - No bonus
 - No perquisites
- Non-monetary
 - Interference in job from superiors
 - Loss of job
 - Assignment to unimportant tasks
 - No promotion
 - Humiliation

The compensation package

- **Salary**
- **Benefits**
 - Pension and health benefits
 - Perquisites of various types
- **Incentive compensation**
 - **Short-term incentive plans**
 - Based on the performance in the current year or less
 - **Long-term incentive plans**
 - Based on the performance measured over periods greater than 1 year and often related to the company's stock price

Short-term incentive plans

- **Based on performance in the current year or less**
 - For example, piece-rate payments, commissions, bonuses
- **Calculation (by formula) of short-term incentives**
 - For example, 2% of sales; 10% of net profits
 - For example, 60% of target bonus at 80% of target;
100% of target bonus at 100% of target
(where target bonus = 30% of salary)

Long-term incentive plans

- **Based on the performance measured over periods greater than 1 year**
 - Usually restricted to higher management levels
 - **Accounting performance** (e.g., EPS, ROE, ROA) over a period of 3–5 years
 - **Market-based performance**
 - Stock options
 - Restricted stock
 - Stock appreciation rights

Purpose of incentives (1 of 3)

- **Motivation**

- Motivation has two elements

- **Inducing effort:** *getting employees to work hard*

- Employees typically put forth more (less) effort on activities that are (not) rewarded

- **Directing effort:** *helping employees understand what is expected of them*

- Rewards attract the employees' attention and inform them of the relative importance of often-competing result areas

Purpose of incentives (2 of 3)

- **Attraction/retention**

- Paying employees only guaranteed salaries tends to attract **risk-averse** employees
- Paying performance-dependent compensation tends to attract employees who are more **risk tolerant**, more aggressive, more confident in their abilities
- Restricted stock, for example, often are geared toward **employee retention**
 - “Golden handcuffs”

Purpose of incentives (3 of 3)

- **Non-control purposes**
 - Provide a competitive compensation package
 - Make compensation variable with firm performance
 - Tax considerations

Key incentive design elements

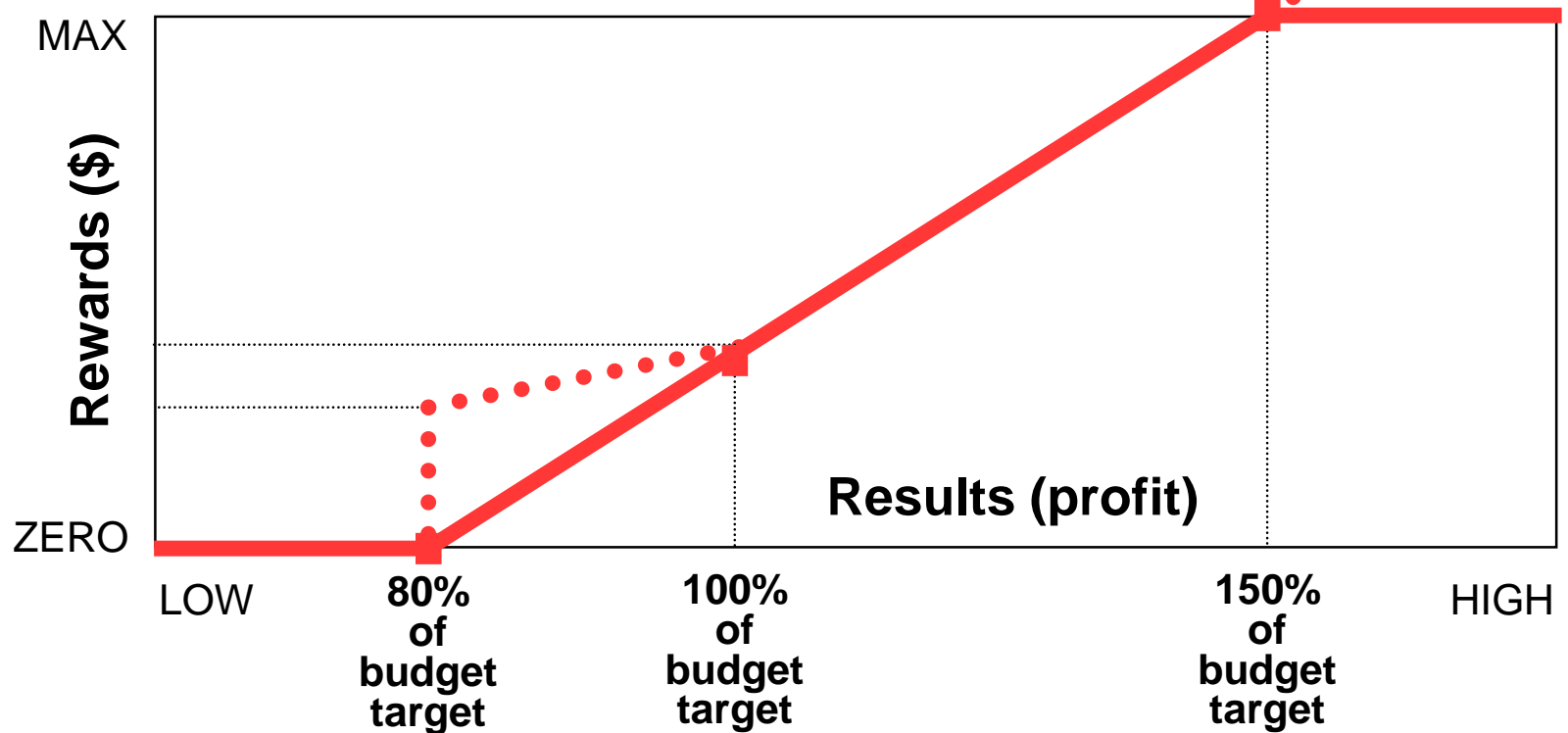
- **Size of awards** (fixed vs. variable pay)
- **Level and type of measurement**
 - Performance at the individual, entity or company level
 - Financial vs. non-financial performance; single or multiple measures or performance criteria
- **Shape of the incentive-performance function**
- **Use of “subjectivity”**

Proportion variable pay

- **Employees are risk averse ...**
 - Performance-dependent rewards impose **risk** on the employees as performance is never fully controllable
 - Across firms, differences in the proportion of “at-risk” pay are greater than differences in base pay
 - Levels of “at-risk” pay generally decrease at lower organization levels

Shape of reward function

- Commonly, the link between rewards and results is linear, but over a restricted performance range only



Cutoffs

- **Lower cutoff**
 - To avoid paying bonuses for performance, which is considered mediocre or worse
- **Upper cutoff**
 - To maintain vertical compensation equity
 - To keep total compensation somewhat smooth over time
 - To avoid the fact that managers will be “unduly” motivated to take actions to maximize bonus payouts
 - To avoid undeserved bonuses due to “windfall” gains
 - To alleviate the possibility of a faulty compensation plan design

Group rewards

- **Team-based rewards are often used to implement personnel / cultural controls**
 - Group members monitor and sanction each other's behaviors
- **They rarely provide a direct incentive effect**
 - Stock-based plans, for instance, provide direct incentives only for a small number of managers at the very top of the firm
 - Hence, for lower-level employees, compensation is made more volatile, although motivation may not be (greatly) affected

Bonus determination approach

- **Formulaically**
 - The performance-reward link is explicit
 - Alleviates bias or favoritism in assessing and rewarding performance
 - but
 - Possibly less focus on performance dimensions that are more difficult to quantify (e.g., R&D)
- **Subjectively**
 - Allows performance to be evaluated more “completely” considering any of a number of hard-to-quantify, but important, performance areas
 - Lack of explicitness increases the employee's **risk** (due to possible bias)

Criteria for evaluating reward systems (1 of 2)

- **Rewards should be valued**
 - Rewards that have no value do not provide motivation
 - Reward tastes vary across individuals and are situational
- **Rewards should be large enough to have impact**
 - Reward “visibility” can affect impact
- **Rewards should be understandable**
 - What is the reason for earning the reward?
- **Rewards should be timely**
 - The discount rate employees apply to delayed rewards is said to be greater than the time value of money

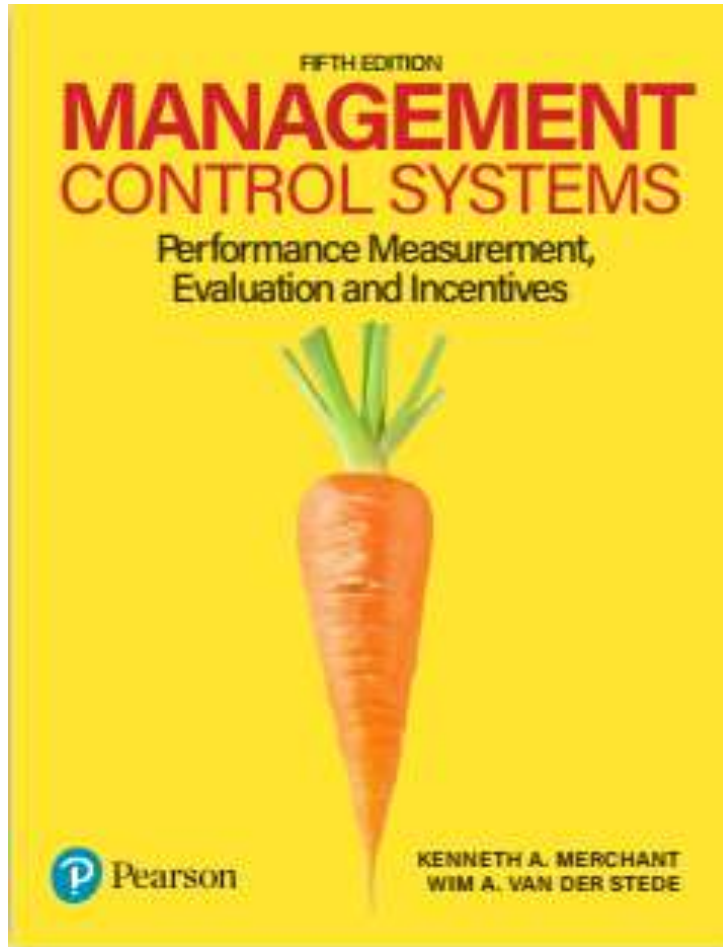
Criteria for evaluating reward systems (2 of 2)

- **Rewards should be durable**
 - Rewards have greater value if positive feelings generated through the reward are long-lasting, that is, if employees remember them
- **Rewards should be reversible**
 - To make rewards “variable” with performance and to create a lasting incentive effect (*pay-for-performance vs. pay-for-pulse*)
 - Promotions, for instance, are difficult to reverse
- **Rewards should be cost efficient**
 - To stimulate the desired motivation at minimal cost

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Section 4

Performance measurement issues and their effects

Chapter 10

Financial performance measures and their effects

Summary measures

- Summary, single-number, aggregate, bottom-line financial measures of performance
- Reflect the aggregate or **bottom-line** impacts of multiple performance areas
 - For example, accounting profits reflect the aggregate effects of both revenue- and cost-related decisions
- Two types
 - **Market measures**
 - Reflect changes in stock prices or shareholder returns
 - **Accounting measures**
 - Defined in either **residual terms** (net income after taxes, operating profit, residual income, economic value added) or **ratio terms** (return on investment, return on equity, return on net assets)

Market measures

- **Timely** – measured in short time periods
- **Precise** – in well-functioning capital markets
- **Objective** – not (easily) manipulable by the managers whose performances are being evaluated
- **Congruent** – the most direct manifestation, or closest proxy, of the theoretical notion of *firm value*
- **Cost effective** – do not require any company measurement expense
- **Understandable** – in terms of what the measures represent (changes in market value of the firm)

Limitations (1 of 3)

- **Congruence**

- Market measures are heavily influenced by future expectations, but these might not be realized
- Market valuations can be affected by carefully timed or “managed disclosures” that are not always in the firm’s long-term interest
- Market efficiency?
 - Due to competitive sensitivities, markets are not always fully informed about a company’s plans and prospects, and hence, its future cash flows and risks
 - Other “anomalies”

Limitations (2 of 3)

- **Feasibility**

- Market measures are not available either for privately held firms or wholly owned subsidiaries or divisions, and they are not applicable to not-for-profit organizations

- **Controllability**

- Market measures can generally be affected to a significant extent only by the top few managers in the organization, those who have the power to make decisions of major importance

Limitations (3 of 3)

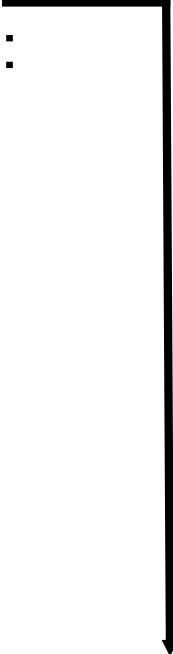
- These limitations of market measures cause organizations to look for **surrogate measures of performance**
 - Accounting measures are the most important surrogates used, particularly at **management levels below the very top of the firm**

Accounting measures

- **Timely** – measured in short time periods
- **Precise** – subject to extensive accounting rules
- **Objective** – audited by independent auditors
- **Congruent**
 - In for-profit firms, accounting profits or returns are relatively congruent with the true firm goal of maximizing shareholder value
 - Positive correlations between accounting profits and changes in stock prices
- **Cost effective** – already required for financial reporting
- **Understandable**

Limitations

- Accounting income does not reflect **economic income** perfectly, because accounting measures:
 - Are transaction oriented
 - Are dependent on the choice of measurement method
 - Are conservatively biased
 - Ignore intangibles
 - Ignore the cost of equity capital
 - Ignore risk
 - Focus on the past
 - ...



The change in the value of the entity over a given period, where “**value**” is obtained by discounting future CFs

Myopia

- The motivational effect of these measurement limitations can be perverse because managers who are motivated to produce accounting profits or returns can (in the short term) do so by:
 - **Not making investments**, even worthwhile ones
 - Investment myopia
 - **Making operational decisions to shift income across periods**, even when harmful long term
 - Operational myopia

ROI performance measures

- **Return on investment**

- ROI is a **ratio** of the accounting profits earned by the business unit divided by the investment assigned to it
- ***ROI = profits ÷ investment base***

- **Residual income**

- RI is a **dollar amount** obtained by subtracting a capital charge from the reported accounting profits
- ***RI = profits – capital charge***

Problems caused by ROI measures

- **Numerator**
 - **Accounting profits**
 - ROI contains all problems associated with these profit measures
- **Denominator**
 - **How to measure the fixed assets portion?**
- **Suboptimization**
 - ROI measures can lead division managers to make decisions that improve division ROI even though the decisions are not in the corporation's best interest

An example

- Assume corporate cost of capital = 15%
- Division investment of \$25,000 that generates 5,000 annual profit (= 20%)

	Division		New Asset Alone
	WITHOUT	WITH	
Profit	25,000	30,000	5,000
Assets	100,000	125,000	25,000
ROI	25%	24%	20%

Another example

ROI

Entity	Cash	Receivables	Inventories	Fixed Assets	Total Invest.	Profit	ROI
A	\$10	\$20	\$30	\$60	\$120	\$24.0	20%
B	20	20	30	50	120	14.4	12
C	15	40	40	10	105	10.5	10
D	5	10	20	40	75	3.8	5
E	10	5	10	10	35	(1.8)	(6)

RI

Entity	Profit	Cur. Assets	Req. Earn.	Fixed Assets	Required Earn.	Res. Income
A	\$24.0	\$60	\$2.4	\$60	\$6.0	\$15.6
B	14.4	70	2.8	50	5.0	6.6
C	10.5	95	3.8	10	1.0	5.7
D	3.8	35	1.4	40	4.0	(1.6)
E	(1.8)	25	1.0	10	1.0	(3.8)

4%

10%

Suboptimization (1 of 3)

- **ROI provides different incentives for investments across organizational entities**

- Entity manager will **not invest** if ...
$$\text{Corporate Cost of Capital} < \text{IRR of Project} < \text{Entity ROI}$$
- Entity manager will **invest** if ...
$$\text{Corporate Cost of Capital} > \text{IRR of Project} > \text{Entity ROI}$$
- Hence, if corporate cost of capital is 10%,
 - **IRR of project is 11%**, then A and B are unlikely to invest ←
 - **IRR of project is 9%**, then D and E are still likely to invest ←

Suboptimization (2 of 3)

Assume

Worthwhile !

Corporate cost of capital = 10%
Investment of \$10 to earn \$1.1 per year

	DOES NOT INVEST	INVESTS	INVESTS
Base situation	Entity A	Entity C	Entity D
Profit before tax	\$24	\$10.5	\$3.8
Investment base	\$120	\$105	\$75
ROI	20%	10%	5%
New situation	New situation	New situation	New situation
Profit before tax	\$25.1	\$11.6	\$4.9
Investment	\$130	\$115	\$85
ROI	19.30%	10.08%	5.76%

Suboptimization (3 of 3)

Assume

Not worthwhile !

Corporate cost of capital = 15%
Investment of \$10 to earn \$1.1 per year

	DOES NOT INVEST	INVESTS	INVESTS
Base situation	Unit A	Unit C	Unit D
Profit before tax	\$24	\$10.5	\$3.8
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New situation	New situation	New situation	New situation
Profit before tax	\$25.1	\$11.6	\$4.9
Investment	\$130	\$115	\$85
ROI	19.30%	10.08%	5.76%

Other issues

- Suboptimization is not an issue with **residual income (RI) measures** when the capital charge is set at or above the cost of capital
- **ROE** measures induce managers to use **debt financing** (if they have financing authority)
 - This is not the case with RI if the capital charge is equal to the weighted average cost of debt and equity
- **ROA** measures induce managers to **lease assets** (again, if they have authority over such decisions)

The fixed assets portion

- **Net Book Value**

- Both ROI and RI get better merely through **passage of time**
- Both ROI and RI are usually overstated if the division includes a relatively large number of **older assets**
- **Example**
 - Invest \$100; Cash flow \$27 per year; Depreciation \$20 (5 years)

Yr	NBV	Incremental Income	Capital Charge	RI	ROI
1	100	7	10	-3	7%
2	80	7	8	-1	9%
3	60	7	6	1	12%
4	40	7	4	3	18%
5	20	7	2	5	35%

(= 27 - 20) 10 %

Misleading performance signals

- Division managers are encouraged to retain assets beyond their optimal life and **not to invest in new assets**
- Corporate managers may be induced to **over-allocate resources to divisions with older assets**
- Combined with the **suboptimization issue**, managers of entities with older assets, and hence a higher ROI, are likely to be more reluctant to invest in desirable projects with an IRR higher than the corporate cost of capital

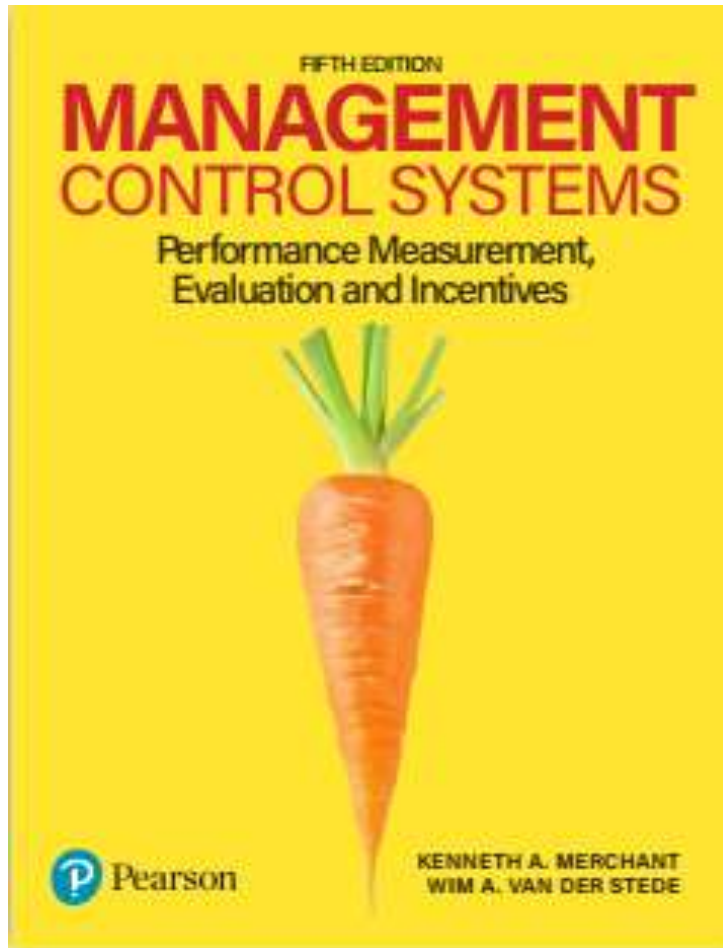
Economic Value Added (EVA™)

- **Modified after-tax operating profit**
 - **(Modified capital × weighted avg. cost of capital)**
- Similar to RI (= profit – capital charge), except for the **modifications** (164 in total, as suggested by Stern Stewart & Co)
 - For example, capitalization and subsequent amortization of intangible investments (e.g., in R&D, employee training), adding LIFO-reserves to correct for undervalued inventories, etc.

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Chapter 11

Remedies to the myopia problem

We seek ...

- a measure,
- or a combination of measures,

that leads managers and employees to take the right actions or make the right decisions in order to create **long-term value**

But ...

Financial measures of performance often are *not*, by themselves, sufficient to motivate optimal management decisions

Worse, financial measures often create pressures for short-term performance potentially at the expense of long-term value creation

- **The myopia problem**

Overcoming myopia (1 of 6)

- **Reduce pressure for short-term profit**
 - Reduce the weighting placed on the annual profit target and emphasize other, longer-term performance indicators, such as market share and technical breakthroughs
 - Use subjective performance evaluations?
 - Make the short-term profit targets easier to achieve
 - Some slack is created to fund longer-term projects
 - But, motivational effects of “easy” targets?

Overcoming myopia (2 of 6)

- **Control investments with preaction reviews**

- Operating expenses
- “Today” businesses
- Developmental expenses
- “Tomorrow” businesses



Financial result controls



Combination of non-financial performance indicators and action controls

Overcoming myopia (3 of 6)

- **Extend the measurement horizon**
 - **Measurement congruence**
 - The longer the period of measurement, the higher the correlation between accounting income and economic income
 - Use long-term incentives?

Overcoming myopia (4 of 6)

- **Measure changes in “shareholder value” directly**
 - **Valuation difficulties**
 - Measurement precision and objectivity of future cash flows for non-publicly traded entities?
 - **Cost?**
 - Expensive to do on a recurring, ongoing basis

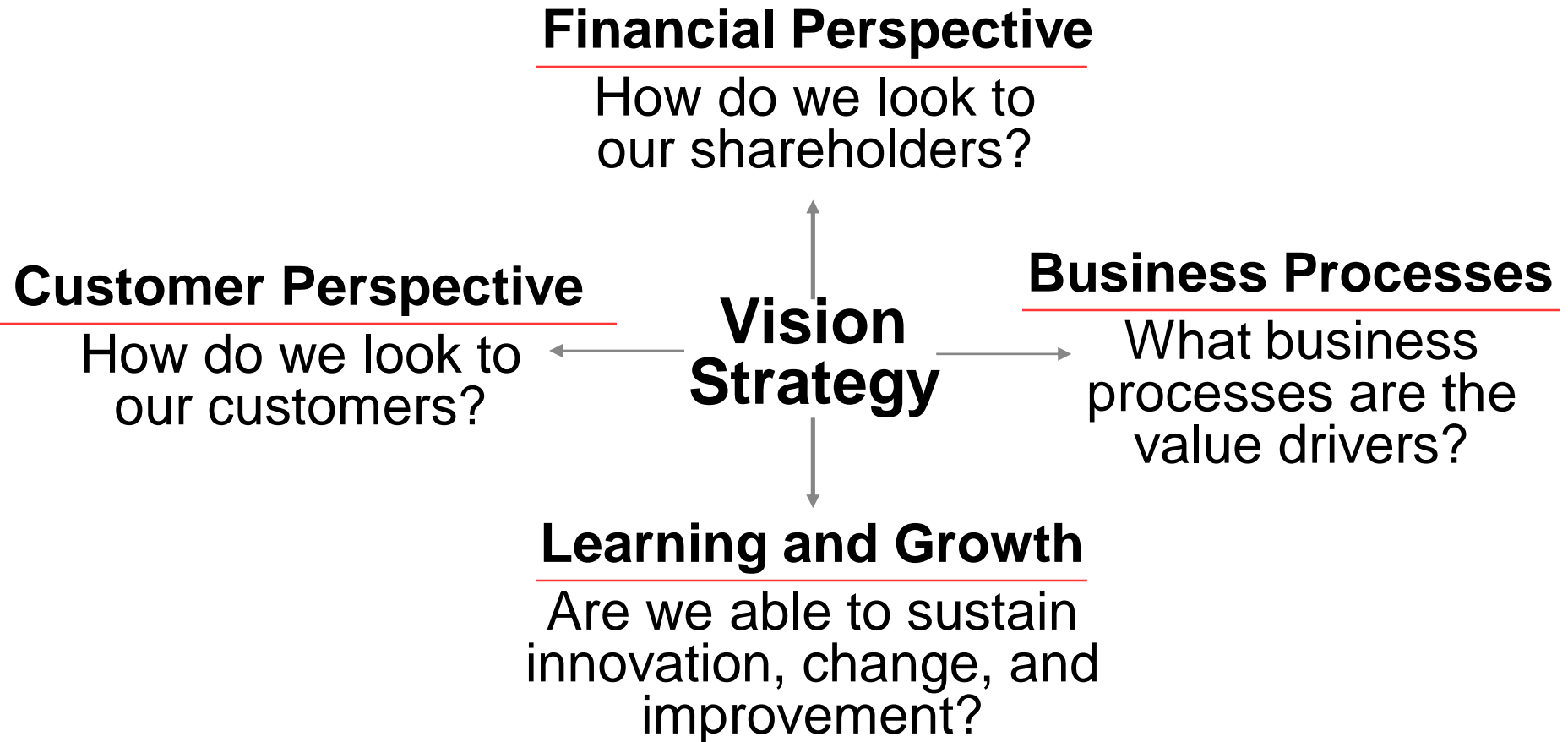
Overcoming myopia (5 of 6)

- **Improve accounting profit measures**
 - Adjust depreciable lives of fixed assets, adopt current-value depreciation, charge depreciation for older assets
 - Capitalize expenditures related to long-term investments
 - Recognize profits more quickly
 - Impute a cost of equity on income statement
 - Put leases on the balance sheet, etc.
- Cost of developing performance reports for control purposes?

Overcoming myopia (6 of 6)

- **Measure a set of drivers of future financial performance**
 - Use non-financial performance measures
 - ***Balanced scorecard***
 - The BSC includes **financial measures** that tell the results of actions already taken
 - It complements the financial measures with **operational measures** on customer satisfaction, internal processes, and the firm's innovation and improvement activities

“Template” balanced scorecard



Slide adapted from Robert. S. Kaplan

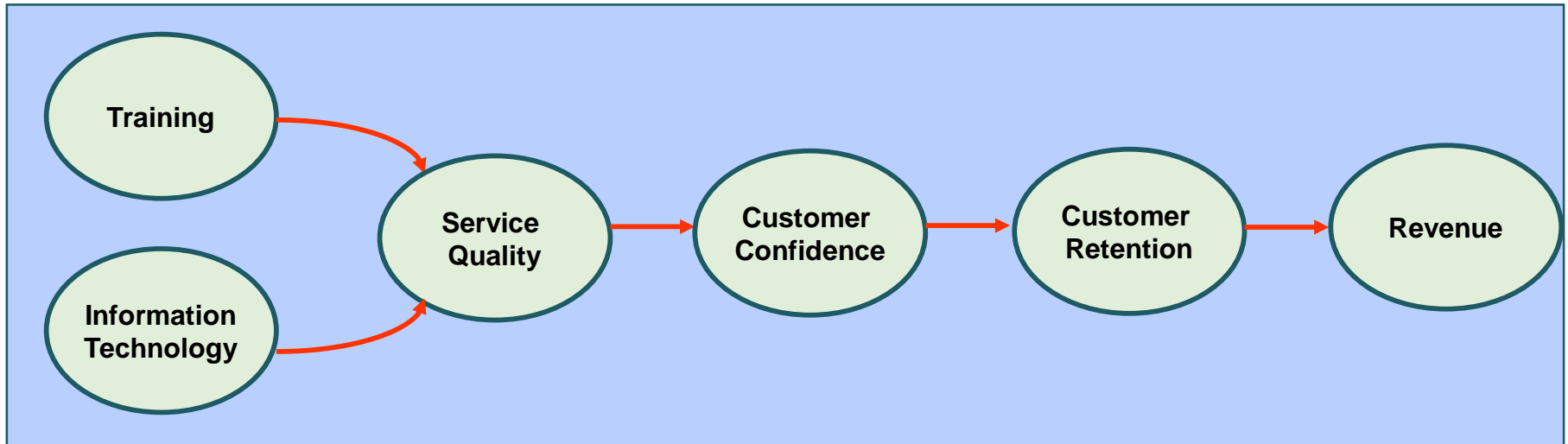
A balanced scorecard ...

“Tells the story of your strategy”

- Every measure is part of a chain of cause-and-effect linkages
- All measures eventually link to organizational outcomes
- A balance exists between outcome measures (financial, customer) and performance drivers (customer value, internal processes, learning, and growth)

Why do companies need a BSC?

- The source of value has shifted from tangible to intangible assets
- Intangible assets do not have a direct impact on financial results – They have second or third-order impacts.



Slide adapted from Robert. S. Kaplan

Evaluating the BSC approach (1 of 3)

- **Are BSCs “balanced”?**

What is the proper weighting to achieve “balance” ...

- Among the four perspectives?
- Among the two dozen measures?

Evaluating the BSC approach (2 of 3)

- **Do employees make the “right” tradeoffs?**

For example, **throughput** and **labor productivity** are possible measures in the internal business process perspective, and **costs** and **profits** are common measures in the financial perspective

- Throughput can be increased by asking employees to work more overtime, but as fatigue sets in, labor productivity will decrease
- The overtime is also costly, so there is a cross-dimension tradeoff between throughput and many financial measures, such as costs and profits

Evaluating the BSC approach (3 of 3)

- **How to tie BSC performance to incentives?**

Tying incentive compensation of managers to a balanced set of scorecard measures will foster commitment to the various goals reflected in the BSC.

Whether such linkages should be explicit or applied judgmentally will likely vary from company to company.

How many measures can be “incentivized”?

– Kaplan and Norton, 1996

Bottom-line measures

- Are like a “**compass**” leading managers in the desired direction
- Allow managers greater **autonomy**
 - The managers can decide what intermediate measures to focus on achieving the desired financial result
 - The managers can achieve the desired financial result by putting different combinations of inputs and outputs together

Baskets of measures

- Are like a “**roadmap**” that provides guidance to managers as to how to achieve the desired end
- If done well, can provide a linked **cascading** of measures from the top of the organization to the bottom. They show everybody how their efforts contribute to the overall goal.
- Can be **restrictive** (managers have less autonomy in making the tradeoffs)
- Propensity to become **obsolete** as conditions change

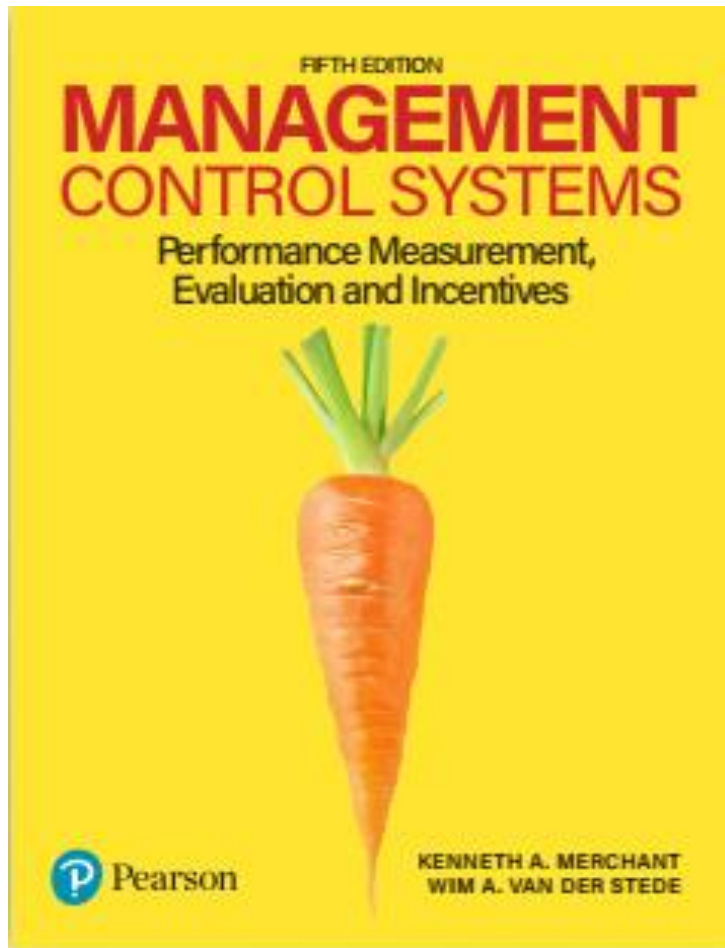
But ...

- **Complexity** provides challenges:
 - Identifying right measures, measurement rules, and importance weightings
 - Developing the measurement systems
 - Setting properly challenging performance targets for many measures
 - Linking to incentive compensation
 - Keeping up-to-date (avoiding obsolescence)

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Chapter 12

Using financial result controls in the presence of uncontrollable factors

Controllability principle

- Employees should be held accountable only for that which they alone can ***control***; or,
- Employees should be held accountable only for that over which they have significant ***influence***?

Rationale

- Uncontrollable factors **distort** performance measures and evaluations
- Uncontrollable **risks** are best borne by shareholders (who are better able to diversify them)
 - If managers bear the risk:
 - They must be compensated for it
 - They may engage in undesirable actions to protect themselves from the risks
 - For example, by engaging in “gameplaying” behaviors

Considerations (1 of 4)

- **Purpose(s) for which adjustments for uncontrollables are made?**
 - Salary raises
 - Incentive pay (short term, long term)
 - Job retention

Considerations (2 of 4)

- **Types of uncontrollables for which adjustments are made?**
 - Acts of nature (*force majeure*)
 - Economic, competitive factors
 - Interdependencies
 - Uncontrollables due to decisions made by personnel in other parts of the organization, such as at higher levels or in other entities

Considerations (3 of 4)

- **Who makes the adjustments?**
 - Immediate superior
 - Upper management
 - (Compensation committee of the) Board of Directors
 - Done automatically by predetermined formulas/rules

Considerations (4 of 4)

- **Which method to use to make the adjustments?**
 - Variance analysis
 - Flexible performance targets (e.g., “flexed budgets”)
 - Relative performance evaluations (RPE)
 - Subjective judgments

Other choices

- Should the adjustments be **total** or **partial**?
- Should the adjustments be **for negative uncontrollable factors only** (i.e., “*bad luck*”), or should adjustments be made in either direction, both positive and negative?

How to decide? (1 of 6)

- **Costs vs. benefits**

- For some types of adjustments, the benefits clearly outweigh the costs

- Factor is “totally” uncontrollable

- Manager is not expected to respond to the factor

- The effect of the uncontrollable factor can be calculated objectively

How to decide? (2 of 6)

- **Benefits of making adjustments**
 - More accurate performance evaluations
 - Less manager frustration; better motivation
 - Better decision-making; less “noise” in the performance measures
 - Lower compensation costs
(in the long run – less risk, less turnover)

How to decide? (3 of 6)

- **What if the company wants the managers to respond to an uncontrollable factor?**
 - Should not buffer them completely from the effects
 - Consider partial adjustment

How to decide? (4 of 6)

- **What if the effect of the uncontrollable factor can only be estimated?**
 - Enter subjectivity
 - Subjectivity introduces another form of risk
 - evaluation bias

How to decide? (5 of 6)

- **What if the factor is only partially uncontrollable?**
 - Consider not making adjustments
 - Performance measures provide some information about manager's performance
 - Consideration of adjustments leads to the creation of an **“excuse culture”**
 - Managers are prone to make excuses instead of addressing the problems
 - Costly in terms of management time involved to investigate the claims and determine appropriate adjustments

How to decide? (6 of 6)

- **If adjustments are made, where they should not be made**
 - Bad decisions; managers fail to consider relevant factors in their decision-making
 - Shareholders lose as managers are given undeserved rewards

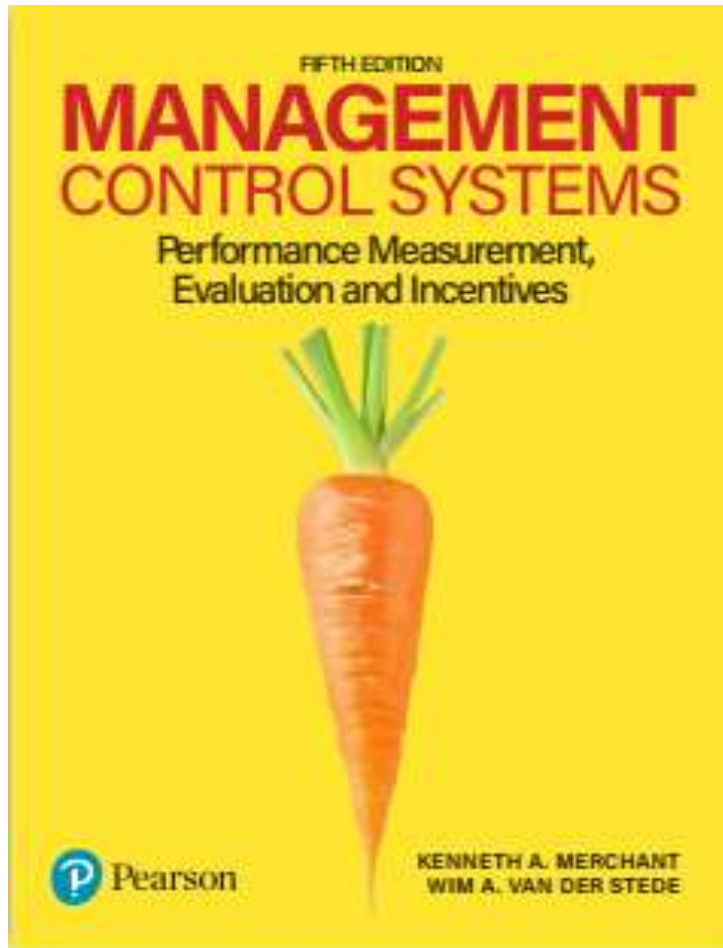
Summary

- **Consider costs and benefits of making adjustments**
 - Benefits exceed costs if:
 - Factor is clearly uncontrollable and if the firm does not want managers to respond (they have no influence)
 - Subjectivity can be avoided (or is tolerated)
 - In all other cases, use adjustments sparingly

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Section 5

Objectives Beyond Profit
Maximization

Chapter 13

Management Control
Implications Stemming from
the Broader Goal of
Stakeholder Welfare
Maximization

Terminology (1 of 2)

- **Triple bottom line/3Ps**
 - financial, social, environmental (“Profit, People, Planet”)
- **Sustainability**
 - Meet the needs of the present without compromising the needs of future generations
 - Subset: “climate-related”
- **ESG** (Environmental, Social and Governance)
 - Non-financial factors about a company that can sometimes provide information that is material for regulators, investors and other stakeholders
 - More used in the context of required disclosures for SRI (= socially responsible investing)

Terminology

(2 of 2)

- **CSR** (Corporate Social Responsibility)
 - Many different definitions of CSR
 - Most frequent dimensions of expectations placed on corporations: (1) economic, (2) stakeholder, (3) environmental, (4) social (legal, ethical, philanthropic)
- Also:
 - Corporate social performance
 - Corporate social responsiveness
 - Corporate citizenship
 - Responsible business
 - “Purpose”-driven organizations

CSR

- Is the broadest term
- Encompasses sustainability and some other important corporate responsibilities

The old corporate goal: profit maximization

- 40+ years ago there was general agreement on Milton Friedman's assertion:

“There is one and only one **social responsibility** of business, to use its resources and engage in activities designed to increase its **profits** so long as it stays in the rules of the game, which is to say, engages in open and free competition, without deception or fraud.”

(Friedman, a professor at the University of Chicago, was the 1976 Nobel Prize Winner in Economics)

- In this view, corporate social responsibility \approx corporate philanthropy

The ‘new’ corporate goal

- “**stakeholder welfare maximization**”
- Challenging ...

[...] Because [ESG] lumps together a dizzying array of objectives, it provides no coherent guide for [...] firms to make the tradeoffs that are inevitable in any society. Elon Musk of Tesla is a corporate governance nightmare [bad on “G”], but by popularizing electric cars he is helping tackle climate change [great on “E”]. Closing down a coal mining firm is good for the climate [and thus good for “E”] but awful for its suppliers and workers [bad for “S”]. Is it really possible to build vast numbers of wind farms quickly [good for “E”] without damaging local ecology [bad for “E” at the same time]?*

* “ESG Should Be Boiled Down to One Simple Measure: Emissions,” *The Economist* (July 21, 2022)

Can we measure ...

- **Stakeholder welfare maximization?**

No. It's just a theoretical concept

- **Overall CSR performance?**

Maybe? e.g., six published ratings, but the ratings do not correlate highly

Average = 0.30; range [-0.12, 0.67] | no “convergent validity”

(A. Catterji, R. Durand, D. Levin, S. Touboul (2015), “Do ratings of firms converge? Implications for managers, investors and strategy researchers,” *Strategic Management Journal*, 37(8), 1597-1614.)

Implications of the lack of a good measure of CSR performance for managers?

- Unable to judge their successes and failures
- Unable to discern whether poor ratings are due to:
 - Poor CSR strategy
 - Poor CSR execution
 - A different conceptualization of CSR than the raters
or
 - Simply poor measurement

Two important managerial challenges

1. **CSR strategy:**

- How much to invest in CSR?
- How to allocate the investments?

2. **Management control / execution:**

- How to ensure that the chosen CSR programs get implemented as desired?

To understand CSR strategy, one must understand how managers view CSR

Are environmental and social objectives:

- A corporation's **responsibility** or “duty”?
and/or
- **Necessary** for effective (risk) management?
and/or
- An **opportunity** to “do well by doing good”?

And against that, a relevant question is:

- Do the CSR investments benefit or **cost** the organization [*in the short-run*]?

Some CSR activities clearly benefit the corporation in the short-run

“win-win” | “doing well by doing good” | “synergistic value creation”

- **Cut costs**
- **Exploit competitive advantage**
 - Generate additional revenues/profits from differentiated products/new customers (e.g., in renewable energy)
- **Enhance reputation**
 - With current and potential customers, employees, suppliers, socially responsible investors
 - Create an “insurance-like” buffer against potential adverse political, regulatory, and social sanctions/penalties

Other CSR activities can have an adverse effect on profit and stock price, at least in the short-run

In other words, some firms are motivated to make decisions that are **not shareholder value maximizing**

- They are “transferring” firm resources to non-shareholder stakeholders

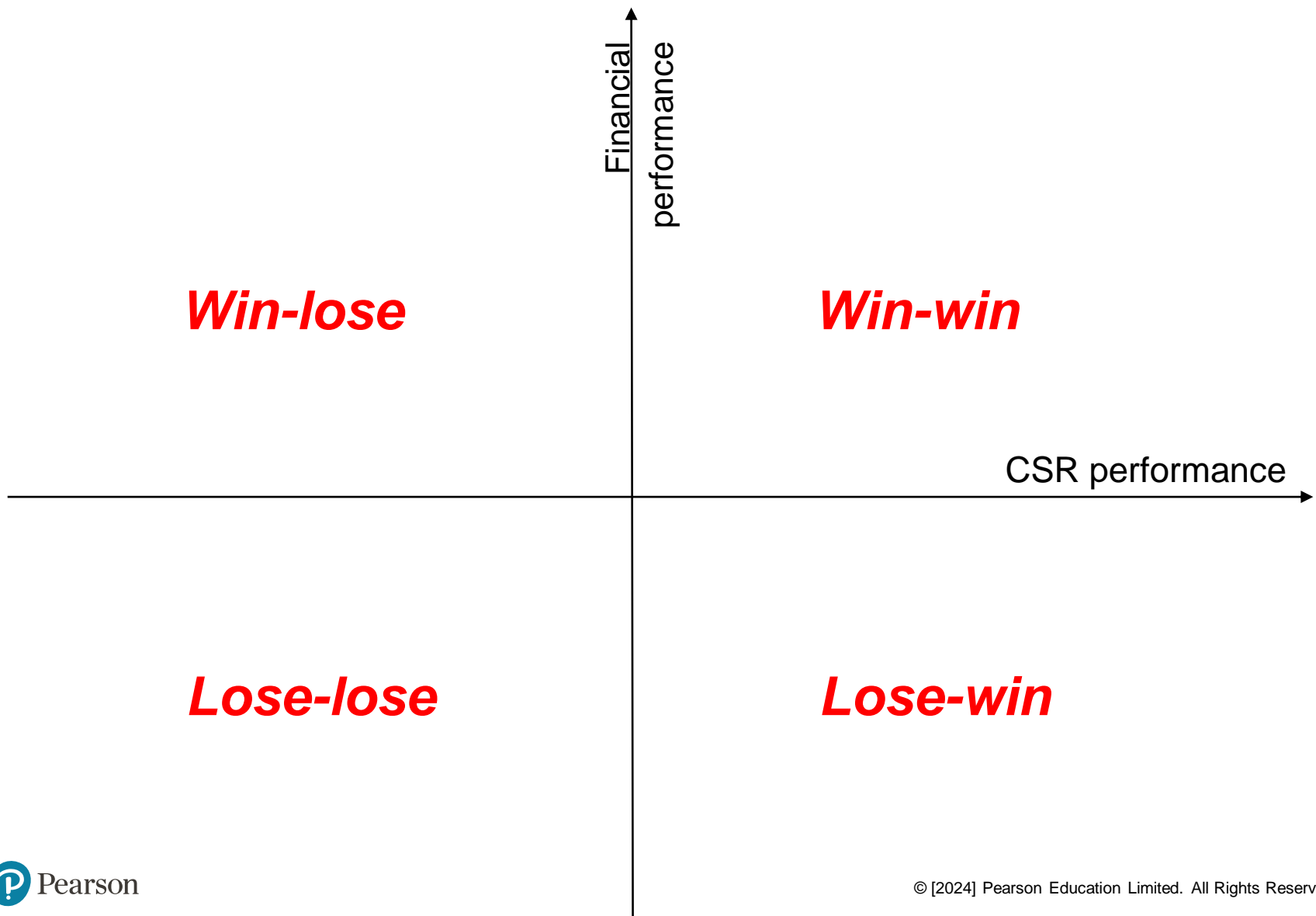
For example:

- Switching to renewable energy sources (if more expensive)
- Responsible sourcing (if more expensive)
- Making contributions to charities (rather than retain earnings)

In the corporate finance tradition, these investments are an “**agency problem**”

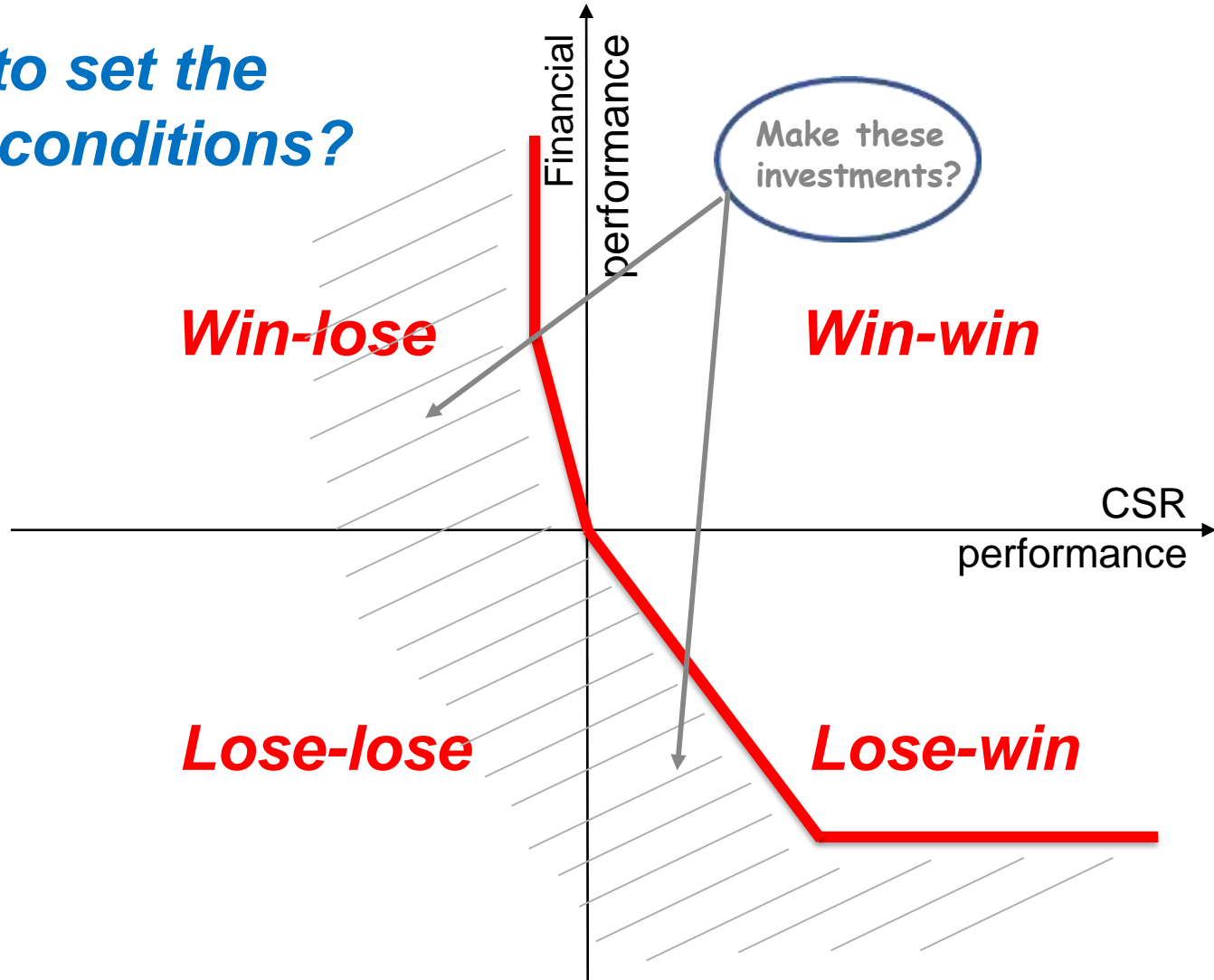
- Alienate investors
- Cause the company to lose focus on shareholders?

Performance tradeoffs: financial v. CSR (1 of 2)



Performance tradeoffs: financial v. CSR (2 of 2)

Where to set the boundary conditions?



Prioritizing various CSR investments

Managers (**should / do?**) invest in programs and projects that:

- Promise to provide the greatest economic and CSR benefits (“win-win”)
- Are in areas of most direct relevance to their business
- Are in areas where greater regulatory, political, or societal pressure for performance is being applied
- Have a champion within the organization

CSR management control / execution

- Once the choices are made, how to ensure that the CSR programs are successful?
- **Result controls**
 - Goals / measures / incentives
- **Action controls**
 - Rules, regulations, audits, enforcements
- **Personnel / cultural controls**
 - Training, passionate CSR people with jawboning rights, organizational culture, tone at the top

Choice of execution approaches

- It would be nice if all employees were passionate about CSR (i.e., embedded **culture**) ... but they're not
- **Result controls** (“incentives”) can have good effect though may suffer from the common “accountant’s trap” ...

“If I can’t measure what I want, then I want what I can measure”

- **Action controls** will be inevitable, but ideally to provide some additional tightness in a complementary way ...

Measurement problems affecting incentives

- Measurement **incompleteness** (i.e., any given measure only captures a small subset of desired CSR goals) – ‘multi-tasking’ problems?
- Measurement **imprecision** (i.e., many CSR areas are hard to measure precisely – objectively, timely, ...) – may induce ‘gaming’ behaviors?
- Measurement **misalignment** (i.e., many CSR actions and decisions do not lead to improved financial performance [in the short-term]) – not every CSR initiative is ‘win-win’
- Other issues (sometimes related to the above):
 - Too much **noise** – uncontrollability issues
 - Not enough **sensitivity** – the effects of even good CSR decisions may not be felt in a timely manner

Use CSR incentives (or not)? (1 of 2)

Why pay managers for doing good; for something they are supposed to do anyway?

But, then, **why pay managers for creating shareholder value?** Aren't they supposed to do that, too?

- It is the analysis of **measurement properties** that should determine the answer whether or not to use incentives.

Use CSR incentives (or not)? (2 of 2)

The question is not ... *whether* companies should tie pay to CSR metrics ... [Answer: yes or no]

Instead, the right question is ...

... *when* they should or should not? [Answer: it depends]

(and when not, rely relatively more on other control types, incl. intrinsic motivation, culture, compliance, etc.)

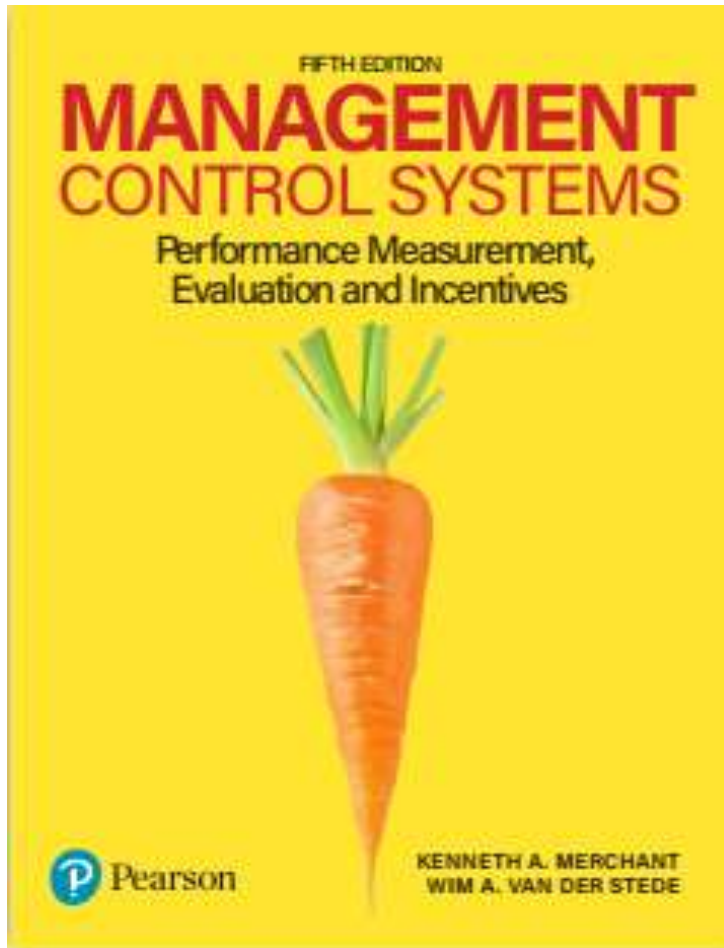
So, then ...

- CSR incentives can be appropriate in companies if the above concerns (about **completeness**, **precision**, and **alignment**) are muted. For example, in an energy company:
 - Decarbonization is likely much more important than any other stakeholder issue, so there is less of a concern about overweighting a single CSR factor (thereby alleviating the **multi-tasking problem**)
 - Moreover, there is relatively little disagreement on how to measure direct GHG emissions (which alleviates **gaming**, improves **sensitivity**)
 - And, boosting CSR performance is also likely to boost financial performance (thus, a **win-win** situation)

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Section 5

Objectives beyond profit maximization

Chapter 14

Management control in not-for-profit organizations

Not-for-profits

- The defining difference between for-profit and not-for-profit organizations does not lie in **how much profit** they can generate, but instead in how it is **distributed**
 - **A not-for-profit organization's profit cannot be paid out to the owners or anyone else associated with the organization**
 - **Instead it must be dedicated to the purpose of the organization**
- Hence, the major defining characteristic of a not-for-profit organization is the ***organization's purpose*** – *its mission or goal*

Non-profit MCS challenges

- Non-profits are sometimes perceived as relatively small organizations that pursue altruistic purposes, such as food banks and community charities staffed by a few dedicated managers and unpaid volunteers
- But many non-profits are major employers, and a large part of the revenues they generate is needed to cover their expenses or overheads
 - In other words, besides the not-for-profit purpose and the lack of shareholders, it is often difficult to tell some of these non-profits from their for-profit counterparts
 - **Nevertheless, non-profits tend to have some characteristics with MCS implications that are unique**

Lack of goal clarity

- Goal: provide some kind of public service
 - Governmental, scientific, educational, charitable, religious, etc.
- Various constituencies enforce sometimes conflicting goals
- **Difficult to design MCSs and assess their effectiveness**

Difficulty to measure performance

- The degree of achievement of the overall goal (provision of quality service to constituencies) usually cannot be measured accurately in financial terms
- **Difficult to use result controls, install responsibility centers, and compare the performances of subunits with dissimilar activities**

External scrutiny

- Many overseers (donors, government entities, alumni, etc.) often constituting the not-for-profit organization's governing body
- **Extra demands on the MCS (detailed project proposals, action reports, lengthy and time-consuming planning and budgeting processes, etc.)**

Legal constraints

- Compliance with legal constraints calls for **tight action controls** and increases control costs
- The **provision of incentives may not be feasible**

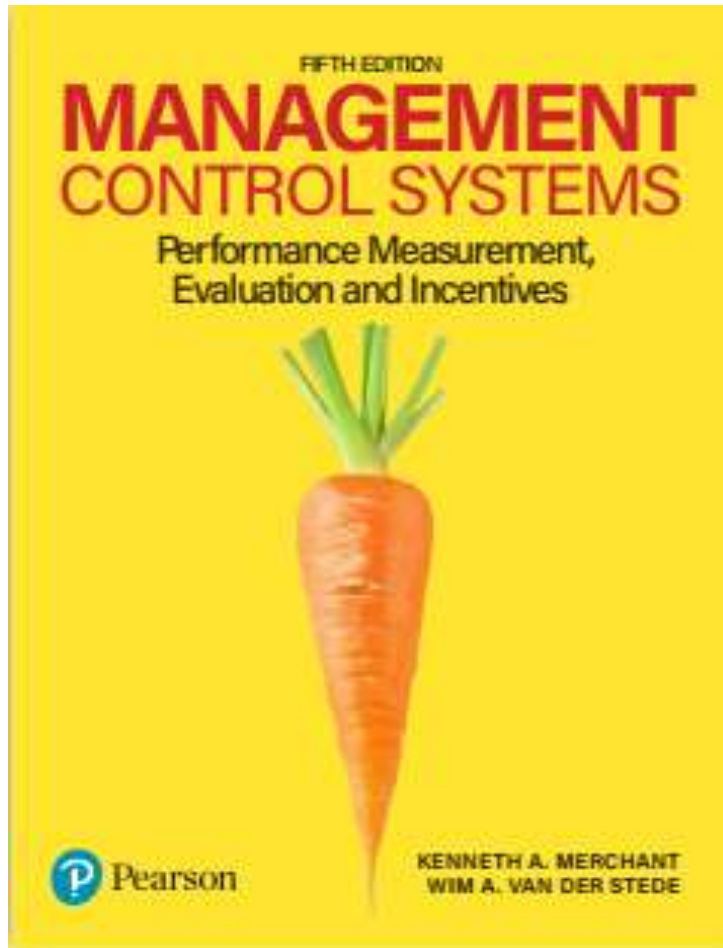
Employee characteristics

- Compensation is not always competitive
 - **Impact on employee quality**
(*cf.*, personal limitations)
- Employees are often highly committed
 - **Control can be achieved through personnel and cultural controls**

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Section 6

Corporate governance,
important control-related
roles, and ethics

Chapter 15

Corporate governance
and boards of directors

Boards of directors

- Dispersed shareholders delegate the authority for control to a board of directors
 - The board is given ultimate control over management
 - It monitors and approves management decisions, and chooses, dismisses, and rewards managers
- Two main control responsibilities
 - Safeguard the **equity investors' interests** by ensuring that management seeks to maximize shareholder value
 - Protect the **interests of other corporate stakeholders** (employees, customers, suppliers, competitors, and society at large) by ensuring that the employees in the corporation act in a legally and socially responsible manner

Directors' duties

- For example:
 - **Duty of care**
 - Make/delegate decisions in an informed way
 - **Duty of loyalty**
 - Advance corporate over personal interests
 - **Duty of good faith**
 - Be faithful and devoted to the interests of the corporation and its shareholders
 - **Duty not to waste**
 - Avoid deliberate dissipation of shareholder value

All of these duties are defined by, and enforced through, the legal system

Board independence

- To carry out their responsibilities, boards must ensure that they are **independent** and **accountable** to shareholders, and they must exert their authority for the continuity of executive leadership with proper vision and values

Board competence

- Boards are given ultimate control over management
 - They are singularly responsible for the **selection and evaluation** of the corporation's CEO and must ensure the quality of senior management
 - Boards also review and approve the **corporation's long-term strategy and important management decisions**, such as the design of equity and compensation policies that motivate management to achieve and sustain superior long-term performance

Audit committees

- Audit committees provide independent **oversight over companies' financial reporting processes, internal controls, and independent auditors**
- They enhance a board's ability to focus intensively and relatively inexpensively (without involving the full board) on the corporation's financial reporting-related functions
- In publicly held corporations, audit committees must be comprised of **financially literate outside (non-employee or independent) directors**

Compensation committees

- Compensation committees deal with issues related to the **compensation and benefits provided to employees**, and particularly to **top executives**
- Fiduciary responsibility to ensure that executive compensation plans are fair and appropriate, but not excessive, to attract, retain, and motivate managers and in view of the company's economics and the relevant practices of comparable firms
 - Rely on the company's **HR function** for staff support
 - Because the design of compensation plans can raise many complex issues, compensation committees often employ **outside consultants** to provide data or expertise that the company does not have internally

Nominating/governance committees

- Nominating/governance committees are responsible for the composition of the board; the structure and composition of the board committees; the corporate governance framework and guidelines, which include board procedures, practices and bylaws; and the **evaluations of the board, board committees and individual directors**
- This committee could also oversee the **corporate ethics** program, **CEO succession** planning, **director compensation**, a variety of people issues, such as recruiting and retention and corporate culture and, more generally, any of the issues related to **corporate social responsibility**

CSR committees?

- A new trend in corporate governance is the formation of a separate board committee dedicated to **Corporate Social Responsibility (CSR)**-related issues
 - Worldwide, the percentage of publicly listed firms with CSR committees increased from 5% in 2001 to 12% in 2018
 - These committees can be given the responsibilities for overseeing all the policies and activities affecting the welfare of the firm's non-shareholder “**stakeholders**” and the reporting of those activities
 - Forming such a committee highlights the importance of CSR to the firm and increases the board's accountability for CSR issues (see also Chapter 13)

Corporate governance

- The sets of mechanisms and processes that help **ensure that companies are directed and managed to create value for their owners while concurrently fulfilling responsibilities to other stakeholders** (e.g., employees, suppliers, society at large)
- Corporate governance deals with **controlling the behaviors of top management**

Relation to management control

- Corporate governance systems and management control systems (MCS) are inextricably linked
 - A corporate governance focus is slightly broader than a MCS focus
 - A MCS focus takes the **perspective of top management** and asks what can be done to ensure the proper behaviors of employees in the organization
 - The corporate governance focus is on **controlling the behaviors of top management** and, through their direction, those of all the other employees in the firm

An example from the US - Sarbanes-Oxley Act

- To improve the transparency, timeliness, and quality of **financial reporting** of companies registered with the Securities and Exchange Commission (SEC) in the United States
- Many other countries have also revisited regulations in that spirit
 - Key provisions typically include the regulation of the external audit and auditors; the independence of boards; prosecution of, and stiffer penalties for, fraud, etc.

Section 404 (1 of 2)

- Perhaps the most significant, and most expensive, provision is the internal control-related section of the Sarbanes-Oxley Act, “**Section 404**”
- Prior to the Act, good internal controls were said to be **good business practice**
 - Not only did good controls help ensure fair and accurate financial reporting, they helped ensure that managers would have good information with which to make their business decisions and they helped reduce the incidence of fraud and asset loss
- Sarbanes-Oxley made good internal controls a **legal requirement**

Section 404 (2 of 2)

- Section 404 mandates an evaluation of the effectiveness of a firm's internal controls by both **management** and the firm's **external auditor** and **formal written opinions** about the effectiveness of those controls
- Managers and auditors are required to examine a **broad range of internal controls over financial reporting**, including:
 - Policies and procedures
 - Audit committee effectiveness
 - Integrity and ethical behavior programs
 - Whistleblower programs
 - “Tone at the top”

Conclusion

- Since many internal controls serve **management purposes** as well as **financial reporting purposes**, the Sarbanes-Oxley Act has directly affected firms' MCSs

Various forms of “corporate governance” (1 of 2)

- Many mechanisms and institutions can have corporate governance effects, and their effects vary considerably across countries
 - In **Anglo-American** economies, the primary governance mechanisms are provided by **equity markets** and the structures that support them or result from them
 - Laws and regulations
 - Boards of directors
 - External auditors
 - Governance ratings
 - Takeover threats

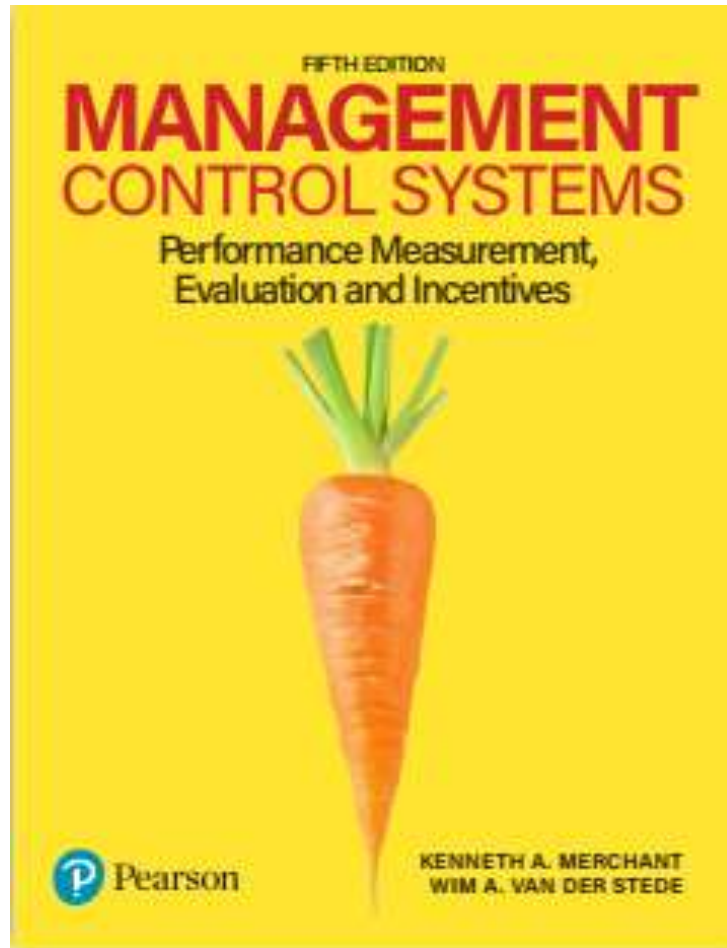
Various forms of “corporate governance” (2 of 2)

- In some **Western European** and **Asian** economies, relatively more corporate governance is effected by **concentrated ownership**
 - *Keiretsu* (Japan)
 - *Chaebols* (Korea)
 - Institutional investors (India)
 - State ownership (China)
- Governance in **German** companies is heavily influenced by **banks**, insurance companies, and **employee representation**
- **Scandinavian** countries rely more on **social norms**
- **Islamic** countries follow **Sharia law**

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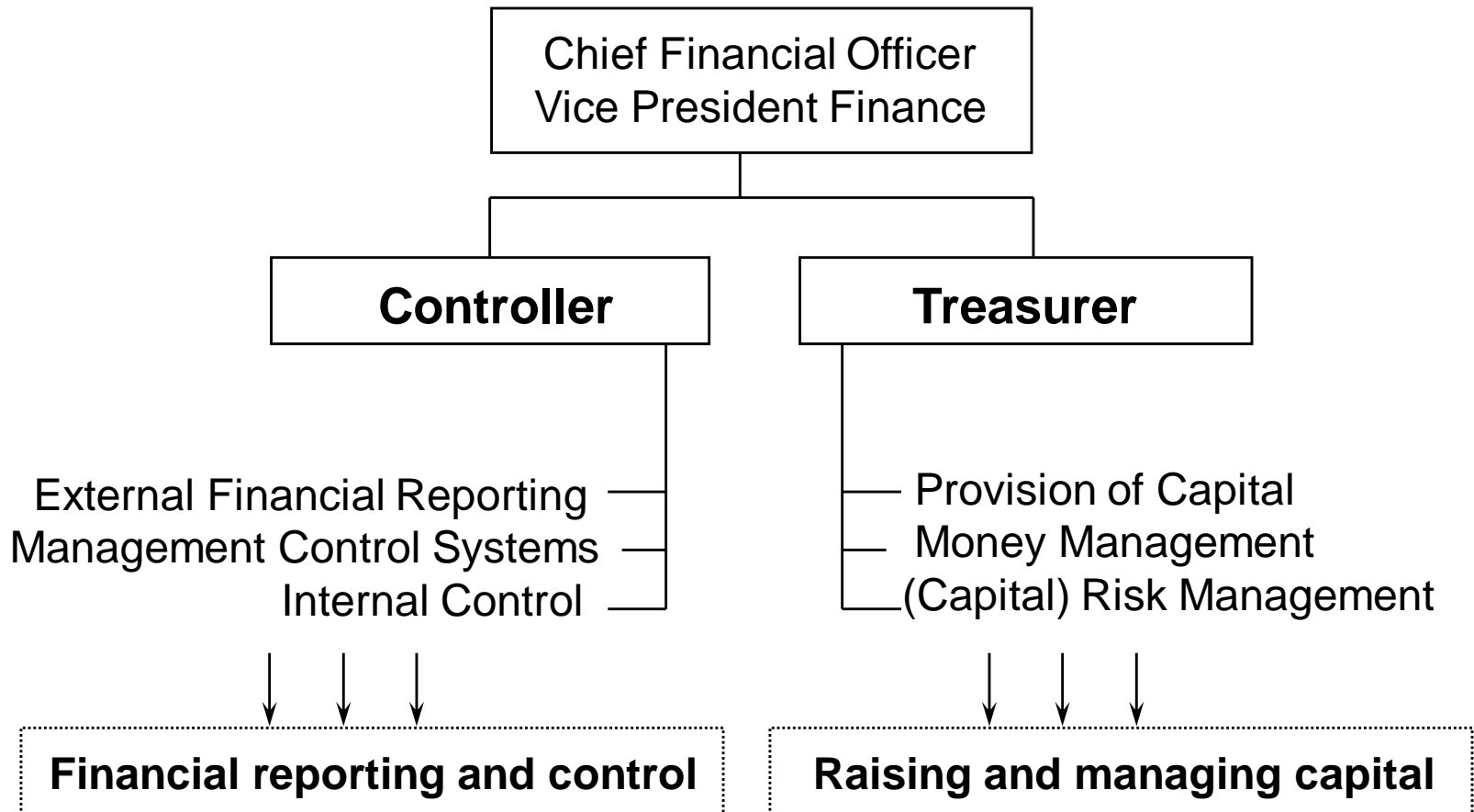
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Chapter 16

Controllers and auditors

Corporate financial management roles



The controller function (1 of 2)

- **The controller (or the control department)**
 - Designs and operates information and control systems
 - For example, supervision of all accounting records (financial/managerial)
 - Prepares financial reports to shareholders and external parties
 - Prepares and analyzes performance reports and assists managers by interpreting these reports

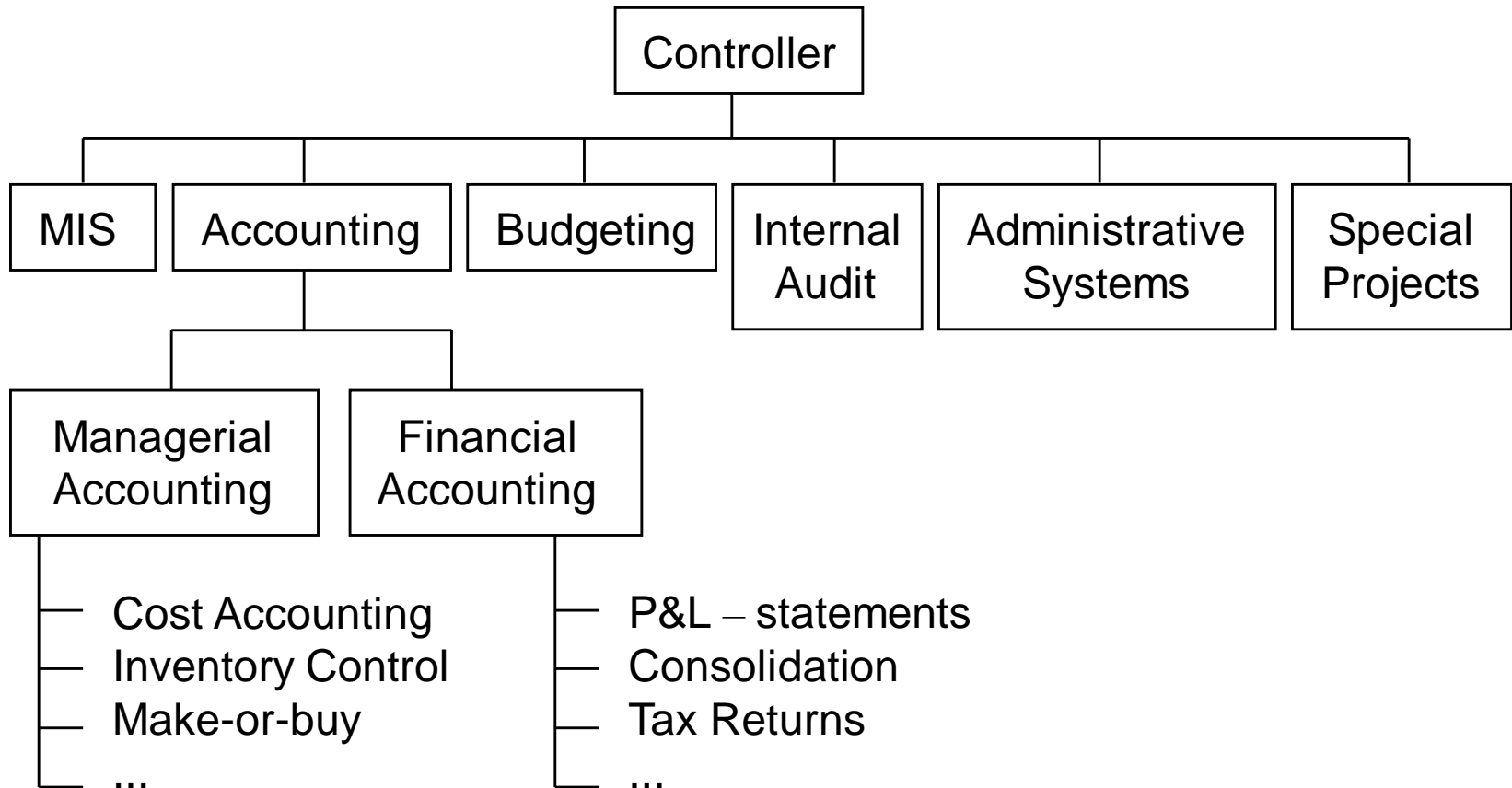
The controller function (2 of 2)

- **The controller (or the control department)**
 - Analyzes program and budget proposals and consolidates the plans of the various business segments into an overall annual budget
 - Supervises internal audit and accounting control procedures to ensure the validity of information
 - Performs operational audits
 - Develops personnel in the controller organization

The treasury function

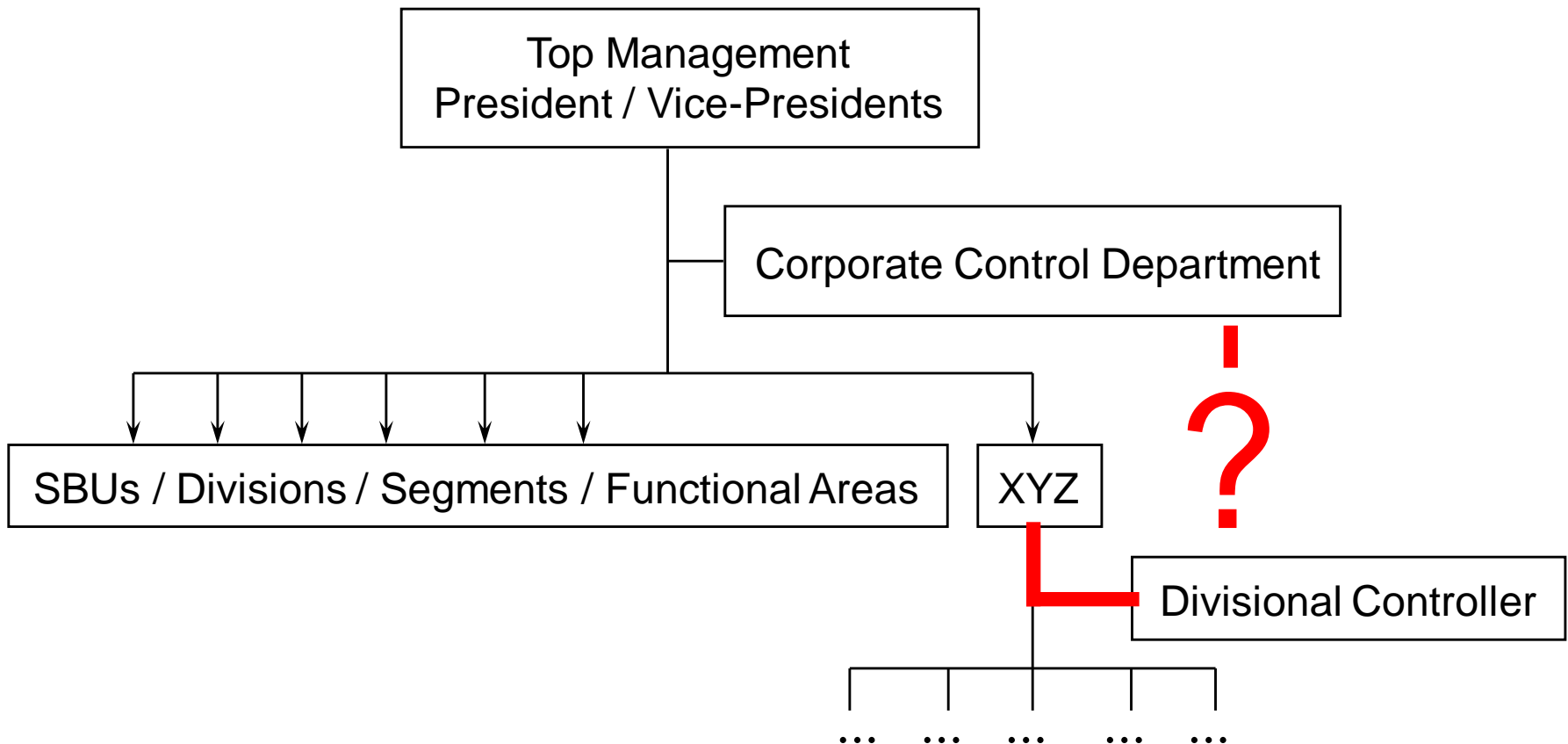
- **Entails the control of corporate funds**
 - Provision of capital
 - Financing
 - Cash planning
 - Investor and creditor relationships
 - Money management
 - Banking: cash and deposits
 - A/R, A/P, collections, disbursements
 - Loans and investments (securities)
 - (Capital) risk management
 - Insurance, including employee benefits

The control department



Relation to the line? (1 of 2)

- What should be the relationship between the corporate controller and the division controller?



Relation to the line? (2 of 2)

- **The controller function is a staff function**
 - The controller designs and operates the control and information systems (e.g., control measures)
 - However, the use of this information remains the responsibility of line management
- **The controller can make recommendations for action to management, but he or she does not make nor enforce management decisions**
 - This is not to say that the controller should not be involved in or have a good knowledge of the business

The business unit controller (1 of 2)

- Two major responsibilities
 - **Management-service responsibility**
 - Help business unit management in the business decision process
 - It requires that the business unit controller becomes **actively involved in the local decision-making process**

▪ **INVOLVEMENT**

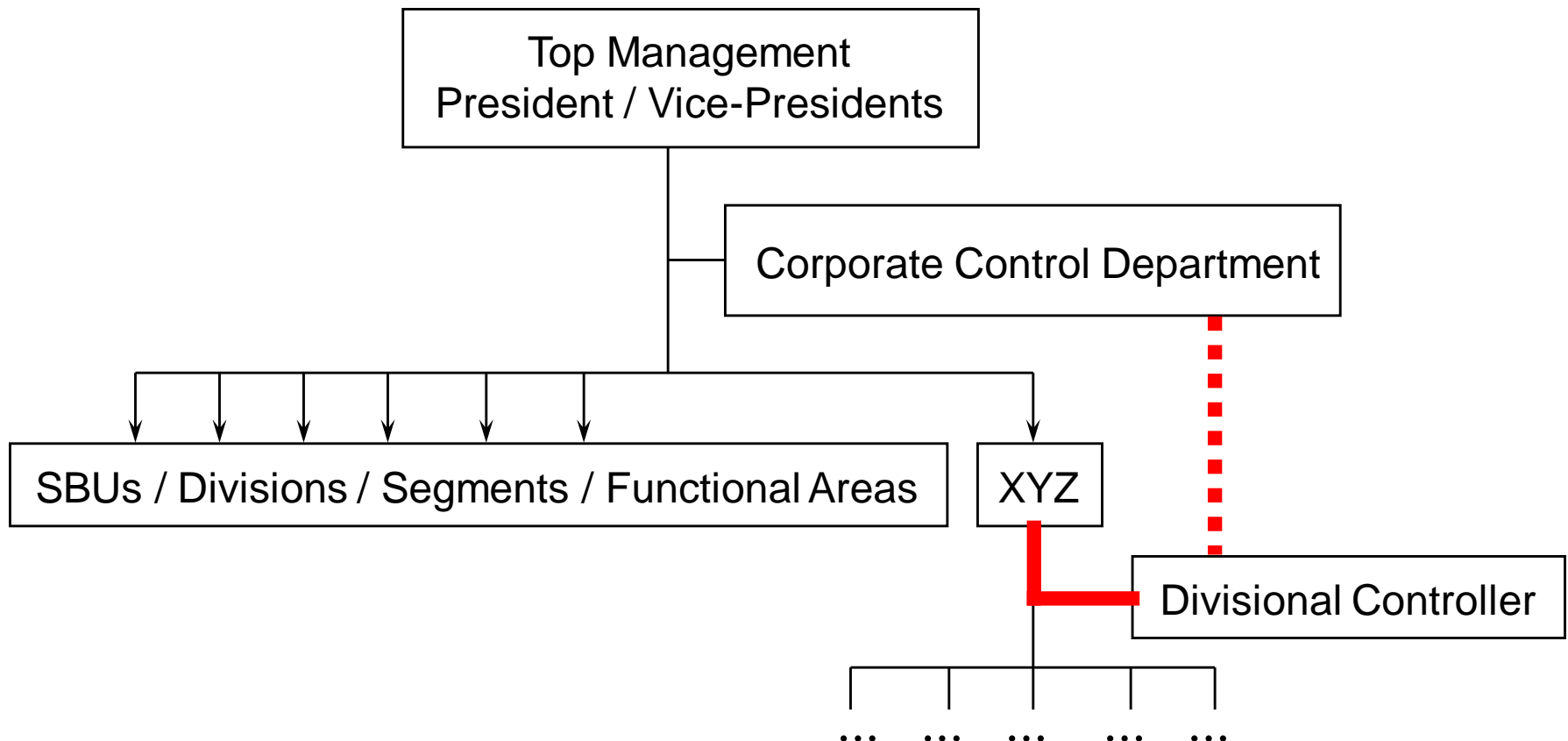
The business unit controller (2 of 2)

- **Financial reporting and internal control responsibility**
 - Ensure that the financial information from the business unit is accurate and that internal control practices conform to corporate policy and procedures
 - It requires that the business unit controller acts as a “policeman” or **local guardian** for the corporate office

– **INDEPENDENCE**

“Dotted line” relationship

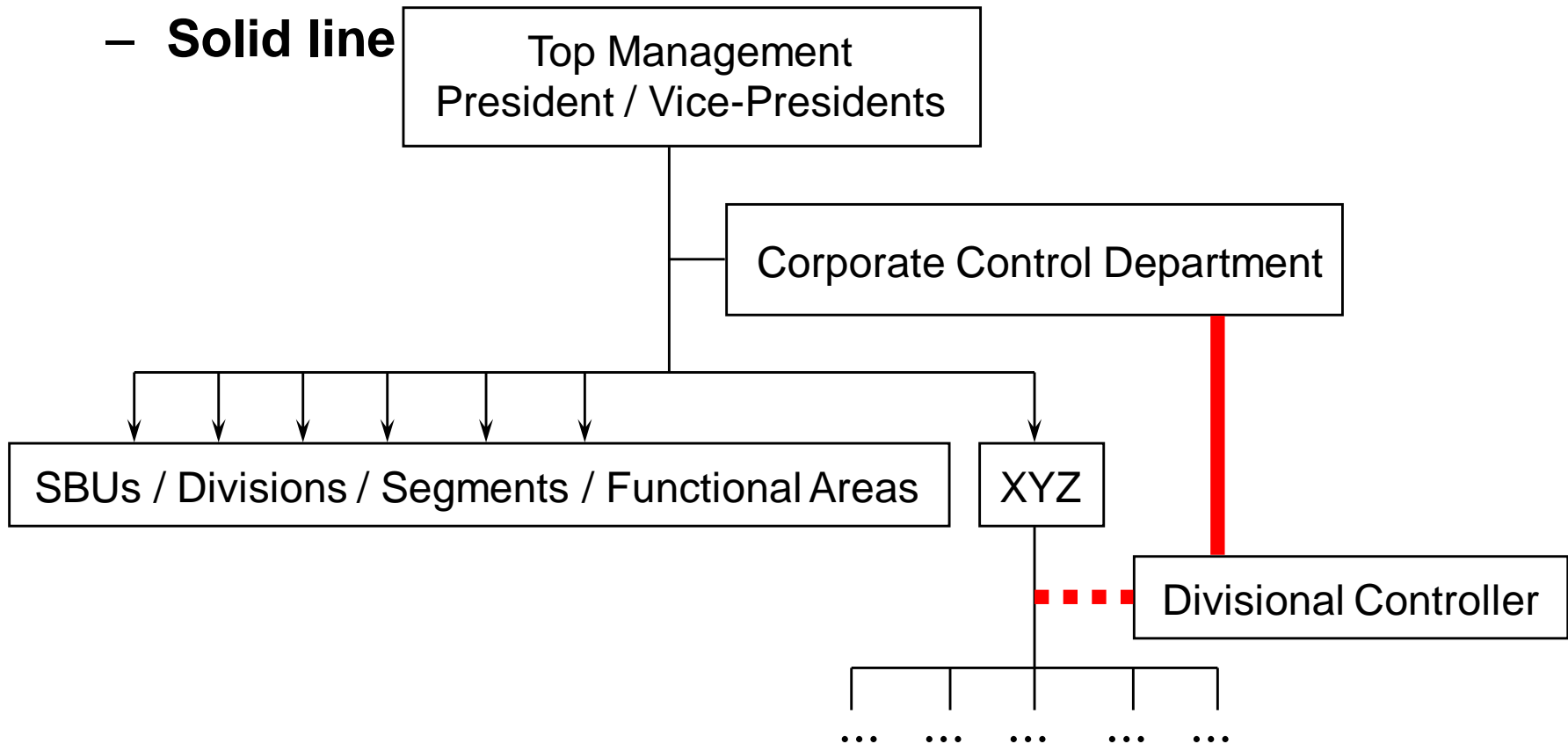
- **Decentralization of the controller function**
 - **Dotted line**



“Solid line” relationship

- **Centralization of the controller function**

- **Solid line**



Divided responsibility and loyalty (1 of 2)

- The business unit controller's job priorities and loyalties are changed when the reporting relationship is changed
 - **Centralization of the controllership function**
 - **Solid line with the corporate controller;**
Dotted line with the business unit manager (staff relationship)
 - Emphasis on financial control responsibility
 - “**Corporate spy**” (HQ representative, irritant, checker, policeman)

Divided responsibility and loyalty (2 of 2)

- **Decentralization of the controllership function**
 - Dotted line with the corporate controller;
Solid line with the business unit manager
 - Emphasis on management-service responsibility
 - **“Business unit ally”** (trusted assistant, helper)

Factors influencing (de)centralization

- Corporate's desire to:
 - Exercise “tight” control
 - Implement uniform control systems across business units or divisions
 - Achieve economies of scale in control
 - Speed up the introduction of control changes or procedures

Relationship with corporate controller?

- The corporate controller has **functional control**
 - Develop (uniform) control/information systems
 - Prescribe rules/procedures for the collection of information
 - Develop/propose new control techniques for the better performance of the controllers in the business units
 - Train controllers (formal courses and informal meetings)

Additional “control of the controllers”

- **Internal auditors** and **audit committees** can be used to oversee the controller function
- **Personnel / cultural controls** (selection and training of controllers)
- **Incentive systems** that do not create temptation (e.g., rewards based on performance measures they can manipulate)

Auditors

- The internal audit function operates in **staff capacity** and reports high in the organization, at least to the controller or VP Finance
- **Financial audits**
 - External auditors
- **Compliance audits**
 - External/internal auditors
 - Compliance with laws and rules/administrative policies
- **Performance audits**
 - External/internal auditors/consultants
 - Evaluation of the performance of the company, its management, a department, or a specific activity (+ making recommendations)

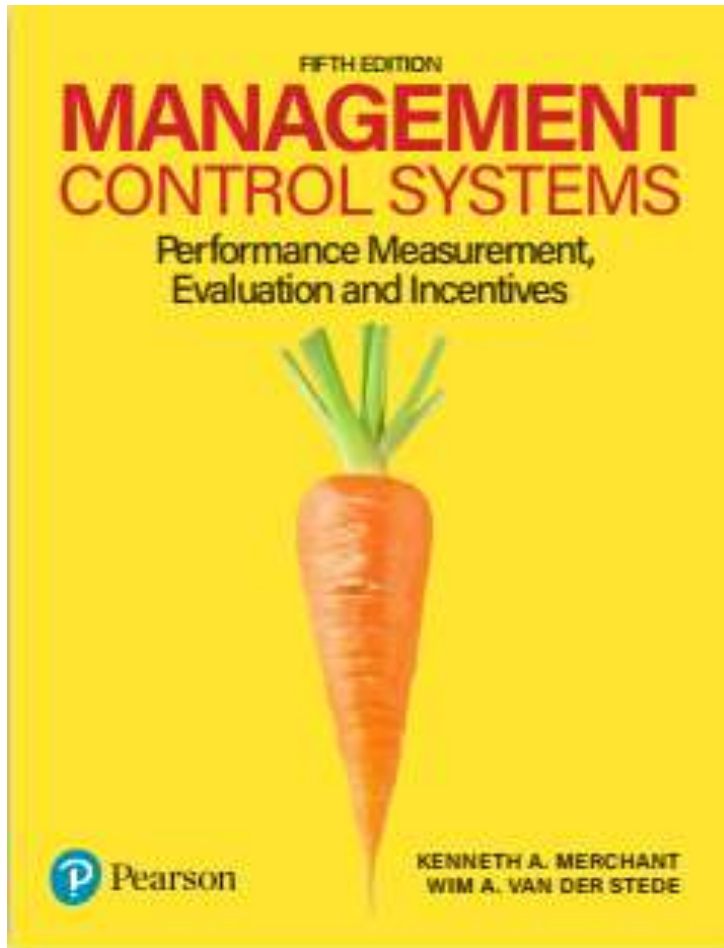
Benefits of audits

- Add **credibility** to the information provided to user groups
- **Anticipation of the audit** increases the motivation of the individuals involved to act in a legal, ethical way, and in the best interest of the company and its owners

Management Control Systems

Performance Measurement, Evaluation, and Incentives

5th edition



Chapter 17

Management control-related ethical issues

Ethics

- Ethical principles can provide a useful guide for defining **how employers and employees should behave**
- Both employers and employees should consider the impact of their actions on a variety of **stakeholders**
 - Shareholders, bondholders, and creditors
 - Board of directors, management, and employees
 - Competitors, customers, and suppliers
 - Government and communities
 - Society at large
- **Ethical issues ≠ legal issues**

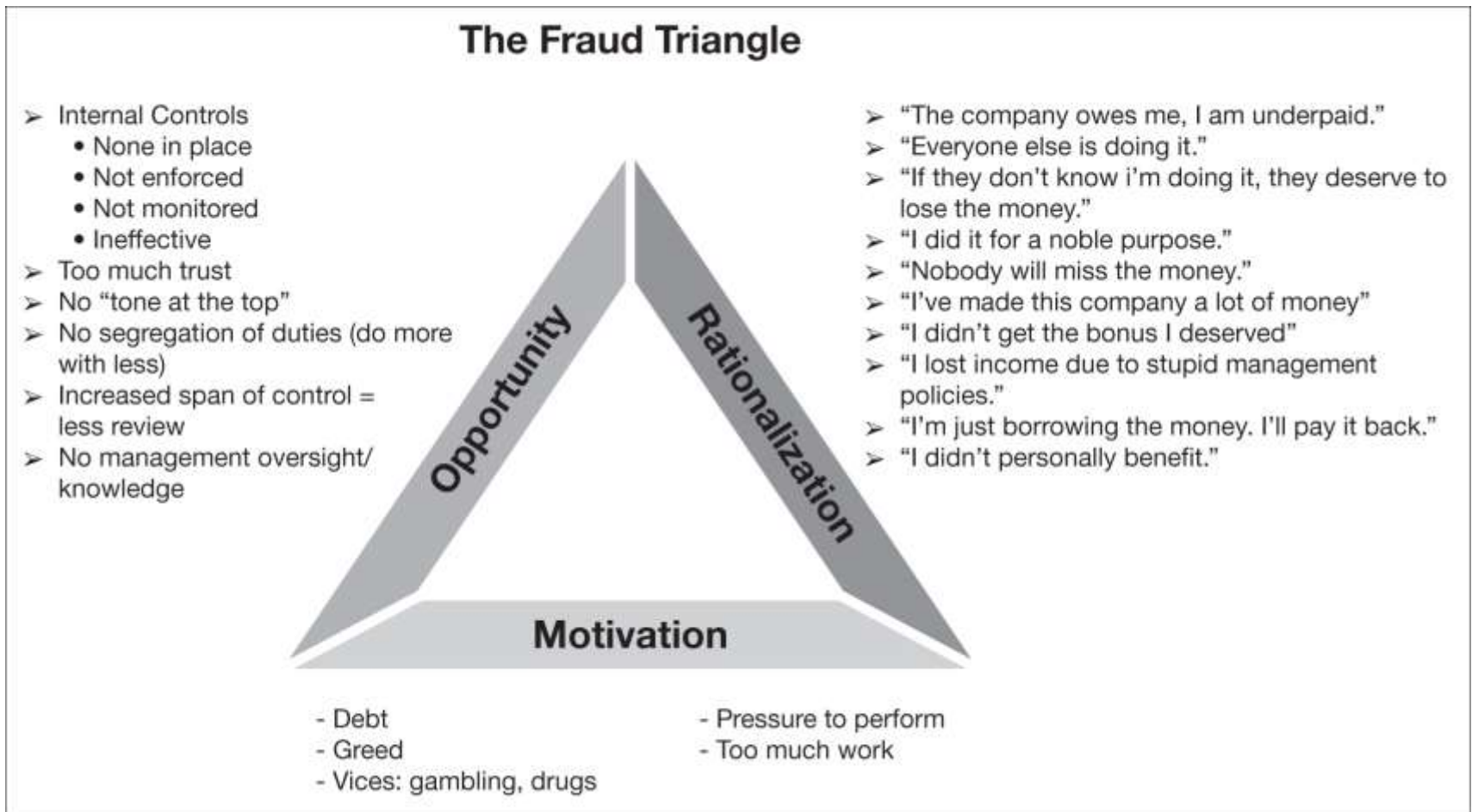
(Some) ethical models / principles

- Utilitarianism
- Rights and duties
- Justice or fairness
- Virtues

Codes of conduct

- **Corporate codes of business conduct and operating principles** often make ethical behavior explicit as part of a **personnel / cultural control** mechanism
- They often include **virtues**, such as:
 - Integrity
 - Loyalty
 - Objectivity
 - Confidentiality
 - Competence
- **Tone at the top** as a “reinforcing mechanism”
- Many important ethical issues are not black or white

Drivers of unethical behavior



Creating budgetary slack

- **On the one hand**, employees who create slack ...
 - Exploit superior knowledge about business possibilities
 - Increase the probability that they meet the budget and earn performance-dependent rewards (which is costly to the shareholders or owners)
 - Distort resource allocation and performance evaluation decisions that rely on the budget submissions
- **On the other hand**, these employees ...
 - Protect themselves from the downside potential of an uncertain future
 - Protect themselves from evaluation unfairness caused by imperfect performance measures
 - Just do “what everybody else does” and is aware of ...?

It depends on?

- How good the performance measures are
- How rigid budget targets are
- What the employees intentions are (self-interest)
- Whether superiors are aware of the slack
- Whether the superiors encourage slack creation
- Whether the amount of slack is “material”
- Whether the individual is bound by one or more explicit codes of professional conduct

Earnings management (1 of 3)

- **Earnings management**
 - Actions taken to make performance look better in the short-run than it otherwise would; plus,
 - Those engaging in them know the actions have no real economic benefits and may actually be quite costly in the long-run
- **Earnings management comes in many forms**
 - Choices of accounting policies
 - Accounting judgments (e.g., reserves)
 - Timing of sales, expenses, etc.

Earnings management (2 of 3)

- **Risks for the long term?**
 - If discovered, the firm would earn a reputation for reporting “**low quality**” earnings and users of the information will discount the firm’s claims
 - Smoothed systems **hinders management to detect problems early**
 - It creates a **gameplaying culture** (the people who get promoted may incongruously be those who are best at managing earnings!)

Earnings management (3 of 3)

- **On the one hand**, influencing reported earnings ...
 - Violates the duty to disclose fairly presented information
 - Is inconsistent with integrity obligations to be honest, fair, and truthful
 - Is not apparent to external or internal users of financial statements, so that personal advantages could be derived
- **On the other hand**, “managed earnings” may ...
 - Smooth out meaningless, short-term perturbations in the earnings measures to provide more, rather than less, informative performance signals to financial statement users?
 - Protect employees from rigid, unfair performance evaluations?
 - Avoid taking other, more damaging actions (e.g., layoffs)?

It depends on?

- The direction of the manipulation (boost vs. smooth)
- The size (materiality) of the manipulation
- The timing (e.g., related to a bond or share offering)
- The method used (e.g., defer discretionary spending, change accounting policy)
- The employee's intent
- The clarity of the rules prohibiting the action
- The degree of repetition (one-off vs. on-going)

Controls that are “too good”

- Computer surveillance programs, cameras, personal location devices, etc.
- **On the one hand, ...**
 - Congruent, accurate, and timely controls
- **On the other hand, ...**
 - Employees’ right to autonomy from controls that are “oppressive”
 - **Electronic sweatshops**

It depends on?

- Has the use of these controls been disclosed?
- Are employees involved in establishing the system (making it fair)?
- Are these controls used for monitoring employees in training, or do they also monitor experienced employees?