Management Control Systems

Chapter 12: Financial Results Control
Remedies to the Myopia Problem
Recall that ...

- Accounting income does not reflect economic income perfectly, because accounting measures:
  - Are transactions oriented;
  - Are dependent on the choice of measurement method;
  - Are conservatively biased;
  - Ignore intangibles;
  - Ignore the cost of investments in working capital;
  - 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 cash flows.
Myopia ...

- **Investment myopia**
  - Reduce or postpone investments that promise payoffs in future measurement periods.
  - cf., Accounting number’s conservative bias.

- **Operational myopia**
  - e.g., destroying goodwill with customers, suppliers, employees, or the society at large.
Overcoming myopia …

- **Measure changes in economic income directly**
  - Measurement precision and objectivity of future cash flows?

- **Control investments with preaction reviews**
  - Operating expenses — Developmental expenses
  - Today businesses — Tomorrow businesses

  ![Financial results controls](#)

  ![Combination of nonfinancial performance indicators and action controls](#)

- Distinction between operating and developmental expenses?
Overcoming myopia ... 

- **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; ... 

- Cost of developing performance reports for control purposes?
Overcoming myopia ...

- Extend the measurement horizon

  » Measurement congruence:
    - The longer the period of measurement, the higher the correlation between accounting income and economic income.

  » Long-term incentive plans, but higher cost of rewards?
Overcoming myopia …

◆ 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.

  » Risks associated with discretionary 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 …

- Measure a **set** of drivers of future financial performance.
  - Also use non-financial performance measures.
  - Managers should not have to choose between financial and operational 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.
The Balanced Scorecard...

- **Financial Perspective**: How do we look to our shareholders?
- **Customer Perspective**: How do we look to our customers?
- **Business Processes**: What business processes are the value drivers?
- **Organization Learning**: Are we able to sustain innovation, change and improvement
- **Vision Strategy**: At the center, indicating the alignment of the perspectives

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Customer perspective ...

- Time / quality / performance & service / cost

- Measures?
  - Percent of shipments that arrived on time;
  - Equipment up-time percentage;
  - Mean time response to a service call;
  - Rankings against competitors on efforts to improve quality, delivery time, and price performance;
  - Percentage delivery schedule disruptions;
  - Percentage incorrect deliveries; etc.
Internal business perspective ...

- Customer-based measures must be translated into measures of what the company must do internally to meet its customers’ expectations.

- Measures?
  - Cycle time;
  - Defect rates;
  - Productivity;
  - Percentage scrap, waste;
  - etc.
Innovation and learning perspective ...

- Targets for success keep changing ...

- Measures?
  - Percent of sales from new products;
  - Rates of improvement for:
    » On-time delivery;
    » Cycle times;
    » Defect rates;
    » Yield; etc.
  - etc.
Financial perspective ...

- The extent to which the company’s strategy, implementation and execution are contributing to the bottom-line.

- **Measures?**
  - EPS, EVA, ROE, RI, CF;
  - Operating income by division;
  - etc.
Thus ...

- A method for the organization to systematically consider what it should do to develop an ...  
  - ... internally consistent + comprehensive system of planning and control.

- The BSC brings together, in a single measurement report, many of the seemingly disparate elements of a company’s competitive agenda.

- The BSC guards against suboptimization; i.e.,  
  - It should prevent that improvement in one area comes at the expense of another.
What does a BSC-approach really do …

- It forces clear **specification** of strategic objectives and appropriate **measures in four areas**: financial, customer, internal business, and learning/innovation.

- It helps managers understand the **causal linkages** from high-level financial and strategic objectives to operational measures.

- It helps managers understand critical success factors and helps them move toward the **development of measures of value drivers** throughout the firm.
What does a BSC-approach really do …

- It provides a method of **balancing short-term and long-term concerns** by directing attention both to short-term financial indicators and leading indicators of forthcoming performance (“**performance drivers**”).

- The BSC can be used to balance any **competing concerns** (e.g., productivity vs. employee morale).

- The BSC helps top management **communicate its strategic vision** throughout the firm.
Limitations of the BSC-approach …

- It is not the final story: performance measurement \(\rightarrow\) performance management
  
  - e.g., measuring customer satisfaction doesn’t tell anyone how to improve it.

- When multiple measures are used, there is a danger that some measures are really not value drivers (i.e., there is no link between the measure and financial success).
  
  - e.g., some customers are not willing to pay for improved quality, and improved quality is costly.
Limitations of the BSC-approach …

- Choices of measures get confounded with **measurement difficulties**.
  - e.g., Few would argue that customer satisfaction leads to repeat sales, and hence, shareholder value. But can customer satisfaction be measured accurately?

- It does not solve the problem of **setting good goals**.
  - How can the goals be made equally and optimally challenging across the organization and over time?
Limitations of the BSC-approach …

- When multiple measures are used, managers face the problem of **how to weight them**.
- Link with **incentive systems**?
- The system may lag reality. **Can the BSC keep up?**
In sum ...

- The BSC is **future-oriented**.

- It is perhaps particularly useful if an organization is undergoing **significant change** or if management wants to shift the **strategic focus**.

- It is a **costly** process, but with these demands for change on an organization, its benefits may outweigh the costs.
Bottom-line measures vs. BSC ...

- **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 to achieve the desired result.
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;
- Likely to become obsolete as conditions change.