



# Chapter 1

## Management control: an overview

### Introduction

This first chapter introduces management control, providing an overview of its fundamental objectives, components, concepts and tools. Its aim is to elucidate the general anatomy of this management approach so that the reader will be able to understand the links between the various topics that are dealt with in subsequent chapters of the book.

Management control will be defined progressively. In the first section we will deliberately place ourselves within a simplified context, that of an autonomous entity – a small company, for example. This will allow us to explore the basic elements of the approach. In the second section we will take a look at the more complex context of an “organisation”, made up of several “entities” (operational divisions, functional departments, etc.) and will explore the new dimensions engendered by this broader configuration.

## 1. The basic elements of the approach

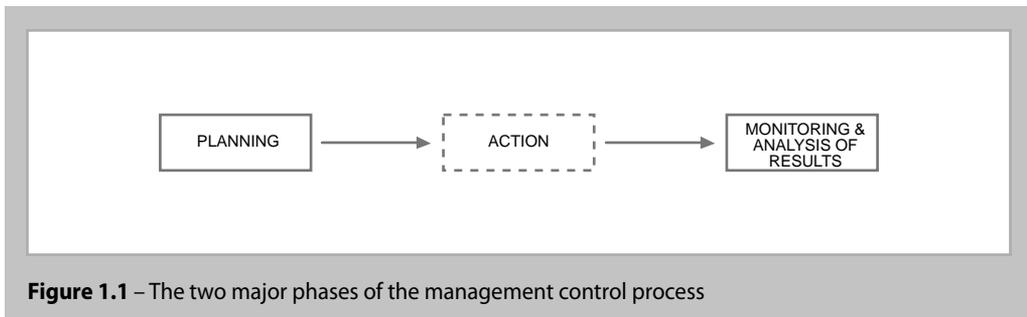
### 1.1. The control process\*

What does management control comprise and what are its aims? In order to grasp this notion, we need to draw on a broad definition of “control”, such as found in the *Oxford English Dictionary*: “to determine the behaviour or supervise the running of, to maintain influence or authority over...to regulate...”, “to hold sway over, to dominate, to command. To hold in check or repress one’s passions or emotions; so to control one’s feelings, etc.” Some concrete examples of the use of the word “control” are: to control one’s breathing, air-traffic control, etc. In other words, it encompasses the idea of a deliberate intervention on the part of an agent in order to produce desired effects. Control is the opposite of chance, but is also at odds with an excessive dependence on external factors. It is related to the notions of command and regulation.

Taking one of the above examples of control, to say that a person controls his breathing means both that he has an active role (no artificial respiration) and also that he tries to achieve a given effect (calm and steady respiration), while resisting external factors (strong emotions, a lack of oxygen) and taking action to regulate his rate of breathing (for example through regular physical training or relaxation exercises).

By analogy, management control is an approach that enables a company to produce desired results (generally expressed in terms of “performance”) by taking action to achieve those results and by dealing with the dangers brought on by external difficulties (particularly those related to the market, competitors and the economic or political context) and the internal difficulties of the organisation. In other words, management control can be defined as the process whereby a company sets itself performance objectives and strives to achieve them as best it can over time. It is a method for managing the performance of the company.

Management control is an approach that is pursued over time: we situate ourselves both before the action, in the *planning* phase, and after the action in the *monitoring and analysis of results* phase. The approach is therefore progressive, which is why we speak of the *control process*.



Control cannot be reduced to a simple exercise of “verification”, because then we would be operating “after the fact”, once the decisions and action had already been undertaken. In such a case the scope of control would be confined to reactions rather than fully effective action. In seeking to control the attainment of desired outcomes and results, it is essential to prepare the action, to organise it, to perform simulations and to anticipate its consequences. The planning phase is therefore crucial.

### 1.1.1. Planning\*

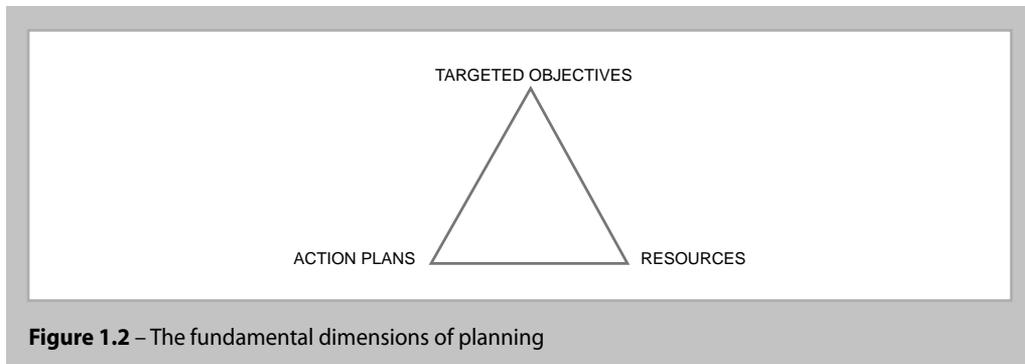
As we have seen, the general function of the planning phase is to prepare for action. Without going into the details here, which will be presented in chapter 7, we can identify its main components.

First of all, planning involves the setting of *objectives*. The term “objective” comprises two notions:

- **the kind of outcome or result desired, or a particular type of performance.** Is the company trying to increase its profitability? To increase the volume of its activity? To decrease its debt load? Is it pursuing all of these goals at once? Other types of goals?
- **the level of performance desired.** If the company’s goal is performance in terms of profitability, are they aiming at 10% or 20%? Are they trying to *double* their volume of business to become the market leader or are they seeking to *maintain* their current market share? Is their aim to *reduce* structural costs?

In following chapters we will see that each of these aspects raises a particular set of problems, which is why we feel that it is useful to distinguish them conceptually and to use different terms. We will use the term “objective” to refer to the type of performance sought and the term “target” for the desired level of performance. Of course, these two aspects are intrinsically linked and in practice are often decided together. Consequently, the first role of planning is in fact to determine *targeted objectives* (for example, a 10% increase in sales).

The second role of planning is to anticipate how the company will go about achieving these objectives. It is important to put a coherent system in place before launching into the action stage *per se*. Planning also involves decisions about the ways and means that will be brought to bear, *i.e.* both the choice of *action plans* to be set in motion and the identification and mobilisation of the *resources* that will be necessary (financial, human and material resources, etc.).



**Figure 1.2** – The fundamental dimensions of planning

### Example

Ordinatix, an IT service company, wants to expand on the French market and sets itself a target of 20% market share.

In order to increase its turnover, Ordinatix may consider various action plans: extend its activity to new client segments, increase the attractiveness of its services in its current markets (for example by reducing its prices), or create new services. Based on the choice of action plans, the various needs in terms of resources will have to be anticipated and arranged: the number and type of business locations, IT staff, training expenses, promotional actions and financial resources.

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The further off the time horizon, the more the company can anticipate and organise its action. But, inversely, risk levels will also be higher due to greater uncertainty. The function of the first planning tool, the *strategic plan*, is to determine the company’s “long-term” objectives, finding a compromise between these two considerations (anticipation/risk). Strategic plans are generally formulated on a five-year timeframe, but in reality this greatly depends on the sector that the company operates in, as well as the magnitude of the action plans being considered.

**Example**

Companies like Arcelor-Mittal and Orange are currently operating on five-year strategic plans.

In some cases the timeframe may be longer: eight years at AXA (the “ambition 2012” plan announced in 2004), ten years at EADS (the “vision 2020” plan announced in 2010), 12 years at the CNRS (“Horizon 2020” announced in 2008), and several decades for energy companies.

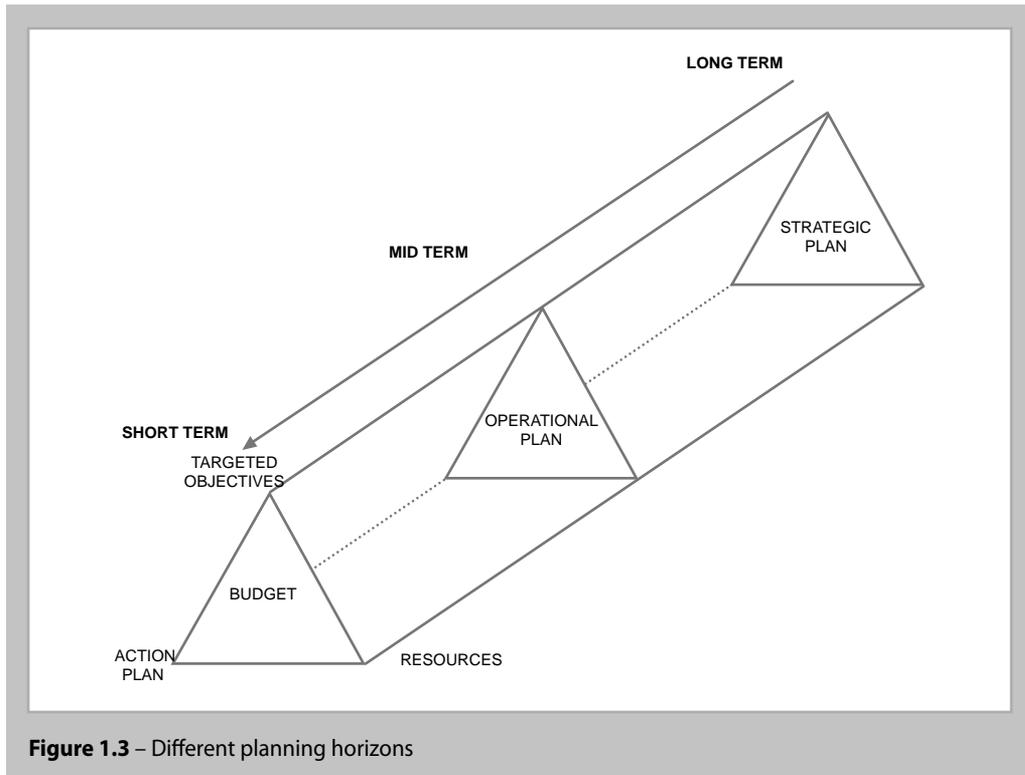
But it can also be shorter: in 2010 Dexia established its long-term objectives on a four-year timeframe.

“Controlling” the objective entails the creation of a *path* leading to the intended goal(s). This is done by setting milestones along the space-time corridor, which leads from the present situation to the long-term objective, in other words, breaking it down into shorter periods and creating intermediate stages. To achieve this, the strategic plan is assisted by two other planning tools:

- **the operational plan**, which translates the objectives to a mid-term plan, generally on a three-year timeframe;
- **the budget**, which translates them to an even shorter time horizon, usually one year.

As its name suggests, the operational plan “operationalises” the strategic plan by establishing an intermediate stage in the achievement of the final goals. The budget continues this process, setting milestones on the annual time horizon. If the company’s goal is to achieve a market share of 20% in ten years and its current level stands at 5%, the road leading to this objective may at first glance seem long, arduous and perhaps even unrealistic. To give itself a real chance of attaining this goal, the company may set a target of 10% over three years in the operational plan and a target of 8% in the budget for the following year. Long-range action plans and resources will also be translated into shorter-term targets.

If the planning phase is done well, it will later serve as a valuable guide for monitoring results. Indeed, the results will be considered in terms of “variances” with the objectives. Therefore, if the planning is done in a cursory manner or is too limited, it will be hard to determine whether a variance indicates poor performance, for which solutions must be found, or if it simply stems from bad planning and does not require any specific reaction. On the other hand, diligent planning will provide the manager with reliable information on the level of performance achieved and enable him to focus on unfavourable variances. This is what is known as *management by exception*\*.



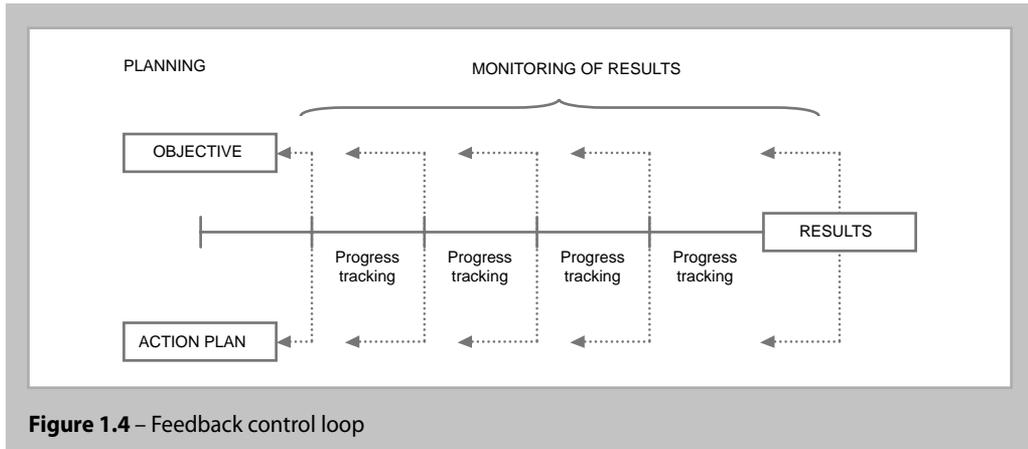
**Figure 1.3** – Different planning horizons

### 1.1.2. Monitoring and analysis of results

The aim of planning is to anticipate, as much as possible, any potential difficulties in attaining objectives, by setting targets properly, by formulating coherent action plans and by allocating the necessary resources. Even so, it may happen that the results are not attained, particularly if the action plans are improperly implemented or unexpected events occur. Thus it is necessary to monitor the results obtained. This is the downstream phase of the control process.

The purpose of monitoring is not merely to “observe” whether targets have been reached or not. It is an integral part of overseeing the achievement of objectives: it is not done at the end of the timeframe, but rather *during* the implementation of action plans, which gives the manager the chance to react “mid stream” if the final result appears to be in jeopardy. Consequently, the “monitoring” of results strictly speaking is preceded by results *progress tracking*. Navigating the path towards goal achievement is done progressively through regular progress checks. Thus, if the time horizon for budget objectives is annual, then budget monitoring will generally be carried out on a monthly basis. Likewise, as the budget is the short-term part of the operational plan, annual year-end results will constitute interim tracking points for the three-year plan. The control process (planning and monitoring of results) is not therefore a straight-line sequential process, but rather a “loop”, where the company regularly intervenes to check on progress. At this stage it is called a *feedback control loop*\*.

If a variance between targets and results can prompt the company to reconsider the implementation of action plans, it can also lead them to review the targets themselves. Certain assumptions held during the target setting process may no longer be valid and new elements may have appeared. For example, economic growth may be weaker than expected, currency exchange rates may have shifted significantly, an economic partner may have suffered irreversible setbacks, and a competitor may have made an important commercial innovation, seriously weakening the probability of reaching the initial targets. It is therefore important to know how to incorporate these changes through the use of *reforecasts*, in order to quickly adjust the course of action and resources brought into play.



**Figure 1.4** – Feedback control loop

Several methods exist for monitoring results. Generally based on the identification of variances with respect to targets, they break down these variances according to different configurations. In chapter 8 we will see that they provide the manager with a basis for analysing actual performance whose richness and responsiveness varies depending on the configuration used. As a result, their usefulness in terms of making corrective decisions is also variable.

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#### Management control and financial accounting

Management control is often seen as a field of “numbers expertise”, which is why people often associate it with financial accounting. There are, however, fundamental differences between these two systems<sup>1</sup>. Financial accounting is primarily concerned with external communication and reporting on the overall performance of the company for legal and fiscal purposes, as well as for the financial analysis requirements of third parties. It follows reporting standards for publishing results.

1. The distinction drawn here is perhaps excessive with respect to the real links that exist between management control and financial accounting and which are more complex than presented here in this boxed text. This distinction nevertheless serves an important pedagogical purpose: to clarify the fundamental framework of management control by providing clear definitions and by identifying the final goals of these systems. Throughout this book we will repeatedly see the importance of this in terms of the concrete configuration of measurement and performance management tools.

The purpose of management control, on the other hand, is for company executives to formulate strategic objectives and oversee their achievement. It is therefore principally an internal process and is less concerned with *measuring* results than *producing* them, which also means defining them upstream. Moreover, the tools that it uses are generally adapted to the specificities of each company (objectives, strategy, structure). Finally, as we shall see, it is not confined to the financial dimensions of performance.

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## 1.2. Performance measurement systems\*

### 1.2.1. What performance?

A company's short-, medium- and long-term objectives can be established on the basis of very diverse conceptions of the kind of performance sought. In newly formed companies, the profitability of the activities may temporarily take second place to an objective of growth, or cash flow may be a higher priority than profitability, to offer but two examples.

#### Example

The past few years at the Pernod Ricard group have been marked by strong external growth with the acquisition of Irish Distillers (Jameson), a part of Seagram, Allied Domecq, and Vin & Spirit (Vodka ABSOLUT). Two priorities have been defined for 2010/2011:

- internal organic growth, especially through the development of the group's strategic brands
- debt reduction following this series of acquisitions

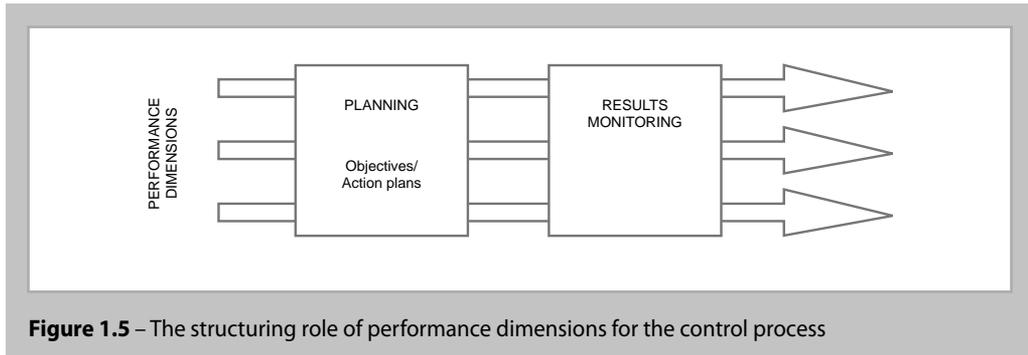
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Although management control was initially developed on the basis of a representation of performance expressed exclusively in financial terms, this is not its inherent nature. In some sectors, performance objectives are not limited to economic profitability, but also include public service goals or environmental constraints. Management control as we define it in this book can be applied to sectors such as town councils, hospitals and humanitarian associations. It is not therefore confined, as is sometimes thought, to for-profit businesses.

We will also see that as soon as we move from final objectives to intermediate targets, the nature of performance may change as we shift from goals, strictly speaking, to the *performance levers* by which they are achieved. For example, a company whose goal is performance in terms of profitability can set itself an intermediate objective of cost reduction. A humanitarian association may feel that an important lever for launching its charitable undertaking is having attained a certain level of public awareness and consequently it may set itself intermediate objectives in terms of public relations.

Performance is not a universal notion. It is a construct that is influenced by various factors: the type of organisation, its sector of activity, its strategy, and the configuration of stakeholders, which we will discuss in chapter 2. In general, this variety of factors makes the definition of performance specific to each organisation.

Implementing the control process (planning, results monitoring) is thus impossible unless the desired performance dimensions are first spelled out and prioritised. This constitutes its structure: targets must be set and results monitored for all the performance dimensions chosen by the company.



**Figure 1.5** – The structuring role of performance dimensions for the control process

Management control cannot be systematically associated with an objective of profit maximisation, nor can it be assimilated to a cost-reduction objective, as is sometimes thought. Broadly speaking, the activity of a company generates both consumption (in raw materials, time, energy, etc.), which results in costs, as well as more positive aspects of performance which makes it attractive to customers (product quality, diversity of services, image, etc.). The notion of performance cannot therefore be reduced to its “negative” side (costs), it also encompasses elements of value creation.<sup>1</sup>

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#### Cost accounting and management control

Cost accounting focuses on the measurement of the costs generated by the company. It covers different concepts of costs which may correspond to different calculation stages (purchase cost, production cost, cost price), the degree to which expenses are incorporated into the costs (full cost, variable cost, direct cost), the standpoint from which they are calculated (budgeted cost, actual cost), to name the main distinctions. It uses various methods of calculation (cost pool method, ABC<sup>2</sup>, inventory valuation methods, techniques for the rational allocation of overheads, etc.).

1. In chapter 2 we will see that the notion of “value creation” is rather hackneyed and can have several different meanings.
2. ABC = Activity Based Costing.

Management control is broader than cost accounting in that it focuses on the notion of performance, which is not confined to cost reduction. For example, in the luxury goods sector, product image, quality and packaging are also very important dimensions of performance; in the area of rail transport, safety, punctuality and reliability of service are important dimensions to integrate into the performance management system.

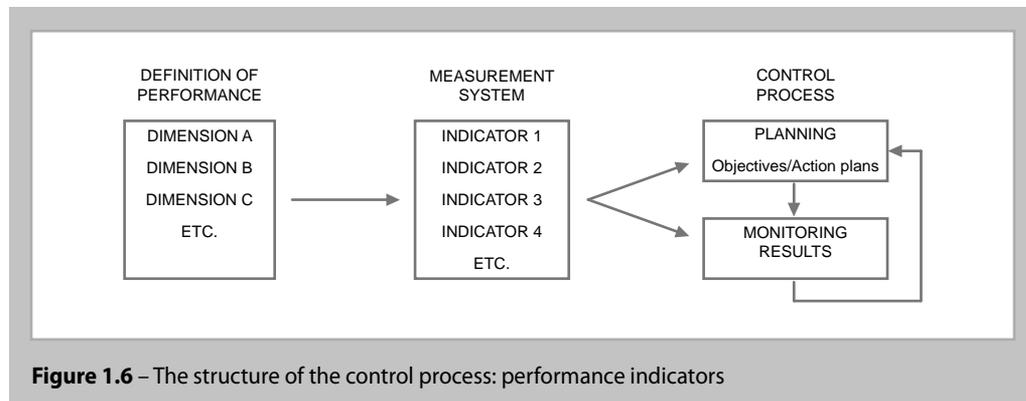
Moreover, management control covers the entire dynamic of performance management. It cannot therefore be reduced to static “accounting”.

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### 1.2.2. The role of measurement systems

Basically, as we have just seen, performance dimensions are defined qualitatively: the goals are profit, product quality, an innovative image, etc. However, in order to set quantitative targets and monitor results, these qualitative dimensions will have to be translated into measurable units or indicators.

For example, profit can be measured using an indicator like net income, and customer satisfaction gauged by the number of complaints. It is then possible to decide if the target should be a net income of 100 or 200 and a decrease in the number of complaints of 5% or 10%. These indicators can be multiple and in general we speak of a *measurement system*. Targets will be set for each dimension and the results of each will be monitored.



**Figure 1.6** – The structure of the control process: performance indicators

Once built into the framework of the control process, these measurement systems play a significant structuring role, as encapsulated in the saying: “What you measure is what you get!” It is generally thought that objectives are more likely to be controlled if they are the result of a deliberate pro-active control process that is built into management systems.

In fact, the advantage of measurement systems is that they translate performance into concrete, “objective” terms. They facilitate the clarification and communication of performance which is particularly important in large organisations where people have to coordinate their actions (see section 2).

We must not however lose sight of the fact that measurement systems are first and foremost representations and that fundamentally there is a great deal of subjectivity in the selection of performance dimensions, as we will see in the following chapters. We will also see that the use of measurement systems has certain limitations and can generate pernicious side effects, which is why they must be used wisely (see in particular the conclusion to part 1).

### 1.2.3. Building measurement systems

Measurement systems play a central role in performance management systems, but they are not easy to build. The qualitative goals being pursued are not always very clear. They may be perceived differently depending on whether one is an operational manager or a member of executive management who has a more strategic view of the company's long range goals and issues, but less detailed knowledge of the specificities of each customer segment. Likewise, a sales manager will have a view that is substantially different from that of a factory director or the head of human resources. In clarifying the terms of performance, it is essential then that these different representations be brought into line with each other.

Besides, a given qualitative phenomenon is not always easy to capture with an indicator. The indicator is often just an approximation, a more or less faithful reflection of the phenomenon. It often rests on conventions whose suitability is not always easy to demonstrate.

How can one measure a customer's satisfaction? Customers do not necessarily show their displeasure in a direct and immediate fashion. An indicator such as the number of products physically returned by the customer to the company overlooks cases where customers were unhappy but did not bother to return the product. The number of telephone complaints is also imprecise. A satisfaction score coming from surveys carried out by interviewing customers will depend on how the customer sample was set up.

How can one measure the profit margin generated by a given product? Does one include the costs of the entire manufacturing chain from the purchase of components to the sale of the product? Should product creation costs (design costs, prototype costs, etc.) be included or only those expenses undertaken when production has reached "cruising speed"? How can one take into account structural costs and what is the most appropriate way of allocating them to the different products?

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### The properties of a good measure

On a theoretical level, we can distinguish two types of quality required to make a "good" measure:

- **Intrinsic qualities:**

- *Reliability*: the measure should capture the phenomenon to be measured with a satisfactory level of precision, while limiting "noise". In a transport company, for example, the working hours of each driver are measured in the following way: a tachograph automatically measures the time that the vehicle is in motion. To this driving time we have to add "physical" working time (loading and unloading trucks) and "standing" time (various kinds of waiting time), as well as rest time.

To do this, the driver manually switches on the tachograph to record the appropriate kind of time. In practice, the way drivers record the time varies quite a lot. Still, at the end of the week, before the IT system automatically generates the payroll, the working hours declared are verified by the owner (himself a former trucker who knows the ins and outs of the system), which helps to improve the reliability of the system.

- *Validity*: the measure must be suited to the phenomenon that we are trying to measure. For example, measuring the total time worked by a driver, even if it is carefully checked by the owner (as far as possible) is not a very valid measure if we are trying to measure the driver's performance. He is of course expected to put in a certain number of hours working, but other factors are also essential (safety, observance of speed limits, etc.).
- **Suitability to purpose:**
  - *Relevance*: the measure chosen has to be suitable in terms of the type of decision to be taken. For example, the cost of production is more relevant than cost price for measuring the performance of a factory because cost price includes selling costs which are not directly related to manufacturing. We will also see in the first part of this book that measures are not designed the same way for outside parties as for managers or for “local” managers or for the directors of the company, and also differ depending on whether the measure is used for evaluating the performance of activities or that of the managers in charge of these activities, *i.e.* the purpose envisaged for the measure.
  - *Cost*: producing a measure costs money, because data has to be collected, verified, processed and interpreted, which generates costs in terms of time spent and IT systems. The information delivered by the measure has to be sufficiently useful to justify these costs.
  - *Time*: information that is delivered “too late” is of little use. Certain measurement systems will have to be rejected by management because they are too slow or too cumbersome and not suited to the context of quick management decision making.
  - *Legibility*: a measure is an instrument for information which means users must be able to read and understand it without difficulty.

Difficulties also emerge in terms of the list of indicators that will be selected. The natural tendency is to use measures that are readily available, for example indicators coming from financial accounting (which companies have the legal obligation to publish in order to inform third parties, and which are therefore “available” for the needs of management), information generated directly by production or sales processes: orders taken from customers, volumes delivered, stocks, company workforce data (which are necessary for the operational needs of the company and which can therefore be “collected” for the purposes of management). We will see that the construction of measurement systems has more demanding requirements: all the data available are not necessarily *relevant* and it may be necessary to construct indicators specifically for the needs of performance management.

In part 1 of this book we will put forward clear principles to guide the construction of suitable performance measurement systems.

#### 1.2.4. The learning loop\*

The difficulties involved in choosing a measurement system always impart a certain degree of fragility in spite of the care taken in developing it. The “technical” selection of indicators and *a fortiori* the prior definition of performance dimensions are underpinned by choices, representations, strategies, analyses of the company’s business environment, the constraints it imposes or the opportunities it offers, and the entire set of representations that constitute the *performance model*\*, on the basis of which the measurement systems are going to be constructed.

Owing to this element of subjectivity, the performance model is intrinsically linked to the people who designed it, to their standpoint, their competencies, as well as to the political context of the company and its quality will depend on out of which organisational configuration it comes. The performance model is also contingent in temporal terms because it derives from the analyses and decisions of a particular moment – which may evolve. The configuration of markets and competitors is constantly evolving. By definition, action plans have a limited lifespan and unforeseen events can occur in the company. The model is therefore always more or less provisional.

It is essential therefore to remain vigilant and to regularly check on the relevance of the model underpinning the performance management systems. Variances between targets and results may be a symptom of the weakness or obsolescence of the model and will therefore alert the manager to the necessity of reviewing it. This is what we call a *learning loop*, which completes the feedback control loop presented above. In the feedback control loop, one tries to reduce a variance by reinforcing the action plans already underway or by reviewing the objectives that have been set. In the learning loop, the corrective action operates on the performance model which underpins the targets and action plans.

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##### Example

Specialising in the publication of management books for the general public, the Sweet company has enjoyed regular sales growth in recent years, although the market has become increasingly difficult. The fact that shelves are bursting with this type of product, coupled with the impact of fads, have made the selling process difficult and sales forecasts are hard to make. Still, the managers of Sweet have decided to face these difficulties by adopting a proactive, ambitious approach. They set themselves a sales growth target of 8% per year for the next three years and intend to maintain the ratio of margin to sales. To achieve this end, they have decided to intensify their sales efforts to retail outlets, increasing the frequency of visits by their salespeople to booksellers so they can present the most recently published titles, check the positioning of their books on the shelves and gather precise information on the behaviour of customers.

At the end of the first year, however, the results are far below the sales forecasts. What options does Sweet have?

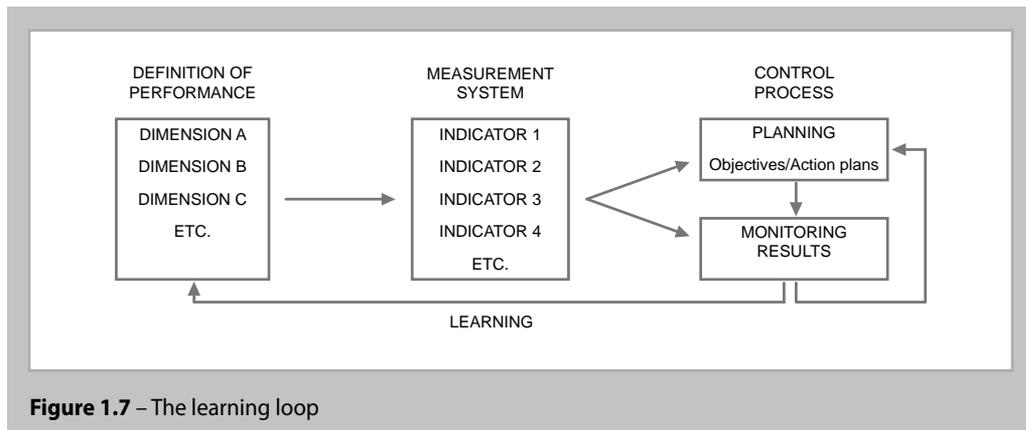
- Intensify their action plans, for example by improving the quality of the sales negotiation (improving the sales presentation, training the sales team), by reorganising customer visiting rounds, by more closely supervising their sales people or by hiring extra staff.
- Lower their targets for the year 201n+1 to pursue a more gradual pace of growth.

These first two courses of action constitute the feedback control loop.

- The company directors may also examine the appropriateness of their performance model more thoroughly. Should they continue to sell through neighbourhood bookstores? How is the digital book market evolving and should they try to position themselves on this very uncertain market segment? Should they perhaps consider partnerships with educational institutions?

This third approach constitutes the learning loop.

Here we glimpse one of the main difficulties of the dynamic of control: if action is not organised in advance (planning, construction of a performance model translated into a measurement system), the desired performance has little chance of being achieved. But in an unstable and uncertain context, the relevance of this plan and this model is ephemeral. It is necessary therefore to provide guides for action, to impart a predefined direction, to remain vigilant in case these action frameworks have to change, and to be ready for change when necessary. A balance must be found between the two opposing dangers of incoherence and rigidity.



**Figure 1.7** – The learning loop

### 1.3. The role of controllers in the performance management system

Management control is naturally associated with one function in the company: the controllers, who may be organised in separate departments or grouped together with other functions in the company.

But the performance management system is far from being the exclusive domain of the controllers. Basically, it is an approach that concerns *managers* whether they be company directors, business unit directors, managers of an operational department (factory, sales department) or a functional department (marketing, finance, human resources, etc.). When a manager is in charge of a business segment and has the authority to engage his business unit in a course of action through operational decisions, it is vital that he does not act blindly and that he manages the performance of his unit in line with his responsibilities. He must therefore clarify the objectives to be pursued and plan for the future in an active manner. He must oversee the convergence of the results obtained and take necessary decisions when the results are not on track.

However, a lack of time and the need for expertise relating to certain tools may compel him to delegate part of this process to another person, the controller, who thus takes on a part of the performance management process. The controller plays an essential role in designing systems and tools (plans, budgets, dashboards and so on) and in their implementation, as well as in the resulting economic analyses and running the process. He thus plays a *support role* to the manager.

We will see in chapter 9 that this positioning has significant consequences on the required profile of management controllers, their rank in the company and the organisation of their functions, as well as the conditions for performing their duties.

At this stage it is essential to understand that the control process is implemented *jointly* by operational managers and controllers, that it is not just an area for specialists, *a fortiori* numbers experts, but is a broader approach in which numerous people participate. These roles are closely intertwined and can have a different configuration depending on the company. For example, in organisations where management control is not highly developed, such as non-market sectors, the management controller may have a significant role involving awareness building, information and the training of operational managers, in addition to their more technical responsibilities. In certain companies managers depend heavily on their management controllers to analyse business results, whereas in others they would perform this function themselves.

## 2. Management control in large corporations

Section 1 presented the basic management control approach, describing:

- its dynamic organisation over time (planning, monitoring results)
- and its structuring around a performance measurement system (a set of indicators based on a performance model).

As we will see, this type of approach can be implemented in companies of very different sizes. The belief that management control is reserved for large corporations is ill founded: the director of a small company is confronted with potential uncertainty in his sector of activity, with the need to chart a course and to organise his resources and action plans in a

way that is consistent with this orientation. He has to make sure that the results are in line with the ambitions that he has set. His “need for control” is therefore quite real.<sup>1</sup>

Nevertheless, in bigger organisations where many different people are involved and decision-making processes are highly complex, management control has to face additional challenges which we will present in this second section.

## 2.1. Two levels of performance management

Large corporations require a clear structure for decision making. This structure can follow different configurations of varying complexity: divisional (which themselves can be organised according to different criteria: geographic areas, markets, products, etc.), functional and matrix structures or a structure organised by projects. The structure may also entail a certain degree of decentralisation of decision making.

In terms of management control this introduces a new difficulty: when decision-making authority is distributed among multiple actors, or to be more exact, between several entities<sup>2</sup>, and particularly between different hierarchical levels, at what level should the control process be carried out? In section 1 we saw that managers were directly involved in the control process, but how are things organised between different levels of managers?

### 2.1.1 Autonomous control by entities

Part of the answer is provided by the very reasons that justify the delegation of decision-making authority down the hierarchical line. In reality this responds to multiple preoccupations: shortening the decision-making process, having decisions taken closer to local contingencies, and the heightened motivation of the people to whom greater room to manoeuvre has been given, to cite just a few examples.

In order to preserve the advantages of decentralisation, it is important for “local”<sup>3</sup> managers to be able to implement an autonomous control process at their own level, and for several reasons:

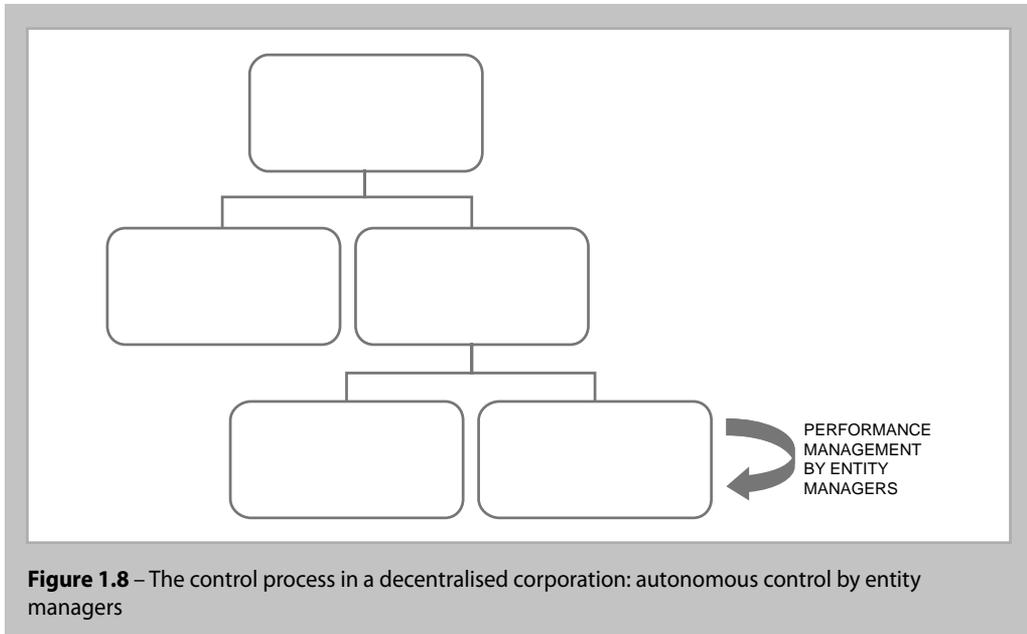
- If target setting and results monitoring were only performed by the directors of the corporation then local managers would have no “visibility” of the progress of their activity; they would be navigating blind. This would therefore be inconsistent with the decentralisation of decision-making authority.
- Furthermore, senior executives would be overwhelmed with detailed data for monitoring results because a corporation generally has multiple activity areas.

1. It is conceivable that performance management systems may be simpler in small companies than in large companies and the function of management controller may be grouped together with other similar functions owing to more limited financial resources. Nevertheless, this in no way eliminates the need for management control.

2. We will further define the notion of entities in the rest of this chapter and in chapter 4. At this stage, we will simply say that it is a subdivision of the corporation: division, business unit, department and so on.

3. For purposes of simplification, we use the term “local” managers here to refer to all managers who report to a higher-ranking manager, who is thus more “global”. This terminology is not meant to imply anything about the level of “localness” of the manager, who may be situated at a very high level in the hierarchy (director of a division or branch in the group, for example, the director of a central support function) or may be positioned at an intermediate level in the hierarchy (head of a department).

Basically, the performance management of the company's various activities comes under the responsibility of the managers to whom the management of these activities has been delegated. Local managers have to plan for the future and follow their results, based on performance indicators suited to their activity areas, just like SME directors. These managers are therefore the first users of the various control tools and systems.



**Figure 1.8** – The control process in a decentralised corporation: autonomous control by entity managers

As we have pointed out, this does not only concern managers who are in charge of large activity areas (directors of divisions, branches, projects, etc.). It can be extended to finer levels of responsibility within the company (factory managers, sales and purchasing managers, etc.) as well as functional areas (managers in charge of marketing, human resources, R&D, etc.).

### 2.1.2. Overall performance management by senior management

The decentralisation of decision-making authority engenders the need for autonomous control by the managers concerned. This is not enough however, because the effective performance management of every entity in the organisation will not guarantee performance at an overall company level.

The first challenge is to ensure good vertical coordination in the control process, both top-down and bottom-up, which we call *strategic alignment*. Indeed, the choices made at the general level of the organisation should serve as guidelines for each business area. If a corporation has chosen a general market position which prioritises a service offering in addition to the physical delivery of products, it is important that this orientation be relayed to the various business areas in the company.

Inversely, “local” considerations related to each activity area should also be “sent up” so as to be taken into account during the formulation of overall company strategy, so that strategy may be both informed and realistic.

Coordination should also be done horizontally between the different entities in the organisation.

### Examples

If a distribution entity has plans to break into new markets, it is essential that this information be relayed back to the level of the production entities so they can adjust production capacities and formulate their own action plans.

New product design should involve the joint expertise of operational and functional departments so that customer needs can be integrated all along the value chain.

Synergies should be sought out between comparable entities in order to derive maximum benefit from belonging to the same group.

Boxed text 1.8

Finally, the decentralisation of decision-making authority incurs a more basic risk, known as *agency risk*, which relates to the very act of delegation. This risk manifests itself along two dimensions:

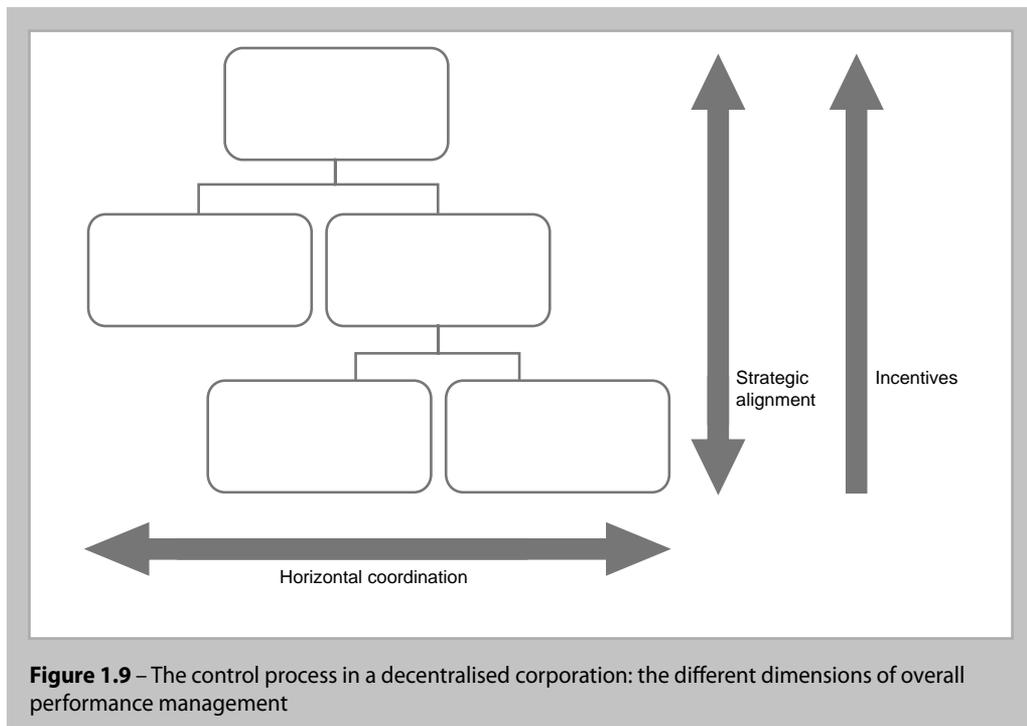
- **What ensures that decision-making authority is oriented in the interests of the company?** This problem relates to the “direction” in which local decisions are taken.
- **What ensures that action is done in a sufficiently vigorous fashion?** This is a problem of “energising” action.

Agency risk is all too often associated with extreme forms of behaviour such as the hijacking of decision-making authority for personal benefit (problem of direction) or the laziness of the agent (problem of “incentivisation”). This sometimes generates confusion concerning the objectives of management control, leading some people to think that the objects of control are the individuals, the “agents”. This would suggest that the function of the control process is to ensure that individuals do not “get out of control”, that it has primarily a disciplinary function.<sup>1</sup> We feel that this conception is doubly excessive: first, although managing agency risk is one of the dimensions of management control, it is not the only axis. Second, agency risk cannot be reduced to these extreme forms of behaviour. When the action is shared among several actors (particularly in a vertical configuration), there are inevitably differing points of view, an overall approach and a local approach, and therefore a risk of divergence between these approaches. Thus, for example, when a manager is given a great deal of independence in a given area of responsibility, the risk arises – in contrast to the benefits of this choice – of “excessive independence”, of compartmentalisation, of personal fiefdoms, which can be very harmful to the synergies needed by the company as a whole. We will present a particularly telling illustration of this in the “Environmental Services” case study at the end of the book.

1. In everyday usage, the word “control” has a certain disciplinary connotation, which increases the risk of confusion. Indeed, to control can mean “to dominate, to maintain influence or authority over, to regulate”.

One way of dealing with agency risk is to put *incentive schemes* in place for the managers who are in charge of the organisation's entities. While coordination mechanisms aim to align the representations and information held by each party, the aim of incentive schemes is to align the *interests* of the various agents, to “motivate” local managers to pursue common objectives.

Concrete incentive schemes can be quite formal and be powerful driving forces especially if a portion of managers' income is indexed to the results achieved, as recommended by the dominant form of management control and as can be seen in certain company practices. But motivating individuals is a complex process and can spawn less formal incentive mechanisms, allowing more room for dialogue between the different hierarchical levels, not confined to vertical evaluation processes and associated with less direct forms of “sanction/reward”: approval, blame, career progression, etc.



The three fundamental functions of overall performance management (strategic alignment, horizontal coordination, staff motivation) can be summed up in the idea that the role of senior management in the management control process is above all to *orient behaviour* and to motivate staff, and not only a direct contribution to performance management.

In practice these functions can however be performed by very different systems, as we will explain below.

## 2.2. Responsibility centres and results control

One of the central mechanisms for achieving this triple function of strategic alignment, horizontal coordination and motivation of managers is the concept of *responsibility centre*, which is closely related to that of *results control*.

### 2.2.1. The concepts

In the preceding paragraphs we developed the idea of the responsibility of the managers in charge of the entities that make up large organisations. By “responsibility”, we refer above all to the fact that they have substantial room to manoeuvre and broad decision-making authority, hence a significant degree of autonomy.

The scope of this decision-making authority can be broader or narrower depending on the manager’s position in the organisation:

- Obviously, the director of a division has broader powers than the director of a business unit within that division, who in turn has greater responsibilities than a department head within this business unit, and this narrowing of authority continues as we move “down” the organisational hierarchy.
- Furthermore, the amount of freedom given a manager depends on the degree to which the organisation is decentralised. For example, the division directors of two different companies may have differing degrees of autonomy depending on whether or not they have authority over commercial decisions (choice of commercial strategy, choice of target markets, price setting, discounts, payment terms, etc.), over production (choice of product and service ranges offered, latitude on operational decisions, on the human, financial and material resources they draw on, etc.), over development (engineering and design department, new product development department, etc.) or over short and mid-term investments. In some companies, these decisions are totally decentralised, in others they may be considered strategic and remain centralised at the level of executive management.

Thus the concept of responsibility centre refers first of all to entities which have substantial decision-making authority. As we have seen, this includes divisions, branches, business units and departments. Companies seldom create responsibility centres below these levels however.

In addition to this first idea, the term “responsibility” also refers to the “accountability” engendered by the delegation of decision-making power. When a manager engages the company on a course of action through his operational decisions, it is essential that the consequences of these decisions can be imputed to him. The idea is not to “point the finger at the guilty parties” (or at the good managers, for that matter) but, as we have seen above, to promote the coordination and motivation of company employees which we sum up in the idea of “orienting behaviour”.<sup>1</sup>

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1. We won’t go into an extended discussion here of the multiple meanings of the concept of responsibility in general. This is a controversial topic in fields as broad and as varied as philosophy, law, etc. People will recall the debates it raised in France concerning the “tainted blood scandal” which hinged on the question of whether or not “being responsible” meant “being guilty”. We will emphasise here one of the main differences that can be identified between the search for guilty parties and the idea that we are advancing here, the orientation of behaviour: the former is oriented towards the past and the latter towards the future.

How can we define what the manager is accountable for? In the traditional doctrine of management control, there are three prevailing principles:

- *A principle of demarcation*: in setting results targets for managers, one must first mark out the area that they will be accountable for, in other words, the scope of the *contribution* that they are asked to make to the general objectives of the company. A local manager can only contribute partially to the overall objective and it is the size of this contribution that must be clarified.
- *A principle of anticipation*: as we remarked at the beginning of this chapter, it is more important to be proactive than reactive, to situate oneself as far upstream as possible in order to best “control” things. Thus the manager of each entity will be told *beforehand* what he will be answerable for, what is “expected” of him, in other words, his *objectives*. Establishing the responsibility of the manager is done on a *contractual* basis).
- *A principle of results control*<sup>1</sup>: the *objectives* that managers are accountable for are objectives of *results*, in other words, managers do not have to report all of the detailed decisions they take or the action plans they implement to achieve results in their area of autonomy.

In sum, a responsibility centre is defined as an entity within the structure<sup>1</sup> to which the company directors have delegated a certain amount of decision-making authority. The kind and level of its contribution to the organisation’s overall performance objectives has been specified.

### Boxed text 1.9

#### Example

In a large corporation, the management of a product line can be grouped within a product division. For this division to be considered as a responsibility centre, it is necessary to clarify what kind of decisions it is authorised to take: purchasing, manufacturing, sales, development, investments, etc. But the contribution it is expected to make to company objectives must also be clarified, for example increasing the profitability of this product line.

The scope of the responsibility centre would be different if decision-making authority at the entity level were more restricted (for example, if investment decisions remained centralised at head office), or if responsibility encompassed two different product lines. Similarly, its scope would be different if the type of contribution expected were the growth in business volume, for instance, or the development of an innovative image.

This “classic” definition of the concept of responsibility centre conveys a particular conception of the responsibility of managers, bearing the hallmark of the American origins of management control, which is still very present today:

- a very formal conception of responsibility that one tries to translate into a measurement system in order to make it clear and intelligible: profit margin, turnover, customer satisfaction index, and so on;

1. We will come back to the notion of “entity” in chapter 4, where we will see that there are several different types of entity.

- adoption of a particular approach to orienting behaviour: results control;
- adoption of a particular approach to regulation between parties: the contract.

These characteristics are not necessarily always appropriate. Results control can make more room for management dialogue about measurement, there are other methods of orienting behaviour besides results control (see Boxed text 1.10), the contractual approach is not suitable for all cultures.<sup>1</sup>

### Alternative control approaches

Results control is not the only method of orienting behaviour. Among the other “control methods”, two tend to dominate:

- **Direct control of behaviour:** this consists in controlling behaviour itself rather than the results it generates. The rules and norms established by the company, as well as the physical and administrative authorisations/prohibitions (access restrictions, limitations on decision-making authority, separation of tasks, etc.) belong to this category.
- **Control by organisational culture:** this seeks to develop forms of socialisation among individuals in the company. This category includes company projects, codes of ethics, the company’s internal rites, dress codes, language codes, etc.

As all forms of control have their strengths and weaknesses, an appropriate and useful system for orienting behaviour would require a combination of these different forms rather than a single form.

Boxed text 1.10

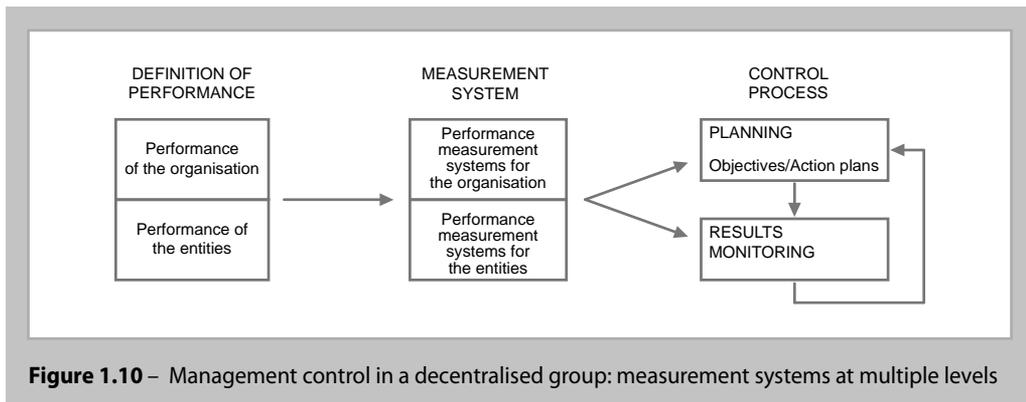
### 2.2.2. From global performance measurement to local performance measurement

According to this standard definition, a responsibility centre works somewhat like a small organisation that has to navigate towards its own performance targets, themselves defined as a contribution to the organisation’s overall objectives.

Just as at the level of the organisation as a whole, measurement systems play an important role in clarifying the scope of these objectives. In the previous example, if the contribution of the product division is defined in terms of the profitability of the product line, a logical performance measure might be, for example, the operating income of the product (and not of the company).

In a decentralised corporation, it is therefore necessary to construct performance measurement systems at several levels in the organisation and not only at the broad company level.

1. For a discussion of these critical elements, see Giraud, F. et al., *The Art of Management Control: Issues and Practices*, Pearson Education France, Paris, 2011, chapter 1.



In chapter 4 we will see that there are four major types of responsibility centre: cost centres, revenue centres, profit centres and investment centres, which are mainly distinguished by the measurement system used to evaluate their performance.

### 2.2.3. Coordination of local-level autonomous control and performance management at the company level

The concepts of responsibility centre and results control outlined above help to fine-tune the integration of autonomous local control by entities and overall performance management by company directors.

When entities report on the achievement of a given target to their superiors, the choice of the means employed to achieve these results falls under its responsibility. Senior management does not have to intervene in this type of decision unless the results do not meet expectations. This allows local managers to preserve their autonomy and also keeps senior management from being overburdened with the surveillance of delegated activities. This is another aspect of management by exception, referred to in section 1, whereby monitoring focuses on problem areas (variance with respect to objectives at both the overall and local levels).

This integration hinges on the objectives assigned to the entities and this increases the complexity of the control process presented in section 1:

- First, planning (setting targets, formulating action plans) is done at several levels of the organisation, which raises the problem of maintaining coherence between the different levels of plans. In chapter 7 we will see that iterations between the overall level and local levels are necessary to the formulation of the final plan.
- Second, results monitoring is also carried out at several levels: results and analyses must be performed for the managers in charge of entities, as well as for the purposes of overall control (see chapter 8). At this second level, the results of the entities must be “sent up” the hierarchical line, a process that is known as “management reporting”.

## Conclusion

In this chapter we have seen the broad outline of the anatomy of a management control process, its various dimensions and the fundamental concepts involved.

This overview is necessary because it allows us to see how and where each of the different elements fits into the process and thus avoids having an incomplete or partial view of it.

It is all the more necessary as some of these dimensions can be conflictive at times, requiring compromises that one would not see the need for if one only had a partial view. For example, we will see that the functions of coordination and motivation of managers are sometimes difficult to combine. Similarly, even though they are integrated in theory, overall performance management by company directors and local performance management by entity managers are often sources of conflict in the day-to-day life of the company.

We will explore these first elements in greater detail in the rest of this book. The first part of the book will look more specifically at the question of performance and how measurement systems grasp its various dimensions. The second part will develop the two major phases of the control process: planning and results monitoring. The function of the third part of the book is one of integration: it will examine the question of the different organisational members involved in performance management and will provide two comprehensive case studies that combine the various elements of a management control system.

## Key concepts

### Definitions and concepts

**Control process:** dynamic management process made up of two major phases: planning and the monitoring and analysis of results.

**Feedback loop:** a sequential process where the downstream phase of results monitoring is used to update the upstream phase of planning, either by reactivating/re-energising the current action plans or by adjusting targets.

**Learning loop:** process of updating the performance model.

**Local-level autonomous control:** performance management process carried out locally by entity managers.

**Management by exception:** principle whereby only the unfavourable variances between planned targets and actual results are the focus of particular attention in the monitoring phase. By extension: the principle whereby top management only intervenes in the operational decisions of an entity when there is a danger that its results objectives will not be achieved.

**Management control:** process of guiding the achievement of an organisation's performance objectives.

**Measurement system:** set of measures/indicators by which performance can be quantified.

**Objective:** type of performance desired; translated into indicators.

**Overall performance management:** performance management process carried out by directors at the level of the organisation as a whole.

**Performance model:** manager's representation of the performance dimensions to be taken into account in the control process, drawing especially on their conception of relevant objectives and performance drivers.

**Planning:** company projections for the future, comprising the setting of performance targets on different time horizons and the formulation of action plans to achieve those objectives.

**Responsibility centre:** an entity within the organisation that the directors of the corporation have placed under the authority of a manager to whom they have delegated decision-making authority and who is accountable for a targeted contribution to overall company results.

**Results control:** principle whereby a responsibility centre is accountable for the achievement of results in terms of preset targets, while being free to choose how it attains these results.

## Key messages

- Management control is a dynamic process made up of two major phases: planning and the analysis of results.
- In order to structure the control process, it is necessary to define the performance outcomes desired on two levels: the overall level of the organisation's performance and the local level of the contributions made by entities to this combined performance.
- Measurement systems play an important, structuring role in defining the company's performance and the contributions of entities.
- The control process comes under the responsibility of operational managers and therefore is not the sole responsibility of the controller, whose role is to ensure its coherence.
- In large corporations the management control process is implemented both centrally (overall company level control) and at the level of entities (autonomous control).
- The control process fulfils several functions: regulation, learning, and the coordination and motivation of managers.
- Management control does not aim only to oversee and monitor people, though certain conceptions and practices tend to favour this view.
- The management control process is not exclusively reserved for large corporations, nor even for for-profit companies.
- Management control differs from cost accounting in that it is oriented to the total performance of the company, whereas cost accounting focuses on one particular dimension of this performance: costs.
- Results control is not the only way of orienting behaviour.

# Exercises

## Quiz

Is the purpose of management control to monitor the financial results of a company?

What is the meaning of this sentence: “Management control seeks to influence and orient behaviours in the company”?

Why is financial reporting only one part of management control?

Do controllers have operational responsibilities?

In a decentralised organisation, is it correct to say that there is a transfer of responsibility to the managers in charge of entities?

Is it possible to design a standardised management control system?

## Exercise 1.1

The table below contains a list of common terms and expressions involving the word “control” (column 1) and a list of terms which are more or less synonymous to the different meanings of the verb “to control” (column 2).

**Match each expression in column 1 with the closest synonym(s) in column 2.**

**State which synonyms you think are closest to the objectives of management control and explain why the others may generate unwanted effects in one’s understanding of these objectives.**

Terms and expressions	Synonyms
Passport control	To inspect
Quality control in a factory	To monitor
Control tower at an airport	To check, to verify
Political control over a region	To guide
The fire-fighters have the blaze under control	To command, to dominate
Border control	To restrict
Self-control	To compare with a standard
Birth control	To regulate
Control group in clinical trials	To restrain, to rein in
Parental controls on a computer	To have authority over

## PART I

# Measuring performance

In chapter 1 we presented the major phases of the performance management dynamic (planning, monitoring and results analysis), the different dimensions of performance that it applies to and the structuring role of systems for measuring this performance.

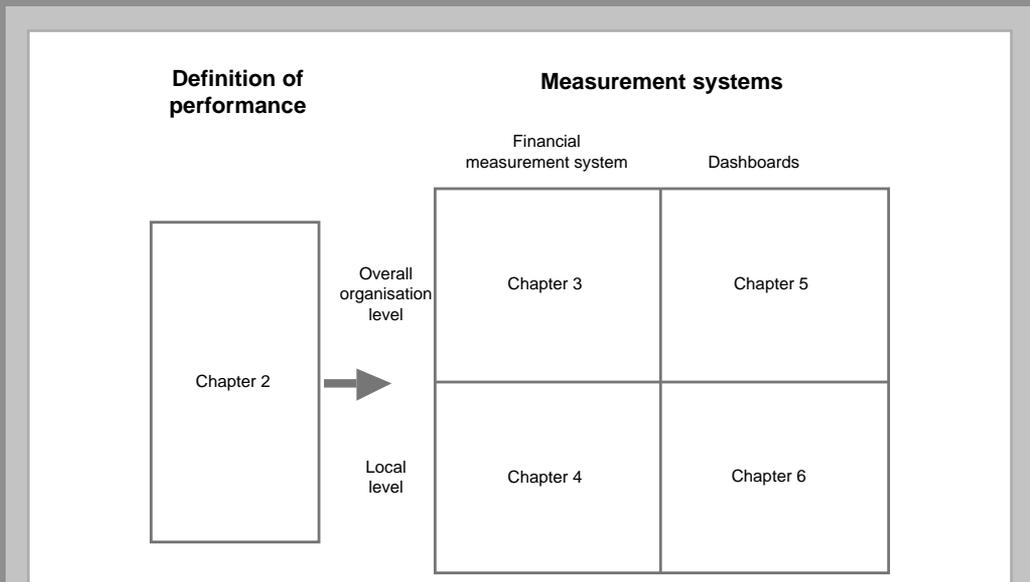
In this first part of the book, we will further explore the question of how performance is apprehended in measurement systems. Chapter 2 will look at the question of defining performance on a qualitative level, the clarification of its different dimensions and the criteria by which it can be apprehended in a useful way. The following chapters will structure the problem of building performance measurement systems around two fundamental distinctions:

- the first distinction will be drawn between “financial” measurement systems and systems which are not exclusively financial, such as dashboards. This distinction pertains to a noteworthy evolution in the design of measurement systems for managing performance in companies which were initially strongly marked by their financial nature, then broadened to include new dimensions mainly starting in the late 1980s. As a certain number of today’s performance management tools still bear traces of these financial origins, this distinction will provide us with a first level of positioning between the different management tools;
- we will also distinguish between systems that measure the “overall” performance of the organisation, *i.e.* company-wide performance without entering into the details of the sub-divisions that make up this organisation (divisions, subsidiaries, departments, etc.) and systems for measuring “local” performance, which are situated at the level of each of these sub-divisions. As we announced in chapter 1, we will see that these levels differ both in their content and in the principles for building their measurement systems.<sup>1</sup> Consequently, we will complete the elements of the qualitative definition of performance seen in chapter 2 for the organisation as a whole with considerations pertaining to the local performance of the organisation’s entities (see chapter 4).

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1. Concerning dashboards, a certain number of principles and methodological elements apply to both the overall and local levels. These will be dealt with in chapter 5. Chapter 6 focuses more specifically on the question of coordinating the dashboards of different hierarchical levels.

The first part of the book (chapters 2 to 6) will therefore progress in the following way:



**Figure I.1** – Performance measurement systems approach