University of Rome
Tor Vergata

DEPT. MANAGEMENT & LAW

BACHELOR DEGREE IN BUSINESS ADMINISTRATION & ECONOMICS

COURSE

Cost Analysis for Business Decisions

SUPPLEMENTARY MATERIALS:
Control Function of Management

Dr. Gabriele Palozzi

palozzi@economia.uniroma2.it

MANAGEMENT & CONTROL

Lets start with an example; in 2012 the UBS Bank was fined from FSA because its systems and controls failed and this allowed an employee (called A.) to cause substantial losses totaling **US$2.3 billion** as a result of **unauthorized trading**.

MANAGEMENT & CONTROL

Failure of UBS controls

- **The computerized system** operated by UBS to assist in risk management **was not effective** in controlling the risk of unauthorized trading.

- **The trade capture and processing** system **had significant deficiencies**:

  The system allowed trades to be booked to an internal counterparty without sufficient details, there were no effective methods in place to detect trades at material off-market prices, and there was a lack of integration between systems.

- There was an understanding amongst personnel supporting the trading desk that the operations division's main role was that of **facilitation**.

  They focused mainly on efficiency as opposed to risk control, and they did not adequately challenge the front office.

MANAGEMENT & CONTROL

Failure of UBS controls

- There was **inadequate front office supervision**.

  The supervision arrangements were poorly executed and ineffective.

- The trading desk **breached the risk limits set** for their desk without being disciplined for doing so.

  These limits represented a key control and defined the maximum level of risk that the desk could enter into at a given time. This created a situation in which risk taking was not actively discouraged or penalized by those with supervisory responsibility.

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

MANAGEMENT & CONTROL

Failure of UBS risk control: the FSA report

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

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

MANAGEMENT ACCOUNTING

The *Institute of Management Accountants* (IMA) defines management accounting as “***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 organisation's strategy***”.

https://www.imanet.org

MANAGEMENT & CONTROL

Management control is a critical function in organizations.

Management control failures can lead to large financial losses, reputation damage, and possibly even organizational failure.

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

MANAGEMENT & CONTROL

The literature includes many definitions of management. All relate to the processes of organizing resources and directing activities for the purpose of achieving organizational objectives.

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

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

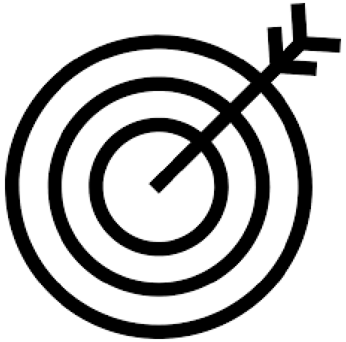
The term *management control* appears in the third column of the table, which separates the management functions along a *process* involving objective setting, strategy formulation, and management control.

The term **management control** in has the same meaning as the terms ***execution* and *strategy implementation***.

OBJECTIVE SETTINGS

Knowledge of **objectives** is a prerequisite for the design of any MCS and, indeed, for any purposeful activities.
Objectives do not have to be quantified and do not have to be financial, although that is how they are commonly thought of in for-profit organizations; nevertheless, many for profit organization also have non-financial objectives, such as related to sustainability or **personnel development** and well-being.

In any organization **employees** must have a basic understanding of what the organization **is trying to accomplish**. Otherwise, no one could claim that any of the employees' actions are purposive, and no one could ever support a claim that the organization was successful.



A **not-for-profit** organization's primary objective might be to provide shelter for homeless people, for example; but even in these organizations, there have been calls to express the achievement of these objectives in financial or *quasi*-financial terms, such as social return on investment

STRATEGY FORMULATION

Having set the firm's **strategic intentions or objectives**, strategies then define how organizations should use their resources to meet these objectives. A well-conceived strategy guides employees in successfully pursuing their organization's objectives

All the **planning** in areas as diverse as marketing, branding, financing and training, is **designed around** [our] **objective** – as are [our] **incentive** [systems]. We have a **detailed road map**, but it starts with a simple vision that everyone can understand and buy into. Everything else we do comes on the back of those goals. In effect, we can reverse-engineer the business to those objectives

("Keep Sight of Your Vision," *The Sunday Times,* 2008)

STRATEGY FORMULATION AS INTERACTION

Many organizations develop formal strategies through systematic, often elaborate, planning processes.

However, strategies can sometimes be left largely unspecified.

In this case, **organizations' strategies** emerge from a series of **interactions** between **management**, **employees**, and **the environment**.

Nonetheless, if some **decision-making** consistency exists, a strategy can be said to have been formed, regardless of whether managers planned or even intended that particular consistency. In that sense, **strategic visions sometimes come about through dynamic organizational processes** rather than through formalized strategic planning.

STRATEGY FORMULATION AND ANCTIONS

For purposes of **designing MCSs**, it is useful to have **strategies** that are **as specific** and **detailed as possible**, if those strategies can be kept current.
The formal strategic statements make it easier for management both to identify the feasible management control alternatives and to implement them effectively.

Formal strategic statements are not a sufficient condition for success, however:

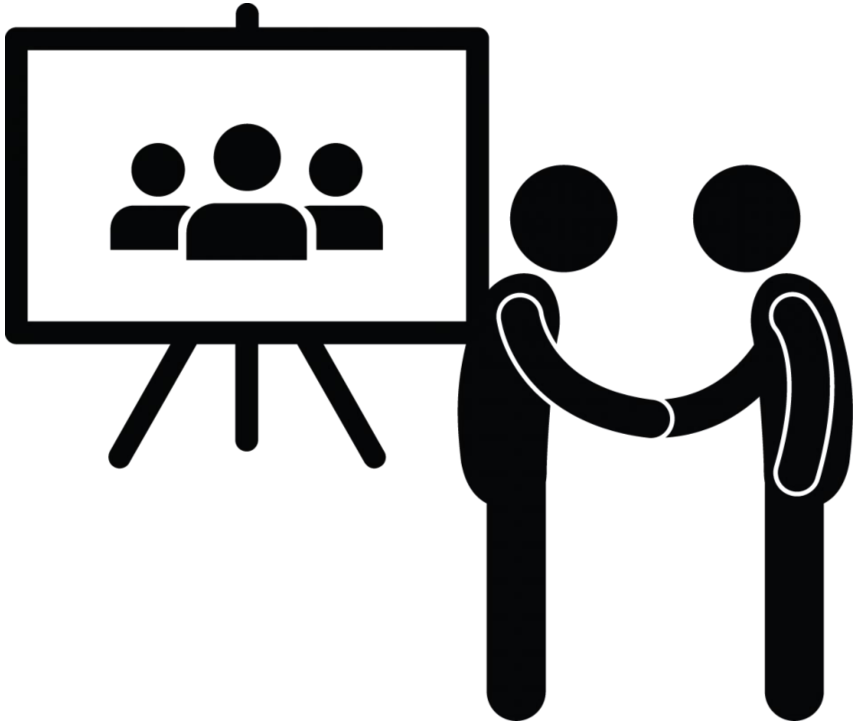
> *I have seen businesses with 400-page documents outlining their strategy and it's clear they should have spent less time outlining the vision and more* ***time thinking about how they will deliver on it****. You can have the best vision in the world but if you can't put it into effect, you are wasting your time.*
> (“Keep sight of your vision”, The Sunday Times, 2008)

MANAGEMENT CONTROL

Management control focuses on execution, and it involves addressing the general question:
Are our employees likely to behave appropriately?

This question can be decomposed into several parts:

- First, do our **employees understand** what we expect of them?
- Second, will they **work consistently** hard and try to do what is expected of them – that is, will they pursue the organization's objectives in line with the strategy?
- Third, are they **capable** of doing a good job?



MANAGEMENT CONTROL & STRATEGY CLEARNESS

From a management control perspective, strategies should be viewed as useful but not absolutely necessary to the proper design of MCSs.
When strategies are formulated more **clearly**, more control alternatives become feasible, and it becomes easier to implement each form of management control effectively.
Managers can, however, design and operate some types of MCSs without having a clear strategy in mind.

’’*If you don’t have [a strategy] but you know how to deliver, you might still make it. Success in business is 25% strategy but 75% execution*’’

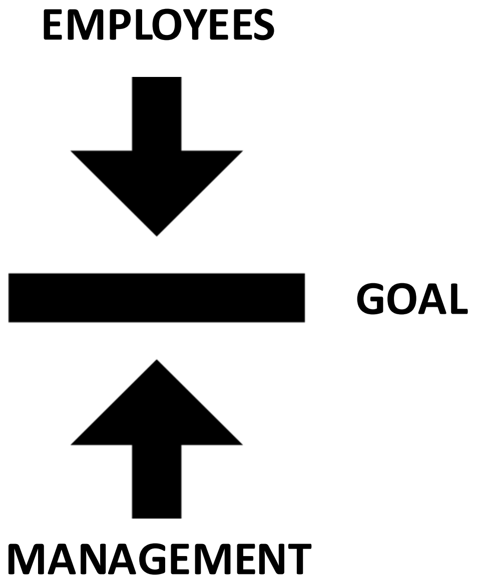
(Adrian Grace, Bank of Scotland)

BEHAVIOURAL EMPHASIS

Management control **involves managers** taking steps to help ensure that the employees do what is best for the organization. This is an important purpose because it is people in the organization who make things happen. Management controls are necessary **to guard against** the **possibilities that people will do something the organization does not want them to do**, or fail to do something they should do.

As many examples throughout the text will illustrate, employees can work against or around systems, thereby leaving many objectives unmet or producing unintended consequences.

> *Having a vision and having confidence doesn't mean anything unless you're able to communicate it to your team [...]. The ability to communicate well didn't come easily for me. I always assumed that everybody would see things the same way I see them, and now I understand it takes a lot of time to get people aligned (*Roman Stanek, GoodData in San Francisco)



CAUSES OF MANAGEMENT CONTROL PROBLEMS

LACK OF DIRECTION

Causes of Management Control Problems

Some employees perform **inadequately** simply because they do not know what the organization wants from them

One function of management control involves informing employees as to how they can direct their contributions to the fulfillment of organizational objectives

A study of 414 World-at-Work members in mostly managerial positions at large North-American companies suggested that the organization value driver are understood by:

- 81% of senior managers;
- 46% of middle managers;
- 13% of non-management employees.

SOURCE: World-at-Work, Sibson, and Synygy, *The State of Perfor- mance Management* (Survey Report, August 2004); and J. Kochanski and A. Sorensen, "Managing Performance Management," *Workspan* (September 2005), pp. 21–6.

CAUSES OF MANAGEMENT CONTROL PROBLEMS

MOTIVATIONAL PROBLEMS

Motivational problems are common because individual and organizational objectives do not naturally coincide – individuals are self-interested.

Employees **sometimes act in their own personal interest** at the expense of their organization's interest.

Particularly, wasting, mismanaging, and misappropriating organizational resources, among other types of employee misconduct, are prevalent in most organization.

EG. Surfing the Internet while on the job, for example, has been estimated to have cost US employers in the billions of dollars per year (*KPMG 2013 Integrity Survey* (KPMG LLP, 2013)

CAUSES OF MANAGEMENT CONTROL PROBLEMS

MOTIVATIONAL PROBLEMS

The most serious forms of **employees' misdirected behaviors**, such as fraud, can have severe impacts, including:

- deteriorated employee morale,
- impaired business relations,
- lost revenues from damaged reputations,
- investments in improving control procedures,
- legal fees and settlements of litigation,
- fines and penalties to regulatory agencies,
- losses from plummeting stock prices.

Many other forms of misaligned behaviors occur when employees, for example, **manipulate their performance reports**, either by falsifying the data or by taking decisions that **artificially boost performance**, with the intention of **earning higher**, but undeserved, **incentive**.

CAUSES OF MANAGEMENT CONTROL PROBLEMS

PERSONAL LIMITATION

The final behavioral problem that MCSs must address occurs when employees who know what is expected of them, and may be highly motivated to perform well, are **simply unable to perform** well because of any number of other limitations. Some of these limitations are person-specific.

They may be caused by a lack of aptitude, training, experience, stamina, or knowledge for the tasks at hand.

- Research in psychology and behavioral economics suggests that all individuals, even intelligent, well-trained, and experienced ones, face **limitations in their abilities** to perceive new problems, to remember important facts, and to process information properly (or rationally).
- In looking at the future, it has been shown that **people tend to overestimate the likelihood of common events** and events that have occurred relatively recently (both of which are easier to remember) as compared with relatively rare events and those that have not occurred recently.

CAUSES OF MANAGEMENT CONTROL PROBLEMS

PERSONAL LIMITATION

“Such biases may, for example, affect employees’ propensities to assess risks by biasing their estimates of either the likelihood or impact, or both, of certain risk events. Sometimes training can be used to reduce the severity of these limitations. Nonetheless, these limitations are a problem because they reduce the ***probability*** *that employees will* ***make the correct decisions*** *or that they will correctly assess the problems about which decisions should be made”*
(R. Thaler, *Misbehaving: The Making of Behavioral Economics* (London: Allen Lane, 2015).

FEATURES OF GOOD MANAGEMENT CONTROL

Good control means that management can be reasonably confident that no major unpleasant surprises will occur.

- The label out of control is used to **describe a situation** where there is a **high probability of poor performance**, either overall or in a specific performance area, despite having a sound strategy in place.
- **Perfect control** would require complete assurance that all control systems are foolproof and all individuals on whom the organization must rely always act in the best way possible. Thus, it is obviously **not realistic**.
- **Optimal control** can be said to have been achieved if the **control losses are expected** to be smaller than the cost of implementing more controls

Good control also is not established over an activity or entity with multiple objectives unless performance on all significant dimensions has been considered.
As difficult as this assessment of management control is, however, it should be done because organizational success depends on good MCSs.

CONTROL PROBLEM AVOIDANCE

ACTIVITY ELIMINATION

Managers can sometimes **avoid** the control problems associated with a particular entity or activity by turning over the potential risks, and the associated profits, to a third party through such mechanisms as:

- subcontracting,
- licensing agreements,
- divestment.

Managers who are not able to control certain activities, perhaps because they do not have the required resources, because they do not have a good understanding of the required processes, or because they face legal or structural limitations, are those most likely to eliminate activities

When the German financial regulator ordered Deutsche Bank "***to do more to ensure that commodity prices cannot be manipulated by its traders***", the bank responded that it "*has since shut trading desks dedicated to energy, agriculture, dry bulk and freight and base metals*. *Other commodity businesses have been transferred to Deutsche's non-core bank where they will be wound down or sold, while some parts remain active*," adding that "*we significantly scaled back our commodities business and exited entirely non-precious metals trading. As we have previously said, we continue to cooperate with authorities in their industrywide review of certain benchmarks and are investing to further improve our control environment*"

CONTROL PROBLEM AVOIDANCE

AUTOMATION

Automation is a second avoidance possibility. Managers can sometimes use computers, robots, expert systems, and other means of automation to reduce their organization’s exposure to some control problems. These automated devices can be set to behave as required, and when they are operating properly, they perform more consistently than do humans.

Computers, for example, eliminate the human problems of inaccuracy, inconsistency, and lack of motivation.

LIMITATIONS:

- One limitation is ***feasibility***. Humans have many talents – particularly those involving complex, intuitive judgments – that no machines or decision models have been able to duplicate. There are often also regulatory constraints, where the regulators may be understand- ably wary of fully autonomous systems in some settings, such as in health care. In other set- tings, such as automated trading in banks, they may welcome them. Regulators may find fully autonomous or “self-driving” cars not yet feasible, but they are likely to welcome semi-autonomous systems that help “take the human error out of driving»
- A further limitation is ***cost***. Automation often requires major investments that may be justifiable only if improvements in productivity, as well as in control, are forthcoming.

CONTROL PROBLEM AVOIDANCE

CENTRALIZATION & RISK SHARING

CENTRALIZATION of decision-making is a third avoidance possibility, which is a key element of almost all organizations' MCSs. High degrees of centralization, where all the key decisions are made at top management levels, are common in small businesses, particularly when they are run by the founder or owner. High degrees of centralization also exist in some large businesses whose top managers sometimes have reputations for being "detail oriented" or "control freaks."
When that is the case, top management reserves the important, and sometimes the not-so- important, decisions for themselves, and in so doing, they avoid having the lower-level employees make poor judgments.

RISK SHARING with outside entities can bound the losses that could be incurred by inappropriate employee behaviors. Risk sharing can involve buying *insurance* to protect against certain types of potentially large losses the organizationmight not be able to afford.

REFERENCES

- Merchant, K. A., & Van der Stede, W. A. (2017). *Management control systems: performance measurement, evaluation and incentives*. Pearson Education. CH. 1 & 2.