7 Know Your People

CHAPTER CONTENTS

INTRODUCTION

Recent studies, such as those referred to in Chapter 2 (see Jazayeri and Cuthbert, 2004), have highlighted the gap which exists in the management accounting literature with respect to papers devoted to human resources issues. Chief executives consistently attach great importance to human resources topics, and they are popular in the practitioner journals, but they remain relatively neglected in the pages of refereed academic journals. This chapter attempts to partly close this gap by devoting more attention to 'people' issues.

TOTAL QUALITY MANAGEMENT

As recently as the late 1950s, Japanese products were denigrated in the West for their shoddiness and unreliability. The transformation in the reputation of Japanese goods by the 1990s – led by the electronics and motor sectors – has much to do with their readiness to accept and apply the latest management principles. Their flexibility to do so lies substantially in the restructuring of unions and institutions following the Second World War, allowing the changes necessary to incorporate just-in-time, value-added management and total quality management to take place. Interestingly, activity-based costing has never received widespread approval, or been widely adopted, in Japan. The initial forays into South-East

Asia during the 1950s of W. Edwards Deming, the celebrated US guru of quality management, meant that his ideas were incorporated at a time when the inflexibility of attitudes and union resistance to change prevented them from being adopted in his home country. The considerable competitive advantage that Japanese companies were able to establish in quality and timeliness, compared to their US and European counterparts, is more than a little attributable to their readiness to recognize these American advances. Subsequently, Easton and Jarrell (1998) found a positive association between the implementation of TQM and long-term financial performance, measured using both accounting and market-based measures.

TQM is too often viewed as a technique whose potential usefulness is confined to manufacturing processes. This section argues that TQM assumes greater importance as a tool for addressing human resources issues to produce improved efficiency in service areas. By focusing on the management accounting function, we will devise a process through which quality improvement methods might be used to highlight problem areas and facilitate their solution. An initial understanding of the difference between the three major 'quality' terms – quality control (QC), quality assurance (QA) and quality management (QM) – is essential to the short-, medium- and long-term focus of business:

- QC is concerned with the *past*, and deals with data obtained from previous production which allow action to be taken to stop defects being produced.
- QA deals with the *present*, and concerns the putting into place of systems to prevent defects from occurring.
- QM is concerned with the *future*, and manages people in a process of continuous improvement targeted at the products and services offered by the organization.

Thus while QA is responsible for systems which prevent departures from budgeted costs and corrective mechanisms to prevent future departures from budgeted costs, QM uses the skills and participation of the workforce to reduce the costs of production of goods and services. It becomes TQM when it embraces the whole organization.

In this section we will consider an in-depth study of the implementation of the TQM process in the management accounting function. A systematic process is adopted to identify and implement solutions to prioritized opportunities for improvement. The TQM approach highlights the need for a customer-oriented approach to management reporting, eliminating some of our more traditional reporting practices.

TQM seeks to increase customer satisfaction by finding the factors that limit current performance. The practice of TQM in a manufacturing environment has produced tangible improvements in efficiency and profitability as a result of many small improvements. The generation of similar results in the areas of overhead costs and, particularly, indirect labour productivity is long overdue. Performance measurement and quality improvement are not the sole domain of manufacturing industry, but they dominate the literature. This chapter focuses on an implementation in the professional service environment and details the opportunities for improvement available in a management accounting environment.

On the shop floor, quality concepts have been based around the involvement of employees and an approach according to which each worker sees the next person on the assembly line as their customer. The application of quality concepts to service areas, like the accounting function, requires a similar approach, necessitating a focus on customer requirements. The 'customers' are the receivers of a 'product' – in this case periodic management accounting reports – and their 'satisfaction' is determined by the usefulness of this product in the decision-making process.

There is a danger of viewing TQM in terms of statistical processes and control charts. It is much more than this. Quality is not some vague utopian ideal associated with 'goodness'; it can be seen as requiring that we conform to very specific performance requirements. Close enough is not good enough in this respect. The cost of quality is the monetary impact of a failure to conform, a measurable characteristic which can be reduced through a system of prevention in much the same way as safety standards are implemented.

In a manufacturing environment the cost of quality might be viewed as the sum of the costs associated with scrap, reworks, warranty claims and inspection expenses. The same costs are those associated with management accounting procedures which produce inaccurate, error-prone or untimely services for their 'customers'. Errors in the wages function, for example, are perceived as intolerable, so it is inappropriate that they be any more acceptable elsewhere.

The following example is concerned with operationalizing TQM and with the commitment of a large Australian manufacturer to a TQM process seeking greater organizational attainment through constant improvements and the co-ordination of individual efforts. The focus is on the accounting function within Australian operations with the objective of implementing a process which will lead to the adoption of new strategies, the solving of problems and the elimination of identifiable deficiencies. The section describes the process adopted together with details of internal deliberations, giving valuable insights into the problems and benefits associated with TQM implementations.

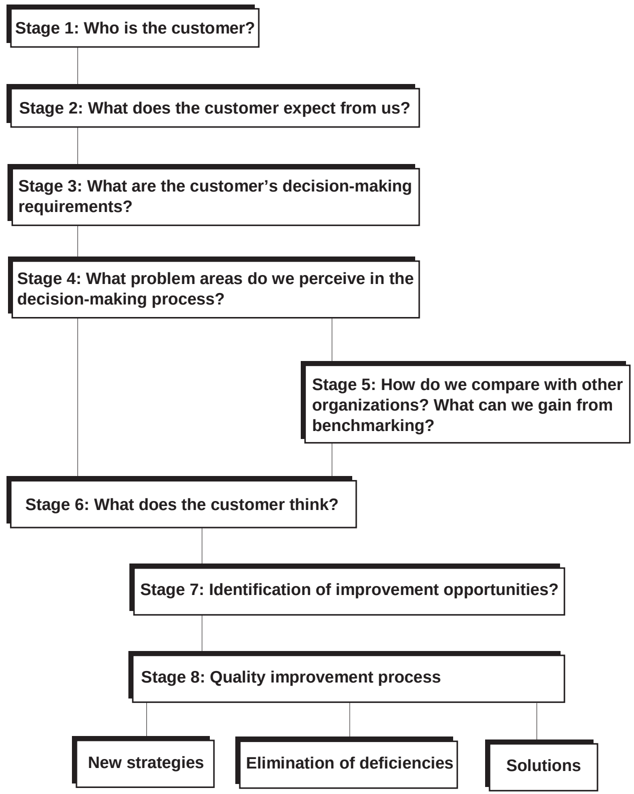
OPERATIONALIZING TOTAL QUALITY MANAGEMENT

Figure 7.1 outlines a systematic process for the examination of a number of fundamental questions. The first four stages of this procedure are conducted internally within the management accounting team. They comprise a situation audit of current practice embracing corporate culture, product and customers.

A team approach was adopted to generate priorities in the identification of customers (stage 1) and critical issues in the provision of decision-support information. This provided a structured, group decision-making process for reaching consensus through the assignment of ranked priorities, together with an environment conducive to the development of creative suggestions. The nominal group technique discussed earlier was employed.

A multi-voting technique was employed to prioritize the list of customers and provide a focus of services. The ranking of perceived customer

FIGURE 7.1



The process for reviewing the management accounting function

importance reveals the priority customers for management accounting services as:

1 managers;
2 engineers; and
3 leading hands.

Managers having been identified as the priority group in receipt of accounting output, a second brainstorming session was used to generate a comprehensive list of their perceived expectations of the accounting function (stage 2). Multi-voting was again used to identify the relative importance of these expectations, providing a ranking of 12 accounting functions:

1 compliance with procedures;
2 focus on problems;
3 performance reviews;
4 provision of budget information;
5 assessment of proposals;
6 payment of salaries;
7 tax advice;
8 management processes advice;
9 information forecasting;
10 commercial training;
11 information-processing skills; and
12 professional advice.

Turning now to the customer's decision-making requirements (stage 3), brainstorming revealed a list of 18 processes perceived to be major elements of the service provided by management accountants:

1 pay people (wages and salaries);
2 pay accounts (vendors and contractors);
3 keep the books of account;
4 budget;
5 forecast;
6 audit;
7 conduct business-impact analyses;
8 manage authorization procedures;
9 issue guidelines;
10 maintain a library of procedures;
11 analyse performance;
12 manage licences;
13 contribute to meetings;
14 manage property;
15 carry out strategic planning;
16 train others;
17 evaluate insurance requirements; and
18 produce *ad hoc* reports.

Combining management perceptions of customer expectations and the importance of the various functions, we find four processes clearly ranked as the key areas of importance to managers:

1 performance analysis;
2 *ad hoc* reporting;
3 strategic planning; and
4 contribution to meetings.

This series of steps, therefore, establishes managers as the priority customers for management accounting reporting and procedures, while performance analysis is the priority consideration in their use of management accounting information.

Typically, management accountants focus on the analysis of total performance in cost centres, using cost-per-unit comparisons and calculations of variance to generate plans. Where the focus is on quality improvement, the overriding need is to stay close to the customers and follow their suggestions. In this way, a decision-support system can be developed, incorporating both financial and non-financial information, which provides a flexible reporting system meeting user requirements. In order to do this properly, we need to know:

- the nature of the decisions being made;
- the nature of the decision-making process; and
- the degree to which information requirements are being met.

A survey of users is required to provide this information, but critical issues can be identified and prioritized in advance, in order to refine the necessary survey questions.

The process next considers the problem areas perceived to be in the decision-making process (stage 4). Once again using brainstorming and multi-voting, the team ranked the characteristics of an accounting information system thought most desirable from a decision-making point of view, as follows:

1 *Relevance*. A targeted decision-making process.
2 *Congruence*. Consistency with the long-term strategy of the business.
3 *Comprehensibility*. Systems should be readily understandable, and therefore readily usable, by customers.
4 *Linkage to non-financial indicators*. Systems need to reflect the monetary impact of physical parameters.
5 *Timeliness*. Systems should be on time and on-line.

These characteristics were perceived as being areas of weakness where the greatest impact could be achieved through the implementation of improvements. It is instructive to consider some of the actual situations that might be associated with improvements in these areas.

- *Lack of relevance*. If line managers ignore most of the data reported to them by traditional cost accounting systems and treat head office cost analysts with disdain, they may prefer to perform their own specific cost investigations to determine the cause of deviations from plan, seeing management accounting reports as irrelevant and technically unrealistic. These informal systems may incorporate superior information which would be of benefit to all and which would be better incorporated within a global management information system. The solution: develop formal and informal reporting mechanisms targeted to the needs of the user.

- *Lack of congruence*. Where the management accounting system focuses entirely on the measurement of costs, then it is not surprising that employees adopt a similar focus. Where the plant-level emphasis is on production and productivity, a detailed analysis of process performance evaluation may reveal that the pursuit of efficiency measures is not necessarily consistent with the stated strategic goals of the organization as a whole. For example, a reputation for industry leadership and innovation might be aided by a strategy of rapid asset replacement. Where divisional performance – and management rewards – are based on return on investment (ROI) type indicators, a short-term perspective might be adopted, inconsistent with corporate strategy. But the revaluation of old assets, no longer depreciable, through inflation indices might promote their replacement with new, more efficient assets. The solution: develop a robust process to ensure that the accounting department's performance analysis is linked to strategic direction.
- *Lack of comprehensibility*. If management accountants believe that they prepare detailed financial reports for their managers to enable them to report to the managing director at the monthly board meeting, and the managing director declares that he or she is already aware of all the relevant reported material from informal sources, well in advance of the meeting, then clearly the customer for existing management accounting reports is not the managing director. Where such reports do not embrace the full extent of information generators, and fail to target a designated customer, there is room for a distinct improvement in the service offered. This may derive from more timely reporting, the provision of NFIs, new performance measures, or a complete reformatting of the reporting process. The solution: generate accounting information systems of a format and content suitable to meet user requirements.
- *Absence of a link to non-financial indicators*. The focus of management accounting must move beyond summary, financial measures of manufacturing operations if it is to maintain its central evaluation and control role. If a corporate goal of rapid internal growth is being pursued through a strategy of introducing automated production processes requiring less direct labour, then products using automated machinery intensely will be undercosted if direct labour hours are used to allocate manufacturing overhead costs to products. A more flexible allocation procedure should be adopted incorporating NFIs, such as inspection and set-up times, in order to provide a 'fairer' distribution. In the absence of a 'right' answer, corporate strategy might serve to provide more guidance. Perseverance with an allocation on the basis of direct labour penalizes those products reliant on manual operations and provides an incentive to automate, consistent with the corporate strategy. The solution: generate a concise group of NFIs which reflect the overall performance of the company.
- *Lack of timeliness*. Suppose that the management accounting team prides itself on producing its monthly operating report on the eighth working day of the following month. An unexpected equipment failure means that it is unable to meet its accustomed deadline until the fifteenth working day. The team receives no complaints or enquiries during the interim on timeliness. The following month it produces, but does not distribute,

the report. There is no response from the customer. The team continues this practice for the next three months until an internal memo indicates that the customer no longer wishes to receive the report – it is now surplus to requirements. In this case, the relevance of the whole reporting process is questionable and a close look at the distribution list of any given report, if not the existence of the report itself, is advisable. The solution: generate reports in a form and time envelope which meet the needs of the target customer.

Detailed and systematic internal deliberations allow the accounting team to develop a clear idea of their own strengths and weaknesses and of the areas of most significant deficiency. The benchmarking exercise at stage 5 of the TQM review process allows us to see how other similar companies are coping with similar problems and opportunities. (The details of the benchmarking process itself were considered in Chapter 3.)

Stages 1–5 provide an information base developed without reference to the key player – the customer. This is rectified at stage 6 with a survey of representative customers which embraces their views on perceived problem areas. Respondents to the survey were encouraged to talk freely about their attitudes towards accounting information services, within a semi-structured outline covering:

1 the nature of decisions made;
2 the use made of existing formal reports;
3 the preferred format (graphical, tabular or narrative) for formal reporting;
4 other information sources employed;
5 information, currently unavailable, which would aid decision-making; and
6 NFIs used in performance appraisal.

Attitudes to the management reporting process were particularly illuminating, and directly applicable to other organizations. Monthly variance reports as a means of control were viewed as pointless by senior management, conscious of inevitable process fluctuations during the year, and by junior management, who viewed budgets as unrealistic and no major constraint on their spending.

Formal reports were generally perceived as having four positive features:

- highlighting and reinforcing the existence of large variances, especially when close to the budget setting period;
- reporting unanticipated items associated with unexpected and late accruals, end-of-month ‘adjustments’, and misallocations to inappropriate accounts;
- providing information which might change priorities; and
- communicating a degree of analysis not available through on-line systems.

However, a number of criticisms of content were widespread. The reports were considered to:

- place too much emphasis on the reporting of unfavourable variances constituting insignificantly small monetary amounts rather than focusing on an explanation of large expenditures actually incurred;

- expend too much energy chasing inconsequential items representing minor out-of-budget fluctuations, rather than focusing on wrongly trended items (even where in budget);
- show an unrealistic concern with comparisons of actual versus budgeted outcomes where unfavourable variances were in fact inevitable and symptomatic of inflexible budgeting and time shifts; and
- report too many items for their own sake rather than to satisfy particular objectives or meet the requirements of particular individuals.

Unsatisfied needs embraced three major areas:

- Ease of access to labour information to facilitate: the quantification and explanation of severe downturns in maintenance productivity; the distinction between normal and overtime hours on maintenance jobs, replacing inadequate composite hourly rates; and accounting for non-productive hours per worker resulting from the adoption of a more participatory style of management.
- Predictive models concerning: early warning of massive deteriorations; forecasts of monthly maintenance expenditures; relationships between breakdown and scheduled maintenance expenditures; the impact on performance of safety training; probability-based analysis of risk to facilitate the management of maintenance expenditures.
- Trend information, ideally weekly and on-line, covering: downtime and cost of breakdowns; operating supplies; maintenance materials; purchased services; and statistical process control.

The outcomes of the customer survey, benchmarking, and internal analysis, provide the raw material for stages 7 and 8 of the review process: the identification of improvement opportunities and the implementation of a formal improvement process. Table 7.1 depicts the framework for the six-step analysis, identified by the acronym 'PRAISE'. The successful adoption of this sequence of steps demands discipline and commitment. The goal of quality improvement is paramount and guides the actions of the change team throughout. Difficulties will be experienced at each step:

1 The symptoms or observed effects of a problem may be readily apparent, but it may be more difficult to identify a measurable improvement opportunity. Attempts to identify problems broadly as 'communication', 'organization', 'morale' or 'productivity' should be resisted – much more specific target areas are required to allow a focus on precisely what is wrong.
2 It may not be possible to achieve consensus because of the pet projects of a minority of the team members. Multi-voting may therefore be necessary to provide a focus in a democratic manner.
3 Lateral thinking may be helpful to encourage a wide-ranging discussion and to avoid a blinkered approach to the nature of the problem. The required objective is the identification of the root cause, and this is unlikely to be one that promotes a quick-fix solution.
4 'Innovation' and 'creativity' are the key words to encourage a multitude of suggested solutions. These may then be evaluated in terms of the

TABLE 7.1

The PRAISE six-step quality improvement process

Step	Activity	Elements
1	Problem identification	Areas of customer dissatisfaction Absence of competitive advantage Complacency regarding present arrangements
2	Ranking	Prioritize problems and opportunities by: • perceived importance; and • ease of measurement and solution
3	Analysis	Ask 'why?' to identify possible causes Keep asking 'why?' to move beyond the symptoms and to avoid jumping to premature conclusions Ask 'what?' to consider potential implications Ask 'how much?' to quantify cause and effect
4	Innovation	Use creative thinking to generate potential solutions. Operationalize these solutions by identifying: • barriers to implementation; • available enablers; and • people whose co-operation must be sought
5	Solution	Implement the preferred solution Take appropriate action to bring about the required changes Reinforce with training and documentation back-up
6	Evaluation	Monitor the effectiveness of actions Establish and interpret performance indicators to track progress towards objectives Identify the potential for further improvements – and return to step 1

extent to which they may be converted into operating plans which achieve the required objectives. A systematic evaluation of positive and negative aspects of each strategy is essential – but remember, no matter how sophisticated the analysis, the final solution is only as good as the original list from which it is chosen.

5 The implementation of the solution may require a great deal of diplomacy, especially in divisions or departments resistant to change. Possible side-effects must be identified and the whole process smoothed through with the co-operation of the workforce at all levels, efficient internal communication, training programmes where appropriate, and feedback throughout.

6 The evaluation at this step may indicate the trouble-free implementation of a strategy which has solved 100% of the problem. More likely it will not! As part of the drive for continuous improvement in quality, several other areas capable of improvement will emerge. As such, this step is not the last stage in the process but the first stage in a renewed process. The

new problems emerging here provide fresh improvement opportunities ready for restatement at step 1 and prioritization at step 2.

Central to the whole PRAISE system are both quality control – the search for continuous improvements in quality – and total employee involvement – the co-operation and commitment of employees. This dual approach provides a single focus – the customer – whose increased satisfaction remains the primary goal of the procedure.

A number of essential requirements emerge, therefore, for successful implementation, which may be described as the six Cs of TQM:

- *Commitment*. If a TQM culture is to be developed, so that quality improvement becomes a normal part of everyone's job, a clear commitment from the top must be provided. Without this all else fails. It is not sufficient to delegate 'quality' issues to a single person since this will not provide an environment for changing attitudes and breaking down the barriers to quality improvement. Such expectations must be made clear, together with the support and training necessary to their achievement.
- *Culture*. Training lies at the heart of effecting a change in culture and attitudes. Management accountants too often associate 'creativity' with 'creative accounting' and related negative perceptions. This must be changed to encourage individual contributions and to make 'quality' a normal part of everyone's job.
- *Continuous improvement*. Recognition that TQM is a 'process' not a 'programme' necessitates that we are committed in the long term to the never ending search for ways to do the job better. There will always be room for improvement, however small.
- *Co-operation*. The application of TEI principles is paramount. The on-the-job experience of all employees must be fully utilized and their involvement and co-operation sought in the development of improvement strategies and associated performance measures.
- *Customer focus*. The needs of the customer are the major driving thrust – not just the external customer (in receipt of the final product or service) but the internal customer (colleagues who receive and supply goods, services or information). Perfect service with zero defects is all that is acceptable at either internal or external levels. Too frequently, in practice, TQM implementations focus entirely on the external customer to the exclusion of internal relationships; they will not survive the short term unless they foster the mutual respect necessary to preserve morale and employee participation.
- *Control*. Documentation, procedures and awareness of current best practice are essential if TQM implementations are to function appropriately. The need for control mechanisms is frequently overlooked, in practice, in the euphoria of customer service and employee empowerment. Unless procedures are in place, improvements cannot be monitored and measured nor deficiencies corrected.

Difficulties will undoubtedly be experienced in the implementation of quality improvement and it is worthwhile detailing procedures that might be adopted to minimize them. To these, then, we now turn.

OVERCOMING TOTAL QUALITY PARALYSIS

Little attention has so far been paid to the practical problems of overcoming the inertia of organizations and the reluctance of some individuals to embrace management accounting change. This section argues for a systematic approach to overcome the apparent paralysis besetting many companies in implementing a quality policy.

A quality improvement process like the PRAISE system restricts the adoption of sub-optimal quick-fix solutions and increases the participants' awareness of the barriers to change. However, it does not overcome completely some of the behavioural difficulties associated with individual motivation and group dynamics. The problem is not one of an awareness of the usefulness of TQM but rather the ability to do something about it: the inertia associated with total quality paralysis. Some fundamental requirements in getting started are:

1 A clear commitment, from the top, to TQM ideals. Without this, all else fails. It is not sufficient to delegate 'quality' issues to a single person, since this will not provide an appropriate environment for changing attitudes and behaviour and breaking down the barriers to quality improvement. The aim is to develop a TQM culture so that quality improvement becomes a normal part of everyone's job. This expectation must be made clear, and whatever support and training are necessary to its achievement must be provided.
2 Managers must be provided with the skills, tools and techniques to pursue systematic improvement. Training should be practical, avoiding unnecessary abstractions and keeping management jargon to a minimum. It may even be necessary to avoid the acronym 'TQM' itself, because of the barriers associated with buzzwords, reverting to reference instead to the phrase 'quality improvement process'.
3 The general awareness of improvement opportunities must be improved through the creation of a database documenting the *status quo* and covering those things that the organization currently does well, as well as its deficiencies. Such a database should contains answers to questions like these:
   (a) Where do we make errors?
   (b) Where do we create waste?
   (c) What should we do that we currently make no attempt to do?

Ideally, the quality improvement process should be a vehicle for positive and constructive movement within an organization. We must, however, be aware of the destructive potential of the process. Failure to observe the fundamental principles associated with the 'four Ps' of quality improvement may so severely damage motivation that the organization is unable to recover fully. Those four Ps are:

- *People*. It will quickly become apparent that some individuals are not ideally suited to the participatory process. Lack of enthusiasm will be apparent from a generally negative approach and a tendency to have prearranged meetings which coincide with the meetings of TQM teams! Where these individuals are charged with the responsibility for driving group success, progress will be slow or negligible. Quality improvement teams may have to be abandoned largely for associated reasons before they are allowed to grind to a halt.

- *Process*. The rhetoric and inflexibility of a strict Deming approach will often have a demotivating effect on group activity. It is essential to approach problem-solving practically and to regard the formal process as a system designed to prevent participants from jumping to conclusions. As such it will provide a means to facilitate the generation of alternatives while ensuring that important discussion stages are not omitted.
- *Problem*. Experience suggests that the least successful groups are those approaching problems that are deemed to be too large to provide meaningful solutions within a finite time period. Problems need to be approached in bite-sized chunks, with teams tackling solvable problems with a direct economic impact, allowing for immediate feedback together with a recognition of the contribution made by individual participants. For example, while 'communications' and 'morale' are frequently cited as key problem areas, they are too broad to provide successful quality improvement targets. Smaller aspects of these issues must be identified.
- *Preparation*. A training in the workings of Deming-like processes is an inadequate preparation for the efficient implementation of a quality improvement process. Additional courses on creative thinking and statistical processes are needed in order to give participants a greater appreciation of the diversity of the process. This training must quickly be extended beyond the immediate accounting circle to include employees at supervisory levels and below who are involved at the data input stage.

A three-point action plan for the choice of projects and the implementation of the process is as follows:

1 *Bite-sized chunks*. It is tempting to seek a large cherry to pluck, but big improvement opportunities are inevitably complex and require extensive interdepartmental co-operation. The choice of a relatively small problem in the first instance provides a greater chance of success.
2 *A solvable problem*. The problem selected should not be trivial, but it should be one with a potential impact and a clear improvement opportunity. Measurable progress towards implementation should be accomplished within three or four months (or less if possible) in order to maintain the motivation of participants and advertise the success of the improvement process itself.
3 *Recognition of participants*. The successful projects and team members should receive appropriate recognition throughout the enterprise, at the very least being 'mentioned in despatches' via company newsletters. Prominent individuals should be rewarded for their efforts both as personal recognition and as an encouragement to others. The precise nature of the reward may be the recognition itself, although in some situations material, but usually non-monetary, prizes may also be appropriate.

The implementation of TQM processes can provide long-lasting benefits as long as the achievement of quality goals is not in conflict with other objectives. This might be the case, where, for instance:

- bonuses are based on the volume of output alone; or
- retrenchments result from the increased efficiency associated with the quality improvement process.

By overcoming the initial obstacles, a TQM process can provide us with an additional tool to improve competitiveness and ensure long-term survival.

CONTROL: THE MISSING LINK OF TOTAL QUALITY MANAGEMENT

The fundamental principles of TQM focus on a process of continuous improvement which enhances the satisfaction of customer requirements by changing the attitude of the workforce. The reduction of waste is made implicit in each worker's task. This suggests the elimination of all non-value-adding processes, processes which include all control functions – monitoring, inspecting, progress chasing, even auditing – which would now be replaced by self-auditing as part of the change in corporate culture. Such extreme expectations are unrealistic. A control function, properly defined, is essential and can contribute to the achievement of TQM objectives.

The development of TQM provides a vehicle for the accounting function to achieve control, continuous improvement and maximum efficiency by ensuring that all of the processes carried out by that function are both in control and capable. Such movements will have a dramatic effect on the accounting function and may well redefine the audit function.

The basic requirement of accounting control is that a process is capable of meeting customer requirements, whether they are those of the directors, the shareholders, or the law. Techniques which have historically been used to achieve this control include procedures and audit, but these have major flaws. If we are not appropriately focused, it is possible that the process is *never* going to be capable of meeting customer requirements, no matter how complex the levels of audit or procedure adopted. Further, there will be no focus for the documentation of flaws and their subsequent reversal.

Qualitative and non-financial data, though vital for control, may not be subject to the same strict standards of measurement as financial and technical data. Their role in the quality programme may, therefore, be underestimated.

Documentation of the *activities* to be performed in the accounting function is an essential first step in identifying the dimensions of processes and the interrelationships between tasks. Table 7.2 details eight basic processes which may be identified in the accounting function, each covering multiple activities and crossing task boundaries.

A narrow control function is apparent in each process, but this is effectively just the checking or audit component of controllership. The controllership function interacts with the TQM process to impact upon the other six dimensions to provide timely and relevant information to

TABLE 7.2

Dimensions of the accounting function

Process	Activity
1 Planning	Strategic planning Operations planning Forecasts
2 Book-keeping	Costing Inventory accounting Project accounting Fixed capital Maintenance system
3 Discharging liabilities	Payroll Accounts receivable Accounts payable Cashier Contracts administration
4 Reporting	Corporate reporting Statutory reporting Management reporting
5 Business support	Project or opportunity evaluation Cost improvement Tax advice or guidance Operating centres
6 Corporate services	Tax Insurance Legal
7 Functional administration	Technology management Human resource management Non-accounting procedures TQM Agreements
8 Controllership	Accounting guidelines Accounting procedures Accounting policy and standards Internal audits External audits

decision-makers and to monitor compliance with corporate expectations where policies, procedures, ethical behaviour and professional conduct are concerned.

The quality manual is usually the major document controlling the implementation of the quality process. It defines the basic philosophy of the organization, the structure and responsibilities of managers and departments, and the relationship between them. It also contains the methods to be used to ensure quality, including the composition of teams, and the audit procedures to be adopted.

The definition of the process, inputs and outputs gives a framework for the writing of procedures and standard methods while also providing a focus for improvement opportunities. Underpinning both is a control and audit process, defining the way that the system is to be checked.

For every process within the accounting organization, a policy and procedures are established in accordance with industry best practice and communicated throughout the organization. The objective of these is to satisfy customer requirements and to identify improvement opportunities which allow the continuous extension of the customer service provided.

The writing of procedures and standard methods is a fundamental step in pursuing excellence of process. Procedures are concerned with the properties of the system that we are trying to influence (controlled parameters). Standard working methods are concerned with the process variables that are being manipulated in order to influence the system (control points). Thus, if we want to control the water level in a bath, the level is the controlled parameter, and the tap and plug are the control points.

By providing a sound control environment, which supports business decisions with appropriate measurement and analysis, the controllership function pursues complete customer satisfaction. The aim is to achieve acknowledged industry leadership for excellence of process, personnel and service. Underpinning this aim is an audit process that ensures that all of the above are in place and operating. The audit process is partly external, but largely internal, consisting of a control check system that monitors the critical processes of the system. Depending on the breakdown consequences and risk of failure, additional control points can be introduced into the process chain. Thus, the system allows for not only control but also continuous improvement. The monitoring of the data around a process will allow modifications which make it in control and capable. As changes or improvements are made they are documented and the system updated so that everyone uses the current best method.

The clear definition and documentation of procedures facilitates job flexibility, making control easier and increasing the level of productivity in the accounting department. Thus, a good control system facilitates continuous improvement by focusing on customer needs, identifying priorities, and relating processes to one another. Variation and inaccuracy are caused by poor control and incompatible systems. A quality system is therefore essential to reduce these problems.

The application of the PRAISE quality improvement process to the timeliness problem provides an excellent example of service improvement, one which observes the fundamental quality principles of waste elimination and doing things right first time. Documentation of key data on processes is the first, and arguably the most important, step in the procedure. By charting processes for each activity, establishing time barriers, constraints, priorities, degrees of difficulty and expected improvement times, a critical database is established. Small, dedicated problem-solving teams can be charged with developing solutions for task improvements, with the success of the process demonstrated by widespread internal reporting.

Significant further improvements are also likely to follow:

- the elimination of double handling and manual data delays in day-to-day operations;

- the acceptance of the quality process for problem-solving; and
- the highlighting of opportunities for interdisciplinary teamwork.

The reasons for the success of the improvement process in the area of timeliness are firmly grounded in the principles of TQM, embracing TEI and process measurement. These principles include:

- the clear exposition of the benefits of a project;
- the involvement of *all* customers and contributors;
- the elimination of non-relevant data;
- an understanding of the needs of the *whole* process;
- the use of graphical and pictorial techniques to achieve understanding;
- the establishment of performance specifications and targets;
- the use of errors to prompt continuous improvement; and
- the use of statistics to tell people how well they are doing.

The basic need for controllership is a practical reality and provides a springboard for the provision of accurate, timely data to manage and enhance a business. Control features are, therefore, essential constituents of the TQM process, facilitating the successful implementation of customer-focused improvements.

TOTAL EMPLOYEE INVOLVEMENT

The pursuit of TQM has increased awareness of the need for customer focus in the service sector. Changes in attitude and corporate culture necessary for the successful implementation of TQM strategies require total employee involvement and the empowerment of individuals, so that decision-making about issues affecting the quality of service becomes a normal part of the everyday workload.

TEI involves the maximum utilization of employee talents. Using a team-oriented approach to enhance co-operation, employees participate actively in the improvement of process efficiency and product quality. Accordingly, greater responsibility for operating decisions is assigned to employees, together with the development of a multi-skilled workforce to increase production flexibility and minimize idle time.

TEI aims to facilitate the creative involvement of the workforce by making best use of those closest to the sharp end of the production process. Like many management initiatives, it leans heavily on the development of an attitude of responsibility. An increased perception of customer service is a part of business strategy, essential to survival and long-term profitability. Research has demonstrated the strategic benefits of quality in contributing to market share and ROI as well as lowering manufacturing costs and improving productivity. TQM processes provide welcome relief from the short-term myopia of financial reports, in that they suggest we have to begin treating both customers and employees as assets, although neither appears formally in the balance sheet.

In achieving excellence and ensuring the long-term survival of the enterprise, five critical dimensions of service quality can be identified:

- *Tangibles*. Physical facilities and the appearance of personnel.
- *Reliability*. Accurate performance of promised service.
- *Responsiveness*. Prompt and willing help provided to customers.
- *Assurance*. Confidence resulting from employee knowledge.
- *Empathy*. Caring, individualized attention.

Customer perceptions of the quality of the service they are receiving may be a weighted combination of these five factors.

To provide customers with friendly service which minimizes the need for control and bureaucracy, a fundamental change in employee attitudes is required, embracing a number of important issues.

- **Leadership**. The leadership function involves setting directions in order to challenge the status quo and create a vision of the future. This vision must then be communicated from the top in order to encourage the alignment of subordinates with the new culture. A further, fundamental aspect of leadership is the motivation of sub-managers, supervisors and plant-level employees about the importance of group values and their importance as individuals in fulfilling the vision. Commitment from the top is critical, enforced by the visibility and accessibility of active leadership.
- **Goal congruence**. Strong leadership is essential if goal congruence from all participants is to be achieved. Attitudes must be changed, and entrenched views sometimes reversed, if the alignment of *all* employees is eventually to be achieved. Everybody must see how the vision affects them and how their support is vital for its achievement. TEI is, therefore, central to this aspect of team performance.
- **Training**. The enforcement of motivation through training in fundamental skills and competencies is essential to the success of the process. Benchmarking should establish industry best practice for working methods and procedures, and initiative and creativity should be encouraged in decision-making beyond these areas. Training in lateral thinking, brainstorming and similar management methods will facilitate successful implementation.

The aim is to provide a level of service which facilitates repeat orders and results in happy, satisfied customers. In this respect, customer service and price discounting are very different.

The participation of the workforce allows the encouragement of attitude changes which facilitate both quality control improvements and supplier relationships. TEI will allow the evolution of common goals and a work environment which is at least more pleasurable, at best fun. The delegation of day-to-day decision-making reduces the stress levels imposed on senior management and allows them to spend more time on strategic planning. Customers will benefit from a reduction in bureaucracy and from contact with representatives of the business who are fully empowered to deal with any issue which raises customer satisfaction.

A problematic small business scenario highlights improvement opportunities involving the employment of TQM and TEI methodologies.

CASE STUDY

Mercian Dry Cleaners: A TQM case study

Jack Taft has spent 10 years building a successful chain of eight dry-cleaning outlets in Birmingham, each situated in one of the shopping centres dotted around the West Midlands metropolitan area. He feels that the new millennium has brought a time for consolidation, and he has now abandoned ideas of expanding the chain to concentrate on improving the profitability of each of his existing outlets.

Each of the shops has a full-time manager and three part-time employees. Even the word 'manager' is something of a misnomer – supervisor being more appropriate – since Jack effectively manages the whole operation, with very little delegated decision-making. There is very little communication between the shops, virtually all information and direction being provided by Jack in his daily shuttle between the shops.

Jack monitors the competition carefully. He regularly takes pieces of his dry-cleaning to his rivals for service – one first thing in the morning and another last thing in the evening. The difference in the numbered dockets allows him to estimate weekly revenue and to make comparisons with his own takings. His survey findings show Mercian to be the second ranked outlet in each of the locations, with no single competitor consistently occupying the top position. The chain is doing well, with each of the outlets separately profitable, but Jack is anxious to occupy the top slot in at least half of his eight locations.

A number of alternative ideas have been tried out in his 'Blue Riband' shops, located in the Solihull and Sutton Coldfield centres, with a view to implementation across the whole chain if successful:

- close control on raw material usage in order to reduce the use of solvents while maintaining cleaning quality;
- implementation of a computer system to track items and costs and to give immediate feedback on daily progress;
- staff training to target 'lost' customers by encouraging knock-on sales; and
- repackaging of the existing product to provide a deluxe service, at an increased margin, to existing customers.

Staff reaction to the trials has not been favourable. They feel they are not trusted because of the close monitoring imposed – a perception recently magnified by Jack insisting on conducting the cleaning operations himself for both expensive items and 'celebrity' customers. The implementation of a new computer system without consultation or training has further advanced their perception of being watched constantly. The introduction of formal staff training sessions is associated with a feeling that they are not doing their jobs properly and need to be reinstructed, apparently in the basics of providing customer service.

CASE STUDY (cont.)

Jack is disillusioned by the lack of success of his attempts to implement improvements. He needs help in making recommendations for actions which will improve the performance of the Mercian chain.

CASE ANALYSIS

The SWOT analysis in Table 7.3 is an ideal starting point for the analysis of Mercian Dry Cleaners. It is apparent that Jack Taft has clear aims and has established a strategic direction for his business. Unfortunately, he has failed to match the duties and responsibilities of employees with either their skills or designated position, with the result that there is no goal congruence among owner, managers and employees and a potentially damaging atmosphere exists.

A number of major improvement opportunities are apparent, of which those below are, arguably, the four that need immediate attention:

- *The need for active leadership from Jack Taft*, whose highly autocratic leadership style restricts information flow between the operating units, with the result that neither job satisfaction nor business performance is at an optimum.

TABLE 7.3

SWOT analysis for Mercian Dry Cleaners

Strengths	Weaknesses
• Successful chain • Well spread throughout metro area • Staff structure appears to be 'lean' • Flat organizational structure • Each shop profitable • Owner has a clear 'mission' for business	• Owner's autocratic managerial style • Lack of delegation to shop managers • Little inter-shop communication • Owner is conduit for all business communication • Shops have feeling that they are being watched • No delegation • Jack's method of monitoring competition • Method of computer implementation
Opportunities	**Threats**
• Improvement through TQM • Possibilities of a TEI approach • Computer as a tool to assist with TQM • Let his managers 'manage' • Inter-shop communication • Possibility of chain being more strategic	• Owner not getting optimism or enthusiasm out of staff • Lack of goal congruence of employee and organizational objectives • Computer implementation could result in a 'Luddite' attitude by employees

CASE STUDY (cont.)

- *The need for improved communications between Jack Taft and his staff*, apparent from the introduction of new systems without consultation and the absence of inter-store contact.
- *The need to encourage the involvement of the staff* in the day-to-day running of the business, apparent from the lack of empowerment of managers, the prominence of part-time staffing and the missed learning opportunities arising from employee feedback.
- *The absence of meaningful performance indicators* for either staff or business, which might be used to address staff morale, service quality, customer satisfaction and cost efficiency.

The identification of key improvement opportunities yields a number of strategies that might be adopted to correct existing deficiencies.

Strategies for improving morale and job satisfaction

- Leadership style must be addressed. Training for Jack Taft to facilitate the delegation of authority to managers – allowing them to increase their commitment, motivation and self-work. He must actively seek their feedback, encourage information flows and empower decision-making within organizational goals. Jack must himself be committed to the process of change and recognize the required impact on his autonomy and organizational structure.
- Encourage teamwork in pursuit of a top position within each location; establish teams to address improvement opportunities and provide a 'think-tank' to support Jack Taft.
- Provision of incentives to motivate improved performance. This might embrace changes in the reward structure, particularly if associated with team-earned bonuses.
- Training of managers and staff is essential to increase their awareness of: goals and strategies; quality and TQM processes; and their role in ensuring customer satisfaction.

Communications through a TQM process

Jack needs to establish open lines of communication between himself and the staff, and between staff at different outlets. The encouragement of teamwork and modified attitudes to change can provide a focus for improvement opportunities which are recognized and communicated across the whole business. This might be illustrated by the adoption of the PRAISE system (see Table 7.1) of quality improvement in order to trial new services.

1 *Problem identification*
   - Customer satisfaction may be improved by the introduction of the deluxe service and better service to customers in general.
   - Reduction in raw materials (solvents) may provide the same quality garment at reduced cost.

CASE STUDY (cont.)

- Computer systems improve costings on a daily basis and improve inventory control.

2 *Ranking of opportunities*

- Take an incremental approach to implementing improvement opportunities.
- Select the most important opportunity with the greatest significance, in this case customer satisfaction.

3 *Analysis*

- Autocratic leadership and staff mistrust have led to resistance to changes that would enable quality improvement. This limits the potential of any TQM approach to improving customer satisfaction.

4 *Innovative alternative*

- Delegation of authority from Jack Taft.
- Undertake staff training in TQM, team building and customer satisfaction.
- Provide incentives for improved performance linked to group effort and customer satisfaction.

5 *Solutions implemented*

- Begin with staff training to overcome distrust and lack of support.
- Improve communication with weekly meetings to review objectives and progress.
- Ensure that Jack Taft also has training in delegation and that leaders provide top management support.
- Implement change in smooth and efficient process. Ensure appropriate training, documentation and resources are committed to the process to ensure its success.
- Continuous evaluation and feedback both from and to employees to ensure understanding of change and its effective implementation.
- Identify any problems which were originally overlooked and address them.

6 *Evaluation of outcomes*

- Continually evaluate the effectiveness of the changes to ensure their continued success.
- Identify signals which suggest that the process needs further attention to maintain the gains achieved.

Implement a TEI process

This would embrace:

- active pursuit of customer feedback;
- communication between stores;

CASE STUDY (cont.)

- formal 'benchmarking' with competitor stores;
- empowerment of managers and delegation to lower ranks;
- a reward system linked to store performance; and
- involvement of employees in the strategic plan, to induce a commitment to goals and the strategies for their achievement.

Establish a systematic set of performance measures

These would embrace both financial and non-financial indicators and might be expected to include: measures of quality, such as customer perception of service (cleanliness, timeliness, accuracy, reliability), number of lost items, number of customer complaints, conformance to competitors' standards, durability of creases, speed and courtesy of service, knowledgability of operatives, staff turnover levels and absenteeism levels; and measures of cost, such as overhead variances, solvent usage, inventory build-up, returns per square metre on labour costs, and relative cost/profitability of service provision.

The case highlights the importance of 'commitment from the top' and a willingness to change the culture of the group in the successful implementation of a TQM process.

STRATEGIC INTERNAL CONTROL

Internal control has always been a strategic process which goes far beyond policy manuals and internal audit to embrace corporate goals and the people, at all levels of the organization, who are employed to achieve them.

Casual observation of management accounting control systems (MACS) within large, complex organizations suggests that they are all the same – a combination of short- and long-term planning, budgets, variance analysis and project reporting. Closer examination reveals that the manner in which the MACS are applied varies greatly and reflects the preferences of senior management. Where, for example, management signals its perception of the importance of NFIs in interactive control systems, we might anticipate that in consequence subordinates will focus on the monitoring of these activities and the development of new measures.

The goals of MACS address four key strategic areas:

- planning – the setting of goals and an overall vision;
- control – the monitoring of external events and the measurement of internal activities to ensure a direction congruent with these goals;
- motivation – concerned with getting the best out of employees and linked to participation, empowerment and reward systems;
- performance – evaluation of individual and group performance for consistency with objectives and ethical considerations.

Following the seminal work of Anthony (1965) the planning and control areas have provided the traditional link between MACS and strategy. The SPAMSOAP mnemonic, so familiar to students of examinations in the management control area, designates the eight elements of the traditional system of internal control:

- Segregation of duties
- Physical safeguards
- Authorization and approval
- Management review
- Supervision and audit
- Organizational structures
- Accounting and information systems
- Personnel arrangements.

Planning and control activities rely heavily on financial and non-financial performance measures, but the internal control process goes far beyond policy manuals and audit, because it is determined by people at every level of the organization. It is geared to the achievement of corporate goals, not just financial reporting, making it a strategic process.

As Hiromoto (1988: 22) points out, 'Japanese companies must value inventory for tax purposes and financial statements … but don't let these accounting procedures determine how they measure and control organizational activities.' He emphasizes instead a direct link between management accounting practices and corporate goals whereby MACS are used to support and reinforce manufacturing strategies aimed at process and product innovation. Although recognizing that such practices do not represent *all* Japanese companies, his study provides early evidence of the importance of NFIs in motivating employees towards innovative practices and improved performance.

Information systems and control procedures (embracing authorization, verification, reconciliation, review and reports against budget) are necessary but insufficient features of a successful control environment. The Institute of Chartered Accountants in England and Wales (ICAEW, 1993) identified additional features which contribute to our 'motivation' and 'performance' goals; features which have remained substantially unaltered through subsequent reports (e.g., ICAEW, 2002):

- commitment to truth and fair dealing;
- commitment to quality and competence;
- leadership in control by example;
- communication of ethical values.

Corporate integrity, culture and code of ethics are thus central to successful internal control and lead us to consider alternative managerial approaches to motivation as a means of overcoming non-goal-congruent behaviour and the exploitation of MACS gaps. The seminal work in this area is F.W. Taylor's treatise of 1911 on *scientific management* in which he assumes that unskilled workers can be motivated to work only by money and close supervision (see Taylor, 1947). The resulting control system is one based on standard costing, budgeting and variance analysis. The natural consequences of the tight identification and planning of resource inputs, costs and variances are:

- work study, to analyse jobs and processes and find the 'best' way that unskilled labour can perform the task;
- scientific selection of personnel for the task at hand;
- minute division of labour to short specialized tasks;
- incentive schemes and targets;
- deskilling and potentially dehumanizing the workforce;
- ensuring that management, and not craftsmen, controls production and the speed of the production line.

Taylor's principles were widely adopted in the 1920s, most notably by Henry Ford in the mass production auto industry. Subsequent theorists have suggested alternative roles for management and supervisors in the organization. The *human resources movement* of the late 1930s recognized that financial reward was only one aspect of what working people wanted from their employment. The importance of mutual respect, discretion and recognition of contribution to the organization became more apparent. The implications for MACS were a focus on interpersonal relations and the monitoring and measurement of morale and job satisfaction. Since the 1950s the *human resources model* has extended the focus on individual needs to embrace working conditions and the nature of supervision. The implications for MACS have been greater employee participation in decision-making, TEI and employee empowerment. Recognition that subordinates often 'know the job' better than their managers, and associated research, suggest that participation in decision-making and employee empowerment will lead to greater motivation, greater job satisfaction, improved morale and greater commitment to the organization. The human resources model blends the 'motivation' and 'performance' goals of MACS by suggesting that goal congruence will be achieved by:

- strong organizational leadership;
- satisfying work and appropriate rewards;
- opportunities for advancement; and a
- supportive work environment.

The simplistic Taylorist assumption that financial reward is the only motivator to improved performance causes distinct problems for reward systems under *scientific management*:

- a short-term focus;
- high costs associated with servicing the system (particularly with share option schemes);
- manipulation opportunities (particularly with bonus plan schemes);
- doubts about whether the actual rewards target the most appropriate employees and whether they increase shareholder value.

The *human relations movement* and *human resources model* promote teamworking and reward systems associated with the contributions of individuals to the team effort. Rewards may take the form of non-cash payments (e.g., gifts, or points schemes leading to gifts). TQM is one philosophy which aims to encourage teamwork and rewards participants for their co-operation in instituting organizational improvements.

Cullen et al. (1994) suggest that internal control failures will result from one of five eventualities:

1 *Lack of integrity of top management*. This may be apparent from dishonest, fraudulent or unethical behaviour. The resulting ethical dilemmas will emerge in the form of conflicts between individuals and organizational values, and between an organization's stated and practised values.
2 *A weak control environment*. This may be associated with corporate culture (e.g., a culture of excessive and unrealistic risk-taking). Shields and Young (1989) suggest that it will be very difficult to change organizational culture, especially in those organizations with weak leadership and no clear direction, or where internal conflict is high because of autocratic rule. They suggest that change will be resisted because of fear of the new, the cost of change in terms of both time and money, and the resulting changes in the balance of power in the organization.
3 *Inconsistent or unrealistic objectives*. For example, it would be inconsistent to pursue a corporate goal of industry leadership through technological innovation while still allocating overheads to product costs in a manner which penalizes the use of high-tech machinery.
4 *Communication breakdown* resulting in the pursuit of conflicting objectives. For example, innovation in entrepreneurial firms may be constrained by the implementation of unsuitable control systems focusing on costs to the detriment of the innovation goal.
5 *Inability or inflexibility to react appropriately*. This may mean that corporate inertia prevents the organization from taking advantage of technological opportunities or responding to threats from the external economy. For example, Williams and Ashford (1994) highlight four of the changes in control systems and product costing systems that may be necessitated by new manufacturing technologies:

   (i) competitive pressures necessitating shorter product life cycles and the faster introduction of new products and services. MACS must respond with flexible management structures, project teams and new performance measures.
   (ii) emphasis on activity analysis and the supply chain. MACS must respond with much closer attention to long-term supplier alliances and investigate activity-based management systems and customer profitability analysis.
   (iii) adoption of TQM. MACS must respond with an increased emphasis on NFIs, to observe internal and external failure costs, to monitor prevention costs and to measure the costs of quality.
   (iv) adoption of JIT management. MACS must respond by making wholesale modifications to traditional systems based on labour productivities, machine efficiencies, rejection and wastage rates, and inventory holdings. These will no longer be appropriate and new NFIs must place the emphasis on service to customers and speed of delivery.

Roslender (1992), Puxty (1993), Atkinson, et al. (1995) and Otley (2001) all provide excellent summaries of the accounting literature relating to management control, but no generally accepted view of the adequacy of existing theories in explaining organizational behaviour emerges. Researchers (e.g., Porter, 1980) agree that an 'overall cost leadership' strategy requires sophisticated cost controls, but otherwise such studies have been of little help in the design of MACS. Porter's cost leadership strategy in pursuit of sustainable competitive advantage provides a grounding for much of the subsequent research in the areas of value-chain analysis and strategic management accounting. It has popularized strategic cost analysis, with its identification of a value chain between raw materials and end-user, and the specification of cost drivers and cost reduction opportunities for each activity of the chain to effect appropriate internal management. The value-chain perspective is explored in detail by Shank and Govindarajan (1992).

Companies with different management control systems compete in different ways. Goold and Campbell (1987) identify three different strategic control styles where the degree of control from the centre is dependent on the balance between the competitive and financial goals of the enterprise. Leadership and the manner in which controls are implemented emerge as key distinguishing features between companies. Future research must focus on the relationship between MACS and corporate strategy to provide empirical support for those systems and non-financial measures which promote the short- and long-term goals of organizations.

Anthony's (1965) initial definition of management control has spawned a number of variations to facilitate understanding. Thus we have administrative and social controls (Hopwood, 1976), output and behavioural controls (Ouchi, 1977), market, bureaucracy and clan controls (Ouchi, 1979), results, action and personnel controls (Merchant, 1981), and, formal and informal controls (Anthony et al., 2003). The latter emphasize the importance of 'informal' control approaches while acknowledging that they are notoriously difficult to measure, or even quantify.

Studies founded within a 'contingency' framework have made a significant contribution to the management planning and control literatures by identifying contextual factors with the potential to influence the operation of the organization's 'package' – rather than system (Otley, 2001) – of accounting and non-accounting information mechanisms, for planning and control (Ittner and Larcker, 2001). The most prominent contingent factors include the external environment, technology, organizational structure, size, culture, competitive situation, and industry characteristics. (e.g., Chenhall, 2003).

Otley (1999) argues that accounting controls have historically been viewed as the principal means by which management control is effected, but that this orientation is no longer sufficiently broad to capture contemporary approaches. He argues for more 'management' in management accounting (Otley, 2001). These views are shared by Merchant and Van der Stede (2003), who observe that accounting controls form only part of broader control systems. Chenhall (2003) is especially concerned about the spurious research findings that might result (and have resulted) from failing to study specific accounting controls, and other organizational controls with which they are inextricably linked, at the same time.

The way in which particular combinations of controls can be aligned with strategic imperatives in particular circumstances, for optimum impact, remains a key concern in management accounting research. Malina and Selto (2001) suggest that an effective management control device should have both 'strategic alignment' and 'positive motivation' if it is to generate the desired outcomes. For strategic alignment they identify, respectively, the following critical attributes:

- measures of critical performance variables, linked to strategy;
- measures of critical performance demonstrably linked to desired outcomes;
- effective performance measures for communication purposes.

Correspondingly, for positive motivation, they identify:

- controllable performance measures;
- challenging but attainable performance targets;
- performance measures linked to the reward system in a meaningful manner.

These attributes have found considerable support in the empirical research literature, and provide a sound framework for further investigations.

The importance of sound internal controls is illustrated by the following case study which details the need to operate in a strategic manner to deal with significant external pressures.

CASE STUDY

Bradford Funerals: Performance and internal controls

This case concerns a company, operating within a highly sensitive industry, which needs to adopt new planning and control procedures and performance measures in order to ensure its long-term survival. The case explores the characteristics of the UK funeral industry and the impact of the incursion of large overseas companies on the operation of small family businesses.

Porter's (1980) *competitive strategy* framework provides the opportunity for the analysis of generic strategies to secure competitive advantage, when cost leadership is not a practical possibility. Product diversification and niche marketing are explored instead, together with a renewed focus on the internal controls in place.

Bradford Funerals is the largest funeral director in West Yorkshire, and one of the larger family-owned businesses in England. Even so, with an annual turnover of £1.6m and a full-time staff of only 15 it must still be categorized as a 'small' business.

The nature of the UK funeral business has changed rapidly during the past five years. Competition is becoming increasingly intense

CASE STUDY (cont.)

with the entry of overseas competitors; traditionally bereaved families had a tendency to choose a funeral director close to their home to be near their loved one, and the Co-operative Society has thus carried out about half of all UK funerals. But now Service Corporation International (SCI) has secured a significant share of the market by taking over the only public limited companies devoted to funeral operation. SCI is now the largest provider of death-care services in the world, operating over 3000 funeral service locations, 400 cemeteries and 200 crematoria in 20 countries. Growth by acquisition has been phenomenal; during 1994 SCI expanded into the UK by acquiring 154 funeral homes, two cemeteries and 13 crematoria owned by Great Southern Group plc, and 380 funeral homes held by Plantsbrook Group plc. In so doing SCI instantly gained approximately 15% of the UK market and became the country's largest privately-owned death-care operator. SCI's success has been driven by lowering costs through a 'clustering' strategy: clusters of geographical groups of funeral homes and cemeteries share common resources (e.g., personnel, accounting, sales, vehicles). However, such rapid growth in an acquisition company has come at a cost, as illustrated by the trends of Table 7.4. Despite record revenues in 1999 of £3.32 billion, up from only £1.65 billion in 1995, SCI's debt levels, having peaked in 1998, had forced a reorientation to reduce overhead and increase cash flow, including the disposal of non-core assets in the financial services areas.

The maintenance of market share is a key goal for Bradford Funerals across each of the three sectors of the business: burials (relative importance 20%), cremations (70%) and repatriation (10%).

TABLE 7.4

Financial trends for Service Corporation International (Source: http://www.moneynet.com)

Year ended	31/12/99	31/12/98	31/12/97
INCOME STATEMENT (£000)			
Revenues	3,321,813	2,875,090	2,535,865
Total expenses	3,153,067	2,223,159	1,915,034
Pre-tax income	(37,690)	518,527	579,973
Post-tax income	(34,297)	342,142	374,552
BALANCE SHEET (£000)			
Current assets	996,151	1,209,080	811,408
Total assets	14,601,601	13,266,158	10,514,930
Current liabilities	1,057,865	630,325	535,442
Long-term debt	3,636,067	3,764,590	2,634,699
Total liabilities*	11,106,328	10,112,056	7,788,296

*Total liabilities include '*deferred pre-arranged funeral contract revenues*' and '*deferred pre-need cemetery contract revenues*' which together account for almost the whole of the difference between total liabilities, on the one hand, and current liabilities plus long-term debt, on the other.

CASE STUDY (cont.)

Repatriation is a significant component for Bradford Funerals because of its location close to a large Muslim population; although some Muslims bury their relatives in the UK as many as 80% are flown back to Pakistan for burial. The operations of SCI mean that it is impossible for Bradford to compete on a cost-efficiency basis. They must be cost-conscious, but rely on alternative strategies to stay competitive. In terms of Porter's (1980) generic strategies, this suggests that Bradford Funerals must look at product diversification and niche marketing.

THE NATURE OF THE SERVICE

Funeral direction is primarily a 'service' organization, responsible for supplying coffin, hearse, limousines and appropriate personnel and ensuring a smooth, dignified operation. However, the public perception of a 'product'-based business is still widespread.

Most funeral providers are professionals who try to satisfy the client's best interests, but the wide variety of customer choice means that the cost of a funeral can vary greatly. Table 7.5 details the scope of the service that might be provided by the funeral director. The cost of a coffin can vary from as little as £50, for cardboard or lightly veneered chipboard, to over £700 for a mahogany vessel with top-of-the-range handles, lining and fittings. Even so, a basic funeral – with no embalming, and just a hearse with no following limousine – is likely to cost at least £1280:

Professional services, hearse, oak veneer coffin	745
Crematorium fees	225
Minister's fees	150
Doctor's fees	85
Obituary and acknowledgements	75
	1280

The addition of the costs of embalming and dressing the body, visiting fees for the chapel of rest, an oak coffin, flowers, limousines for mourners, etc. means that this figure will quickly exceed £2000.

Most crematoria are run by local authorities and fees have historically been modest, though increasing to meet the cost of addressing European Union anti-pollution requirements. By 2000 SCI owned 21 out of 242 UK crematoria (8.7%), despite the potential undesirability of a firm that sells funerals in an area also controlling its crematoria. Most UK crematoria allow only 30 minutes for a service, some 45 minutes, but only very exceptionally longer; extra time for grieving may be purchased.

MARKET SHARE

When a call comes in from the customer about a bereavement, funeral arrangements commence immediately, with the actual

CASE STUDY (cont.)

TABLE 7.5

Services provided by funeral directors (Source: http://www.yorkshireco-op.com.uk)

Funeral directors' charges may include:
- a personal interview to receive instructions
- arranging for the removal of the deceased at anytime of the night or day
- use of private chapel of rest facilities
- liaison and confirmation with clergy, church, cemetery or crematorium
- completing and forwarding legal documentation to the appropriate authority
- supply and fitting of the coffin or casket
- supply of the necessary bearers
- provision of the hearse and limousines as required (alternatively, horse-drawn hearse and carriages)
- liaison with the police and coroner
- arranging the dispersal or interment of cremated remains
- providing transport to the registrar (if required)
- professional attendance and supervision throughout the funeral
- retaining detailed records of each funeral for future reference by the family if required
- repatriation both to and from abroad

Supplies attracting value-added tax at the current rate:
- insertion of press announcements
- assistance in ordering and the receipt and care of floral tributes
- arranging for the production of service sheets, etc.
- arranging for catering either at home or elsewhere
- provisions of designs and estimates for memorials

Disbursements on behalf of the client may include:
- arranging for the completion and payment of medical certificates for cremation
- arranging for the removal of the memorial (if applicable)
- arranging for the purchase and preparation of the grave
- payment of minister's fees/church fees
- payment of cremation fees
- payment of honoraria and gratuities

funeral taking place within four or five working days. Muslim funerals, on the other hand, will often take place on the same day as the death, including weekends and public holidays. Although the speed of events frequently causes logistical difficulties, it also has the advantage of facilitating regular monitoring of demand and the impact of competition. The great majority of funerals are published in the local newspaper, and in 80% of cases a named funeral director is associated with a particular funeral. This is not surprising because it represents a cheap form of advertising for the funeral director, appropriately located in the newspaper, and at the

CASE STUDY (cont.)

customer's expense. Thus market share can be calculated very precisely for 80% of funerals, but further research is necessary to fill the gap posed by the unidentified 20%. Back-up information is available relating to every death in the area from death registrations at the local registrar's office; this information is published monthly by the Office of Population Census and Surveys, and broken down weekly by locality. This gives a more accurate indication of market share and how busy the competition has been over the corresponding time period. However, while the above indicate who has died within the locality, this does not necessarily correspond with the number having their funerals in the area; local deaths and registrations may result in repatriation or persons being transported to their home town for burial. The same sort of problem in a reverse direction causes data inaccuracies arising from transportation into the area for burial; this is occurring increasingly with hospital deaths in specialized units (e.g. cardiac, spinal, transplants) outside the locality. Market share is perhaps best measured as the percentage of those people who died in the area who also had a funeral within the area, but this is less easy to specify with confidence because local cemeteries and crematoria regard this information as confidential. However, for cremations it is quite easy to ascertain the share of the market: when clients request the return of their relative's cremated remains, within 24 hours of the funeral the local crematorium returns them to the funeral director, individually packed in a functional plastic ash casket, which bears the name of the deceased and cremation number. These numbers are sequential, and each crematorium operates the same system, so that it is easy to calculate the proportion of total cremations conducted by Bradford Funerals.

LOGISTICS

Bradford Funerals conducts about 1000 funerals a year, but the unpredictability of the funeral business means that there is great potential variation in the demand for staff and vehicles. It is almost impossible to forecast when a funeral will be needed or how often the Bradford service will be required during a given week. The only certainty is that the demand will be greater during the winter months (November to February) than during summer.

A core of full-time staff is required with the skills to conduct embalming, chauffeuring and funeral directing. Added to these are a pool of relatively unskilled chauffeurs/bearers who may be called upon at short notice, in order to provide the required degree of flexibility during periods of high demand.

Until recently Bradford used a single estate car to transport bodies from hospital/mortuary to their chapel of rest. This car could only hold two cadavers at a time, meaning a lot of wasted transportation time, particularly when the vehicles were travelling backwards and forwards to the same hospital. This situation has been considerably eased with the purchase of a converted private ambulance which

CASE STUDY (cont.)

allows the movement of up to five cadavers simultaneously from one or more place of death, before returning to the chapel.

Funerals can only be arranged with the cooperation of other interested parties, notably a religious minister to conduct the service, the crematorium or cemetery and the family, friends and relatives. Most funerals take place between 11.00 a.m. and 2.00 p.m., although the local crematoria are available from 9.00 a.m. until 3.30 p.m. at half-hour intervals. However, early morning funerals are very unpopular because of the difficulties of relatives travelling long distances to be there, and late funerals are unpopular because of the extra emotional burden it places on waiting family. Consequently the demands on the limousine fleet are very high over a relatively short period of time. Bradford has two hearses and three limousines, so that with careful timing it can conduct two funerals at the same time, starting one whilst the other is finishing. During exceptionally busy periods it has been known to conduct three funerals more or less simultaneously with the same core fleet, perhaps supplemented by a hired limousine. The hiring of additional hearses and limousines becomes essential due to exceptional circumstances:

- punctures or breakdowns to vehicles;
- last-minute requirements for additional limousines by clients wishing to transport additional family members; and
- families spending an excessive amount of time around the grave, talking, after the funeral.

These circumstances make mutual respect between competitors essential in the industry. All will be subject to the same difficulties, and all will be prepared to lend limousines to even their staunchest rivals at very short notice. There are no inter-company charges or transfers associated with this arrangement.

During such busy times job queues and excessive work in progress can arise. Sometimes in the winter months as many as 15 funerals need to be arranged for the same day, with the consequence that coffins are readied and cadavers moved to the chapel and placed in a queue awaiting embalming and then gowning once they have been placed in the coffin. The Bradford mortuary can only cope with two cases at a time, so that delays are inevitable during busy periods. The mortuary bottleneck is only relieved by staff working very long hours – often until very late in the evening – to ensure that preparations are complete for funerals taking place on the following day.

INVENTORY CONTROL

High build-ups in stocks of coffins, handles, gowns and shrouds are a feature of the business, associated with the irregularity of the service provided. An additional and not insignificant issue is the inventory associated with Muslim funerals. Bradford Funerals has an enviable reputation in this regard, which it has sought to

CASE STUDY (cont.)

encourage in order to expand market share. But Muslim funerals usually require repatriation to Pakistan for burial, and – because of the very tight time constraints imposed – Bradford must keep an inventory of hermetically sealed zinc-lined coffins in stock. These are a requirement of overseas carriage by air, and their inventory cost is right at the top of the range described earlier. These items frequently remain in stock at a cost of £6000 each for some months before they are required. Bradford's reputation with its competitors as the market leader for the provision of Muslim burials means that it is frequently called upon to supply zinc-interior coffins when their competitors have repatriation requirements. While the low level of demand experienced by competitors makes this a cost-effective strategy for them, for Bradford it imposes further inventory management problems as they seek to source coffins for all Muslim burials in the area, not just their own.

However, it is possible that some of the excess inventory may be attributable to bad planning and poor forecasting. The product range is extremely wide, catering for people of all shapes and sizes – from less than 20 cm in length for babies and small children up to a maximum length of about 220 cm and maximum width of 80 cm. The need for more than one style and type of coffin in the range means that an inventory in excess of 120 coffins will be held in a typical month. Even in relatively quiet times inventory holdings are high to provide a buffer against unanticipated increases in the workload. Given the 10% of high-value zinc-lined coffins required, this means that monthly inventory holdings will typically be £39,600. The average size coffin selection ranges from 150 cm to 190 cm in length and Bradford has coffin sizes at 5 cm intervals within this range. Consequently, size differences alone contribute to a substantial inventory, which arguably might be lower, since the occupant is unlikely to complain (nor the customers to notice) if the coffin is slightly too large. Bradford estimate that a halving in the number of coffin sizes they offer could cut inventory levels by as much as 15%, and reduce the value of inventory holdings by nearly £6000.

COSTING AND PRICING

A standardized costing and pricing system is the norm in the funeral industry, even though there may be significant cost differences between individual cases. Customers, especially those who lose a loved one out of normal working hours, expect a great deal in terms of attention, compassion, service and reverence from their funeral director, while at the same time wanting very little in the way of direct contact. The distress associated with ascertaining the precise requirements of the family necessitate the adoption of a standardized approach to both product and service. For example, a coffin 150 cm in length is much cheaper for the funeral director to supply than one which is 200 cm long, typically £300 rather than £350, but in providing an estimate of funeral costs an average figure is given to the

CASE STUDY (cont.)

customer rather than subjecting the bereaved to distressing questions relating to the height and weight of their recently deceased loved one.

Similarly, charges for the removal of the deceased back to the Bradford chapel for the funeral are standardized; the charge for a death occurring at 2.00 a.m. is the same as one at 9.00 a.m., both requiring immediate removal. The former is, in practice, a much more expensive service to provide, requiring overtime payments for attendance out of normal working hours as well as additional communications costs associated with keeping a team on call 24 hours a day, 365 days a year.

FINANCIAL INDICATORS

Bradford records creditors, debtors and bank statement balance on a month-by-month basis to allow comparisons against both budget and last year's performance. However, the budget is set on the basis of the actual performance in the previous year and involves no forecasting or projections. Capital expenditures in one year are entirely dependent on the profits earned in the previous year.

Cash flow is also monitored monthly, and debtors tracked from a period of three months, and thereafter every month. Bad debt averages only £8000, modest given that many customers have no savings or insurance cover, and may not be able to claim funding from the state (the Department of Social Security in the UK).

The financial accounts thus provide a 'broad brush' approach to the performance of the business, but they are regarded as reasonably accurate and perfectly adequate to meet the needs of day-to-day decision-making. The current annual position (at the end of 2000) is as detailed in Table 7.6.

TABLE 7.6

Bradford Funerals financial position as at 31/12/2000

Profit and Loss Account (£000)		Balance Sheet (£000)	
Revenue	1,600	Non-Current Assets	560
Cost of Sales	920	Current Assets: Cash	20
	680	Debtors	300
Wages & Salaries	370	Inventory	90
Rent, utilities etc.	60		410
Fleet maintenance	6	Current Liabilities:	10
Other expenses		Overdraft	
(including	12	Creditors	90
depreciation)	448		100
Net Profit	232	Long-Term Liabilities: loans	100
Taxation	72	Pre-sold funerals	70
Profit after Tax	160		170
		Share capital and Reserves	700

CASE STUDY (cont.)

We are required to make recommendations to Bradford Funerals about improvement opportunities that exist in the areas specified, together with a discussion of their implications for the strategies and control mechanisms that might be adopted to stay competitive.

CASE ANALYSIS

Bradford Funerals is a large family business, though still small when compared with the quoted service sector. Its goals appear to be survival as an independent company, while at least maintaining its market share.

The SWOT analysis of Table 7.7 highlights the internal weaknesses of the company and external threats to its survival. But it also offers some encouragement in the improvement opportunities that exist.

In examining Porter's three generic strategies for competitive advantage, cost leadership does not appear to be an option; Bradford cannot compete with the likes of SCI on cost or efficiency of operations. While it remains a family business it can ensure its independence, and with appropriate action to correct internal deficiencies be efficient enough to remain profitable. Such a focus should mean that Bradford can avoid the financial difficulties impacting on SCI, so apparent in Table 7.8. The ratio trends clearly demonstrate the need for the management actions currently being undertaken by SCI. Although debt levels are high, the gearing ratios have remained stable over the period, but both earnings and liquidity

TABLE 7.7

SWOT analysis for Bradford Funerals

STRENGTHS	OPPORTUNITIES
Largest funeral director in West Yorkshire	Increase market share
Amongst larger family-owned businesses in England	Improved forecasting
Family reputation	More realistic costing methods
Cooperation with rival funeral directors	More personal service

WEAKNESSES	THREATS
Small business (turnover £1.6m)	Intense competition from overseas
Logistical difficulties	Cost-cutting from larger operations
Staff inflexibility	
Average pricing policy	
Process bottlenecks	
High inventory levels	
Large product range	
Need for 24-hour cover all year round	

CASE STUDY (cont.)

TABLE 7.8

Financial ratio trends for SCI

Year ended	31/12/99	31/12/98	31/12/97
Profit Margin(%) – PBT/S	(1.13)	18.0	22.9
Return on Assets (%) – PBT/TA	(0.26)	3.9	5.5
Liquidity – CA/CL	0.94	1.92	1.52
Gearing – TL/TA	0.76	0.76	0.74

have declined, necessitating a renewed focus on improving cash flows and reducing overheads.

The financial accounts for Bradford demonstrate the relative strength of the balance sheet – very low levels of debt and high levels of liquidity (current ratio 4:1, quick assets ratio 3:2). But the profit and loss accounts reveal problems: the profit margin at 14.5% is good, but the net profit of only £160,000 may leave little room for future capital expenditure outlays. Both 'cost of sales' and 'wages and salaries' are too high and inconsistent with these revenue levels. The company needs to seek more profitable markets, balance its throughput better to avoid extensive 'out-of-hours' payments, and reduce the costs of its service provision.

Bradford can compete on service, and here its reputation as a sound local business is invaluable. It may also try to carve out a niche for itself as a specialist in particular funerals, for example for Muslims or small children, as well as in grievance counselling for the bereaved to break down the barriers of intrusive contact. Bradford Funerals is clearly already regarded by its competitors as the expert in Muslim burials, but this recognition has apparently not yet permeated to the whole of the market. The company needs to look at its markets more closely to determine why it is currently the funeral director of choice, and in what circumstances it might change the purchasing habits of potential customers.

Forecasting and inventory control

Levels of uncertainty in the funeral directing business are very low when compared with other industries (e.g., computer software). Even so, demand varies to such an extent as to make the use of resources (and idle time) very uneven. Bradford can significantly improve on the current situation by better forecasting of demand peaks and troughs, and making better use of existing resources.

Some form of simple time series analysis would assist in providing guidance of the expected highs/lows in demand and would reflect the seasonal patterns associated with high but variable demand due to climatic conditions. For any given month of the year their historical records will allow them to link climatic conditions

CASE STUDY (cont.)

with the range of likely demand. This analysis would allow Bradford to control resource use and allow inventory holdings to be kept in check, but would need to be monitored closely to avoid stock-outs. Given the contribution of the holdings of zinc-lined coffins to the value of inventory holdings, time series modelling of the incidence of repatriations could be very helpful in reducing inventory costs.

The data from the case suggests that the Bradford revenue of £1.6m is derived from approximately 1000 funerals, priced between £1300 and £2000, implying a mean cost of sales of £920 per funeral. The number of funerals peaks at 15, at the height of the winter, so that realistically the company will be conducting approximately 50 funerals per week during the winter months. Allowing for holiday periods, well over half of the annual number of funerals will be conducted between November and February, allowing an annual schedule similar to that below to be developed:

Month	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sept.	Oct.	Nov.	Dec.
Funerals	120	200	100	30	30	20	20	30	30	100	200	120

Inventory holdings should match this anticipated pattern of demand, and modelling will allow the gap between actual demand and holdings to be minimized, especially during the relatively light April to September period. The case suggests a ‘typical’ monthly holding of 120 coffins (at a cost of around £39,600, based on 10% at £600 and 90% at £300), whereas a schedule of the kind developed would suggest that this is unnecessarily large for all but the peak months.

Activity analysis would allow the development of standards for time and quality for each of the sequential processes. It will also facilitate job scheduling to overcome some of the extremes of bottlenecks and excess capacity which exist at demand extremes. However, a stock turnover period of about (90/1600) ∞ 365 = 36 days suggests that stock control is not the most serious problem facing Bradford Funerals.

Costing and pricing

Cost control is essential if Bradford Funerals is to survive in the long term, and the absence of an adequate costing system is perhaps their most pressing problem. Inventory should also be reduced, at least by the 15% envisaged, and probably more. This can be accomplished by radically reducing the size range of coffins held in stock, and their number. The forecasting methods referred to above should help in this regard too.

At present, price averaging means cross-subsidization across all the activities of the funeral director. There is no ‘user pays’ philosophy because activities in unsocial hours (e.g., early morning retrieval of corpses) and at peak periods (e.g., funerals between 11.00 a.m. and 2.00 p.m.) are currently all charged at a standard

CASE STUDY (cont.)

rate, in order to be able to quote a single price at the outset which causes the bereaved the least distress. However, funerals requiring more limousines (for example) will already be priced higher, so it should not be difficult to impose penalty charges for 11.00–2.00 funerals which encourage the use of facilities in non-peak periods. This would also help to smooth out resource use and make better use of capacity.

Bradford Funerals might consider the adoption of a total quality management approach to prioritize problems/issues and implement appropriate solutions with strategies consistent with the corporate goals.

Financial indicators

The 'broad brush' approach adopted by the company in the monitoring of performance means that they are focusing on a very restricted set of financial accounting numbers. There appears to be relatively little focus on profit performance, causal factors or on the three E's of management accounting: economy, efficiency and effectiveness. A better appreciation of the cost of provision of each part of the service would undoubtedly yield cost efficiencies and waste reduction. A renewed focus on budget setting might also highlight further improvement opportunities.

EMPLOYEE EMPOWERMENT

In the earlier section on strategic internal control we observed the trend away from the 'rational goals model' approach, so closely associated with the 'command and control' type regime of F.W. Taylor (1947). Instead we saw the development of human relations models, emphasizing participation, collaboration and teamwork, of which the TQM philosophy is so typical. Employee empowerment is an extension of this trend, with managerial control being sought through mechanisms which seek to encourage self-discipline and the assumption of responsibility.

The quality improvement process should be a vehicle for positive and constructive movement within an organization, but we must also be aware of the destructive potential of the process. Failure to observe the fundamental principles of quality improvement may destroy motivation irrecoverably. Some authors, notably Carlzon (1987), Albrecht (1988) and Albrecht and Zemke (1985), have criticized the direction that TQM implementations have tended to take in practice, in particular:

- the focus on documentation of process and ill-measurable outcomes;
- the emphasis on quality assurance rather than improvement; and
- an internal focus which is at odds with the alleged customer orientation.

Carlzon has revived customer focus with an emphasis on total employee involvement culminating in the empowerment of the 'front line' of customer service troops. The main features of his empowerment thrust have been:

- loyalty to the vision of the company through the pursuit of tough, visible goals;
- recognition of satisfied customers and motivated employees as the true assets of a company;
- delegation of decision-making to the point of responsibility by eliminating hierarchical tiers of authority to allow direct and speedy response to customer needs; and
- decentralization of management to make best use of the creative energy of the workforce.

Albrecht suggests that TQM may not be appropriate for service-based industries, because the standards-based approach of 'industry best practice' ignores the culture of organizations. He recommends a move towards total quality service (TQS), which is more customer-oriented and creates an environment to promote enthusiasm and commitment. Albrecht suggests that poor service is associated with sloppy procedures, errors, inaccuracies and oversights, and poor co-ordination, all of which represent improvement opportunities which can be achieved through tighter controls.

Not all managers adopt such collaborative and participative perspectives, so that differences persist in the choice between 'rational goals' or 'human relations' approaches in generating appropriate behaviours in particular circumstances. The following two case studies adopt alternative stances, but both illustrate the opportunities for dysfunctional behaviour. Thus the Harvey-Harris case pursues the employee empowerment route, with disastrous consequences, while the Borthwick Construction case follows the more traditional approach of bonuses awarded for reaching specified performance targets – again with undesirable outcomes.

CASE STUDY

Harvey-Harris Stores: Empowerment from the top floor to the shop floor

This case study focuses on the application of employee empowerment principles to a large retail group. It provides the opportunity to analyse the manner of the strategy implementation and the consequent impact on both individuals and the organization.

The case establishes significant financial underperformance in one part of a retail group and investigates the use of 'employee empowerment' techniques – following Carlzon (1987) – to provide a solution. The case illustrates the dysfunctional activity associated with implementing empowerment without either appropriate management control or staff training, together with the dire financial implications. The case analysis discusses alternative approaches that might have been adopted.

CASE STUDY (cont.)

Harvey-Harris operate 150 department stores across England and Wales, through two separate divisions which together offer a product range to cover all income groups. Thus, the 80 W.J. Harvey stores are targeted towards upper- and middle-income families and the 70 R.S. Harris stores target lower- and middle-income families. The Harvey stores are larger (often with two or three floors) while the Harris stores all operate on a single level. The stores are distributed as follows:

	Wales and the West	*South East*	*Midlands*	*North East*	*North West*	*Anglia*	*Cumbria*	*Total*
Harvey	*15*	*38*	*10*	*4*	*8*	*3*	*2*	*80*
Harris	*26*	*18*	*10*	*6*	*8*	*1*	*1*	*70*
	41	*56*	*20*	*10*	*16*	*4*	*3*	

The financial results for the current year (1999) are as follows:

	Group	**W.J. Harvey**	**R.S. Harris**
No. of stores	150	80	70
Sales revenue (£m)	4,846	3,718	1,128
Profit before tax (£m)	192	98	94
Selling area (sq m)	1,362,773	992,442	370,331
No. of employees	46,211	33,257	12,954

One of the factors which explains the poor performance of W.J. Harvey relative to R.S. Harris is that the latter is not involved in food retailing – which is traditionally low-margin and requires more selling space. Another is the expense associated with the provision of a superior decor in the Harvey stores.

Of more concern to the Group is the trend in sales and profitability. Harvey sales are static, Harris sales show only a modest increase over the last two years; both divisions are losing market share to competitors who are perceived to be more ‘customer-friendly’. Table 7.9 details the trend, together with comparative industry benchmarks.

Clayton Watts, the Group Managing Director, commissions a customer survey across the W.J. Harvey division to determine what service customers really want. Table 7.10 details the outcome.

Clayton Watts prides himself on being well versed in the latest management techniques and is determined to apply them to correct the current weaknesses of the group. His intention is to redirect the group’s objectives by introducing a new ‘mission’ together with employee empowerment to the ‘front-line troops’ of customer service personnel. He is looking for a system to push responsibility down to lower levels in order to free up senior management for strategic purposes. He has been impressed by the work

TABLE 7.9

Relative performance at Harvey-Harris stores

		1999		1998		1997		1996		1995	
W J Harvey											
No of Stores		80		77		75		74		74	
Sales Revenue (£m) Food		364		359		360		356		350	
Non-Food		3354		3268		3203		3181		3202	
			3718		3627		3563		3537		3552
Profit before Tax (£m) Food		8		9		10		10		10	
Non-Food		90		93		93		96		97	
			98		102		103		106		107
Total Assets (£m)		1090		1019		1007		980		981	
Finished Goods Inventory (£m) Food		62		58		56		54		50	
Non-Food		518		528		514		466		415	
			580		586		570		520		465
Selling Area (sq m)		992,442		954,220		930,435		917,030		917,030	
No of Employees		33,257		32,032		31,256		30,780		30,796	
R S Harris											
No of Stores		70		66		60		57		55	
Sales Revenue (£m)		1128		1042		928.6		838.0		768.2	
Profit before Tax (£m)		94		85		78		70		60	
Total Assets (£m)		326		309		295		298		296	
Finished Goods Inventory (£m)		280		275		260		258		240	
Selling Area (sq m)		370,331		346,169		317,474		302,630		291,956	
No of Employees		12,954		12,220		11,100		10,530		10,180	
Retail Industry Benchmarks											
Food:	PBT/S (%)	6.0		6.0		6.0		6.0		6.0	
	Sales/sq.m. (£000)	8.0		8.0		8.0		8.0		8.0	
	PBT/Inventory	10.0		10.0		10.0		10.0		10.0	
	Sales per Employee (£000)	150		150		145		145		140	
Non-Food:	PBT/S	10.0		10.0		10.0		10.0		10.0	
	Sales/sq.m. (£000)	4.0		4.0		4.0		4.0		4.0	
	PBT/Inventory	30.0		30.0		30.0		30.0		30.0	
	Sales per Employee (£000)	100		100		100		100		100	

CASE STUDY (cont.)

TABLE 7.10

Results of customer survey

Customer requirements

Pricing:
- all items clearly ticketed
- competitive pricing
- facilities for easy use of credit cards

Product range:
- departments easy to locate
- product available in the size and colour required
- good selection/variation of fashion items
- value for money

Speed of transaction:
- speedy, accurate purchases
- no long queues
- only one signature of authorization required

Staff availability:
- adequate staffing at peak trading times
- clearly visible staff to provide help
- staff with a pride in their appearance and sales performance
- no huddles of staff, talking or on the telephone

Staff service:
- complaints handled seriously and followed through to a satisfactory conclusion
- staff knowledgeable about products and alternatives
- genuine interest and attention to customer needs
- patience and courtesy shown at all times, especially when under pressure
- staff able to locate products and provide in-store directions
- staff provide careful and detailed advice
- acknowledge regular customers as special people
- respect customers as normal individuals

of Jan Carlzon (1987) in initiating the idea of employee empowerment to emphasize the role of employees in achieving customer focus, and sees empowerment as a means of facilitating commitment to corporate goals and recognition of the importance of both satisfied customers and motivated employees. To implement the strategy he intends to follow Carlzon by delegating decision-making to the point of responsibility by eliminating hierarchical tiers of authority, and allowing direct and speedy response to customer needs, and decentralizing management to make the best use of the creative energy of the workforce.

Since the W.J. Harvey division is apparently in need of the more urgent action the new approach will be implemented there first, and if successful then used in the R.S. Harris division too. First, he

CASE STUDY (cont.)

changes the mission statement of the group to reflect a shift in focus away from profitability and towards a customer focus. 'Customer satisfaction' is to be the new buzz-phrase, supported by a new responsive, friendly attitude to customers which is both helpful and genuinely respectful. Success will be measured by customer satisfaction and the degree to which customers return to make repeat purchases. To make the new initiative work the staff on the shop floor will be 'empowered' so that they have the authority to make immediate decisions without recourse to middle management. A new slogan, 'It's up to you', will be introduced to motivate sales staff to take the initiative in sales transactions. They will then be able to be 'responsive' to customer requirements and to ensure that they leave W.J. Harvey happy with their shopping experience.

The initiative was implemented in January 2000, with an immediate impact on the financial results as indicated below in the six months' figures to June 2000:

	Actual	Target
Sales revenue (£m)	1,950.0	2,000.0
Profit before tax (£m)	35.0	60.0
Profit margin (%)	1.8	3.0

Sales are almost on target, up 7.5% on the previous half-year, but profits have collapsed and the profit margin has slumped to a disastrous 1.8%. Clayton Watts orders an immediate investigation of the causes underlying this poor performance, with the focus on the way the 'It's up to you' policy has operated at sales floor level. The outcome is a devastating insight into the way employee empowerment has been implemented at W.J. Harvey:

- When staff on the sales floor have been reluctant to make a decision, and have appealed to middle management, the latter have retorted 'It's up to you' and failed to provide the necessary guidance.
- Sales staff have frequently become involved in bartering, allowing customers to negotiate generous discounts on the ticketed price of an item, in the belief that this is consistent with the 'customer satisfaction' objective.
- Staff have operated a generous refund policy on goods returned as apparently soiled or damaged. Even where there has been doubt about the cause of the damage, and the goods have been in the possession of the customer for up to three years, a full cash refund has been provided.
- Staff have operated a generous exchange policy too, for goods that customers believe not to have worn well, or to which they take a dislike. The abuse of the exchange policy has been most

CASE STUDY (cont.)

apparent in fashion departments where shoes have been replaced as they wear out, and dresses have been replaced after one or two wears. The sales staff perceive that they have been led to believe that such action is consistent with the new 'customer-friendly' policy.

- Sales staff are in the habit of complying with the requests of customers, however outrageous, once such customers start making a fuss or attract the attention of other shoppers with a raised voice.
- Generous policies have provided virtually a 'shoplifters' charter'. Thieves remove items from the shelves, abuse them (e.g., dirtying or pulling threads on fashion items) and take them for immediate refunds without even removing the goods from the store.

Clayton Watts knows that he must act quickly, if he is to save his own job and if he is to produce a satisfactory set of year-end figures for 2000. Employee empowerment has clearly been a complete failure which must be abandoned, and a new policy adopted in its place. Not being one for compromise, Clayton decides to change the whole complexion of the business. A new 'mission' statement will be drafted in which references to 'customer satisfaction' will be absent. Instead the focus will revert to short-term profitability in terms of the 'achievement of world best practice which creates shareholder value'.

To ensure the achievement of the new objective he implements two new strategies:

- Swingeing staff cuts. He eliminates a whole level of middle management, amalgamates the management and administrative functions of branches located in the same town, closes some small stores and cuts the sales staff by 20% across the board. Any undermanning on the sales floor will be covered by management at all levels; all must be prepared to be visible and facilitate sales.
- A strict policy of standard operating procedures for sales staff. Gone are the days of discretionary decision-making; in their place are rigid guidelines to control both exchanges and refunds (e.g., receipts must be produced) and the way in which sales staff react with customers. Rigid service standards are implemented which involve staff being scripted as to the form of words they can employ and the actions they can take.
- Both strategies are unpopular on the sales floor, and staff morale sinks to an all-time low. Skilled sales staff in the fashion areas are particularly aggrieved; they are commission-driven and are able to handle sales to up to six different customers simultaneously through their own personal approach. But Clayton Watts points to the bottom line; his actions have saved his skin and returned W.J. Harvey to respectability:

CASE STUDY (cont.)

	2000 (1st half-year)	2000 (2nd half-year)	2000
Sales revenue (£m)	1,950.0	1,570.0	3,520.0
Profit before tax (£m)	35.0	60.0	95.0
Profit margin (%)	1.8	3.8	2.7
Selling area (sq. m.)	992,442	864,212	
No. of employees	33,257	23,744	

The results of the previous year have put all thoughts of extending the employee empowerment experiment to R.S. Harris out of his mind. But he does have some lingering doubts that had he done things differently the new initiative might have been successful. It is possible that he could make R.S. Harris even more successful than it already is.

We are required to identify the weaknesses in Clayton Watts' approach to the implementation of employee empowerment, and suggest what he might do differently were he to extend the initiative to R.S. Harris.

CASE ANALYSIS

The financial numbers for 1999 highlight the need for action at Harvey-Harris and pinpoint the W.J. Harvey stores as the major problem area. Table 7.11 details performance trends for the two sides of the business over the last five years. Sales per store are in decline for W.J. Harvey, where most alarmingly profit margin is only 2.6% and profit per square metre £82 (both figures a third of that achieved by R.S. Harris). Profit per employee, at £2947, lags way behind the Harris equivalent too. Neither store is performing outstandingly relative to retail industry benchmarks.

The adoption of employee empowerment may or may not be the best way to correct the imbalance; what is not in doubt is that the manner of its implementation has not given empowerment the chance to work. If Clayton Watts had given more thought and carried out research into the joint introduction of standard operating procedures and employee empowerment, then the dual management techniques could have provided excellent financial results while also uniting management and the sales force. There has been no consideration, for example, of whether the empowerment programme should be implemented differently in departments of the store responsible for 'food' and 'fashions'. Nor have the management controls been thought through, together with the associated implications for the management accounting and internal audit functions.

The fundamental weakness of the approach adopted is that the sales force have been empowered (i.e., given their freedom) without any corresponding establishment of ground rules for the implementation of this empowerment. If standard operating procedures had been documented in the first place then everyone would have

CASE STUDY (cont.)

TABLE 7.11

Harvey-Harris performance ratios

	1999	1998	1997	1996	1995
W.J. HARVEY					
Sales per store (£m.)	46.5	47.1	47.5	47.8	48.0
Sales per sq.m. (£000)	3.7	3.8	3.8	3.9	3.9
Sales per employee (£000)	111.8	113.2	114.0	114.9	115.3
Profit margin (%) (Overall)	2.6	2.8	2.9	3.0	3.0
Profit margin (%) Food	2.2	2.5	2.8	2.8	2.9
Profit margin (%) Non-Food	2.7	2.8	2.9	3.0	3.0
Return on inventory (%) Food	12.9	15.5	17.9	18.5	20.0
Return on inventory (%) Non-Food	17.4	17.6	18.1	20.6	23.4
Return on assets (%)	9.0	10.0	10.2	10.8	10.9
Profit per store (£m.)	1.2	1.3	1.4	1.4	1.4
Profit per sq. m (£)	82.2	106.9	110.7	115.6	116.7
Profit per employee (£)	2946.7	3184.3	3295.4	3443.8	3474.5
R.S. HARRIS					
Sales per store (£m.)	16.1	15.8	15.5	14.7	14.0
Sales per sq. m. (£000)	3.0	3.0	2.9	2.8	2.6
Sales per employee (£000)	87.1	85.3	83.7	79.6	75.5
Profit margin (%)	8.3	8.2	8.4	8.3	7.8
Return on inventory (%)	33.6	30.9	30.0	27.1	25.0
Return on assets (%)	28.8	27.5	26.4	23.5	20.3
Profit per store (£m.)	1.3	1.3	1.3	1.2	1.1
Profit per sq. m (£)	253.8	245.5	245.7	231.3	205.5
Profit per employee (£)	7256.4	6955.8	7027.0	6647.7	5893.9

understood the real objectives of the operation – ‘to make a profit by satisfying customer needs’.

As it is, Clayton Watts’ initiative is perceived to be a radical one by the sales force and they have responded likewise – by making radical business decisions. An apparently extreme business philosophy is matched by extreme business practice. Had the standard operating procedures been in place prior to the adoption of empowerment, then sales staff would have been able to improve service levels without giving away profits. Such a policy would have avoided the necessity of the draconian steps taken to reverse the chaos, notably the ‘scripting’ of staff for all transactions.

Should the new techniques be extended to R.S. Harris, then a number of pre-implementation steps are essential, if employee empowerment is to be given the chance to work:

1 Introduce a mission statement with the emphasis on ‘profit through service’.

CASE STUDY (cont.)

2 Introduce standard operating procedures, which would embrace at least service standards, an exchange and refunds policy, and merchandise selection and presentation. These would be modelled on the information gathered through customer surveys and detailed in Table 7.10.
3 Ensure that everyone knows their goals and limitations before empowering.

Follow-up work after implementation should include monitoring by further customer surveys and confidential staff surveys at two-month intervals. Deficiencies can then be corrected before the consequences are too serious, and Clayton can gauge levels of customer satisfaction and staff commitment.

If the strategy is successful R.S. Harris will benefit from improved financials and an upward shift of staff morale.

Borthwick Construction : A case study of dysfunctional bonus schemes

Borthwick Construction is a UK company based in Wolverhampton which is providing construction and building materials within the industrial West Midlands. It has a divisional structure, with each of the five divisions making a significant contribution to group profits, as follows:

	Builders' Materials	Corrugated Board	Plastics	Roofing	Glass
Contribution to group profits	15%	20%	35%	17%	13%
Bonus-related profit target	10%	15%	20%	12%	10%

The performance of each division is measured by reference to the profits it generates relative to its asset base. The bonus element of the divisional managers' compensation packages is highly geared to the achievement of a target profits/net assets performance ratio. Senior managers within each division receive bonuses which are a fixed percentage of that awarded to the divisional manager. For bonus calculation purposes, profit is defined as the annual trading profit, excluding any extraordinary items, and net assets are defined as the net book value of assets at the year end after netting off both cash and overdraft:

$$\text{Net assets} = [\text{Fixed assets} + (\text{Current assets } \textit{less} \text{ Cash})] - [\text{Long-term liabilities} + (\text{Current liabilities} - \text{Overdraft})].$$

Cedric Black is head of the Plastics Division; his division consistently provides the lion's share of group profitability but

CASE STUDY (cont.)

the nature of the business requires investment in expensive high-technology equipment, increasing the value of the asset base. He feels that he is being doubly penalized by being asked to achieve a target profit ratio significantly larger than any other division in order to earn his annual bonus.

The Divisional Management Accountant (Antonia Bracken) has alerted Cedric to the likelihood of the 2004 target not being achievable. Bracken forecasts that at 30 June 2004 trading profit will be £350,000 while net assets employed at the year end will be £1.8m, resulting in a profit ratio of 19.4%, marginally below the 20% target for earning performance-related bonuses.

Cedric calls on his function managers – Bob Forrest (sales and marketing), Peter Dobson (production), and Dorothy Marsden (personnel) – together with Bracken, to come up with proposals which might avert a personal financial reversal.

Antonia Bracken highlights the reason for the shortfall: investment in new equipment essential for the division to remain competitive, at a cost of £250,000. This equipment will allow the Division to produce a range of products recently released by its competitors, and is expected to result in additional sales of £150,000 per year over each of the next 10 years. Variable manufacturing costs are approximately 40% of sales, and it will cost the Division an additional £5000 to install the machinery. The equipment will be depreciated on a straight-line basis, and it is estimated to have a salvage value of £10,000 at the end of its useful life. Borthwick's weighted average cost of capital is 10% and the company tax rate 30%. Bracken suggests that the simple solution to achieve the required 20% profit target would be to defer the £255,000 expenditure to the next financial year.

Dorothy Marsden is unwilling to endanger the long-term competitiveness of the Division and suggests a safer alternative, as long as the Division is prepared to bite the bullet by retrenching a few workers. She proposes to close down the small, but profitable, Biddulph plant with a loss of 25 jobs. This move would incur a disengagement payout approaching £50,000 and would reduce divisional profits by £10,000 per year. On the other hand, the sale of the plant would immediately raise £250,000 while reducing the book value of assets by £200,000.

Bob Forrest is amazed that such draconian measures are even being contemplated. He suggests that a simple manipulation of creditors would provide an appropriate solution. Plastics Division owes £100,000 to Jones Brothers, a small independent manufacturer and long-standing supplier. There are plenty of alternative suppliers and Jones cannot afford to lose Plastics' business. They are vulnerable to exploitation and Forrest suggests that payment of the debt be deferred from 14 June to 2 July. A £5000 late-payment penalty would result and Jones would likely have problems meeting their own creditors. But that was not Plastics' problem!

CASE STUDY (cont.)

Peter Dobson is unhappy with the unnecessary £5000 late-payment pay-out and suggests a time-shift in the opposite direction, by bringing forward customer receipts. He suggests that by introducing an extra shift, additional overtime working and cutting a few corners, he can complete the Vertex project four weeks ahead of schedule (20 June instead of 18 July). Quality might suffer a little as a result, but the customer could then be invoiced in June, increasing profits by £20,000, at a cost of only £2500 resulting from penalty production rates.

Cedric is encouraged by the ingenuity and creativity of his executive team, but requires guidance in choosing the most appropriate of the alternatives. After all, there is no point in implementing all of the policies. He is rewarded for beating target, not for beating target by 10%, and he does not wish to alert the group executive to the flexibility of his accounting procedures. Any one of the suggested alternatives will satisfy his immediate requirements, but each has different implications.

We are required to consider the relative merits of each of the proposals and to discuss any ethical issues that might be apparent. It is possible that we may be able to recommend to Cedric one alternative that is superior to the others, given the financial and behavioural implications. From an organization-wide perspective it is also clear that Borthwick Construction is in need of a new bonus scheme, and we need to explore the possibilities for an improved scheme.

CASE ANALYSIS

This case addresses the ethical issues that are raised when performance bonuses are awarded on the basis of accounting numbers. In the absence of self-control, or executive controls, bonus recipients are placed in a position where their decision-making is capable of distorting the intentions of the scheme for their own advantage.

The case provides the opportunity to discuss the potentially dysfunctional impact of such decisions on shareholders, employees and the community, when financial benefit to bonus recipients is apparently the only consideration. Corporate malpractice, ethical and unprofessional behaviour, provide a background in which alternative bonus schemes, of potentially long-term benefit to the organization and its stakeholders, might be explored.

Evaluation of the current situation reveals the extent of the problem as Cedric Black views it. The profitability ratio must exceed 20% in order for bonuses to be earned, but current projections from Antonia Bracken, Divisional Management Accountant, show

$$\text{Profitability} = \frac{\text{Trading profit}}{\text{Net assets employed}} = \frac{£350{,}000}{£1.8\text{m}} = 19.4\%.$$

CASE STUDY (cont.)

For the 20% barrier to be exceeded the profitability ratio must be 'modified' – either by increasing the numerator, or reducing the denominator, or both. Black's colleagues have come up with schemes which accomplish this, with the desired outcome, but with different emphases.

Antonia Bracken suggests a deferral of the proposed £255,000 investment in order to reduce the size of net assets employed:

$$\text{Profitability} = \frac{\text{Forecast trading profit}}{\text{Net assets} - \text{Deferred capital expenditure}}$$
$$= \frac{£350,000}{£1.8\text{m} - £255,000} = \frac{£350,000}{£1,545,000} = 22.65\%.$$

This measure satisfies the bonus conditions, but at what cost to the company?

The new investment yields a positive cash flow of £150,000 ∞ (1 – 0.4) ∞ (1 – 0.3) = £63,000 each year. With a projected life of 10 years and a cost of capital of 10% p.a., the present value (PV) of the proposed investment (including an allowance for salvage value) is

$$\text{PV} = (63,000 \times 6.1445) + (10,000 \times 0.386) = £390,964.$$

This figure is well in excess of the initial outlay, giving an NPV which is clearly positive and of long-term benefit to Borthwick Construction. The investment is essential to remain competitive, as Borthwick's competitors have released new product lines to the market. A delay in purchasing the new equipment (and consequent delay in offering competitive products) will enable these competitors to strengthen their market position. Such a delay may result in the proposed economic return of £135,964 (i.e., £390,964 less £255,000) becoming an opportunity cost greater than £135,964 through loss of market share. This investment may be even more profitable than stated, since interest and depreciation expense should be reduced if the equipment is not purchased, but such adjustments are assumed to be minimal.

Dorothy Marsden's suggested closure of the Biddulph plant would reduce the book value of the assets by £200,000 and divisional profits by £10,000 per year. The impact on the following year is:

$$\text{Profitability} = \frac{\text{Forecast trading profit}}{\text{Net assets} - \text{Book value of disposed assets}}$$
$$= \frac{£350,000 - £10,000}{£1.8\text{m} - £200,000} = \frac{£340,000}{£1.6\text{m}} = 21.25\%.$$

This figure would be even greater were the sale of the assets (£250,000) and retrenchment costs (£50,000) to be included in trading profit (i.e., profitability = £540,000/£1.6m = 33.75%). But it

CASE STUDY (cont.)

is likely that both of these items would be treated as extraordinary and not included in the profitability calculations for performance bonus purposes. However, the Biddulph plant is profitable (the PV of accumulated losses is £100,000 at 10% p.a. cost of capital) and its closure would be harmful to the company, its customers and employees. The adjustment nevertheless satisfies the bonus requirement, and might be justified on economic grounds, since the return on assets from the Biddulph plant (only 5%, based on annual returns of £10,000 from an asset base of £200,000) are well below the 20% target expected of the Division.

Bob Forrest's 18-day deferment of payment to a trade creditor will reduce net assets by £100,000 but cause the company to incur of a £5000 late-payment penalty.

$$\text{Profitability} = \frac{\text{Forecast trading profit} - \text{Late payment penalty}}{\text{Net assets} - \text{Increase in cash} - \text{Increase in accounts payable (due to penalty)}}$$

$$= \frac{£350{,}000 - £5000}{£1.8\text{m} - £100{,}000 - £5000} = \frac{£345{,}000}{£1{,}695{,}000} = 20.29\%.$$

The deferment is of no long-term benefit to the company and might even jeopardize a long-standing trading relationship if Jones' existence is threatened by the action. The company could earn interest on the deferred amount of £100,000 for an 18-day period, but at realistic rates the interest accrued would be nowhere near £5000.

Peter Dobson's solution is simpler, involving the expedition of the Vertex project. Early completion will increase profits by £20,000 and incur penalty production rates of only £2500.

$$\text{Profitability} = \frac{\text{Forecast profit} + \text{Increase in profit} - \text{Penalty charges}}{\text{Net assets} + \text{Increase in accounts receivable} - \text{Penalty charge}}$$

$$= \frac{£350{,}000 + £20{,}000 - £2500}{£1.8\text{m} + £\,20{,}000 - £2500} = \frac{£367{,}500}{£1{,}817{,}500} = 20.22\%.$$

The bonus requirement is again satisfied, but with an unnecessary reduction in profit margins resulting from the additional overtime working. Of even greater consequence is the potential long-term impact on customer perceptions and repeat orders resulting from reduced product quality and 'cut corners'. Vertex may appreciate the prompt delivery but have reservations later on if the order is unfit for purpose because of the number of defective items that are subsequently rejected.

Each of the four alternative forms of action is consistent with Cedric Black's guidelines. They correspond with our expectations of management manipulation practices, from the income smoothing literature, that is, where a lower bound for the award of bonuses exists we would anticipate upward manipulation, where feasible, to ensure that the bonus measure just crosses the line. In the

CASE STUDY (cont.)

Borthwick case crossing the line is all that is required – even a 21% return might be considered excessive! If a different bonus scheme was in operation, with rewards proportional to returns once the lower bound was exceeded, we might anticipate bonus-motivated management manipulation on an even greater scale. The danger of this course of action would be an increased likelihood of detection by group internal auditors.

Changes in the bonus scheme are an essential requirement in order to generate a 'profit ratio' whose achievement is more consistent with the goals of the company, and less easily manipulated by the Plastics Division. However, the attitude of the co-conspirators to this action (Bracken, Forrest, Dobson, and Black himself) is of much greater concern and must be addressed immediately. None of the four proposals is in any way justified if their purpose is solely to satisfy the requirements of the bonus recipients; the actions are unethical, and, in the case of Bracken, the management accountant, unprofessional too, since she will be breaching the accounting bodies' ethical codes. However, the actions might be justified, for other than bonus-earning reasons, if they were seen to be of benefit to the organization rather than individuals: for example, Dobson's proposal (the advance shipment of product) will increase short-term profit, and is the only proposal to do so; if it could be argued that this increase was of benefit to shareholders, through an increased share price, then it might be justified, despite its likely detrimental impact on long-term quality. Similarly, Marsden's proposal to close the Biddulph plant could be supported on purely financial grounds; the return on investment at Biddulph is a miserable 5%, and closure and reinvestment to yield 25% (i.e., £40,000 p.a.) would be of benefit to shareholders. However, no such arguments for financial benefit can be attributed to Bracken's and Forrest's proposals.

It is possible that Black's motivation to manipulate is partly driven by his view that the Plastics Division is disadvantaged relative to the other divisions. Plastics contributes 35% of group profits – more than double the contribution of all the other divisions, apart from Corrugated Board – and its profit target is correspondingly higher at 20%. Group action is necessary, in consultation with divisional managers, to determine a target structure which is deemed to be equitable. Modifications at this level, which benefit the Plastics Division, may reduce the need for accounting manipulation in the future.

Alternative bonus schemes

Bonus plans which are based on accounting numbers are open to manipulation by management who seek to maximize the possibility of achieving a bonus. The plan operated by Borthwick Construction appears to be particularly vulnerable for a number of reasons:

- It seems inequitable. The trading profit is divided by net assets to take account of the size of the division and the return on the

CASE STUDY (cont.)

investment. If net assets are an appropriate measure of size of the division the target ratio for each division should be the same, but this is not the case. The Plastics Division has the highest ratio of all the divisions, and the feeling that this is unfair may provide an incentive to manipulate the plan. This difference in ratios should be investigated to see if there is some valid reason for the different levels and whether this needs to be explained to the various divisions.

In addition, there may be a problem with using net assets as a guide to the size of division as some divisions may be asset-intensive. If Black is correct when he says that the Plastics Division is asset-intensive then it would appear that Plastics is being doubly penalized by having to achieve a higher target ratio as well as requiring larger values of net assets. The target ratio may, therefore, be unrealistically high and in need of investigation to determine whether it is appropriate.

- It is not progressive. As a result managers have no incentive to earn anything above the target level.
- Decision-making power is highly concentrated in those persons who are able to earn the bonus. It would be advisable to implement a system whereby an independent arbiter, such as Borthwick Construction's group accountant, is involved with each division of the organization to oversee the decision-making and achievement of the target ratio.
- There appears to be no consideration of non-financial factors in the bonus scheme. These might be equally important to the long-term survival of the company. These factors might be more difficult to measure, but their inclusion in the bonus scheme might make exploitation of the system more difficult, though on the down side they could encourage dysfunctional behaviour of a different manner!

A number of alternative bonus schemes are worth considering, which would eliminate some of the manipulation opportunities, correct some of the inequities of the present scheme and help in the pursuit of long-term objectives:

Alternative 1: Better use of the accounting numbers. Change the basis for profit distribution to one paid on the attainment of a specified sterling amount of profit for each division; this amount to be determined based on previous years' profit and general economic conditions. Provisions should be added to the scheme so that profits made above the specified levels are further rewarded. This will alleviate the possible inequities in the current bonus system because the allocation will no longer be dependent on the net assets employed by the division. In addition, increasing the bonus for attaining higher profits than necessary provides an incentive for

CASE STUDY (cont.)

the managers to maximize their profits. A switch from return on investment to residual income might be another approach, but there may still be problems with these alternatives because there is no change to the existing focus on short-term profit. The managers are still in a position to manipulate the accounting information and their objective will be to maximize their own rewards.

Alternative 2: A longer-term focus. Reward the divisional managers with shares, or stock options, in the company, instead of cash; the more profit made, the greater the number of shares. This could also be implemented so that the attainment of long-term profit targets is rewarded in a similar manner. Rewarding the managers with shares will encourage them to look at the long-term effects of their decisions on the profitability of the company. They will also want to make as much profit as possible, in order to obtain a larger number of shares. There is still the problem of perceived inequities if the basis for the bonus allocation stays the same. Attention to the terms of issue of the stock options must ensure that a long-term focus is preserved, otherwise the temptation to influence short-term profits remains: an increasing share value will facilitate disposals if the terms of issue so permit. Also, the managers may choose to sell the shares, in which case they will be focusing on short-term profits in order to maximize the price they can sell the shares for.

Alternative 3: A company-wide focus. Reward all divisional managers based on the price of the shares in the company; bonuses to be paid for increases in the value of the shares. Managers can be given the option to buy shares at a bargain price; the more the share is worth, the more valuable is this option. This alternative means that all divisional managers will be rewarded the same amount. If the price of shares increases, the bonus is paid; if the price stays the same or goes down, the bonus is not paid. This encourages the divisions to work together to achieve a common goal. The bonus can be made dependent on continued improvement in the price of the shares over a number of years. For example, performance over a five-year period might be rewarded to provide a focus on long-term profitability.

Alternative 4: A non-financial approach. A similar alternative would provide ‘salary packaging’ for the divisional managers in that they would be rewarded for increases in the value of the shares, but be able to select the way in which they are to be rewarded from a list of possible benefits (e.g., savings and superannuation plans, life insurance, travel expenses, extended or flexible holiday options or a company car). This allows the managers to choose the way in which they are to be compensated and the managers may be more

CASE STUDY (cont.)

motivated to increase the value of the shares because the reward is something that is highly valued by them. This option may increase morale and loyalty towards the company because it allows the divisional managers a considerable amount of autonomy over their own salary packages.

The challenge to Borthwick in rewarding executive performance is achieving an appropriate balance of short- and long-term incentives. Managers need some sort of ownership if their interests are to be aligned with those of shareholders, and stock options may help to provide such a motivation. If 'short-termism' is to be avoided, then stock options may help in this regard too. To reduce the incidence of dysfunctional activities the corporate culture must change; higher levels of monitoring and increased training in professional ethics may both be required in the short term.

SUMMARY

This chapter focuses on 'people' aspects – and in particular the 'internal' and 'external' customers of organizations. We begin by looking at TQM implementation as a group-based means of inspiring a customer-based philosophy throughout the company, and then progress to look at the control measures we might employ to ensure that our 'internal' customers are not performing in a dysfunctional manner. The chapter concludes with reference to reward structures, and the opportunities for manipulation when accounting numbers are involved.