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Using Financial Results Controls in the Presence of Uncontrollable Factors

Chapter 12

MANAGEMENT CONTROL SYSTEM

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MANAGEMENT CONTROL SYSTEM

Section IV

Performance Measurement Issues and Their Effects

- 10 Financial Performance Measures and Their Effects
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MANAGEMENT CONTROL SYSTEM

Chapter 12

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INTRODUCTION

Financial Crisis 2008-2009

- The effects of unpredictable and uncontrollable events have occurred everywhere (the **pandemic** of 2020-2021 was more **uncontrollable**)
- causing widespread **volatility** and wreaking havoc on:
 - strategic,
 - decision, dan
 - Business plans

INTRODUCTION

Natural disasters – effects:

- Closure of most airspace in Europe for several days in mid-April 2010
 - Fears that ash from Iceland's Eyjafjallajokull volcano could damage aircraft engines are also spreading far and wide, like ash, to affect a wide range of economies, sectors, and businesses.
 - Airplanes are punished, which greatly disrupts business not only in the aviation industry, but also in tourism, shipping, supplies, and so on
- Came the explosion of the Macondo oil well in the Gulf of Mexico
 - also known as BP or Deepwater Horizon oil spill, and
 - a temporary offshore drilling moratorium imposed accordingly.
 - severely impacted not only BP, but also the entire oil industry and related sectors as the knock-on effects became apparent.

INTRODUCTION

Natural disasters – effects:

- March 2011, Fukushima nuclear disaster in Japan
 - caused Germany to shut down its nuclear reactors,
 - cast a dark cloud over the future of Japan's nuclear fuel industry
- October 2012, Hurricane Sandy, the deadliest and most destructive hurricane of the Atlantic hurricane season at the time, and the second costliest hurricane in U.S. history,
 - disrupt business,
 - Leaving Insurance Companies and Insurers Back with Bills Over \$25 Billion

INTRODUCTION

Natural disasters – effects:

- In July 2014, still reeling from the loss of flight MH370 in March, Malaysia Airlines received news of another flight, MH17, crashing in Ukraine.
 - Two unprecedented accidents of the same airline in a span of four months - tragedies by no comparison.
 - Malaysia Airlines is still flying but struggling to **survive** because,
 - Despite the mistake, the customer left the airline.

INTRODUCTION

Natural disasters – effects:

- The Ebola outbreak in West Africa in the summer of 2014, which was not contained (in planning) until the end of 2015,
 - Hitting many African economies
 - Where they are most vulnerable - the tourism industry -
 - as travelers reconsider travel to popular destinations far away from Ebola-stricken countries, such as Kenya and South Africa.

INTRODUCTION

Natural disasters – effects:

- oil prices fell by more than a third in 2015
 - extended the decline by more than half in 2014,
 - change almost any economic plan and any business dependent on oil in a nontrivial way.

INTRODUCTION

Natural disasters – effects:

- The list of disasters goes on.
- Business is full of things that uncontrollable;
- events that cannot be remedied in advance with reasonable confidence or accuracy in terms of likelihood, timing, impact, or magnitude.

THE CONTROLLABILITY PRINCIPLE

The controllability **principle**:

- people should held accountable only for what they control.
 - Employees should not be penalized for bad luck or given extra rewards for good luck.
 - Many important result measures are only partially uncontrollable.

THE CONTROLLABILITY PRINCIPLE (CONT'D)

- When employees are hold **accountable** for uncontrollable factors,
 - the organization bears the costs of doing so
 - because the vast majority of employees are risk averse.
- Employees like their performance-
 - dependent rewards to stem directly from their efforts and
 - not be affected by the vagaries of uncontrollables

THE CONTROLLABILITY PRINCIPLE (CONT'D)

Risk aversion

- is the basis for the primary argument supporting the controllability **principle**.
- Owners are risk neutral because they can diversify their portfolios through elaborate financial markets set up for exactly that purpose.
- The owners' rewards stem directly from the risk-bearing function they perform.

TYPES OF UNCONTROLLABLE FACTORS

Types of uncontrollable factors (by manager):

1. Economic and competitive factors.
2. Acts of nature
3. Interdependence

TYPES OF UNCONTROLLABLE FACTORS (CONT'D)

Types of factors - 1. Economic and competitiveness.

- Profit is affected by many factors that change and every other results measure can be affected by multiple, uncontrollable factors.
- Most evaluators do not buffer managers completely from changes in economic and competitive factors, although they might take steps to have the organization share some of the risk with the managers.

TYPES OF UNCONTROLLABLE FACTORS_(CONT'D)

Types of factors - 2. **Acts of nature:**

- These are large,
- unexpected,
- one-time,
- totally uncontrollable events, such as
 - hurricanes,
 - earthquakes,
 - floods.

TYPES OF UNCONTROLLABLE FACTORS (CONT'D)

Types of factors - 3. **Interdependence**

- It signifies that an organization's or an individual's area is not completely self-contained, and
- thus, the measured results are affected by others within the organization.
- Three types:
 1. Pooled interdependencies: where a firm's entities use common resources or resource pools. Low when entities are relatively self-contained.
 2. Sequential interdependencies: when the outputs of one entity are the inputs of another entity. High: vertically integrated firms.
 3. Reciprocal interdependencies: organizational entities both produce outputs used by other entities and use inputs from them.

TYPES OF UNCONTROLLABLE FACTORS (CONT'D)

Interventions from higher-level management:

- higher-level managers can force a decision on a lower-level manager and
- in so doing significantly affect a results measure linked to one or more forms of rewards

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES

Managers can reduce some of the distorting effects by either of both of two complementary **approaches**.

1. Before the measurement period begins, they can define the results measures to include only those items that employees can control or at least influence.
2. After the measurement period had ended, they can calculate and adjust for the effects of any remaining uncontrollable factors.

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **before** the measurement period:

- Purchasing insurance
- Design of responsibility structures:
 - hold employees accountable
 - for the performance areas you want them to pay attention to.

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Tabel 12,1: Income statement as controlable and uncontrolabel:

	\$
Sales	XXX
Less: variable costs	<u>(XXX)</u>
Sales margin	XXX
Less: controllable division expenses	<u>(XXX)</u>
Controllable profit	XXX
Less: non-controllable division expenses	(XXX)
Less: allocations of central expenses	(XXX)
NET PROFIT	<u>XXX</u>

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **after** the measurement period:

1. Analysis of variance
2. Flexible performance standards
3. Relative performance evaluation
4. Subjective performance evaluation

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **after** the measurement period - 1. **Analysis of variances**

- A technique developed to explain how and why two numbers are different.
- They are used to explain why actual results are different from predetermined standards, budgets or expectations.
- They have two purposes:
 1. Segregate some uncontrollable factors from the controllable factors causing actual results to be different from plan.
 2. Isolate certain controllable performance factors from others so that specific individuals can be held accountable for them.

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Tabel 12.2: Aplikasi analisis varian

Sales plan	Actual Ind. Vol.	Actual MS	Actual Price	Actual Ex. Rate
Expected industry volume (IV_B)	IV_A	IV_A	IV_A	IV_A
Planned market share (MS_B)	MS_B	MS_A	MS_A	MS_A
Planned price (local currency) (PLC_B)	PLC_B	PLC_B	PLC_A	PLC_A
Planned foreign exchange rate (FX_B)	FX_B	FX_B	FX_B	FX_A
	Ind. Vol. Variance	Market Share Variance	Sales Price Variance	Exchange Rate Variance

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **after** the measurement period - 2. **Standar kinerja yang fleksibel:**

- The performance that employees are expected to achieve given the actual conditions faced during the measurement period

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **after** the measurement period - 3. Evaluasi kinerja **relatif**:

- Employees' performances are evaluated not in terms of the absolute levels of the results they generate,
- but in terms of their results relative to each other or
- relative to those of their closest outside competitors

CONTROLLING FOR THE DISTORTING EFFECTS OF UNCONTROLLABLES (CONT'D)

Controlling for uncontrollables **after** the measurement period - 4.

Subjective performance evaluations:

- They take into consideration all the logic embodied in the objective methods of adjusting for uncontrollables.
- They can correct for flaws in the results measures.
- Popular with evaluators because they provide a significant source of power over their subordinates.
- However, it is likely to be biased and often leads to inadequate feedback about how performance was evaluated.
 - Employees often do not understand or trust them.
 - Subjective performance evaluations are expensive in management time.

OTHER UNCONTROLLABLE FACTOR ISSUES

Issues when considering adjustments for uncontrollables:

- The purpose for which adjustments are made.
- Direction of adjustments.
- Only protect employees from suffering from bad luck,
 - but not to protect the owners from paying out undeserved rewards for good luck.

CONCLUSION

- The principle of control holds employees accountable **only** for what they can **control**
- Its application is much problematic
 - Outcome measures are only partially uncontrollable, and estimating the degree of uncontrollability is often less than the exact science.
 - Organizations want employees to respond correctly to the many factors that influence those measures even if these factors are partially out of control.
- The principle of control or (principle of influence)
 - hold employees accountable for what they can reasonably influence
 - provides good general guidance.

CONCLUSION

- When decisions are made to protect employees from uncontrollable effects, each method of doing so is mutually overriding (*tradeoff*).
 - If adjustments are made after the performance period ends, some of the advantages of having fixed, predefined performance standards are lost.
 - Adjustments involving subjective judgments can create biases, inconsistencies, and challenges.
 - If complex procedures are implemented to deal with many types of factors that may go uncontrollable, simplicity is lost, increasing the likelihood that some employees will fail to understand what they are being asked to accomplish.
 - Despite its complexity, the stakes are high, as significant problems can arise if unchecked not handled properly.

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