CONTINGENCY THEORY AND MANAGEMENT CONTROL PACKAGES IN SMALL FIRMS: CASE EVIDENCE FROM INDIA.

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ABSTRACT

This paper aims to investigate the extent to which firm strategy influences the development of management control systems (MCS) in small businesses in India. It also aims to determine what the makeup of the typical small business MCS is. A case study approach is used. Three businesses are studied over six month period. Data is collected using interviews, observation and document review. We find that firm strategy is greatly influenced by the size and owners disposition to developing the business. MSC development is influenced by internal and external factors including strategy, technology, size and organisational culture with size and strategy being the most important factors. The MSC in turn influences strategy development and implementation and firm growth. This paper contributes to the growing body of knowledge on MCS development and contingency theory of management. It also makes a significant contribution to literature on MCS in small firms.

Keywords: Contingency; Management Control Systems; Strategy; SME; India.

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1. INTRODUCTION

Small businesses are the backbone of economies worldwide representing on average over 90% of the firms within democratic countries. The importance of studying small firms has long been recognised as they have been a catalyst for economic growth and creation of wealth (Motwani et al, 2006).

Global trends have suggested that small business is the biggest contributor to the economy in most countries. In India, the Ministry of Micro, Small and Medium Enterprise (MSME) in its 2011 annual report, estimates that this sector employs 59.7 million people spread over 26.1 million enterprises. It also estimates that in terms of value, MSME sector accounts for about 45% of the manufacturing output and around 40% of the total export of the country. This makes it a very important sector of the Indian Economy. (Ministry of MSME 2011)

While small businesses are vital to the economies of most countries, management accounting research has focused on larger businesses or their sub units (Luft and Shields 2003). Existing research which takes an organizational view of management control systems (MCS’s) mostly focuses on medium and large firms where formal systems have long been established and play a major role in structuring the organization and implementing strategy (Davila 2005).

The focus of this paper is the management controls in small businesses in India. The theoretical framework used is based on both the contingency theory of management accounting which sees the organisations strategy, aims and environment (both internal and external) impacting on the management accounting system development and consequently on the nature and quality of management controls developed; and the view of management control systems as a package which specifies the different constituents of a management control system. A case study approach is adopted which studies in depth three small firms in India who have recently adopted management controls.

2. THEORETICAL FRAMEWORK

The study will seek to examine the management controls in Indian SME’s using the MCS as a package theory and also the contingency approach to MCS development which a discussed briefly below.

2.1 MCS as a Package

Management control involves addressing the question: Are our employees likely to behave appropriately? The collection of control mechanisms that are used is generally referred to as a Management Control System (Merchant and Van der Stede 2007).

Malmi and Brown (2008) argue that term ‘package’ should be employed because in most contemporary organisations there are a number of MCS. If all those were designed and coordinated intentionally, we might call the whole system a MCS. However, the concept of a package points to the fact that different systems are often
introduced by different interest groups at different times, so the controls in their entirety should not be defined holistically as a single system, but instead as a package of systems. They further argue that in general, an MCS package is comprised of five types of controls: planning, cybernetic, reward and compensation, administrative and cultural controls.

Planning sets out the goals of the functional areas of the organisation thereby directing effort and behaviour; it also provides the standards to be achieved in relation to the goal, making clear the level of effort and behaviour expected; and it enables congruence by aligning goals across the functional areas of an organisation, thereby controlling the activities of groups and individuals (Flamholz et al 1985). Cybernetic control system consists of measures that enable quantification of an underlying phenomenon, activity or system; standards of performance or targets to be met; a feedback process that enables comparison of the outcome of the activities with the standard; a variance analysis arising from the feedback; and the ability to modify the system’s behaviour or underlying activities (Green and Welsh, 1988). Reward and compensation controls focus on motivating and increasing the performance of individuals and groups through attaching rewards to control effort direction, effort duration, and effort intensity. Administrative controls direct employee behaviour through the organizing of individuals, the monitoring of behaviour and who employees are made accountable to for their behaviour; and through the process of specifying how tasks or behaviours are to be performed or not performed (Simons, 1987). Cultural controls are the values, beliefs and social norms which are established influence employees behaviour.

2.2 Management Control and Strategy

The contingency theory of management accounting has been around for quite a while and is based on the premise that there is no universally appropriate accounting system for all organisations in all circumstances (Emmanuel et al. 2004). This means that efficient organisational accounting and control systems will vary with organisational contextual factors such as strategy, technology and environment (Waterhouse and Tiessen 1978). The development of contingency theory may be viewed in terms of its historical evolution, the approach that was taken by Reid and Smith (2000). An alternative representation, which runs in terms of an analytical cross-tabulation of authors’ contributions to the subject is provided in Emmanuel et al. (2004, ch. 2).

Under a contingency view, it has been proposed that accounting control systems should be designed specifically to suit the business strategy of the firm (Otley, 1980). Recent work of Gerdin (2005) finds some support for the notion that organizations adapt their Management Accounting System design to the control requirements of their contextual situation while Cadez and Guilding (2008) findings support contingency theory’s tenet of no universally appropriate Management Accounting system, with factors such as company size and strategy having a significant bearing on the successful application of Management Accounting Systems.

There are different ways of classifying firms and the strategies adopted by them. For this study, we have adopted the classifications in Porter (1980) and Miles et al. (1978).
Porter (1980, 1985) describes three generic strategies – cost leadership, differentiation and focus strategies. Each of these strategies provides a basis for sustainable competitive advantage in an industry and defines the context of the internal operations of the firm including its control system. Cost leadership strategies usually entail low price, high market share focus, standardized product, economies of scale and tight cost control. Differentiation strategies entail product uniqueness leading to brand loyalty, emphasis on marketing and research and a focus strategy entails focus on defined buyer group, product line or geographic market.

Miles et al. (1978) describe four organisational types by the strategies they adopt – defender, prospector, analyzer and reactor. The first three types are successful while the reactor is usually unsuccessful. Defender are usually characterised by stable environment, limited product range, competes through low cost or high quality, efficiency paramount, centralized structure. Prospector are characterised by always seeking new product and market opportunities, uncertain environment, flexible structure. Analyzers are hybrid and characterised by core of traditional products, entering new market after viability established, and matrix structure. Reactor firms lack coherent strategy, structures are usually inappropriate to purpose and they miss opportunities.

3. INTRODUCTION TO THE CASE STUDY

The purpose of this section is to introduce the case study. The three companies that are included in the study are briefly introduced and the data collection method on which the case study is based is described and the principles for data analysis are outlined.

3.1 Companies

Company A is a hire purchase firm which was founded in 1995 to meet the need for the financing of automobile purchases. Its initial capitalization was Rs 2 million and the intention was to grow the firm organically. Its stated objectives were to provide cheap short and long-term finance to the general public for the purchase of automobiles on which the loans were secured. The firm employs 30 staff, a planning and control manager, and a general manager and is headed by the founder and Chief Executive Officer (CEO). The general manager makes day to day operational decisions and communication with employees is kept informal.

Company B is an automobile dealer with six branches in India. It was founded in 1998 with an initial capital of Rs 5 million and the intention was to grow the business organically. It currently employs a total of 47 people in all its branches. The firm has a flat decentralised organisational structure with a lean head office staff. The branches are run by managers who report to a general manager at the head office who in turn reports to the founder / CEO. The head office provides administrative and treasury support to the branches.

Company C is a cloths retailer which was established in 2000 with initial capital of Rs 3.5 million and with the intention of growing the business organically but fast. It currently has 48 employees working in its 10 branches. The business with extremely
fast growing speed has 10 branches and currently employing 48 employees. The branches are run as independent units by managers who report to a general manager at the head office who in turn reports to the founder / CEO. The head office provides administrative and treasury support to the branches.

3.2 Data Collection and Analysis

Data collection was undertaken for approximately six months on average. Interviews with organizational participants; observation of operations and meetings and document reviews are the primary data source. People were interviewed from various organizational levels and functions. Interviews consisted of current employees and those who had already left the company. About 18–24 interviews were carried out in each company. Each interview took between one and a half to two and a half hours. Each was recorded and transcribed. The interviews were carried out in English. With respect to the observations of the meetings, written summaries and protocols were produced as documentation.

The methodology used in the analysis of data from interviews was inspired by Yin (1993) and Eisenhardt (1989). We coded the data in two stages. First, we coded the talks from the transcript made from the recording. This was done using a list of themes drawn up from our theoretical framework. We then verified the reliability of this transcription by recoding a sample of the interviews to check that the initial coding could be applied sufficiently objectively to the interviews so as not to introduce any bias into the processing of the answers. For the analysis of these qualitative data, we proceeded by reclassifying the words transcribed on the basis of their theoretical theme. The final results of our study were produced after data from all the phases in the investigation had been compared and crosschecked. Instead of promoting a particular category of data, we simultaneously addressed primary data collected during interviews and secondary data from internal documents.

4. DISCUSSION

This section reviews the strategies, environment and management control systems of the four companies studied.

4.1 Company A

The company operates in a market where there are many competitors and which is heavily regulated by the government. Competition is generally from established commercial banks and from other small finance houses which offer similar services.

Initially the company set its rates below those of its competitors to try and attract clients. At that time it did not have any formal Management controls and all decisions were taken centrally by the founder / CEO.

In 2006, the company took a decision to improve on the quality of its service delivery and efficiency of its operations. It employed a Planning and Control Manager who was responsible for setting up a quality management system. It also decentralised the decision making allowing staff to take decisions in their areas of responsibility.

In 2007 the company developed new loan products for purchase of four wheeler vehicles and also introduced some management controls like short term budgets,
monthly and quarterly income statements, quality improvement analysis, customer analysis and employee performance analysis. The findings from this company are summarized in Table 1 below:

Table 1. Summary of Findings Company A

<table>
<thead>
<tr>
<th>Types of control</th>
<th>Cybernetic controls</th>
<th>Quality improvement management system</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td>Preparation of short term budgets</td>
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<tr>
<td></td>
<td></td>
<td>Employee performance analysis</td>
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<tr>
<td>Planning controls</td>
<td>Goal and objectives of the business have been laid down</td>
<td></td>
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<tr>
<td></td>
<td>Strategic planning</td>
<td></td>
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<tr>
<td>Administrative Controls</td>
<td>Governance structure include formal lines of accountability</td>
<td></td>
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<tr>
<td></td>
<td>Policies and procedures laid down for the employees</td>
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</tbody>
</table>

| Business strategies | Prospector Focus | The business initially adopted a defender strategy. However, as the business grew, this was changed to a prospector strategy based on charging lower rates and developing new products |

<table>
<thead>
<tr>
<th>Business Environment</th>
<th>Competitors</th>
<th>New competitors emerging in the market as there are very few barriers to entry and exit and large margins to be obtained</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Government Regulations</td>
<td>Regulations on interest rates and future strict regulations may hinder</td>
</tr>
</tbody>
</table>

4.2 Company B

The company operates in a market where there are a large number of competitors providing same sort of products and services to the customers. Since products and services are similar, competition in this market is on price and quality of service delivery.

Initially, the firm set its prices lower than its competitors and sought to sustain these low prices by incurring minimum costs and being heavily reliant on the use of technology in its business processes. However, it did not have management controls in place at the time.
Management controls were developed over time with the aim of ensuring that the cost reduction strategies were working and that quality of service to the customers was monitored effectively. In 2007 the firm introduced a system they called the ‘Initiative-Plans-Resources method’ which emphasised to branch managers which operational aspects they were expected to spend their managerial time on and to apply their skills, and thus contribute to successful implementation of business strategy. As one of the managers stated ‘the Initiative Plans Resources is a fundamental element for the assessment of performance of individuals that are below me and at the same time, of myself’. The Initiative-plans-resources method showed some conceptual similarities with Balance Scorecard. It signalled areas with abnormal performance and promoted debate and learning among managers.

Management accounting reports, flexible budgets, investment appraisal, performance evaluation, technology survey teams and rewards to the managers were also introduced in 2007.

The findings from this company are summarized in Table 2 below:

Table 2. Summary of Findings Company B

<table>
<thead>
<tr>
<th>Types of control</th>
<th>Cybernetic controls</th>
<th>Initiative plan resources method, to improve the employee performance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Flexible budgets</td>
<td></td>
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<td></td>
<td>Financial controls including use of investment appraisal and evaluation techniques</td>
<td></td>
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<tr>
<td>Planning controls</td>
<td>Goals and objectives of the business have been laid down</td>
<td>Branches are integrated into planning process</td>
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<tr>
<td>Administrative Controls</td>
<td>Governance structures</td>
<td></td>
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<tr>
<td></td>
<td>Policies and procedures laid down for the employees</td>
<td></td>
</tr>
<tr>
<td>Rewards and compensation controls</td>
<td>Performance based rewards are given to managers and employees</td>
<td></td>
</tr>
<tr>
<td>Cultural controls</td>
<td>Project Teams</td>
<td></td>
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<td></td>
<td>Formal dress code for employees</td>
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<tr>
<td>Business strategies</td>
<td>Defender</td>
<td>Cost leadership and the use of technology to create competitive advantage</td>
</tr>
<tr>
<td></td>
<td>Cost leadership</td>
<td></td>
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</tbody>
</table>
4.3 Company C

The company operates in a very competitive market where there are no barriers to entry or exit. Initially the company kept its prices at par with its competitors as it was not seeking a large market share. At that stage the company did not use any formal management controls.

However, in 2003, the firm decided to increase its market share. It sought for and obtained additional capital from its promoter. Using the additional capital, it opened up 10 branches at the same time. Its new strategy called for it to mass produce its clothing products and offer them to customers at the lowest possible price while keeping its quality above that of its competitors. To do this it has relied heavily on the use of technology, new product development and the implementation of management controls which include financial management, quality management, performance management and cultural controls. The findings from this company are summarized in Table 3 below:

Table 3. Summary of Findings Company C

<table>
<thead>
<tr>
<th>Type of control</th>
<th>Cybernetic controls</th>
<th>Performance measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Planning controls</td>
<td>Planned structural changes in the business over a long time horizon</td>
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<tr>
<td></td>
<td>Goals and objectives of the business have been laid down</td>
<td></td>
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<tr>
<td></td>
<td>Branches integrated into the planning process.</td>
<td></td>
</tr>
<tr>
<td>Administrative Controls</td>
<td>Clearly defined organisational structure</td>
<td></td>
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<tr>
<td></td>
<td>Governance structure includes an active board which sets out the strategic direction of the organisation.</td>
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<tr>
<td></td>
<td>Policies and procedures are laid down for organisation members.</td>
<td></td>
</tr>
<tr>
<td>Rewards and compensation controls</td>
<td>Performance based rewards for management staff</td>
<td></td>
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</tbody>
</table>
Cultural controls
There is formal dress code to be followed by office employees
Weekly staff meetings

**Business Strategies**
Prospector
Cost leadership
Business initially adopted a defender strategy. However, with growth, a prospector strategy based on lower prices, improved quality and new product development is pursued.

**Business Environment**
Competitors
Several competitors offering similar services. No barriers to market entry and exit.

5. CONCLUSIONS

At inception, all the businesses started out as Defender type firms with no management controls. However, as the businesses grew and interacted with the different environmental factors both from within and without the firms, some of them moved from being Defender type firms to being Prospector type firms. All the firms also placed emphasis on cost control and leadership and on the quality of their products. They operated either a cost leadership or focus strategy.

Of the factors which affected the choice of strategy of the business, the size and owner disposition to developing the business in a particular manner were the major factors.

The development of management controls within the firms was influenced internal factors such as technology and firm size and organizational culture. It was also influenced by the strategy which the business adopted. By far the greatest influences were firm size and strategy. However, these influences were unidirectional as the management controls in place influenced strategy development and implementation, adoption and implementation of new technology and the growth and expansion of the firms.

When management controls were implemented, they were usually implemented as a package albeit not with all the defined elements of the package being present. Figure 1 below is a diagrammatic representation of our findings.
Our findings show that while management controls might be basic in small businesses they do exist and where they are used they usually are used as a package and their development and deployment are influenced by internal and external factors which include technology, size and strategy.

This research being exploratory has used a case study approach and it could be developed on further by conducting a large scale empirical study of small businesses.

REFERENCES


