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## THE ETHICS OF MANAGEMENT CONTROL SYSTEMS

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# THE ETHICS OF MANAGEMENT CONTROL SYSTEMS


## Abstract

In this paper we review the conventional analyses of management control systems, to conclude, first, that the "illusion of control" can mislead managers into believing that everything can be controlled and monitored, and, second, that no incentive system based only on extrinsic rewards can motivate individuals properly. Then, we investigate the philosophical foundations of the basic assumptions that, implicitly or explicitly, are made about the nature of the acting person. Based on personalist phenomenology, we show how the development of technical and moral values is crucial to the long-run survival of organizations. We end by offering some guidelines as to what control systems should be like in order to be compatible with the nature of human persons.



**Keywords:** business ethics, ethical foundations of organization, incentives, management control systems, values.

# THE ETHICS OF MANAGEMENT CONTROL SYSTEMS

The financial scandals of recent years have shocked society in general and the business community in particular. In the words of Osterloh and Frey (2003), there has been "double trouble with managerial behavior: exorbitant salaries and scandalous fraud." To some extent, it may even seem paradoxical that while executive salaries have been higher than ever, at the same time the cases of fraud have been even bigger and more scandalous.

The foreseeable conventional reactions to these phenomena include the demand for closer monitoring, stricter accounting and auditing rules, improvements in the professional competence of Board members, greater independence of Board members, heavier penalties for people caught in such wrongdoing, and so on.

Such measures may be partly necessary, but they are oversimplified solutions to what is a far more complex problem. We will argue, therefore, that while these conditions may be necessary, they are not sufficient. What actually is needed is a change in the way we think of human beings as members of organizations, in organizations' reward systems, in the motives that individuals have to participate, in the way organizations are managed from above, and in management values. An appropriate compensation system (not necessarily involving exorbitant salaries), a notion of purpose and mission, and the identification of the workforce with the organization's objectives are also vital, and may be sufficient to guarantee appropriate behavior.

The paper is conceptually divided in two parts. In the first part, we review the conventional analyses of management control systems, and the role of management in organizations, based on the assumptions of the economics of organizations. We will show how the "illusion of control" can mislead managers into believing that everything can be controlled and monitored, while in fact no incentive system based solely on extrinsic rewards can motivate individuals properly. In the second part, we will start by considering the nature of the acting person, and will attempt to investigate the philosophical foundations of the basic assumptions that, implicitly or explicitly, are made about the nature of human beings in the context of organizations. Borrowing from personalist phenomenology, we will show how the development of technical and moral values is crucial to the long-run survival of organizations. In the concluding section of the paper, we will offer some guidelines as to how control systems should be designed and used in order to be compatible with the nature of human beings.

## Can Anything be Done? Simplistic Solutions and Insufficient Conditions

Most people's reaction to the scandals has been one of mistrust in the institutions and procedures established to protect companies' assets. In a CNN/USA Today/Gallup poll in the US in 2002 it was found that only one in five people had much confidence in big

business, while four out of five said they had great confidence in the military. Big business and Wall Street ranked just above health maintenance organizations when people were asked how they viewed leading US institutions.

The reaction to the problems has often been based on a simplistic understanding of the process by which all this wrongdoing takes place. According to this view, if we would just assign the right people to oversee what is going on in corporations, if they had the right training and knowledge, if they were independent, if they were given the right information, and if there were severe punishments for any type of wrongdoing, then the problem would be resolved: more technical competence, more monitoring, more information, more independence, and more penalties should do the job.

Yet, those conditions may be difficult to fulfill. To begin with, people sitting on a Board of Directors may suspect that the company is engaged in wrongdoing without having any means of knowing for sure. If a distinguished accounting professor could be misled by the fraudulent accounts of Enron, how is a non-technically trained person going to be able to detect whether a given company's accounts are "right"? Second, such a vast amount of financial information may be required to discover signs of wrongdoing that it may be impossible for any one individual to master it all: in an incredibly complex network of related companies and special purpose entities, even a person who has the greatest expertise and familiarity with that type of information can easily be overloaded by it. Third, if external auditors are no guarantee of accurate financial statements, where can such a guarantee come from? Can the Board of Directors do anything to ensure ethical behavior within the firm? Is it even possible for a company to be "properly governed" by the Board, without running the risk of resources being used improperly?

With respect to independence, how can the demand for Board members' independence be reconciled with the need for them to have an in-depth knowledge of the firm and its environment? Obviously, the more they get involved in the firm's operations (which is the only way they can obtain that in-depth knowledge), the less independent they will be, and vice versa.

Briefly, all the conditions that it is assumed would prevent fraud may be impossible to meet to any reasonable extent, and so any solution along those lines may simply be unfeasible.

## Two Levels of Control and their Limitations

Precisely for that reason, it is important to distinguish between two different levels of control that necessarily exist in any corporation. First, there is the control of the behavior of the firm and the people in charge (essentially, the Board of Directors) by society as a whole (or by the different instances of government in its name). Second, there is the control by the Board of Directors of what the top executives do on behalf of the firm, the control by those top executives of middle management, and so on down through the organization.

These two types of control are qualitatively different. The first takes place through market mechanisms, while the second takes place properly through the management control function. In their classical paper on organization, Alchian and Demsetz (1972) provided the economic foundations for that view. They considered a firm as a situation of team production, where one member of the team has to specialize in monitoring the rest. That is necessary

because it is impossible to objectively measure the contribution of each member of the team separately: if that could be done, there would be no need for a firm, and so the market would take care of all the arrangements optimally. As a consequence, the crucial question appears: who will monitor the monitor? Alchian and Demsetz's answer, widely accepted in the Economics literature, is that the market takes care of that. A monitor who has the residual decision rights and receives the residual returns will always make the most appropriate decisions for the corporation as a whole, with the intention of making those residual returns as big as possible.

Unfortunately, the market seems to be less than omniscient in timely monitoring of what firms are doing. Often, as we have seen in the recent wave of scandals, the market detects that something has gone wrong in the firm only when it is too late. If, in fact, the decisions made within the firm (whether by the Board of Directors or by professional managers is now irrelevant for our argument) show obvious, positive short-run effects (again, whether those effects are real or fake does not matter for our argument), the market may value them positively, no matter how bad the consequences are for the long run.

"The market" is an impersonal entity that can only act through impersonal, formal mechanisms: information and trading that result in stock prices. Therefore, from the point of view of the control of Boards of Directors by the market, only one line of action is conceivable, namely to improve the process along the lines suggested above: better information, better trained Board members, stiffer penalties for wrongdoing, and so forth.

Note, however, that the results of such actions will not necessarily be as expected, because this is a complex process. Osterloh and Frey (2003) cite ample evidence that independence, professional competence, etc. did not prevent some of the more extreme cases of malpractice we have seen in recent years. More competence, greater independence and stricter financial controls will not necessarily result in better outcomes.

The second level of control takes place in a personal way, through the interaction of a controllor and a controllee. This offers better opportunities for improvement and avoidance of wrongdoing, but is often overlooked as a somewhat technical matter, even though it has limitations similar to those of the market as a control mechanism. We will analyze that next in more detail.

**Management Control Systems and Goal Congruence**

The role of management control systems has always been considered to be that of changing the behavior of the individuals working in an organization by attempting to align the interests of the individuals with the interests of the organization. One essential element of the management control process is a formal system of: 1) goal-setting; 2) performance measurement and evaluation; and 3) incentives.

There seems to be broad agreement that the basic criterion for evaluating a management control system is that of "goal congruence." In a classic textbook formulation: "In a goal congruent process, the actions people are led to take in accordance with their perceived self-interest are also in the best interest of the organization" (Anthony and Govindarajan, 2003, p. 93).

Ideally, then, in the context of formal control systems, incentives should be aligned with the best interest of the organization through the evaluation process, and a compensation formula that is a function of the result of that evaluation. The process is usually less than perfect, however, because the organizational goal is difficult to measure, possibly somewhat ambiguous, or even fuzzy. The degree of ambiguity, or fuzziness, will vary, depending on the type of organizational unit or job. In simple, mechanical jobs, the goal to be achieved can be defined very clearly and is rather simple to measure. But as soon as we move on to more complex situations, measurement systems are very imperfect or even difficult to define, and the result of the measurement is inevitably different from the goal the organization is actually trying to achieve. Furthermore, the goal to be achieved is often defined only imperfectly, and frequently is intended to be modified or updated as the organization progresses towards it, gaining knowledge of the whole process and the changing circumstances as it goes along.

In contrast, any performance measurement system intended to provide the formal basis for an incentive must necessarily be very specific; therefore, the correlation between the real goal to be pursued and the performance actually measured is bound to be less than one. Broadly speaking, it is clear that the simpler the situation, the higher the correlation between measured performance and the real goal is likely to be; and (of course) the more complex the situation (or the organizational goal), the weaker the correlation. Since structured, mechanical jobs take place at relatively low levels in the organization, it follows that at the higher (e.g., managerial) levels of the organization, where everything is rather complex, the correlation between the real goal and the measured variable is bound to be much lower than one.

Thus, the fundamental management control problem can be expressed as follows. Any action that the controllee can take will (as a rule) influence the organization's real goal and the measured performance differently; therefore, the controllee will on occasion have to choose between an action that will bring the organization closer to its real goal but will result in a low value of measured performance, and an action that improves the performance measure but does not bring the organization any closer to its real goal. The manager's choice, of course, will depend on the incentive system:

- Suppose there is no incentive payment associated with measured performance (i.e., managers are not rewarded differently depending on the action they choose). Then, managers will choose the action on the basis of: 1) what they think is the best course of action for the organization as a whole, and(2) the utility or disutility of each action to themselves (e.g., the effort required to take certain actions, or the enjoyment in others), which will be only coincidentally related to the action's organizational usefulness. The relative importance of 1) and 2) will depend on the specific situation: of course, perfectly selfish managers will neglect the organizational goals, while managers who identify with such goals will do the opposite.

- Suppose there is a monetary incentive on the measured variable. Then, the controllee will be more inclined to do whatever improves the performance measure, but not what is best for the organization, which is only imperfectly correlated with the performance measure. If the incentive is strong enough (as it often has been in recent times, in the form of stock options, for instance), it should not be surprising that the manager will do anything in her power (including fraud) to improve the performance measure.

The analysis above is based on Baker (1992), as reformulated in Gibbons (1998), where the author provides an excellent summary of the findings of the theoretical literature

that has studied this problem in depth. The basic conclusion of Baker's analysis is that to induce an agent to choose first-best actions, a contract must create incentives that match the marginal social benefits; but that is impossible in general.

The Gibbons summary includes two further conclusions on formal control systems. First, that relative performance evaluation systems (in the language of formal models, tournaments), which have become relatively common in the last few years, have some serious drawbacks: a big incentive to win the tournament may induce sabotage of other managers' results instead of efforts to do better oneself (Lazear, 1989). Second, that (i) if an action has an effect on the performance measure but none at all on the organizational goal, and is therefore organizationally useless, the incentive may induce the agent to perform that useless action. Of course, the converse is also true: (ii) if an action has a decisive effect on the organizational goal, but none on the performance measure, the incentive may induce the agent not to perform that action.

Thus, it will be pure coincidence if the interest of the manager (with or without the explicit incentive) happens to coincide with the organizational goal. Therefore, perfect goal congruence cannot exist in practice in any complex situation. Again, according to Anthony and Govindarajan (2003, page 94), we may have to settle for less: "an adequate control system will at least not encourage individuals to act *against* the best interests of the organization."

**Is the Folly of Rewarding A While Hoping for B Inevitable?**

But even that may be too ambitious an objective. In light of our analysis, we might ask, somewhat rhetorically, whether the classical problem analyzed by Kerr (1975) about the folly of rewarding A while hoping for B is avoidable at all. In the 1995 issue of the *Academy of Management Executive* (Vol. 9, No. 1), Executive Advisory Panel members were asked about the subject, and "...ninety per cent of our respondents told us that Kerr's folly is still prevalent in corporate America today. Over half concluded that "the folly is widespread in their companies" (page 15). Obviously, after twenty years, if the solution were easy, it would have been applied already, and the folly would have disappeared. Our analysis provides not only an explanation for the survival of the folly, but also a justification for saying that the answer to our question can only be a categorical no: the folly is not 100% avoidable as a result of any formal system alone. On the one hand, with no explicit incentive systems, firms run into the problems that Kerr explained so vividly: the examples in his article have implicit, unintended incentives rather than a purposefully designed incentive system. On the other, we have just seen that an explicit incentive system that always provides an incentive in the "right" direction (the organizational goal) cannot exist except perhaps in trivial or very well structured situations: the ambiguity or fuzziness of the firm's short-run objectives, explained above, makes it necessary to base the incentives on a different, measurable variable that is only imperfectly correlated with the desired organizational objective.

In general, therefore, individuals in organizations will have to make decisions balancing the organizational goals as communicated to them and perceived by them, against their own self-interest (again, as they perceive it), and (possibly) including the explicit incentive system which is supposed to foster those organizational goals. Depending on the circumstances, this balance may go in the right or the wrong direction for the organization.

**The Illusion of Control**

This is closely related with what in the accounting literature has been called "the illusion of control." According to Dermer and Lucas (1986),

> "...the illusion (of control) fosters the belief among managers that conventional controls such as operating standards, profit targets and budgetary criteria accurately and validly measure, and thereby help determine, behavior. The illusion reflects a presumption that management can intervene when necessary and successfully effect change. Further, the illusion provides for the belief that, by changing a given mix of existing controls, managers make necessary and sufficient functional responses to internal or external change. To those managing with an illusion of control, negative consequences of managerial action often signify the necessity for more controls" (page 471).

The issue goes back at least as far as Merton, in 1940. According to March and Simon (1958):

> "Merton (1940) is concerned with dysfunctional organizational learning: organization members generalize a response from situations where the response is appropriate to similar situations where it results in consequences unanticipated and undesired by the organization …/… Merton's system of propositions begins with a demand for control made on the organization by the top hierarchy. This demand takes the form of an increased *emphasis on the reliability of behavior* within the organization...." (page 57).

Three consequences follow: 1) "there is a reduction in the amount of personalized relationships …/… the official reacts to other members of the organization not as more or less unique individuals but as representatives of positions that have specified rights or duties;" 2) "rules originally devised to achieve organizational goals assume a positive value that is independent of the organizational goals;" and 3) "there is an increased use of categorization as a decision-making technique …/… an increase in the use of categorization for decision-making decreases the amount of search for alternatives" (March and Simon, 1958, page 58). These three consequences increase the rigidity of responses, with the result that reliability of behavior is greater and the defensibility of individual actions is greater, too; but difficulties with clients increase as well. If, therefore, the response of the organization is more control and emphasis on the reliability of behavior, things can only get worse.

Along similar lines, Hofstede (1981) shows that there are four reasons why a cybernetical, mechanistic model of control may not be appropriate: a) the objectives are ambiguous; b) the measures of the outputs are by nature very imperfect; c) there is also imperfect knowledge of cause-effect relationships between management interventions and results; and d) some activities are not repetitive.

His analysis is focused on non-profit activities, but can easily be extended to any kind of organization, including, of course, business firms. Indeed, with respect to the first point, even if we accept that the objectives of business firms are primarily the long-run profitability of the firm, the short-run objectives (which are the only ones that can be used operationally) are rather ambiguous. Is customer satisfaction in the short run more important than training the company's personnel to maintain and develop the firm's distinctive competence? How do they relate to the search for new markets for the company's products? The list of possible questions obviously does not end here, as any conventional application of management by objectives would clearly show.

The second point –imperfect measurability of the outputs– is well-known, both in theory and in practice, and is a crucial one to our purposes. In spite of the current trend toward increasing the number of measurements and the attempt to make them more precise, reflected for instance in the use of "balanced scorecards," it should be only too clear that most of the measurements are very imperfect. In fact, accounting measures are possibly the most precise of all, and yet their shortcomings have unfortunately become only too obvious in the last few years.

The third point –imperfect knowledge of the cause-and-effect relationships– typically leads human beings to use theories of control different from the ones they espouse. Argyris (1990) argues that "most human beings activate a human theory of control to deal with embarrassment or threat. The dilemma is that this human theory of control is counterproductive to objectivity, rigor, tough testing of conclusions, that is, to productive reasoning (…); espoused theories are usually idealized versions that are rarely achieved. They represent an aspiration to be approximated," while "practitioners often react by defining defensive routines to protect their practice." Among others, distortion of accounting information in at least six methods: smoothing, biasing, focusing, gaming, filtering and "illegal acts" (Birnberg *et al*., 1983). Defensive routines can be considered spontaneous reactions based on a simplistic model of behavior.

The demand for more control, more monitoring and stricter procedures goes typically along the lines of such defensive routines; and the answer of the other party goes along the six methods cited in the last paragraph. This happens in a particularly intense way today, where the illusion of control may take a technological form, with the huge quantities of information that IT makes available: it would seem as if a very detailed information system (or a well-thought-out balanced scorecard) could comprehend everything there is in an organization. According to our analysis, that is clearly false.

Formal systems of management control thus have severe shortcomings, but are necessary in spite of them. The total absence of formal systems of performance evaluation, perhaps associated with reward systems, may be extremely dangerous. Performance indices have to be seen as a check on the expected results, which cannot be "really" measured. But provided that there is a reasonable correlation between the "real" variable and the measured performance, a quantifiable variable is a help to any decision-maker to check whether the intangible results the firm wishes to obtain appear somehow in tangible form. But let us insist that, to avoid the illusion of control, performance indices have to be interpreted and used properly, as tools of diagnosis rather than as an expression of the actual achievement of organizational objectives. This has been visualized by Simons (1993), who calls the most classical feed-back control systems, which rely heavily on financial variables, "diagnostic control systems." This expression conveys very well the idea that diagnosis should be the main purpose of such systems. When, in practice, they are seen as expressions of real achievements, management may be said to be leading the organization towards the wrong goals.

**Selfish interests and organizational identification**

It follows, then, that in general it is impossible to have a system of evaluation and incentives, a set of standard procedures, budgetary targets, close monitoring, or any other formal system that can always guarantee that the results of actions by individuals will be ethical or in the best interest of the organization. Formal systems are not only incapable

of doing the fine tuning needed for that purpose, but often they can be at the origin of unethical behavior on the part of executives.

The fact that incentive systems are always less than perfect, and therefore can never be relied upon to induce proper behavior on the part of individuals, is admittedly widely recognized, at least in theory. The search for a "perfect" system is, according to Brickley, Smith and Zimmerman (2003), a "Nirvana fallacy," whereby a system is "discarded or revamped if it allows any minor managerial opportunism, no matter how minor, in favor of the unachievable perfect system" (page 42).

This seems to be common sense. Seldom (if ever) in management are there perfect alternatives; so we should not expect to find one in control systems. Obviously, we have to settle for one that is less than perfect; and an imperfect system will necessarily allow (at least) some "minor" managerial opportunism. Consistent with this view, Brickley, Smith and Zimmerman (2003) argue that what went wrong with all the scandals was essentially that the architecture of the system (allocation of decision rights, performance measures and compensation structure) was flawed. A better design of the incentive system would have eliminated the causes of such scandals.

This may be partially true, but unfortunately it may be a little bit too optimistic in light of our analysis. As a rule, the designers of the systems of the companies that were involved in major scandals were highly competent people who did not mean to do the "wrong thing" from the outset; what they wanted was a powerful system of incentives that would adequately reward outstanding efforts and promote the company's interests. Stock options seemed to be the ideal vehicle for that purpose, by focusing on the future value of the company to shareholders and thus eliminating any short-term temptations. Big rewards seemed to ensure that this would happen. But obviously, the task of evaluating beforehand whether a reward system is going to be congruent with organizational goals is far from simple; and the risk of a system leading to misbehavior is obviously greater, the greater the rewards. It was partly the exorbitant amounts of these incentives, then, that made the delicate balance between personal and organizational goals tilt toward courses of action that simply maximized (or, in any case, made very big) the incentive payments to be received by the executives.

However, the amounts do not have to be exorbitant to induce misbehavior if individuals are selfish utility maximizers. If that is the case, they will take advantage of any opportunity to obtain some gain, no matter how small. Suppose, for instance, that a manager is personally indifferent between two alternatives in terms of intrinsic motivation (effort or enjoyment associated with the two alternatives). The two produce different results in terms of the degree of achievement of the assumed organizational goal, and they also produce different results in terms of the performance measure and incentive payment: the one that is better from the point of view of the organizational goal generates a lower performance measure. Would there be a reason for such a manager to take the action that produces better organizational results, at a personal loss to himself in terms of the incentive payment? Clearly, there would not. As the manager is a selfish utility maximizer, the decision he makes will be the one that leads to higher performance measures, and so to higher incentive payments. This, of course, may simply be taken to mean that agency costs do exist. Performance measurements and incentive systems are intended to correct this fact, but sometimes they merely succeed in making things worse.

The logical consequence would be that the only thing to worry about is to ensure that those costs are never too high, or that the management opportunism the system allows is

only “minor.” But then a crucial question springs to mind: how “minor” is “minor?” And also, how can we judge whether something is “minor?” Any “minor” opportunity to induce managerial opportunism might become “major” if the amount at stake is high. Suppose, for the sake of concreteness, that in the example in the preceding paragraph the difference in the results for the company under the two action alternatives is big, and the difference between the incentive payments to the decision maker in each case is rather small (or at least not so big) and of the opposite sign: then, the agent may cause the company to incur a large (opportunity) loss, while making a small gain for herself. Thus, the firm may be doing the wrong thing for itself (destroying value in the long run) precisely by having such an incentive system. The fact that the gain for the manager is small makes it “minor” for her, even though it may be “major” for the company. Suppose now that things are the other way around, i.e., that the difference in results for the company is rather small, but the difference in incentive payments is big, while still being of opposite sign. Then, the manager may go to a lot of trouble, misallocating her time and effort, in order to secure the big incentive payment provided by the wrong alternative, which again is bad for the company. Can this be considered “minor” for the firm? It will depend on the value of the manager’s time and effort, and on the payment itself.

Therefore, we are back to the idea that no system is fool-proof; and to Berle and Means, who in their classic *The Modern Corporation and Private Property*, already argued in 1932 that managers have their own interests to pursue. Or, in the language of today’s agency theory, that a person is never a perfect agent for anyone else (Jensen, 1993).

But while this last statement is clearly true, a company can try to decrease agency costs by other means. Chester Barnard recognized many years ago that an organization did not necessarily need “objective inducements” (incentives) to “secure the efforts necessary for its existence;” it could also achieve the same result by “changing states of mind” (persuasion) (1938, p.141). Persuasion and informal systems are closely related. You don’t persuade other people of anything in the context of a formal system. The formal system can only encourage the type of behavior it rewards. It is really the direct relationship between two people that makes it possible for one to persuade the other that something is worthwhile.

Quite obviously, there are situations where explicit, monetary incentives do not exist, or are not even conceivable: politicians, judges, the military and many other public officials do their jobs on a fixed salary. There, persuasion plays a crucial role. This point was forcefully made by Vice-Admiral Diego E. Hernández (US Navy, retired), when in the context of a Harvard Business Review Case Study he was asked to give his opinion on the situation presented by the case (Kerr, 2003, p. 10). He recommended “to look beyond pay for performance and make more effective use of intangible rewards. Public recognition, a letter of appreciation, or a word of praise can do a great deal to focus an individual’s attention on organizational targets.” He adds: “Leaders in the US armed services have no control over compensation levels (…) We’re intensely focused on mission achievement and realize that’s entirely dependent on everybody buying in and giving it everything they’ve got (…); we listen to people’s concerns and make use of multiple feedback loops so we can hear the truth. We create interim goals and publicly recognize interim successes (…) We differentiate with an aim to promoting the top performers and getting rid of underperformers (…) In the end, people identify strongly with the goals of the organization and feel energized when they achieve those goals.”

Precisely in this context, organizational identification and loyalty are crucial concepts. The concept of identification goes back at least to Herbert Simon’s *Administrative Behavior*, where he defined the concept by stating that “a person identifies himself with a

group when, in making a decision, he evaluates several alternatives of choice in terms of the consequences for the specified group"). Therefore, a person who is identified with different organizations thinks in terms of "what is good for the country," "what is good for the firm," or "what is good for the fire department," rather than for himself. If members of an organization strongly identify with it, there is no need for explicit incentives, because they will do what is in the (perceived) best interest of the organization anyway (Simon, 1947, Chapter 11).

This is parallel to what Frey and Meier (2002) called having "pro-social" intrinsic preferences, but goes a little bit beyond that concept. "Preferences" are typically static, and are taken as given, while loyalty towards, and identification with, a given organization cannot be taken as given: rather, they develop through time if certain conditions are met (Rosanas and Velilla, 2003). Thus, identification and loyalties may become a complement to Osterloh and Frey's (2003) recommendation of hiring people with such pro-social preferences to avoid misbehavior in organizations.

What becomes important, then, is the dynamics by which identification and loyalties are created and develop. For that purpose, however, we need to go in more depth into the basic assumptions about the acting person.

## The Acting Person

Any theory about how organizations work is based in some assumptions or models about the "nature of man." Sometimes the assumptions are made totally explicit (e.g., Jensen and Meckling, 1998; Simons, 1995); sometimes they are only implicit. But in any case, these assumptions are crucial to the purpose of management control. According to Simons, they are:

> "... assumptions about how value is created, how strategies are formed, and how people behave in organizations. In the day-to-day life of organizations, these assumptions, which are unspoken and unchallenged, influence the ways in which managers control strategy and the extent to which their efforts are successful. These assumptions determine how managers deal with subordinates, how decision authority is delegated, and what types of behavior managers expect from themselves and from the people who work for them." (1995, p. 171)

Simons goes on to suggest that if managers have to choose between two models of human behavior (along the lines of McGregor's Theories X and Y), they can make two types of errors. Type 1 errors occur when managers assume that the Theory X model is true, while employees are in fact hardworking, honest and trustworthy; Type 2 errors occur when managers assume that the Theory Y model is true, while employees are in fact lazy and dishonest. In the first case, the error may result in a self-fulfilling prophecy: employees feel they are not trusted, and therefore they may be unwilling to commit to and work toward the organizational goal. Obviously, the long-run consequences to the firm are negative. In the second case, employees may take advantage of the trust deposited in them to shirk and misappropriate assets, at a substantial cost to the firm even in the short run.

In general, these assumptions are based on the postulates of some philosophical school. Here, we are going to base ours in the proposals of personalist phenomenology, in the tradition of Brentano, Scheler, von Hildebrand and, more recently, Wojtyla (1979). That philosophy is consistent, as we will see, with a dynamic analysis that takes into account

the learning by individuals while acting. We will base our work here in the approach of Crosby (1996), because his formulation is very close to our purpose.

The basic postulates of personalist phenomenology that we need for our purposes can be summarized in the following five points:

1. Human beings can achieve through action some effects that they want and that are external to them. Action thus makes actual something that was a mere possibility before. In turn, this possibility is at the origin of any action taken by a human being.

2. Every concrete person has some potential to be developed. The actualization of everything that concrete persons have as potential constitutes, in itself, their end as human beings. That actualization takes place through action, in which individuals develop their values. Thus, action can be seen as the way for human beings to self-actualize.

3. The tension between what human beings can become as persons, but are not yet (i.e., the effect of the action on themselves), is a powerful mover of those persons to action.

4. With the purpose of becoming more and more themselves (i.e., self-actualizing), acting persons interact with other beings that they consider valuable to differing degrees, depending on the nature of those beings. A crucial point in this respect is that this valuation should be "right," mainly with respect to the value of other human beings. Human beings have a value in their own right, and so cannot interact with other human beings as if they were "things" without deviating from their own end as people. In other words, human beings harm themselves when they treat other people as "things," which, essentially, does not mean that they treat them "badly," but that they do not take into account that those other people need to self-actualize through their own actions too.

5. The human person can perceive and develop *values*. The kind of values that are given to the person as potential, and that have to do with that potential being developed (intelligence, knowledge, operating skills, and so on), are called *technical* values. *Moral* values are those values that make a person a better person. Since the two kinds of values are crucial to our purpose, we will develop these concepts further in the next section.

This view of the human being is essentially dynamic. Human persons are responsible for their own acts and, therefore, for their own personal development. Note that this development may be negative, i.e., human beings can deteriorate or become less self-actualized by doing "the wrong thing" in their actions (e.g., dealing with other human beings as if they were "things," as said above). With their actions, they can get closer or farther from their end, which is (in the philosophical approach adopted here) their perfection. At the same time, through action, changes take place *inside* human beings, mainly with respect to the actualization of their potentialities; and, very specially, those that have to do with the capacity to perceive the value of their actions in accordance with moral values.

Osterloh and Frey (2003) rightly observe that "social dilemmas arise if the actions of self-interested individuals do not lead to socially desirable outcomes," the prisoner's dilemma game being a classical example of such a situation. In contrast, our analysis leads us to go beyond those social dilemmas and see a continuous "personal dilemma" between selfishness

and openness to others. By acting selfishly, not only can human beings harm other human beings (which would be the reason for the social dilemma), but also they can harm themselves by becoming more and more selfish and moving backward in their own development as persons. In contrast, by doing the opposite (i.e., by taking other people's interests and needs into account when they act) human beings develop their own freedom, which consists precisely in the degree of perception and practical utilization of moral values, as opposed to simply following one's own (often irrational) impulses. In turn, this development of freedom will entail a development of rationality and the capacity to appreciate moral values.

**Technical values and moral values**

As stated above, technical and moral values are crucial to our purpose, so we need now to go into the concept in more depth. Let's first review the definition. In Crosby's words:

> "There are many things which take on from us a certain character of goodness as a result of satisfying us, or being agreeable to us. (...) The agreeableness of all these things is not simply found, as if it existed independently of being experienced, but exists only in the experiencing of those persons for whom such things are agreeable (...) (In contrast), we find many things whose goodness is independent of our satisfaction" (1996, page 174).

That is, for instance, true of the value of a human being to another being. The value of the one does not depend on being experienced as "pleasant" by the other. According to the philosophical postulates that we have adopted, human beings have a value in themselves that does not depend on such value being experienced by others. Hildebrand referred to this "goodness" we have just described, which is not a consequence of our satisfaction and which presents itself as inherent to the being that possesses it, as "value". Other authors (Wojtyla, 1979; Guardini, 1999) have used the same term consistently.

Value is thus partaking of goodness in the sense of being ourselves good or worthy. Aristotle, and later Kant, saw that many excellent personal qualities are compatible with moral evil. Those values of the person are known as *technical* values. Technical disvalue simply consists of a privation of that value. In contrast, moral values are obviously incompatible with moral evil: a moral disvalue is what is antithetically opposed to goodness.

People are always responsible for their moral value or disvalue, but they are not always responsible for technical value or disvalue. An act has technical value by virtue of a certain relation to the person who performs it. Moral value, besides this relation to the acting person, derives from the harmony of the act with the goods to which is directed. Moral values have a character of transcendence and participation in moral goodness.

Again, according to Crosby,

> "When a person is enriched with moral worth, he gains a qualitative fullness in himself which, though based on a right relation to value and impossible without such a relation, is itself much more than any such relation" (1996, p.224).

> "It is one of the most elementary moral truths that in being morally good, human persons become good as human persons; they become good, not in some

particular, ‘regional’ respect, not good as carpenter, as surgeon, as musician, but good as human persons” (1996, p.231).

**Management Control Systems and Persons**

We have argued above that the basic purpose of any control system is to obtain behavior –a set of actions– on the part of individuals that is congruent with organizational goals. Therefore, it is intended to influence a human action, and every human action has an ethical dimension insofar as it relates to the ultimate ends of human beings. Consequently, controlling human beings as we have described appears to be a rather complex task that has numerous implications, as indicated in the previous section.

To begin with, in exercising this influence over the behavior and actions of people, the control system must respect the characteristics of human action that make it personal action. A personal action is one that originates in oneself. In Crosby’s words:

> “Persons act as persons by acting through themselves, that is, acting with an acting which is radically their own. My acting as a person is not an undergoing, or an enduring, or a transmitting of what originates outside of myself. It is I, I myself, who act when I act as a person and no one else” (1996, p. 26).

According to the philosophy that we have adopted in this paper, a control system reduced to a system of explicit incentives is ethically unacceptable. It de-personalizes the human being by denying her the opportunity of actually performing a personal action. Besides, on the same philosophical basis, such systems ignore people’s potential to develop their technical and moral values, by not appealing to them.

A control system that does not appeal to *technical* values, i.e., the values that can stimulate the actualization of a person’s potential, sacrifices a potential that may be useful for developing the firm’s distinctive competence. At the same time, since values are the engine that originates action, such a system would relinquish the intrinsic strength that perceiving those values arouses in the human person. Therefore, even from a purely economic perspective, this reductionism may become much more costly to the firm in terms of foregone opportunities.

Dynamically, by not appealing to the person’s technical values, the organization will make the chosen alternative unfit to develop those technical values and take full advantage of the individual’s potential. Therefore, the acting person will have difficulties in attaining and developing those values through the action proposed to her.

Of course, the acting person may react and redesign the action to develop her technical values while, at the same time, achieving the goal that the organization desires. This would be a reflection of the person’s professional quality. In any case, such redesign may originate new rules and policies that would make it more difficult to do the same thing again in the future.

This dynamic process may give rise to two different situations:

1. Not seeing herself self-actualized in technical values, the person may become increasingly dissatisfied. To compensate, she may demand that the organization

increase her explicit incentive, which, from an ethical point of view, means continuing the process of de-personalization with respect to the individual's desire to perform a personal action.

2. The person may adapt by giving up the development of those technical values in exchange for the extrinsic incentive. This would mean that the control system has "succeeded:" it has de-personalized that person. But, of course, both the person and the organization are worse-off. Dynamically, the situation is even more unfair, as when the organization changes the desired results, the person is unlikely to be able to adapt to the new objectives. Therefore, the person becomes "worthless" for the organization.

When a control system does not appeal to *moral* values, the organization and the person lose the development of the person as such, and forego the opportunity of having those values act as the starting engines of the action in the future. It is this dimension that gives sense to the action. A system that is based exclusively on extrinsic incentives does not take into account the possibility that the action's ultimate purpose is to satisfy other people's needs, and so loses the potential strength of moral values and, therefore, of identification with the organization's objectives. The message that such a system sends is that identification is unwanted: what is really wanted are the specific results that the system rewards. Therefore, the action is highly unlikely to solve real needs of other people: customers, other people in the organization, or any external party affected by the action. And of course, the more complex those needs, the more unlikely it is to do so.

Again, as in the case of technical values, the person can redesign the action in such a way that she is able to develop moral values while at the same time meeting the explicit demands of the system. But the relationship between the person and the organization will become increasingly difficult: there is a lack of fit between the person and the organization.

If, instead, the person adapts to the system, then the ethical deterioration of the person should be obvious: giving up moral values for extrinsic rewards is merely a first step toward fraud and scandal. Whether fraud actually occurs or not is simply a matter of cost-benefit analysis by the individual, taking into account, on the one hand, the profits from fraud and, on the other, the risk of being caught and the corresponding penalty.

## Conclusion: Toward Management Control Systems that are Compatible with Full Human Development

We started this paper by analyzing some of the technical limitations inherent to Management Control Systems. We have moved to a higher conceptual point of view and shown the (de-personalization) risks involved in systems that rely exclusively (or heavily) on monetary incentives. We shall end by summarizing our findings and attempting to establish the bases for the design of control systems that are compatible with the development of human beings and so avoid the risks of de-personalization.

To begin with, a formal system of management control (a well-established system of quantitative evaluation and performance indices) is necessary in any organization beyond a certain size. The degree of sophistication and the type of incentives it includes will vary, but it is inconceivable that any but a small organization could be run without it. First, for the purpose of decision-making activities: this is the main application of the classical control systems, which

(as we mentioned) Simons calls “diagnostic control systems.” They should be used primarily as tools for diagnosis, rather than as measurement devices that constitute the basis of the incentive system (as is often the case). Second, because it is necessary to achieve a minimum effectiveness of the organization, so that the demands of the various stakeholders can be met. Specific measurements that allow management to evaluate explicit results that will satisfy different stakeholder constituencies are clearly necessary to verify that that is happening.

But, as shown in the preceding paragraphs, a management control system that is not de-humanizing must take into account, first, the need to use and develop the technical values of people in the organization. Technical values cannot, as a rule, be included in the formal control system. In practice, they are taken into account by attempting to match the required personal qualities (actual technical values) with the requirements of different jobs. The usual systems and processes for doing this are Personnel Selection, Job Evaluation, Career Planning, and so on.

Necessarily, all those systems have to be complemented with direct managerial action, an informal relationship based on personal contact. This relationship must be mainly “educational,” in the original (Latin) sense of “educere,” i.e., knowing how to use and develop the potential technical values that individuals themselves may not even be aware they possess.

The process of “discovering” people’s values and helping to develop their technical potential is a substantial part of the organization’s “internal mission” (Pérez López, 1993, Chapter 7), which essentially consists of building unity and mutual trust between the members of the organization. Developing technical values in individuals is also the basis of the organization’s distinctive competence, i.e., what an organization can do better than anyone else. Therefore, it is crucial to the development of the organization’s *character* in the short run, and its survival in the long run (Selznick, 1957).

But also, and in second place, the control process must appeal to moral values, as it is crucially important that people learn about the actions that are desirable to the organization itself as well as to its customers. Those actions are the ones that satisfy the real needs (as opposed to perceived needs) of other people. In order to learn about them, individuals need to develop their moral values. The real needs that the organization intends to satisfy constitute what Pérez López calls the organization’s “external mission.” The organization’s “internal mission” can then be alternatively seen as being to satisfy the real needs of the other members of the organization, including as a necessary condition the development of their technical values (1993, Chapter 7).

A control system that is compatible with the development of human persons needs to satisfy those two conditions as necessary characteristics. Unfortunately, there is not (and perhaps cannot be) any ready-to-use tool or technique to put them into practice. Fortunately, though, there are some ways to make it more likely, but they go beyond a mere technique.

The management control literature contains some elements of what is needed. For instance, in Simons’ analysis, what he calls “belief systems” are closely related to those conditions. In fact, in Simons’ framework, one of the basic assumptions about behavior is that individuals desire to contribute (and, therefore, in our framework, to develop their own moral values, as well as other people’s). According to Simons, an “organizational block” occurs when an organization is “unsure of its purpose;” and the remedy is to “communicate core values and mission.” The “lever of control” for that purpose is the one he calls “belief systems” (Simons, 1995, page 173).

What is decisive for our purposes, however, is the role of management, which goes well beyond those levers. Individuals seldom identify with abstract values: it is much easier to "see them" through the action of top management. Informal relationships are the way to bring to life and transmit those values, essentially through example and persuasion. We finish with the words of Crosby:

> "It follows that the personalistic opposite of unjustified coercion is a certain kind of persuasion. If I want to move another to act, and to move the other in such a way as to respect his or her personhood, then I give the other reasons that can be understood; I convey the point of the proposed action and help the other person to see it for himself. I enable the other to go in a certain direction, not as an extension of my own willing, but with a willing that is truly his own as mine is my own. All authentic education has to use as much persuasion and as little coercion as possible, and has thus to aim at the greatest possible independence of the educated from the educator..." (1996, page 27). □

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