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ACCOUNTING RESEARCH IN CHINA
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Editorial

We are pleased to announce three important changes to the journal effective from 2012. First, following a lengthy consultation exercise, the journal will be renamed *Journal of Accounting Studies—A Publication of the Accounting Society of China*. This change enables the journal to publish significant research undertaken by international scholars as well as Chinese scholars. Second, the journal will publish direct submissions rather than the translation of Chinese papers that are already published in its sister journal *Accounting Research*. Finally, the journal will be published in English only. All these changes are reflected in the journal's Call for Papers included in this volume.

中国会计研究
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编者的话

我们很高兴地宣布，本期刊自 2012 年起将发生三项重要的变化。首先，经过长时间的征求意见，本期刊将更名为 *Journal of Accounting Studies—A Publication of the Accounting Society of China*。这一变化有助于本期刊发表国际学者和国内学者的重要研究成果。第二，本期刊将受理原创性研究成果的直接投稿，而不再是已发表于《会计研究》的中文论文之译文。最后，本期刊将仅发表英文论文。所有这些变化已反映在本卷的“征文启事”中。

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Management Control System for Conglomerates under Diversification Strategy: Evidence from CRG 6S Management Systems

Guliang Tang Bin Wang Fei Du Yang Fu*

Abstract This paper is a case study based on the management control system of the China Resources Group (CRG). Given that CRG has a complex business model based on unrelated diversification strategy, it provides a natural experimental setting to test the trade-off between centralized versus decentralized corporate headquarters. There are three unique features of CRG's centralized management control system: firstly, a flattened organizational structure using the profit center mechanism; secondly, process-oriented strategy control; and thirdly, powerful corporate headquarters. This study presents a logic framework of organizational design and MCS for conglomerates that adopt a diversification strategy.

Key words Group strategy, Management control, Information shortage, Agency cost

1. Introduction

Management Control System (MCS) is increasingly becoming a synonym for management accounting. MCS is a power and responsibility structure found in the managerial process, which manifests itself as a decision-making structure, leadership structure and information structure. Current theoretical studies mainly focus on the MCS of one single company, and yet the MCS of conglomerates are studied less frequently. This essay discusses two related questions: first, how to design and implement the MCS in a conglomerate; second, how to jointly design the MCS and the organizational structure within a conglomerate based on the competitive environment of the conglomerate.

This paper uses single-case analysis, focusing on the 6S MCS created and

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applied for many years by China Resource Group (CRG), a central government state-owned enterprise in China. To construct complete and reliable evidence, and thus to conform to the requirement by Yin (2004) that different data should mutually verify each other, the authors searched much public information including the corporate website and professional publications on the 6S MCS disclosed in the annual reports of CRG, consulted the internal publications of CRG, and communicated with and interviewed many times the CFO of CRG and staff of the finance and human resources departments and the general managers of its subordinate profit centers. Data collected from these channels can serve as data triangulation, which contributes to the validity and reliability of this study.

The 6S MCS not only helps to remodel the organizational structure and improve the strategy execution of CRG, but more importantly it contributes to theory building in the MCS literature. It also provides insights for Chinese practitioners regarding how to implement a control system within a diversified conglomerate.

2. Theoretical Background: Review of the Design of Group Organizational Structure and Management Control System

2.1 TWO APPROACHES FOR THE DESIGN OF GROUP ORGANIZATIONAL STRUCTURE: THE STRATEGY LEADING VIEW & THE INFORMATION SUPPORT VIEW

Organizational behavior studies emphasize the importance of strategic choice to organizational structure when referring to the design of corporate organizational structure. Chandler (1962) analyzes American companies' evolution from U type structure to M type structure, and finds that the whole production process and senior managers' decisions become increasingly diversified and complex when the organization starts new product lines, expands into new markets, and launches a new strategy. He also concludes that in this case "strategy determines structure, and structure follows strategy". Anthony and Govindarajan (2000) point out that different corporate organizational structures and management control systems correspond to different strategic arrangements. They propose that for unrelated-diversified conglomerates each conglomerate consists of relatively independent business departments. Due to the extensiveness and diversity of business transactions, senior managers will concentrate on portfolio management and authorize department managers to develop the production market strategy, and the senior management of unrelated-diversified conglomerates should have expertise in financial management.

While some other scholars explore organizational structure design based on the information cost, Radner (1992) argues that without other considerations, corporate internal organizational structure is mainly determined by the efficiency of internal information processing. Generally speaking, corporate internal information cost mainly consists of information generating cost, information transferring cost, and opportunity cost due to information being impeded and delayed. Because of the high information cost, the essence of organizational design is a trade-off between the cost and the benefit. Jensen and Meckling (1992) produce a model of organizational design and control by weighing information cost against agency cost. According to the model, on the one hand allocating the decision-making authority to those entities who obtain sufficient information and specialist knowledge is the precondition of efficiency; on the other hand, if the manager divides up the decision-making authority to match decision accountability with available knowledge, it would cause the so-called "agency cost". [1] Therefore, we have to consider the boundaries between centralization and decentralization when engaging in organizational design.

It is easy to see that the "structure follows strategy" view has an important influence on the design of the organizational structure and control system, but it is too simplistic and mechanical to consider strategy as the only factor that determines the organizational structure. Taking the organizational decision-making authority[2] as an example, based on this thought a single-industry organization's decision-making authority tends to be more centralized (centralization), while that of diversified organizations will be more decentralized (decentralization). Obviously, the "strategy-structure" (mechanical) relationship is unable to explain the phenomenon that in a number of large conglomerates (especially diversified

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[1] Here the agency cost refers to the cost of designing, implementing, and maintaining appropriate motivation and control system, and the aggregation of residual loss caused by completely solving the problem of agency cost (Jensen and Meckling, 1992).

[2] In the principal-agent theory framework, decision-making authority could be further broken down into proposal right, approval right, enforcement right, and oversight right (Fama and Jensen, 1983). Traditional organization theory doesn't implement such subdivision, which is one of the reasons why it seems too simplified and mechanical. From an authority-allocation perspective, the owner of the decision-making authority should be the one who takes the risk. So, decision-making authority is a governance concept, rather than a total management concept. In other words, no matter whether the decision-making authority is centralized or decentralized; it is the result of "authorization" in the governance framework. The decision maker (risk-taker) could keep all of the decision-making authorities, or keep the approval right and oversight right, and authorize operators with proposal rights and enforcement rights.

conglomerates in modern organizations), the decision-making authority tends to be centralized instead of being decentralized. Similarly, the ideas of organizational structure design under the information support view stress the purity of theory. However, this is not that useful when guiding specific practice, because different people have a different understanding of "sufficient information and specialized knowledge", and therefore cannot define clearly who, in the organization, "owns sufficient information and specialized knowledge", "is able to utilize this information", and "should get the decision-making authority". According to our own opinion, in the process of designing organizational structure and developing management control systems, we should integrate (instead of dividing up) the strategy leading view and the information support view together from a strategic perspective, and discuss the design of the organizational structure and control system after considering both internal and external factors. This article starts from this "integration view", combines this with the viewpoint[3] of Brickley et al. (2006), takes CRG 6S' management system as an example, and discusses the construction of diversified conglomerates' organizational platform.

2.2 CONTINGENT FACTORS THAT IMPACT ON THE MANAGEMENT CONTROL SYSTEM

Anthony and Govindarajan (2000) define the management system as a systematic tool which assists managers in allocating resources in order to realize organizational objectives. Management accounting research mainly applies contingency theory when discussing the determinants of management control systems (Chenhall 2003). Theoretically speaking, corporate strategy leads the orientation of management control system design, and management control system design guarantees the implementation of corporate strategy; they cooperate to create competitive advantages (Simon 1991). Meanwhile, empirical evidence shows that when the management control system design matches with variables such as the external competitive environment, the uncertainty of task, the level of technology, the structure of internal organization and scale, then the organization would have a higher level of organizational performance (Langfield-Smith 1997; Chenhall 2003).

These two major concepts of the strategy and management control system could be further classified into several categories when using different classifica-

[3] Brickley et al. (2006) argued that all the organizations must develop three internal structure systems which support each other: a decision-making authority allocation system; an operating performance evaluation system; and a compensation system based on operating performance.

tion criteria. Strategies could be classified into: growth strategy and competitive strategy based on strategic objectives; corporate strategy, business unit strategy, functional department strategy, and product strategy based on entities' level; offensive strategy, defensive strategy and exit strategy based on competitive situation (Miles and Snow 1978); and differentiation strategy and cost-leading strategy based on the way of gaining competitive advantage (Porter 1980). Management control systems could be classified into formal and informal control (Anthony and Govindarajan 2000); outcome and behavior control (Ouchi 1977); administrative means control and organizational cultural control (Hopwood 1976); and results, actions, and personnel control (Merchant 1989). In addition, if the management control system could be seen as an integrated tool kit, it includes the budget, variance analysis, performance evaluation, compensation system, balanced scorecard, activity-based costing, and many other smaller tools.

As evidenced by a large number of empirical studies, the reason why strategy has been able to affect the management control system design is that both of them are managerial decisions made by managers based on cognitive analysis of organizational mission. However, in the hierarchy of decision-making, strategic decision making is higher than MCS, which is also confirmed by many empirical studies. Bouwens and Abernethy (2000) find that product customization strategy leads to the increasing level of dependence between functional departments, thus affecting the level of salary dependence between department managers. Baines and Langfield-Smith (2003) suggest that the increasing level of market competition made more enterprises adopt a differentiation strategy in order to survive, which impacts on the change in organizational structure, in information platform, and in management accounting system design. All the changes in these three internal systems lead to more reliance on non-financial indicators for budgeting, evaluation, and rewarding and punishing employees when managers make decisions. Auzair and Langfield-Smith (2005) suggest that organisations that use cost-leading strategy place more emphasis on the application of bureaucratic management control systems, compared to those who use differentiation strategy. Moores and Yuen (2001) propose that organizations in different stages of the product life cycle should focus on different points when applying a management control system. Most of these empirical studies use survey methods to study the relationship between strategic form and management control tools (Simons 1987, 2002; Merchant 1985; Govindarajan and Gupta 1985). This article seeks to identify the framework of the relationship between the organizational design and management control system of diversified conglomerates by studying the internal mechanism of the 6S management system.

3. Case Description: 6S Management System of CRG

CRG is a large-scale diversified conglomerate, which is directly supervised by the State-owned Assets Supervision and Administration Commission (SASAC). It is a window enterprise headquartered in Hong Kong which is one of the pioneering companies in undertaking foreign trade. The current business lines cover electricity, retail, microelectronic, petrochemical, beer and real estate etc. The whole system employs about 100,000 people. In 2007, the group assets reached 223.7 billion yuan, the income from operations exceeded 112 billion yuan, and the net profit was more than 9 billion yuan.

Over the years the group has implemented a series of reform measures in strategy, organizational management and other aspects, such as the strategic positioning of the "combination of group diversification and profit center specialization". It has innovatively explored a set of systematic models to manage a diversified conglomerate - the 6S management system. As of early 2008, CRG had 19 first-level profit centers which were managed directly by the group headquarters. The headquarters make decisions on corporate strategy, personnel appointments, financial arrangements, evaluation, budget, and the overall coordination and unified image. The 6S management system is a set of strategic management systems which divides CRG's diversified businesses and assets into strategic business units, treats these units as profit centers and implements specialized management, and thus promotes the construction, fulfillment, monitoring and implementation of profit center business strategy. Specifically, the CRG 6S management system consists of the following elements:

(1) Profit center business strategy system. Because of adherence to the "diversified group, specialized profit center" business strategy framework, the headquarters are concerned with CRG's industrial strategy, geographic strategy, talent strategy, organizational strategy and financial strategy. Profit centers are concerned with the four dimensions of business strategy which are finance, customer, process, and learning.

(2) Profit center comprehensive budgeting system. The comprehensive budgeting system focuses on the annual decomposition and specific implementation of strategic planning and resource support of the strategic action plan, in order to realize the organic integration of operating budget, capital expenditure

budget and financial budget.

(3) Profit center management reporting system. A management report should be prepared on a monthly basis, with each strategic business unit as a report-design unit. The management reporting system particularly requires multi-dimensional analysis of the implementation of the strategy, timely monitoring of the execution of strategy, a focus on the prominent features of the profit center operations, attention paid to operating profit and cash flow from operating activities, and a focus on industry analysis and benchmarking.

(4) Profit center audit system. Multi-dimensional comprehensive strategic auditing, supervision of the completion of planning and budgeting, monitoring the execution of business strategy, and ensuring the quality of the information system, which is the core of the audit system.

(5) Profit center performance evaluation system. Principles of the performance evaluation system are: multi-dimensional strategic-orientated evaluation, performance evaluation driving strategy implementation, and dynamic tracking and strategic review of evaluation indicators. The headquarters set different Key Performance Indicators (KPI) and requirements, based on the difference in each profit center.

(6) Profit center manager evaluation system. This mainly evaluates managers from three aspects: performance, management quality and professional ethics; identifies the responsible leader for strategy implementation; combines strategy promotion and performance incentives; and ensures specific refinement and effective implementation of the strategy. The introduction of Balanced Scorecard (BSC) is the main driver. It links closely the key performance indicators to strategic direction, uses evaluation results to review the implementation of the strategy, determines the sanction system of the overall strategic business unit (SBU), and promotes the strategic execution through effective penalties, so that 6S has become a strategic management system.

CRG has internally summarized the basic characteristics of 6S as follows:

(1) The profit center management model and high concentration of investment decision-making authority ensures the specialized management of diversified holding companies.

(2) Breaking and ignoring the legal framework and defining profit centers by business units and relevant assets to establish the organizational basis of a profit center.

(3) The management system is a strategic management system which develops from budget management or operation control system, covering all aspects of

building, implementing, monitoring and executing the strategy.

(4) It emphasizes different layers of hierarchical management from the group and profit centers, focuses on strategy and carries it out into financial, customer, process, learning and other aspects.

(5) It complements CRG's management philosophy, emphasizes the completeness of the management cycle and forms an integrated system.

4. Theoretical Reflection: The Design Logic for the MCS of Diversified Conglomerates

4.1 THE BASIC STARTING POINT: KEEPING ORIENTED TO THE GROUP OVERALL STRATEGY, RECONCILING ORGANIZATION STRUCTURE TO GROUP STRATEGY AND INTEGRATING THEM

Strategy is essentially the only determinant of organizational design. According to the (strategy-dominant) theory by Chandler (1962), strategy determines organizational structure, while the latter should accord with the former. During the research on the 6S MCS, we find that all organizational activities are constrained by group strategy in CRG, which coincides with the strategy-dominant theory of organizational design. Yet in CRG the design of MCS guided by group strategy involves further system innovations, mainly including the following aspects:

(1) Diversified conglomerates may construct a simplified and centralized organization structure and group system.

On the basis of the strategy-dominant theory, in a group with diversified businesses, the organization should be of a holding structure, corporate management should be finance-oriented, and decision-making power should be highly decentralized. However, through the description of the relationship between strategy and organization and analysis of the 6S MCS of CRG, we discover that the management function undertaken by the parent company over its subordinate diversified business units is not limited to financial aspects such as budgeting, financing, auditing and cash flows, but achieves the integration of the financial dimension and the non-financial dimension from the angle of organizational structure and group system.

Both theory and reality suggest that the organization system of a large diversified conglomerate should be extremely complicated, and this complexity derives from the diversification of its business units and the scale of the group, as a result of which a vertical organizational structure and control system chain of "parent company-subsidiary companies", which is decentralized in management, is favored. But the 6S MCS of CRG places priority on system design, restricting all the business units to the two-tier management system of "investment center-profit center", which makes a concise and clear control system a reality.

Mainstream theorists believe that in a diversified conglomerate a decentralized organization should be constructed and subordinate business units should have the power to develop strategies and core business decisions independently. But in CRG, affiliated companies are designated as profit centers from the perspective of strategy implementation, the parent company is in charge of the 25 profit centers directly, and the parent company has the authority to determine the strategy planning, personnel appointments, capital arrangements, budgeting and evaluation, overall coordination and corporate image of every profit center. Apparently this authority is far beyond the scope of financial management. Although the design and choice of organizational form of an organization, including united structure, holding company and multidivisional structure, or in other words, simple structure, functional structure and competitive structure, is determined by corporate strategy, the practice of CRG demonstrates that a diversified conglomerate can construct a unified or related-diversification organizational structure and management system. So the design of corporate organizational structure under a specific group strategy is not invariable and rigid, and the flexibility of both the organization and strategy is of equal importance.

(2) Paying less attention to the internal property rights relationships and legal position of subsidiaries, remodeling the management system of the parent company over its subordinate business units as investment center—profit center, and integrating legal relationships and management relationships.

Parent and subsidiaries are basic components of an enterprise group, and capital is the factor which bonds them together. The group organizational structure must be manifested in the explicit form of subsidiaries or branches, but this manifestation is restricted to the perspective of legal and property rights, which is far from adequate for the description of the relationship between a parent company and its subsidiaries. We should be more concerned with remodeling and implementing management relationships and the internal structure, such as the group management system and the power and responsibility relationship.

In China, many enterprise groups have a long property rights chain and complex corporate governance. If we simply emphasize the independent corporate position of subsidiaries rather than reconsidering management control relationships,