

## **CHAPTER II**

### **LITERATURE REVIEW**

#### **A. Theoretical Framework**

##### **1. Contingency Theory**

Contingency theory states that if an organization wants to have good performance, they must adjust the system design to conditions of uncertainty for adjust the system design example from the environment, organizational size, and business strategy (Burns and Stalker, 1966). Contingency approaches are conducted on the basis of contingency theory. A contingency approach can be done if it meets the assumption that none of the best organizational designs that are structured definitively and unstructured with certainty. Therefore, they are applied in an organization and the assumption that a variety of organizational designs have the same chance of results or performance. Both of these assumptions are the sign to be able to conduct contingency testing in the form of natural selection, namely by adjusting changes in population size (Gerdin, 2005).

In management accounting research, there are three basic approaches used to study the effect of control systems on performance, namely specific, universal, and contingency approaches. Specific approaches state that the design of the control system is unique and specific in accordance with the form of each entity and cannot be generalized. The universal approach states

that the control system design can be generalized in several changes to all forms of entities so that they can be generalized. This contingency approach is the most dominant method in research on the mechanism of control systems (Fisher, 1995).

Fisher (1995) added that research using a contingency approach has the following four levels of analysis:

1. The first level about the relationship between contingency factors and the control system mechanism without being associated with performance. This aims to form the right system design.
2. The second level about the relationship between one contingency factor and one control system mechanism associated with performance.
3. The third level about the relationship between one contingency factor and the various control system mechanisms associated with performance.
4. The fourth level about the relationship between various contingency factors and the various control mechanisms associated with performance.

Contingency theory in management control perspective is arise from the existence of a basic assumption of universal improvement. It shows that the management control system can be applied to all companies in various conditions. This universal approach arises because of the developments in

scientific management approaches which aim to find the best formulations in the production process of a firm (Purwati and Zulaikha, 2006).

## **2. Goal-Setting Theory**

Beck and Hillmar (1976) in Irmawati (2004) describe one type of organizational development intervention is setting. Goal setting is the process of setting goals or objectives in the field of work. The goal setting process involves superiors and subordinates jointly determine or set goals or work objectives that the employee will carry out as a duty bearer in a certain period (Gibson et al. 1985).

The definition of goal setting proposed by Davis (1981) is the management of setting goals or objectives for the success to achieve performance. Further explained that the implementation of effective goal setting requires three steps, explaining the meaning and purpose of setting the target, both setting clear targets, and the third giving feedback on the implementation of the work conducted. Cascio (1987) states that goal setting is based on directing behavior towards the goals. The target can be added by giving an explanation or information to the employee how to do the task, and why the objective is important to be conducted.

The application of this goal setting to the performance system is very popular and widely used. Management approaches based on these goals include planning, monitoring, appraising employees, and the overall performance system in the organization. The general procedure in

management based on this goal is the most important is to identify the key parts of success. As the result it can affect the overall performance of the organization such as sales volume, production output, and service quality, thus measuring performance can be determined (Luthans, 1981).

Gibson et al. (1985) describe the application of the problem setting from a management perspective. The steps are (1) a readiness diagnosis, for example whether the employee, organization and technology are in accordance with the goal setting program; (2) preparing the employee with regard to interaction between individuals, communication, training and planning; (3) emphasis on targets that must be known and understood by managers and subordinates; (4) evaluating the follow-up for the specified target adjustments; (5) final review to examine the method of work and modification specified. Strauss and Sayless (1981) explained that management procedures based on the objectives providing the employee with an opportunity to make their own judgments about the results of operations, meaning that if they talk about results the individual evaluates their self and is likely to gain insight into how they should improve their attitude and their actions.

### **3. Business Strategy**

According to David (2006), the strategy is a tool to achieve firm goals in relation to long-term goals, follow-up programs, and the priority of resource allocation to be achieved. Hamel and Prahalad (1995) in Rangkuti (2009) state that strategy is an incremental and continuous action, also based

on the perspective of what is expected by customers in the future. Strategy almost always starts with "what can happen" and doesn't start with "what happened". The occurrence of new market innovation speeds and changes in consumer patterns requires some competencies. Companies need to find core competencies in their business. Siagian (2004) states that strategy is a series of fundamental decisions and actions made by top management and implemented by all levels of an organization in order to achieve the goals of the organization.

According to Schroeder (1989), the firm strategy defines what business the firm is in. Business strategy defines how certain businesses compete. Every business needs to find the basis of its own competition based on market segments and certain products that have been decided to enter. He added that in formulating an operating strategy and business strategy issues, an analysis must be made based on the external and internal environment. The external environment usually includes competition, customers, economics, technology, and social conditions.

Business strategy is related to a series of management decisions to be able to compete in an industry and market its products (Walker & Ruekert, 1987; Varadarajan & Clark, 1994). Wheelen and Hunger (2012) argue that this process requires changes in the culture, structure, and management system in all organizations or companies. Thus, various actions in the process of strategy and policy in an organization or firm by paying attention to

changes in internal and external factors become the direction or implementation of the firm strategy.

#### **4. Firm Performance**

In an increasingly competitive environment, businesses can remain competitive and their presence in the market depending on their ability to improve their performance. Performance is a multidimensional concept that can measure the success of a firm and the level of reaching the objectives of the firm as qualitative (quality) and quantitative (quantity). To determine the performance of the firms, it is necessary to evaluate each its own activities and define the measurement criteria (Maris Martinsons et al., 1999).

The concept of performance of a business firm is based upon the idea that an organization is the voluntary association of productive assets, including human, physical, and capital resources, for achieving a shared purpose (Alchian and Demsetz, 1972; Barney, 1995; Carton, 2004;). It is said that the essence of performance is the creation of value. Therefore, value creation, as defined by the resource provider, is the essential overall performance criteria for any organization. A business organization could measure its performance using the financial and non-financial measures. The financial measures include profits, return on assets, return on investment and sales, while the non-financial measures focus on issues pertaining to customer`s satisfaction and customer`s referral rates, delivery time, waiting time and employee`s turnover (Widener, 2004).

Bucklin and Sengupta (1993) in Monday *et al.* (2015) claim that financial measures of performance, such as sales and profit, may not clearly reflect the quality of the firms' performance. Financial measures are objective, simple, and easy to understand and compute, but in most cases, they suffer from being historical and are sometimes not readily available in the public domain. Geringer and Hebert (1991) in Bin-Nashwan., *et al* (2017) suggest that financial data are often not published, and when that type of data is made public, it will be merely incorporated in calculations of financial performance. In fact, a financial measure is unlikely to capture the relative performance of the firms.

An alternative way is to apply the non-financial measures, though subjective in nature, as supplements to the financial measures (Sandberg & Hofer, 1987; Covin and Slevin, 1989). The combinations of these two measures (financial and non-financial) help the owners or managers to gain a wider perspective on measuring and comparing their corporate performance, the extent of effectiveness and efficiency in utilizing the resources, competitiveness and readiness to face the growing external pressure (Chong, 2008).

## **5. Management Control System**

The term management accounting, management accounting system, management control system, and organizational control are used interchangeably. Management accounting refers to a practical collection such

as budgeting or cost of goods, while the management accounting system refers to the systematic use of management accounting to achieve several objectives. Management control system is a broad term that includes management accounting systems and includes other controls such as personal or group control. Organizational control is sometimes used by referring to the formation of controls into activities and processes such as statistical quality control and just-in-time management (Chenhall, 2003).

Management control system is the concept that consists of several elements used to achieve various objectives (Langfield-Smith, 1997). Anthony and Govindarajan (2007) define a management control system as a process in which managers influence other organizational members to implement organizational strategies, related to management control activities. Therefore, activities classified as management control system, namely: a) plan what should be done by the organization, b) coordinate the activities of several organizations, c) communicate information, d) evaluate information, c) decide what actions should be taken, e) influence people to change behavior.

Bin-Nashwan, Abdullah, & Obaid (2017) states there is a strong linkage between management control system, strategy, and firm performance. Ansari (1977) defines a management control system encompassing all organizational rules and actions designed to achieve goals in improving performance with less risk. Management control system is the concept that has two dimensions. There are performance evaluation and socialization of organizational



members (Ansari, 1977; Eisenhardt, 1985; Govindarajan and Fisher, 1990). The aspect of performance evaluation is focuses on the process of measuring, evaluating and rewarding performance (Govindarajan and Fisher, 1990). The main function of performance evaluation of the management control system is the performance measurement system. The benefits of a performance measurement system are as follows: managing the organization's operations effectively and efficiently through maximum employee motivation; assisting decision making related to employees such as promotions, terminations and mutations; identifying employee training and development needs and to provide selection and evaluation criteria for employee training programs, providing feedback for employees on how their superiors assess their performance; and providing a basis for award distribution (Mulyadi, 2001 in Handayani, 2013).

According to Boone and Kurtz (1992), the tools of control in a financial organisation are divided into five categories: (1) financial controls included budgets, financial analysis and ratio analysis, (2) inventory controls, (3) quality controls, (4) production controls and finally (5) organisational control, which include the selection of employees, training and performance evaluation. Otley (1994) and Milgrom and Roberts (1995) clearly state that the management control system is a system consisting of complementary components. Management control systems provide information that is intended to be useful to managers in performing their tasks and to support organisations in developing and maintaining viable patterns of behaviour.

However, any evaluation of the role of such information requires consideration of how managers make use of the information provided to them (Otley, 1999).

The objective of management control system is to provide information that is useful in decision making, planning, control, and evaluation (Kaplan, 1983; Widener, 2004). Based on this objective, the management control system is a management tool for how to carry out management functions properly. Therefore, the management control system is basically a system composed of complementary components (Widener, 2004; Milgrom and Roberts, 1995; Otley, 1994). Peljhan and Tekavcic (2008) found that management control system influences the implementation and monitoring of strategies providing feedback for learning and information to be used interactively to formulate strategy further. It shows that the use of every element of the management control system must be used together to have strength in its implementation.

## **B. Previous Research and Hypotheses Development**

### **1. Relationship between business strategy and firm performance**

The linkage of strategy and performance is central in strategic management research (Anwar & Hasnu, 2016). Zott and Amit (2008) states that the main objective of the strategy is to increase organizational performance. Marri *et.al* (2018) add if strategy is considered as the foundation for accomplishing organizational competitive advantage and

organizational performance. Intense competition motivates organisations to seek competitive advantage and so at some level they consciously identify and proactively formulate their objectives before they make decisions and implement any action (Bhimani and Langfield-Smith, 2007).

Marri, Qaiyum, and Alibuhtto (2018) states that strategy is considered foundation for accomplishing organizational competitive advantage and organizational performance. So, in other words, firm performance could be influenced by business strategy. This statement in line with the prior researches by Spanos et al. (2004), Kim et al. (2004) and Parnell (2010) which have found that business strategy has a positive effect on firm performance. Therefore, in the context of this research, the researcher retests a hypothesis that is understood in the literature:

H1: Business strategy has positive effect on the firm performance

2. Relationship between business strategy and firm performance with management control systems as intervening variable

Anthony and Govindarajan (2007) suggested that the management control system is the structured ways used by managers to ensure that people monitored implement the intended strategy. According to Soobaroyen (2006), what is monitored or regulated in the management control system is the performance of the manager's behavior in

managing the firm to be accountable to stakeholders. It includes defining the corporate mission, specifying achievable objectives, developing strategies, and setting policy guidelines.

Furthermore, Anthony and Govindarajan (2007) explain that management control is between strategy formulation and task control. Kober, *et.al* (2007) add that the interactive use of management control systems mechanisms helps to facilitate a change in strategy. The strategy formulation is more focused on the long term, task control focuses on the short term, and management controls are among them. Thus, management control system is an implementation of the business strategy conducted by the firm in achieving their goals. One of the major firm goals is increasing their performance.

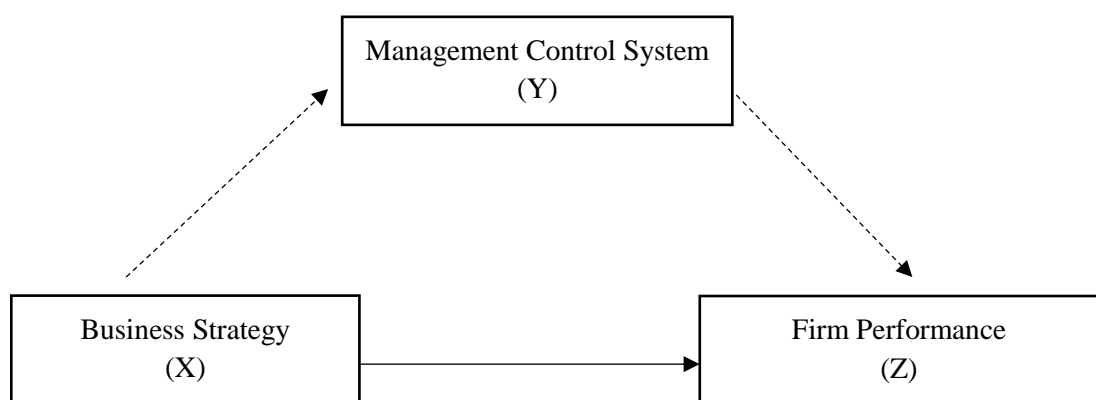
Researches conducted by Bin-Nashwan (2017), Acquaah (2013), Peljhan & Tekavcic (2008), and Kober, Ng, and Paul (2007) support the relationship between business strategy, firm performance, and management control systems. Chenhall (2003) makes several propositions based on several classification strategies that are important to provide conclusions to support the relationship between firm performance and management control system.

Based on the structural model and the results of the hypothesis testing it can be concluded as follows:

H2: Business strategy has positive effect on the firm performance and management control system as the intervening variable.

### C. Research Model

Based on the previous explanation, the following model is obtained from this research. The model of this research is about the relationship between business strategy as the independent variable related to firm performance as the dependent variable and management control system as the intervening variable. The research model is illustrated below:



**Diagram 1. Research Model**