

Management control system case study

Business



Whenever they met, they talked about going into business together. Instead of starting an entirely new business, Ted and Frank really wanted to find a “fixer-upper” – they wanted to purchase and “turn around” a failing business that showed a lot of potential. In good business school fashion,” said Frank, “we established some criteria, which were: 1. The company couldn’t cost much, since we didn’t have much time were managerial skills. 3.

The industry had to be fragmented and non-oligopolies. We didn’t want to be a small fish in a big pond. 4.

We needed to be able to see our way clear to have the company grow at a rate of 20% per year the first five year-period. ” Ted and Frank looked at a number of businesses over the next year and a half and in early fall of 1989, located a fixed-base operational at San Miguel Airport in Texas that was losing money and looking for a buyer. After four months of negotiation, on December 29, 1989, Ted, just 26 years old, and Frank, 28, purchased the stock of the company for \$100,000, assumed the lease on the building (and all the assets and liabilities) and were in business.

The lease on the facilities had a purchase option at a price considerably less than the market value. By exercising the option and then selling and leasing back the building, Ted and Frank were able to raise the \$500,000 for working capital. Ted and Frank discussed the organizational structure at Aerate, and agreed to decentralize its operations by making each operating activity a profit center and grouping them by departments. Each departmental manager would be given authority over his operations,

including granting of credit, purchasing to a predetermined limit, setting policies, and collecting receivables.

He or she would also be held responsible for its results. Frank was concerned, however: I agree with our decision to decentralized this authority, but I am concerned whether now is the time to do it.

We'll have a tough time when we first walk in the door and I don't know if the departmental managers can be taught some of these management techniques fast enough. After all, some have never insides high school. Maybe we should begin by making all these decisions ourselves for a month or two.

I realize that we don't know the aviation business yet, but even though neither of us has been a line manager, maybe we can learn the aviation business faster than some of our managers can learn formal management skills. Either way, we're putting the company on the line and the two-minute warning whistle has already blown.

During the four months they were negotiating the deal, Frank and Ted spent virtually every weekend together. Of this period, Ted commented: 1 Fixed-base operations are companies located on an airport that arrive the non-airline aviation market.

They generally sell, fuel and maintain aircraft as well as provide flight instruction and charter services. These companies can range from small family operations to multiple-location companies with sales exceeding \$500 million. We spent something on the order often hours a week, of which

maybe two or three hours would be trying to understand Sarah Urethra's accounting system and accounting statements, and another two or three discussing pro formal financial projections and the rest on what we would do when we acquired the company.

Frank classically did the financial projections and I designed the accounting system.

Actually, I dreamed it up one afternoon at work. I sat down at my computer and designed the forms myself. Franks projections for the next ten years showed that things were really tight. Even with the \$500, 000 from the sale and leaseback of the facilities, Frank projected that we were going to run out of money near the end of the first year.

We knew this when we were negotiating for the company, and it made us a bit nervous. Well, three days before the closing, Frank came to me, white as a sheet, and confessed that we had made a structural error in the projections. He was computing three months.

We had a little discussion as to whether we should blow the whole deal right there, knowing that we could' t survive. W e decided to go ahead with the deal. We knew it would be an impossible Job, no matter how we sliced it, but we were prepared to go through with it.

AERATE AVIATION PRIOR TO PURCHASE Aerate was one of eight fixed-base operations at San Miguel Airport, which served Center County, Texas – one of the most rapidly growing comma- nineties in the nation. Aerate had a loss of

\$500, 000 on sales of \$10 million in fiscal year 1989, and this left the company with a negative net worth (see Exhibit 1).

The company conducted activities through six informal departments (see Exhibit 2). Fuel line activity The activity employed twelve unskilled fueling people, with an average tenure with the company of eight months, and three dispatchers who coordinated their activities via two-way radio. It was managed by Will Leonard, a man in his mid-30s, who had been the construction foreman for Bill Dickerson when Bill was a real estate developer.

When Dickerson bought Aerate in 1980, he brought Will Leonard with him to manage the “line crew. Will was enthusiastic about his job, extremely loyal to Dickerson, and well-liked by his employees.

Although lacking in any theory of management (he had a high school diploma and some Junior college credits), Will was a good first line manager who was instinctively people-conscious while holding them in line. The fuel activity encompassed five operations: Retail Fueling – A Phillips Petroleum franchise of underground storage of 60, 000 gallons of Jet fuel, 20, 000 gallons of “VA-Gas,” and five fuel trucks to serve locally based and transient aircraft. Wholesale Fueling – Service of a fuel farm for Texas Air, regional airline connecting San Miguel with cities in Texas, Louisiana, Arkansas and Oklahoma. Aerate bought its own fuel separately.

Fuel Hauling – An over-the-road fuel truck and a Texas Public Utilities permit to haul fuel on public roads. The truck, in essence, served Phillips, at a price, by delivering its fuel to Aerate. Rental Cars – An agency of a local automobile rental company, mainly used as a service to train- Steen pilots. Tie-Downs – <https://assignbuster.com/management-control-system-case-study/>

Storage of transient and San Miguel- based aircraft in six hangars and 50 open tie-downs. 2 The fuel activity was open 18 hours a day, seven days a week, year-round.

Service and parts The service activity repaired, maintained, and overhauled aircraft. It employed six mechanics and a departmental secretary.

The parts activity, a separate accounting entity, employed one person and was managed by the head of service, as sales went almost entirely to the service activity. The manager of these operations was Carl Green, a man in his ass, who had been chief mechanic for Dove Aircraft at Love Field in Dallas prior to moving to Aerate. Before that, he was the mechanic/copilot for a Dallas oil executive.

Carl had a high school diploma, aircraft and power 2 A tie-down s an area of asphalt or concrete with ropes, where an aircraft is parked by tying it down to prevent it from rolling away or from sustaining wind damage. Lana licenses, and multi-engine and commercial pilot certificates. He knew airplanes, engines and aircraft mechanics. He was, in Tee’s words, “ not a self-starter, had a bit of retirement mentality, and avoided conflict except when it came to quality. You would never worry about anything he rolled out of his shop. ” Flight training The flight training activity was managed by Roy Douglas, whose pilot license was early days, and was highly respected by the aviation community.

He spent a lot of time “ hangar flying” with old cronies and, while he didn’t manage the department in any real day-to- day sense, he hired the seven instructor pilots and three dispatchers, gave check rides to students prior to <https://assignbuster.com/management-control-system-case-study/>

their FAA [Federal Aviation Administration] flight exam, and set safety policies. He and his chief dispatcher, who now had been with him for over ten years, were intensely loyal to both Aerate Aviation and the flying community. They had, however, “ seen everything and were surprised by nothing,” and they were very resistant to change, be it new aircraft technology, aviation caching methodology, or accounting systems.

The flight training activity, which had lost money each year, had two types of operations: Flight School – Flight training in 18 single- engine light aircraft from eight flight instructors coordinated by three dispatchers. Flight ratings were offered from private pilot through air trans- port ratings. Pilot Shop – Sales of flight supplies, such as logbooks, navigational charts, and personal and training flight supplies.

Sales were made from three display counters by the flight school dispatchers. Avionics Avionics was a single-person activity conducted by Leon Praxis.

Leon was a college- trained electronics technician whose responsibilities included repair- inning radios and electronic navigational equipment. He started at eight every morning and left promptly at five, so that he could spend time working on other interests at home. Aircraft sales Aerate had been a Piper Aircraft dealer until two months before its sale.

The owner, Bill Dickerson, was unable to finance the number of aircraft Piper required to be carried in inventory, so he lost the franchise, fired his two salespeople, and closed down the department.

Accounting The Accounting Department was central to the company in two ways. First, it was located in a glass-enclosed office in the center of the building, where it could be seen by everyone and everyone could be seen from it (see Exhibit 3). The second part of its centrality was the role that its manager, Sarah Arthur, played in Aerate. Sarah had worked for Bill Dickerson for more than 20 years. In his absence, which was frequent, Sarah managed the company.

While her title was accountant, she had no accounting training of any kind, and her idea of running the company was to be the central repository of all information.

She received and opened all the mail – not just mail for her department – and she would distribute it to the department heads as she saw fit. What she distributed, in Tee's words, "was typically nothing – bills would come and she would keep them. Checks would come and she would keep them. And, at the end of the day, she would collect cash from all the departments and keep it." Sarah managed all the receivables and payable.

All accounting information was Sarah's, and nothing left her office. The department managers knew nothing about the profitability of their operations. All they knew was that airplanes would fly and that

Sarah Arthur would come around at the end of each day and collect their money. Then, occasionally, she would berate the department managers for their high receivables. Of course, they had no idea how big their receivables were, or who they represented.

They would just “ be beaten over the head. ” As Ted described it: The management system that was in place when we bought the company was one incomprehensible formal system. There were basic financial statements and a set of reports that were produced for and according to Piper Aircraft’s specifications each month, but they helped Piper, not the management.

We may have negotiated with Bill Dickerson, but we were going to take over the management of the company from Sarah Arthur. ASSUMING MANAGEMENT RESPONSIBILITIES The roles of Ted and Frank Frank and Ted took over the business not only as full and equal partners, but as best friends who understood each other very well. Frank assumed the chairmanship, and turned his attention to specific and critical projects, the first being the reestablishment of aircraft sales – potentially a major profit area.

Ted took the title of president and chief operating officer, and began to manage the rest of the business.

As Ted said later: I knew Frank wouldn’t be right at my side at every session, but I made sure that four times a day I could walk into his office and say, “ Frank, I don’t really know what I’m doing,” and he would give me a pat on the back and put my head in order. Frank, in turn, depended on Ted for operational inputs and intellectual support. They both worked 12-hour days, five days a week, with Ted, not married, putting in 10-12 hours each day on weekends as well. Frank, who had a family, tried to put in three or four hours a day on the weekends.

Management and control Beyond the immediate cash crisis, Ted viewed his three most important tasks as: 1 . Revamping the management of Aerate. 2. <https://assignbuster.com/management-control-system-case-study/>

Installing a control system that would both support the management and provide information needed in order to make decisions. 3. Wrestling De facto control of the company from Sarah Arthur promptly.

Frank and Ted believed that it was very important to provide an environment where the departmental managers could make correct decisions on their own, since they had decided they could not make all the decisions themselves.

They had neither the time nor the technical knowledge. As Ted put it: One of the things I was very concerned about was how to manage by providing an environment that encouraged the managers to make decisions the way I would want them made. That was very, very important to me. I wanted to provide a framework that didn't limit their actions but certainly provided very fast feedback as to how they were doing and made it personally worthwhile for them to do the right things.

I spent a lot of time thinking about how to do that, and it occurred to me that there were really two ways to do that.

I recognize that there has to be the black hat and the white hat in any of these situations, and so I decided to make the control system represent reality and my personal role would then be that of an action leader as opposed to a task leader. I would let the control system be the task leader, and then I could exert more avuncular personal leadership. I also realized that I didn't have the time to train everyone in the management approach we wanted to use at Aerate. Nor did I have the guts to fire everyone and bring in new talent, and that wouldn't have been a good idea anyway.

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I also realized that unless I changed the basic attitudes in the company, we would never survive.

In order to do that, we needed to do a lot of education, and that would be my personal role. But, if I was going to do that successfully, I couldn't at the same time be berating them about the achievable, so it was necessary to take the unity-gritty daily tasks of banging people that, and so to provide this environment for decentralized decision making was very, very important. Ted began to implement a management control structure, incorporating the following policies: 4.

Profit centers would be established for each major activity. These profit centers would be combined where appropriate into departments.

5. Revenues and expenses would be identified by profit center and communicated to the profit center manager. 6. Departmental managers would be responsible for their profit centers, and would receive a bonus of 10% of their profit center profits after administrative- even allocation. 7. The profit center managers would have pricing authority for their products or services, both inter- nally and externally.

The fuel department manager could, and did, charge the Flight School retail price for the fuel they used, whereas he charged the Service Department his cost for its oil. 5. The profit center managers could buy products externally rather than internally, if it was in their best interests to do so. The Flight School manager could, and did, have his aircraft repaired outside Arête's shop when it was unable to fulfill his service deeds. 6. The profit center

managers could buy needed cap- ITIL equipment and operating supplies on their own authority within established purchase order limits.

Ted recalled one of the first times this decentralized authority was tested: When we bought the company, it had an old, rotten, obsolete copier. It was under the control of Sarah Arthur, and everyone who wanted a copy of anything had to go to Sarah, the Witch of the North, and plead – which was really an awful thing to do. I remember one day, Will Leonard, the manager of the Fuel Department, said, “ Can’t I get a copier? I said, “ Will, you can do anything you want within the limitations of the POP. So, he bought the smallest copier he could find, and he let everyone in the company make copies, charging them 10 cents a copy. At the end of the month, he would present bills to every department for the copies they used. He made money on his copier because everyone else was scared to death to walk into the Accounting Department and face the Witch of the North.

Here was a classic entrepreneurial example, and it became almost a cause c©l©BRB. People were saying, “ How did he get a copier? What right does he have to charge me for the copier? I would say, “ If you want a copier, go get one. But with one here at 10 cents a copy, they realized they couldn’t really afford one them- selves, so they grumbled and went about their business. 7. The profit center managers had the authority to hire, fire, and administer the salary schedule in their departments quite independent of the rest of the company. CASH MANAGEMENT Cash and accounts payable When Ted arrived at Aerate on the first day of his ownership, he gathered up the checks Sarah had written and pulled up the accounts payable file on the computer, called in his departmental managers one by one and said, “ Who <https://assignbuster.com/management-control-system-case-study/>

are your most important suppliers? He looked at the individual accounts to see how old the balances were and called up each of the suppliers, saying, “ I’m the new owner of Aerate Aviation, and I would like to come down and talk to you about our credit arrangements.

” He later said: Over the next six months, I got on good terms with the suppliers. I talked to them, took them out to lunch, and let them take me out to lunch. We paid them a little bit here and a little bit there, and we stayed out of serious trouble. A direct result of Tee’s assumption of the accounts payable decision was that agreed upon.

As it became clear that Ted was not going to let her make the manage- meet decisions anymore, she limited her work for the company strictly to the four-month transition period agreed upon in the purchase agreement. As Ted put it: She effectively said, “ I will work from 11 a.

M. To 2: 00 p. M. Every day. I will answer your questions and that is all. ” That was fine with me.

I hired a new accounting clerk to be Sarah’s assistant. She worked from 8 in the morning until 7 at night. I hired her; she worked for me. And when Sarah Arthur quietly packed up and left, the departure was easy.

Cash and accounts receivable With the accounts payable crisis on the road to a solution, Ted turned his attention to cash inflow.

In his words: My biggest worry was how we were going to control cash, or rather, how I was going to provide a system that would motivate the departments to manage cash. The solution I came up with was to take the <https://assignbuster.com/management-control-system-case-study/>

receive- abeles and give them back to the departments. That was very controversial. Everybody in the whole company fought me on that. Frank didn't like it – I was totally alone.

First of all, the managers didn't understand it.

They had never seen receivables, they didn't know hat they were. They felt as though they were playing with dynamite. “ Here they are, but what do I do with them? ” Frank, on the other hand, was concerned that things would get totally out of control because our most important asset – our incoming cash flow – had suddenly been handed out to amateurs. Sarah Arthur may not have been perfect, but she had a lot of experience. In the Fuel Department, I handed the receivables to the dispatcher, a 20-year-old surfer who had dropped out of college after two years.

In the Flight School, I also gave them to the dispatcher, a 55-year-old, loyal employee. These were the only two departments with significant accounts receivable. In Service and Avionics, I gave them to the managers, but these were not significant. One Saturday morning, I sat down at the computer and printed up all of the balances, and physically pre- sensed them to these two women – the De facto depart- meet heads. Then I sat down and showed them how to input the correct information using the current weeks transactions. So, we started to collect data on the accounts receivable.

To motivate the department heads to manage their accounts receivable, Ted gave them the credit- granting authority and the responsibility for OLL- elections. He also established the following monthly charges against their departmental profits: Receivables 60 days old or less 1% of the balance
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Receivables 60-90 days old 3% of the balance
Receivables 90-120 days old 3% of the balance
Receivables over 120 days old 6% of the balance charged the balance to the profit center
Cash and the banks
When Frank and Ted acquired Aerate, they also acquired short-term bank notes payable of \$300,000 from the Center National Bank.

The notes had been outstanding for several years, and Ted was concerned, since if the bank called the notes, it would put the company into bankruptcy. As Ted recalled: One of the people I called just before we bought the company was Hal Latter, the manager of the branch we did business with. I took him out to dinner, and over dinner, I told him about the company and how it was doing, as well as some of my plans for the future.

I said, “ But we have this problem of the \$300,000 I owe you. I would love to convert that to a 24- capital to make us more attractive to our suppliers.

That way, we can get better terms from them. ” He looked at me and, without thinking it over, said, “ Fine, I’ll do it. ” He had made a gut decision based upon some good vibes, and I was shocked, since I was prepared to negotiate with him. I thought to myself, “ The basis upon which business is done, at least with this man, is total candor and honesty.

” So, I started this program of giving the bank our internal financial reports every month, along with a cover letter summarizing what I was doing.

Hall’s reaction was great. He thought it was the best thing he’d ever seen. No customer had ever done that to him before. The result was that whenever I went to him – we paid off the loan ahead of time – and said, “ Hal, it looks

as if I'm going to need \$500, 000 for 60 days," he would say, miss, Eve been following it.

Eve been watching your receive- abeles growing because of your extra business. I know a growing business needs money from time to time. It's no problem – I'll put the money in your account this afternoon. THE ACCOUNTING SYSTEM By the end of the second month, Aerate was producing a profit and loss statement on the activities of each department. Each department kept account of its own sales, receivables, inventories, expenses and, through the POP system, expenses initiated by the department.

In order to provide a predictable, and simple method of cost allocation which still would be understood and “ managed” by the department heads, Ted established an Administration Profit Center which paid taxes, borrowed money, paid interest, utilities, bills, and other general admits- iterative expenses.

The Administrative Department in turn levied a series of monthly charges to each department as follows: I Social Security taxes, health insurance, and other fringe benefits were charged to departments as a predetermined percent of wages. Thus, when a manager took on a new employee, he or she knew that it would cost the department, say, 125% of the wage. I Accounts receivable – a monthly charge based on the amount and age of the receivables. I Operating assets – including the Parts Department inventory and the Service Department' s shop equipment – were charged to the departments using them on a predetermined percent of the asset's cost.

I Rent, fire and occupancy insurance, building main-tenancy and depreciation, and other occupancy costs were charged as predetermined rental per square foot of floor or ramp space occupied.

I A predetermined percentage of sales which repres- ended the cost of Tee's office and the Accounting Department was also charged. As all the charges were predetermined, calculus- elated and announced twice a year, the managers loud control their expenses by managing their receivable balances, conserving on equipment purr- chases, and varying the square footage they coco- pied.

There were never any unanticipated expenses, and the charging rates were set for breakable. As Ted put it: There was an interesting example of the effects of this system. Aerate had a total of 5. 2 acres of land, of which approximately 3 were for tie-downs that accommodated approximately 60 aircraft.

The fuel Department always wanted more space because it meant that they could accommodate more transient aircraft. The Flight School always wanted more space to make it easier to manage their comings and goings. The Shop always wanted more space as a service and convenience to customers leaving or dropping off aircraft to be serviced.

Before the departments conflict. Bill Dickerson, the former owner, or Sarah would have to make what was essentially an arbitrary decision. With our system, however, there was a definite price to be paid for demanding more space.

And with the manager's bonus system, 10% of that price came right out of the manager's pocket. The result was that we had very few of these discussions that did not reach a natural compromise. And when, over time, each department truly needed more space and was more and more willing to pay the rent, we raised the rent until demand equaled supply.

It was great to see a free market in action: THE TASK GUIDANCE SYSTEM As an aid towards educating departmental managers in the management of their operations and for keeping them aware of their activities, responsibilities and results, Frank and Ted instituted a Daily Department Report, which required the departments to submit internally consistent operating and accounting information. Each department kept the customer account information, and central accounting kept only receivables control accounts, which would balance to each department's detail.

The managers would account for their daily activity in units and in dollars.

For example, the Flight School's DIR was prepared each morning by 11 a. M. And reported the activity of the preceding day. The first set of entries on the report (see Exhibit 4) detailed the sales made by the Flight Department by each type of sales. The total represented all the revenue that was credited to Sales (indicated by (1) on the DIR).

The second set of numbers categorized the flow of funds into the Flight Department by type – cash, credit card slips, or reductions in the block accounts or leaseback payments due.

The total of these funds (indicated by (2) on the DIR) are the charges (debits), to cash, accounts receivable or the block accounts payable. The final group of items details the direct costs incurred in the production of revenue. These were:

- I The expenses incurred in utilizing leased training aircraft. These were, by contract, a fixed amount per actual hour of aircraft use.

- I The wages due to the flight instructors. These instructors were paid a contractual amount for each hour of instruction given. If the flight student was charged \$60.00 per instructional hour by Aerate, Aerate would then owe the instructor \$40.00 for that hour.

- I Cost of supplies - the direct cost of the items sold in the Pilot Shop. The total, (3) on the DIR, represented the direct costs of the Flight Department for that day. Cash received in the mail and cash collected by the departments was deposited daily. Photocopies of the checks were given to the departments for identification of source and inclusion on their Dry. Ted commented: We would deposit the check and send the photocopies around to the departments. Sometimes a check would come into Aerate room someone and no one would 3 A block account represented prepaid flying lessons or aircraft rental.

Cash was received in advance and recorded as an accounts payable by Aerate. The customer's flying activities were then charged (debited) to this account as they occurred. Aerate leased most of its instructional aircraft from private owners. Aerate contracted to pay them so much per hour for

use of the aircraft. Some leases were “ wet,” meaning that the aircraft owner furnished the fuel.

Other were “ dry,” meaning that Aerate paid for the fuel used. Know who it was. Sometimes it would take two or three weeks to find out what it was for. It was passed around the various departments, but in the meantime, we had the money.

We couldn't account no one accounted for it, and it became administrative profit.

The detail of charge slips, photocopies of checks, and physical currency would be attached to the DIR and by 11 a. M. Each department would turn them into Accounting – with sales balanced against receipts, inventory against fuel flows, and receivables proven-out. There were still errors, but they got corrected at the departmental level, although at least one department had to hire an additional person to do the DIR. The system left the Accounting Department with a simple task.

They had Dry from each department, but only one sales figure from each. Thus, their postings were trivial. All they had to do was to post the Dry and then worry about other prorated issues, like taxes. Now, only one person was needed in accounting, and the detail was where it should be – in the departments where it could be used. Similar systems were put in place for the Flight School, Service Department and Parts Department. For example, in Parts, a physical card was maintained for each inventory item.

To purchase, the Parts Department would issue a purchase order.

When the parts and invoice arrived, the total inventory-ROR balance was increased by the invoice amount, and a copy of the invoice was sent to the Parts Department. They would update their card balances for sales made. At the end of each month, Accounting would balance its control account against the sums shown on the parts cards. Another control was the requirement for each department to submit aging of their accounts receivables to Accounting. Accounting would compare these amounts against their control totals.

As Ted put it, “ We balanced the aging provided by the departments against the books in central accounting down to the penny.

That gave us our basic control. ” Aircraft sales While Ted was implementing the control system, educating the managers, dealing with the creditors, and establishing a better relationship with the bank, Frank was dealing with aircraft sales. Frank began by reestablishing Arête’s relationship with the Piper Aircraft Corporation. He convinced them that Arête was on its way to financial stability and could not only sell but be able to inventory the requisite number of aircraft to maintain dealer status.

Frank negotiated the terms with Piper, involving Ted only with Piper’s reporting requirements.