International Journal of Economic Perspectives, 2017, Volume 11, Issue 3, 384-391.

Strategy Formation Process and Management Control

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ABSTRACT

A developing area of research interest is the relationship between control systems and strategy. This topic has been covered in the professional literature with anecdotal case studies, and in the academic literature several normative papers have been published. However, there has been little empirical research that has studied explicitly management control systems (MCS) and specific small and medium size enterprises' (SME's) strategies. This study also observes the relationship between the use of MCS and learning system to reach competitive advantage that will finally create sustainable organizational performance. There are many studies observing the relationship between strategy and control system (CS), however there are lack of studies that observe the influence of strategy formation process and the use of CS. The purpose of this study is to observe the relationship between strategy process and control system to improve organizational performance. Data is collected through direct interview. Total questionnaires used in this study is 450. Structural Equation Modeling (SEM) is the tool to analyze model in this study. This study applied AMOS 21 program to solve any problems in covariance based SEM. The study finds out that if strategy changes control system will adapt itself with the changes. The result from this study has also succesfully explained the influence of strategy formation process on diagnostic control that had not been previously discussed.

JEL Classifications, D23; D83; L10.

Keywords: Strategy; Control System; Learning; Organizational Performance.

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1. INTRODUCTION

Management control was defined as the process by managers which ensure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's objectives. There are two uses of control mechanism (Simon, 1995). The result from qualitative method finds out that the use of interactive control system will not only adapt it self with the strategy (Kober et al., 2007), but also improve organizational capability (Henri, 2006; Tubagus, 2016). If control system is used independently, it will not provide strength for an organization (Simons, 1995; Henri, 2006). The purpose of this study is to observe the relationship between strategy formation process and the use of control system (CS), interactive and diagnostic control system, by using quantitative method. The use of both control systems will provide more optimum result (Simon, 1995). Strategy used in this study is intended, emergent and implemented strategy.

A research interest in this study is the relationship between control systems and manufacturing strategy. This topic has been covered in the professional literature with anecdotal case studies, and in the academic literature several normative papers have been published. However, there has been little empirical research that has studied explicitly MCS and specific SME's strategies. This study also observes the relationship between the use of CS and learning system to reach competitive advantage that will finally create sustainable organizational performance. There are many studies observing the relationship between strategy and CS, however there are lack of studies that observe the influence of strategy formation process and the use of CS (Kober, 2010).

2. LITERARY REVIEW

Figure 1 presents a summary of the theoretical model that reflects the relatioanship among variables. Intended strategy, viewed as a proactive formal statement that has been planned before a decision is taken.

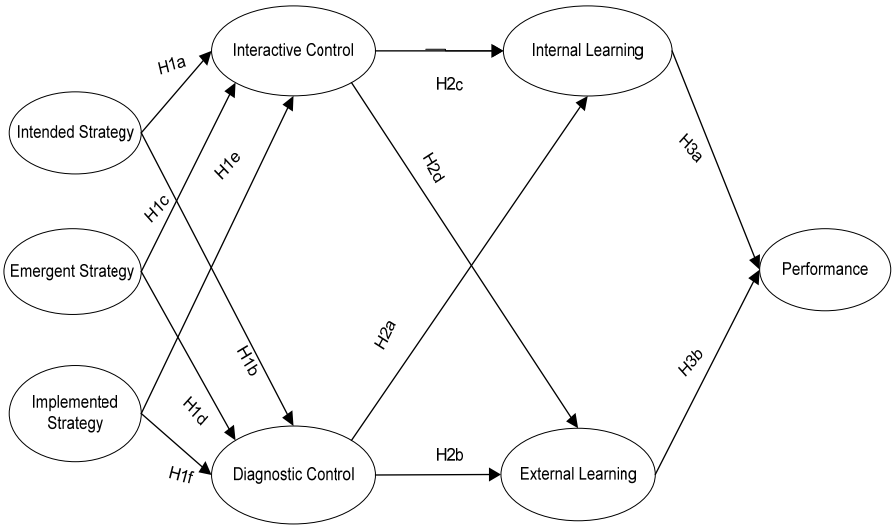

Figure 1.
Theoretical Model

The basic concept of this strategy states that all action must be well preplanned (Simon, 1995). Intended strategy explains the plan from top to bottom line in an organization. The second strategy formation process is called emergent strategy. This strategy is the result of cumulative influence from daily decisions made by middle managers, which is usually tactical decision, and not framed as strategic decision. Emergent strategy is a strategy that responds on external threat which has not been predicted before (Mintzerg, 1994).

Strategy separated from strategy making, is academic at best. It is impossible to comprehend the difficulties associated with the formulation and implementation of strategy if one ignores the inseparability that exists between the concept of strategy and the process of makingit a realityin a partiuclar organizational setting. In fact, the process school of research, as defined by Bower & Doz (1979), views strategy as the outcome of three different processes contributing to strategy formation: 1. The cognitive processes of individuals on which understandings of the environment of strategy are based; 2. The social and organizational processesby which perceptions are channeled and commitments developed; and 3. The political processes by which the power to influence purpose and resources is shifted. They go even further when asserting that "the task of the chief executive is viewed as the administration of these processes," which require the development of a broad vision of what to achieve and the management of a network of organizational forces that lead to the discovery, evolution and enrichment of that vision. We discuss now some issues which we consider the most relevant to gain a deeper understanding of theconcepts of strategy and the strategy formation process.

In the already cited work of Mintzberg (1994), besides defining strategy as a pattern in a stream of decisions, the authors inroduce the concepts of deliberate and emergent strategies. Comparing intended strategy with realized strategy, allows the recognition of deliberate strategy - which are realized as intended - and emergent strategy - patterns or consistencies realized despite or in the absence of intentions. These two concepts, especially their interplay, have become the basis for the proposal of a typology to characterize various kinds of strategy formation processes. At one end of this continuum falls the purely deliberate strategy, with the purely emergent at the other end. Between these two extremes fall strategies which would combine various states of the dimensions we have discussed before: the degree of explicitness, openess, participativeness, centralized involvement, consensus management, formalization vs. power behavior drives, and continuity vs. future change. Also, the type of strategy will be affected by the nature of the enviornment the firm is dealing with, particularly whether it is more or less benign, controllable, and predictable.

The key conclusion to be extracted from this typology is that strategy formation has two critical forces acting simultaneously: one is deliberate, the other is emergent. Deliberate strategy is required because managers need to provide a sense of purposeful direction to the organization. Emergent strategy implies "learning what works - taking one action at a time in search for that viable pattern or consistency. Emergent strategy means no chaos, but unintended order." Emergent strategy does not have to mean that management is out of control, only that it is open, flexible, and responsive; in other words, willing to learn. There are many perspectives to define strategy

implementation. They include controlling, monitoring and evaluating action (Hrebiniak & Joyce, 1985), the performance of strategy plan (Floyd & Woolridge, 1992), resource allocation, operational problems solving (Cespedes, 1991), changing strategy purpose into real action (Johnson & Scholes, 1999).

Unfortunately, there are still few literatures that discuss conceptual model of strategy implementation that will accommodate the natural form of strategy which has emergent or intended trait, especially if it is correlated with management accounting practice. Strategy formulation and implementation include identifying opportunities and threats in the organization's environment, evaluating the strengths and weaknesses of the organization, designing structures, defining roles, hiring appropriate people, and developing appropriate rewards to keep those people motivated to make contributions. Strategy is the forging of company missions, setting objectives for the organization in light of external and internal forces, formulating specific policies and strategies to achieve objectives, and ensuring their proper implementation so that the basic purposes and objectives of the organization will be achieved.

Survey research proved and provided strong explanation that stated the strong influence of strategy on the chosen control system (Daniel & Reitsperger, 1992), and special kind of CS will adapt itself with certain strategy (Miles & Snow, 1978; Simons, 1987). Simons (1995) differentiated the use of MCS as interactive control and diagnostic control. Diagnostic control and interactive control system are the use of management control that completes each other and works simultaneously, but it has different purpose. Management control systems are viewed typically as tools of strategy implementation. More analytical, MCS are broadly defined as the formalised routines and procedures using information to maintain or alter patterns in organisational activity, and include formalised information-based processes for planning, budgeting, cost control, environmental scanning, competitor analysis, performance evaluation, resource allocation, and employee rewards (Simon, 1995).

The broad literature on MCS distinguish the use of MCS in diagnostic and interactive use. The MCS is described as information feedback systems, where goals are set in advance, outcomes are compared with preset objectives, and important variances are given to management teams for amendments, adjustments and follow-up. Since this type of systems is considered as the primary tool for management-by-exception, the literature characterise them as diagnostic control systems (Simon, 1995). Moreover, diagnostic use of control systems represents a negative force mainly for two reasons: (a) it is focused on mistakes and negative variances, and (b) the derived sign of the deviation when outcomes and preset goals are compared is reversed in the feedback signal to adjust the process (Henri, 2006). Simons (1995) mentions that MCSs are not always used to manage by exception. In many cases, top management uses MCSs for day-to-day issues to support organisational decision making. Thus, MCSs can be characterised as interactive when top management teams use them to personally and regularly involve themselves in the decisions of subordinates. The interactive use of MCSs represents a positive force since they are utilised to encourage opportunity-seeking and learning throughout the firm (Henri, 2006).

Interactive control is a formal system used by the owner and the manager of SME to involve themselves personally and continuously in decision making activities which is based on employee's input in an organization (Simons, 1995). Interactive control is used to stimulate dialogues, face to face interaction, and to build informational bridge between the manager and the employee of SME. Interactive control is used by top management to guide and lead strategy formation process by determining personal involvement, problem proximity, and commitment (Mintzberg, 1987). Diagnostic control is a formal feedback system used by the owner and the manager of SME to monitor organization's final result and correct and performance deviation (Simons, 1991). Diagnostic control is clearly explained by business plan. Diagnostic is a feedback system to track any variances that occur in determined organizational purpose (Simons, 1995). Conventional view of strategy and CS relationship stated that strategy formation process and its implementation will influence how CS is used. It is in line with contingence theory (Otley, 1994) which means that CS is needed to be suited with organizational strategy. It will lead into hypotheses as follow:

H1: Intended strategy positively influences interactive control and diagnostic control

H2: Emergent Strategy positively influences interactive control and diagnostic control.

H3: Strategy implementation positively influences interactive control and diagnostic control.

Diagnostic control helps manager by providing final result information which is not met with organization's expectation. It will be an example of single loop learning process (Argyris, 1977). Diagnostic control

communicates agenda and explains strategy through critical success factor keys (Simons, 1991). Management control will also facilitate organizational learning process (Kloot, 1997). Univariate work result from Henri (2006) found positive relationship between diagnostic control and learning process.

Capabilities forge a link between resources and permit their deployment. They are the organizational processes by which firms synthesize and acquire knowledge resources, and generate new application from those resources. Formally stated: "The firm's processes that use resources-specifically the processes to integrate, reconfigure, gain and release resources to match and even create market change. Dynamic capabilities thus are the organizational and strategic routines by which firms achieve new resource configurations as market emerge, collide, split, evolve, and die (Eisenhardt & Martin, 2000). organizational learning is recognized as primary capabilities to reach competitive advantage, to match and create market change. Pastresearch suggests that each of these four capabilities.

Organizational learning refers to the development of insights, knowledge and associations among past actions, the effectiveness of these actions, and future actions (Fiol & Lyles, 1985). An organization's ability to survive and grow is based on advantages that stem from capabilities that represent collective learning (Nevis et al., 1995). Learning is considered to be an important facilitator of competitive advantage by improving a firm's information processing activities at a faster rate than rivals do (Baker & Sinkula,1999). Interactive control is a double loop learning system (Argyris, 1977). The purpose of interactive control is to improve manager's ability in anticipating, managing and directing future uncertainties (Simons, 1987). Organizational learning is a learning process that comes from past experience (Levitt and March, 1988).

Interactive control is a facilitator for learning process in an organization. It is an implemented system to ease an organization in processing information and facilitating existed learning process through vertical line of information. Control will help organization to form new strategy, explain new ideas and possibilities, and also to support and improve curiosity (Simons, 1995). It will also provide signal to the lower part of an organization about the important aspect in implementing and stating new ideas (Simons, 1990, 1991). By keeping open dialogue, debate, and supporting information exchange, interactive control will contribute to knowledge, information, and communication distribution. Interactive control will produce spontaneous strategy (Malina & Selto, 2004; Simons, 1995). Interactive control will contribute on capability by running this way of system. This study uses capability from Schroeder et al (2002) that is internal and external learning in an organization. Based on the explanation above, two hypotheses proposing as follow:

H4: Interactive control positively influences internal learning and external learning.

H5: Diagnostic control positively influences internal learning and external learning.

Organizational learning is a main tool to reach sustainable competitive advantage and it also becomes an important thing to improve organizational performance (Brockman & Morgan, 2003). An organization that able to learn effectively will feel market opportunity in a better way (Tippins and Sohi, 2003). As a result, this organization will be more flexible and faster in responding new challenge from competitor that enables an organization to defend long term competitive advantage (Slater and Naver, 1995). Organizational learning is proposed to affect performance by building and disseminating organizational knowledge. While a few studies have focused on the importance of learning for the long-term survival of the firm, the majority of this research emphasizes the value of what organizations already know. Previous studies have proven positive relationship between organizational learning and organizational performance. Baker & Sinkula (1999) found that learning orientation directly affects organizational performance. Therefore, this study develops hypotheses by evaluating theoretical argument and empirical result as follow:

H6: Internal learning positively influences organizational performance.

H7: External learning positively influences organizational performance.

The following section will describe methodology of this study.

3. METHODOLOGY

Respondents in this study are the owners and the managers of SMEs in creative industries of Western Java, Jakarta, Central Java and Eastern Java province. The criteria to choose respondent are minimum five years of experience and employ minimum 50 employees. Data is collected through direct interview. Total questionnaires used in this study is 450. Structural Equation Modeling (SEM) via the AMOS statistical software is the tool to analyze model in this study.

Each construct in this study is measured by indicators using 7 Likert scale, in which 1 represents totally disagree and 7 represents totally agree. Indicators used in this study comes from previous studies. Intended strategy is adapted from Boyd & Reuning-Elliot (1998). Emergent strategy is measured by indicators from Mintzberg & Waters (1985) and Marginson (2002). Implemented strategy is measured by indicators from Noble (1999) and Heide et al. (2002). Interactive and diagnostic control is measured by indicators from Simons (1995) and Henri (2006). Internal and external learning is measured by indicators from Schroeder et al (2002). SME performance uses indicators from Stam and Elfring (2008).

4. RESULT AND DISCUSSION

On average respondents have run their business for about 6.5 years. The result from Jarque Bera test (JB test) shows that data has been normally distributed, it can be seen from the value of JB test below $\chi 2$ (0.05, 2) = 5.99 (Arasli et al., 2005a; 2005b; 2008). This normality becomes standard assumption which is prerequisited by SEM. Based on the result of AMOS output (Table 1), RMSEA value is below 0.08, AGFI, TLI and CFI value are larger than 0,9, and it has met fit criteria (Katircioglu et al., 2011a; 2011b; 2011c; Byrne, 2010). All latent construct in this study has value larger than 0.5 and composite reliability value larger than 0.7. It means that data in this study is reliable (Katircioglu et al., 2012).

Table 1. The SEM Results

	Standard estimate	**SE**	**CR**	**P**	**Hypothesis**
Intended strategy --> Interactive	0.65	0.133	5.415	***	Supported
Intended strategy --> Diagnostic	0.37	0.122	3.131	***	Supported
Emergent strategy --> Interactive	0.56	0.142	4.696	***	Supported
Emergent strategy --> Diagnostic	0.15	0.089	1.739	0.773	Not Supported
Implemented strategy --> Interactive	0.65	0.121	5.656	***	Supported
Implemented strategy --> Diagnostic	0.38	0.122	3.131	***	Supported
Interactive control--> Int. learning	0.55	0.142	4.696	***	Supported
Interactive control-->Ext. learning	0.15	0.113	4.739	***	Supported
Diagnostic control --> Int learning	0.63	0.121	5.656	***	Supported
Diagnostic control --> Ext. learning	0.38	0.122	3.131	***	Supported
Internal learning -> Performance	0.56	0.142	4.696	***	Supported
External learning -> Performance	0.15	0.113	5.739	***	Supported
	AVE	**√AVE**	**Composite Reliability**	**Mean score**	**JB Test**
Intended strategy	0.753	0.86775	0.942	4.8	3.677
Emergent startegy	0.671	0.81914	0.815	5.7	3.984
Implemented strategy	0.673	0.82036	0.813	4.9	4.328
Interactive control	0.753	0.86775	0.842	5.4	4.479
Diagnostic control	0.671	0.81914	0.915	5.9	4.522
Internal learning	0.674	0.82097	0.913	6.1	4.877
External learning	0.671	0.81914	0.813	5.8	4.238
Performance	0.654	0.80870	0.912	4.7	3.729
Fit Indices					
RMSEA : 0.051					
AGFI : 0.927					
TLI : 0.965					
CFI : 0.977					

Notes: *** significant at the level 0.001

Based on hypotheses testing result in Table 1, all hypotheses are accepted, except one of them which denies the relationship between emergent strategy and diagnostic control. It is in line with CS contingence theory and deeply influenced by strategy formation process. The use of strategy as contextual variable deeply influences the uses of CS. It can be seen from the unexpected situation which push the production of emergent strategy. An organization tends to deny the use of diagnostic control system and prefer to choose interactive control system. Intended strategy provides bigger influence to diagnostic control than interactive control system. Implemented strategy will provide bigger influence to interactive control than diagnostic control.

The result from this study provides enough evidence to support contingence theory. Certain kind of control system will adapt itself with certain strategy, such as intended, emergent and implemented strategy. The result from this study also explains research gap from qualitative study (Kober et al., 2007) which had not been generalized. Based on quantitative result, the relationship from strategy formation process and implemented strategy and management control system can be generalized. The result from this study also explains the influence of strategy process on diagnostic control which had not been explained by Kober et al. (2007). The use of control system will improve learning process and SME performance.

5. CONCLUSION

This study also observes the relationship between the use of MCS and learning system to reach competitive advantage that will finally create sustainable organizational performance. There are many studies observing the relationship between strategy and control system (CS), however there are lack of studies that observe the influence of strategy formation process and the use of CS. The purpose of this study is to observe the relationship between strategy process and control system to improve organizational performance. Strategy is the forging of company missions, setting objectives for the organization in light of external and internal forces, formulating specific policies and strategies to achieve objectives, and ensuring their proper implementation so that the basic purposes and objectives of the organization will be achieved. Survey research proved and provided strong explanation that stated the strong influence of strategy on the chosen control system and special kind of CS will adapt itself with certain strategy. The use of MCS as interactive control and diagnostic control. Diagnostic control and interactive control system are the use of management control that completes each other and works simultaneously, but it has different purpose.

Based on contingence theory, one variable that influences management control system is strategy. If strategy is implemented, it needs to be adapted with the changes happen in organizational environment. Therefore, formed strategy may be realized as it has planned before, or it can be modified and even differently formed from the plan. If strategy changes, management control system must be adapted with the changes happened in strategy. The result from this study provides enough evidence to support contingence theory. Certain kind of control system will adapt itself with certain strategy, such as intended, emergent and implemented strategy.

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