

Management Control Systems

Text and Cases

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Contents

Foreword

vii

Preface

viii

Acknowledgements

ix

PART A — INTRODUCTION TO MANAGEMENT CONTROL SYSTEM

1. Management Control System : An Introduction 3

Introduction – Scope of Management Control System – Need of Management Control System – Functions of Management Control – Organisational Context of Management Control Systems – Design and Purpose of Formal and Informal Management Control Systems – Management Control System and Subsystems that Affect It – Processes of Accounting and Management Control - Complex Industrial Dynamics, Disaster and Management Control System – Cybernetics and System Approach to Management Control System – Summary – Review Questions

2. Key Variables in Management Control Process 14

Introduction – Key Variables and Their Sources – Process of Identification of Key Variables – Classification of Key Variables – The Key Variable for the Business: Ensuring Across the Board Control – Key Control Indicators and Control Mechanism – Techniques to Identify the Key Variables of a Business – Limitation of Usage of Key Variables – Summary – Review Questions – Analytical Questions

3. Designing Management Control Systems 21

Introduction – Process of Designing a Control System – Identifying the Organisation Hierarchy – Understanding the Process of the Business – Establishing the Linkages Between the Various Stakeholders Towards Goal Congruence – Establishing a Formal Information System Flow Between Various Departments and Sub Units of the Business – Designing the Control System – Implementing the Control System – Summary – Review Questions – Analytical Questions

PART B— ENVIRONMENT OF MANAGEMENT CONTROL SYSTEM

4. Organisation, Strategy and Control 31

Introduction – Goals and Objectives as Boundary Constraints – Strategies as a Pathway for Control Systems – Behavioural Aspects of Management and Control Process – Process of Setting Joint Goals through Creation of Responsibility Centres – Benchmarking – Summary – Review Questions – Analytical Question – Questions for Discussion

5. Organisational Infrastructure, Organisational Design and Control System	39
Introduction – Debate on Decentralisation and Centralisation – Control Factors in Organisational Design – Adaptive Control and the Adaptive Organisation – Divisional Autonomy – Responsibility Centres and Related Performance Measurement of an Organisation – Summary – Review Questions – Analytical Question	
6. Approaches to Management Control Systems	44
Introduction – Theory of Contingency versus Theory of Universalism – Strategy and Control Systems – Corporate Strategy and Diversification – Response of the Control System to Corporate Strategy – Strategies Available for a Business Unit – Porter's Five Forces Theory and Competitive Advantage of the Business Unit – Summary – Review Questions – Analytical Question	
PART C — TOOLS OF MANAGEMENT CONTROL SYSTEM	
7. Strategic Planning as a Tool to Management Control System	51
Introduction – Characteristics of Strategic Planning – Benefits of Strategic Planning – Significance of Strategic Planning – Process of Strategic Planning – Allocation of Resources and Strategic Planning Process – Bower's Model of Investment Decision Making Process – Summary – Review Questions – Analytical Question	
8. The Budget as a Tool of Control	55
Introduction – Budgetary Control – Need for Budgetary Control – Objectives of Budgetary Control – Organisational Set Up for Budgetary Control – Formation of a Budget – Administration of a Budget – Types of Budgets – Processes of Budgeting – Capital Budgeting – Summary – Review Questions – Analytical Questions	
9. Valuation as a Tool to Management Control	75
Introduction – Understanding Assets and Liabilities for the Purpose of Control – Measuring Liability Employed: Valuation of Securities for Control – Measuring the Value of the Asset Employed – Book Value: Gross and Net Value – Disposition of Assets – Depreciation – Leased Assets – Idle Assets – Intangible Assets – EVA vs ROI – Considerations in Evaluating Managers – Evaluation of Economic Performance – Summary – Review Questions – Analytical Question	
10. Transfer Pricing as a Tool to Management Control	84
Introduction – Objectives of Transfer Pricing – Fundamental Assumption in Transfer Pricing – The Ideal Situation for Transfer Pricing – Limitations – Methods of Transfer Pricing – Problems with Transfer Pricing – Administering – Transfer Prices – Some Technical Bases of Conceptualising Transfer Pricing – Summary – Review Questions – Analytical Question	
11. Management Control of Responsibility Centers Through Audit	92
Introduction – Why Audit the Responsibility Centre? – Role of the Audit – Process of an Audit – Scheduling an Audit – Audit Plan – Tools and Techniques for Auditing –	

Continuous Improvement through Auditing – Gaining Strategic Advantage through an Audit – Summary – Review Questions – Analytical Question

12. Management Control of Operational Processes 102

Introduction – The Role of Information in Operation Management – Continuous Process Improvement for Operations – Tools in Continuous Process Improvement – Summary – Review Questions – Analytical Questions

13. Production Control 109

Introduction – Production Controls – Measuring Production Performance – Production Control Reports – Summary – Review Questions – Analytical Question

14. Marketing Control 113

Introduction – Types of Marketing Controls – Marketing Audit – External and Internal Marketing Audits – Characteristics of an Effective Marketing Audit – Sales Control – Sales Quotas – Importance of Sales Quotas – Sales and Cost Analysis – Sales Variance Analysis – Market Share Analysis – Sales Reporting – Credit Control – Receivables Management – Credit Rating – Performance Evaluation and Performance-based Compensation – Compensation and Incentive Systems for the Sales Force – Sales Force Management Audit – Distribution Control – Evaluation of Channel Performance – Marketing Communication Control – Marketing Control in Branding – Information Systems for Marketing Control – Sales Force Automation as a Control Tool – Mobile CRM – Enterprise-wide – Summary – Review Questions – Analytical Question

15. Performance Report and Reward System as a Tool of Control 146

Introduction – Analysis of Variance – Types of Standards in Standard Costing – Setting Standards – Variance in Practice – Limitations of Variance Analysis – Tight vs Loose Control – Reward for Good Performance – Purpose of a Reward System – Reward through Compensation – Performance Variables – Designing a Reward System – Summary – Review Questions – Analytical Questions

PART D — MANAGEMENT CONTROL OF SPECIAL ORGANISATIONS

16. Management Control in Multinational Companies 161

Introduction – Considerations of Management Control in MNCs – Issues of Exchange Rate – Issues in Designing a Control System for an MNC – Issues of Management Control in Multinational Companies – Summary – Review Questions – Analytical Question

17. Management Control for Service Organisations 170

Introduction – The Service Sector – Characteristics of Management Control in a Service Organisation – Professional Organisations and their Characteristics – Issues in Professional Organisations – Issues in Management Control Systems – Some Special Service Organisations – Summary – Review Questions – Analytical Questions

18. Management Control of Projects	177
Introduction – Key Issues in the Control of a Project – The Role of Control in Projects – Process Control in Projects – Various Phases of a Project and Control – Summary – Review Questions – Analytical Question	
19. Management Control in Non-Governmental Organisations and Developmental Programs	182
Introduction – The Key Issues in the Management Control of NGOs and Development Organisations – Evaluation System for Development Programs and NGOs – Research Methodology – Summary – Review Questions – Analytical Question	

PART E — SPECIAL ISSUES IN MANAGEMENT CONTROL SYSTEM

20. Use of Management Information System in a Management Control System	189
Introduction – What is MIS? – Designing a Good MIS – Features of an Effective MIS – Types of Information Systems – Role of MIS in the Functional Areas of Management – How to Implement an MIS – How to Evaluate an MIS – Summary – Review Questions – Analytical Question	
21. Ethical Issues and Moral Issues in Management Control	
Introduction – Role of Ethics in Control – Designing a Control System that Supports Ethical Behaviour – Ethical Principles in Designing a Control System – Summary – Review Questions – Analytical Questions	

PART F — CASES FOR MANAGEMENT CONTROL SYSTEM

• LONG CASES	194
Case 1 Action Learning as a Form of Management Control – Dutch Elevator Company	201
Case 2 Strategic Planning and Programming – ITC Limited	206
Case 3 Tracing the Transfer Pricing in Philips India Ltd.	211
Case 4 Reward System in Centurion Bank of Punjab Ltd.	215
Case 5 On Capex Assurance in Telecom Industry	219
Case 6 Management Control in an MNC – Standard Chartered Bank	224
Case 7 Prayas – An NGO in Trying	230
Case 8 Birla Sun Life Insurance Company Ltd. – Insuring Peace of Mind	232
• SHORT CASES	
Case 1 Praga Tools Private Ltd.: Motivating the Sales Force	237
Case 2 Bengal Lamps: Issues in Quality Control	239
Case 3 Paperback Books: Reporting System in the Sales Team	241

Case 4	Rolta Motors: Ethical Issues in Trying to Retain Employees	242
Case 5	Sujata Bakery: Issues in Managing the Transfer Prices of an Organisation	243
Case 6	Viswal Steel: Land and Project Management	244
Case 7	Pumul: Problems of a Milk Union	245
Case 8	SHG: Helping the Way to Weave	246
Case 9	Bioappliances: Issues in Managing the Culture of an Organisation been Taken Over	247
Case 10	Signature Breweries: Financial Dilemma	248
Bibliography		249
Glossary		251
Index		254

CHAPTER 1 Management Control System: An Introduction

LEARNING OBJECTIVES OF THE CHAPTER

- Management control system: An introduction
- Scope of management control system
- Need of a management control system
- Functions of a management control system
- Organisational context of a management control system
- The design and purpose of a formal and informal management control system
- Management control system and subsystems that affect it
- Processes of accounting and management control
- Complex industrial dynamics, disaster and management control system
- Cybernetics and system approach to a management control system

1.1 INTRODUCTION

The business scenario today is rapidly changing due to geo-political environmental factors. The onset of global business is creating multi layer businesses both in the small and large sector. It is very interesting to observe that all these organisations are adapting to similar processes due to the changed economic environment.

This is driven by the fact that organisations are losing business competence if they operate from one location

The onset of global business is creating multi layer businesses both in the small and large sector.

In simple terms the function of management is to plan, organise, integrate and inter-relate organisational activities to achieve its objectives. This is facilitated through management control systems.

or by using one set of guiding principles. The consistency and effectiveness of performance solely lay in the management of the business. In simple terms the function of management is to plan, organise, integrate and inter-relate organisational activities to achieve its objectives. This is facilitated through management control systems.

A control system is a set of formal and informal systems to assist the management in moving forward to realise organisational

A control system is a set of formal and informal systems to assist the management in moving forward to realise organisational goals.

goals. Control helps in guiding employees effectively towards the accomplishment of the organisation's goals. Since, a management control system is a set of interrelated structures that facilitates the processing of information for the purpose of assisting managers in coordinating the

parts, and attaining the purpose, of an organisation on a continuous basis, it is difficult to establish a control system in an environment of distributed accountability, reengineered processes and empowered work structure. Control systems are integral to all organisations. They deal with coordination, resource allocation, motivation and performance measurement.

The development of a management control system started with the development of the theory and practice of modern management theory. In fact F.W. Taylor had suggested a control system in the theories he propounded. The idea of management control system originated at the end of the First World War. The resource crunch

The development of a management control system started with the development of the theory and practice of modern management theory.

and the heavy demand pushed industrial processes to the brink. At that time, the focus of the control system was on the performance of physical production. Later, during the final days of colonial rule of the British Empire, the focus shifted to production control, but by and large still directly controlled physical activities. It was in the late 1950s and early 1960s that the new science of cost accounting revolutionised the system of control process. For the first time it was felt that by controlling costs, a significant amount of business could be achieved. However, by the 1980s the focus had shifted to activity based control with the predominant focus on human resource management. From the late 1990s to date the focus has been on system-sub system management.

Figure 1.1 gives an idea as to how the management control paradigm has shifted and changed with time.

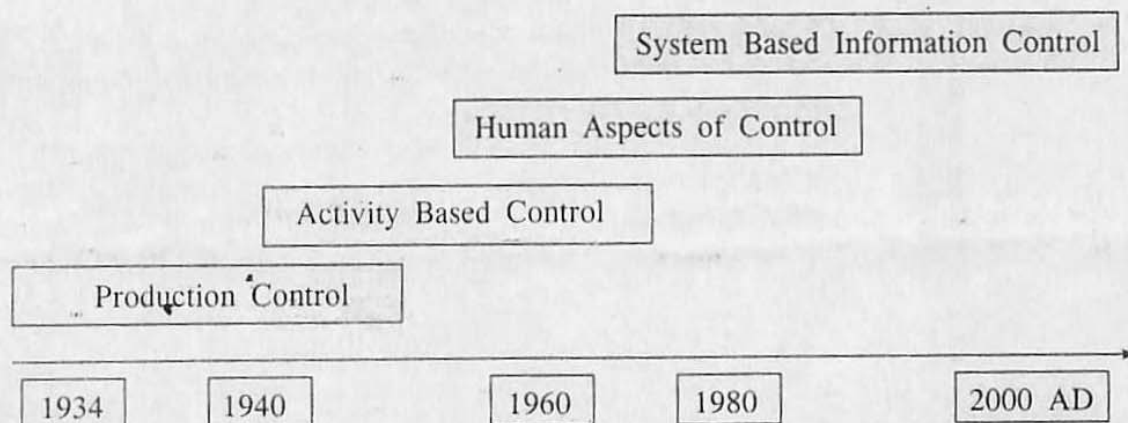


Fig. 1.1 : Historical perspective of development of management control system (A. Dutta, *Management Control System*, 1st Ed Kalyani, New Delhi 2008)

1.2 SCOPE OF MANAGEMENT CONTROL SYSTEM

All businesses have a common goal. In order to achieve that goal, several business processes work in tandem with each other, despite being diverse in nature. The scope of management control system comes into the picture because of this. In this

Management control system is basically a system of information processes which validates and verifies the physical processes in the organisation.

context management control system is basically a system of information processes which validates and verifies the physical processes in the organisation.

Depending on its nature, management control system can be divided into two categories as given below:

1.2.1 The Closed End Management Control System

A closed management system is a system in which the information flows through the activity, the

result, the matching of the standard preset, analysis of the variation if any and taking corrective steps to mitigate the mistake. Closed end control mechanics uses a receptor and a corrector mode of operation.

A closed management system is a system in which the information flows through the activity, the result, the matching of the standard pre set, analysis of the variation if any and taking corrective steps to mitigate the mistake.

In an organisation where there is an annual budget with preset goals and performance parameters, the implementation, collection of performance information, measurement of variance and thereafter taking corrective action on any negative variance across a preset standard is an example of a closed end control system.

1.2.2 The Open End Management Control System

An open management control system is a system in which the feedback mechanism is continuous in every step of the activity and follows a matrix system where several receptors interact with several correctors in the system.

An open management control system is a system in which the feedback mechanism is continuous in every step of the activity and follows a matrix system where several receptors interact with several correctors in the system.

A corporate system in which there is a continuous internal audit parallel to the general accounting and budgeting process enables an open end control system as it provides multiple feedbacks which are supportive of each other and work towards a common objective – say cost control.

Components of a Management Control System

A management control system essentially has the following four components:

1. **A detector or sensor:** This part detects the change or deviation.
2. **An assessor (actual vs. standard measurer):** This part measures the change in relation to a set standard.

3. **An effector (feedback and alternator):** This part begins the control process by taking in the feedback and altering the process to what is deemed to be normal.
4. **A communicating network:** This is the backbone of the control system as all the above mentioned three parts actually work with the help of this network by transferring information through it.

Figure 1.2 below gives a schematic picture of the relationship between the various components of the management control system in a business.

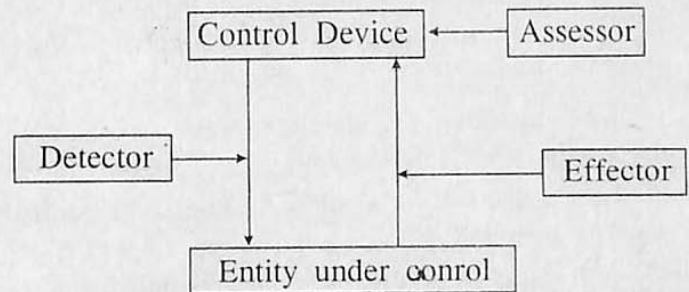


Fig. 1.2: Various components of management control system (A. Dutta, Management Control System, 1st Ed, Kalyani, New Delhi, 2008)

1.3 NEED OF MANAGEMENT CONTROL SYSTEMS

The management control system needs to provide a direction to the overall process of the business and steer the organisation towards the realisation of such goals that the business has set for itself. The management control system runs like a thread through the system and acts as a backbone which supports the organisational systems.

The need of the control system is to maintain that desired state of activity in the business. Information about the actual state of the organisation is compared with the desired state, and if there is a major deviation, corrective actions are taken.

The need of the control system is to maintain that desired state of activity in the business.

In an organisation, the control system involves the following functions:

1. Analysing and planning the activities of an organisation.
2. Coordinating the activities of the organisation.
3. Communicating information to different levels of the hierarchical structure.
4. Evaluating information and deciding the action to be taken.
5. Influencing employees of the organisation to change and accommodate to the new system.

In the planning stage, the management of an organisation decides what the organisation should do. The control process compares actual accomplishments with the set plans. Another important purpose of the control system is to ensure that the work of each part of the organisation is in harmony with that of the other. Control systems are designed to bring about unity of purpose in an organisation through the efforts of individuals.

The purpose of management control is to ensure that the right strategies are carried out to attain the organisation's goals. Management control systems anticipate future conditions. They are not self-regulating in nature. Managers usually operate in situations of uncertainty and the control systems ensure that proper actions are taken whenever they are needed, in spite of the uncertainty.

Management control systems help the management in decision-making. In the management control process, decisions are made according to procedures and timetables.

Management control systems help the management in decision-making.

It may be remembered here that management control system is an interdisciplinary subject. It uses the knowledge of all branches of management as it gives a direction to the business and helps the business to run effectively. This interrelating part of the management control system makes it an integral part of the business strategy. It is believed that the management control system provides for the implementation of the strategy and measurement of any deviation.

Management control system is an interdisciplinary subject.

1.4 FUNCTIONS OF MANAGEMENT CONTROL

The domain of the management control system is to accelerate the productivity and improve the quality of the end product of a business. The basic functions of the management control system are therefore to:

1. **Enable strategic planning:** Management control begins with the enablement of strategic planning of a business. The process of alignment with the vision, mission and goals of the business ensures an effective path for the business.
2. **Establish management control:** Thereafter, the process of control becomes important in the business as it helps in taking corrective steps in every managerial process whenever it goes wrong.
3. **Enable task control:** Task control is the root to all control as it enables the business tasks at all levels of the business to become one with the goals of the business.
4. **Lay the road map for the control of the strategy:** One major role of the control system is to lay a road map to strategy so that it can easily be employed.
5. **Ensure control of the operation.** The last, but not the least, function of the management control system is to ensure the operations of the business are controlled in such a way that the overall strategy, functions and tasks are carried out in the right direction.

1.5 ORGANISATIONAL CONTEXT OF MANAGEMENT CONTROL SYSTEMS

An organisation consists of many functions and the control system must ensure that the multiple functions of the organisation run in tandem. The control systems are designed to assist the management to run the business in orderly way with a realistic description of the goals of the organisation.

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The roles of the management control system in helping the organisation to run effectively are given below.

1.5.1 Organisations

1. **Subunits:** Organisations are divided into subunits. Subunits comprise individuals who perform certain activities to fulfil the purpose of the organisation. The subunits are based on the principles of division of labour. Division of labour enables monitors to specialise in certain tasks which improve the efficiency of the subunits. For example, all the activities that are concerned with marketing may be combined with a marketing department which can be termed as a subunit.

The control system plays a major role in coordinating the efforts of these subunits. The cost of coordinating these subunits may be referred to as transaction cost.

Control system designers try to design systems which help in minimising the transaction costs.	<i>Control system designers try to design systems which help in minimising the transaction costs.</i>
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Inefficient coordination of errors in subunits results in excess transaction costs. Each subunit should have the objective of reducing transaction costs so that the overall performance of the organisation is improved.

2. **Effectiveness and efficiency of an organisational subunit:** An organisational subunit is said to be effective when it meets the overall purpose of the organisation and it is said to be efficient when it meets the needs of the constituents of the organisation.

Effectiveness relates to the organisation's ability to meet the social purpose whereas the efficiency relates to the realisation of the business objectives by the organisation for its stakeholders.

Effectiveness relates to the organisation's ability to meet the social purpose whereas the efficiency relates to the realisation of the business objectives by the organisation for its stakeholders.

If the subunits become effective and efficient the organisation also becomes effective and efficient. An effective and efficient organisation meets its social demands and in the process consolidates and strengthens its constituents within the business.

3. **Executive function and management control system:** Securing essential efforts from the employees, providing a perfect system of communication and establishing the goals and objectives of the business and thereby delegating it are the three essential managerial functions, which were established by Chester Barnard.

However, these functions are not confined to an executive. It is the role of the entire management team to delegate responsibility of the right people and ensure that the management control system is put into place.

4. **Response to internal and external stakeholders:** The management has to be interactive and take various decisions regarding the business, keeping in mind both the internal and external stakeholders. The management control system helps in striking a balance between the internal efforts and the external activities.

5. **Organisational survival and control systems:** The market conditions are highly dynamic in today's modern world. The rapid changes in customer needs and the major stakeholders' needs necessitate that the business adopts innovative business methods. As a result of this the traditional control systems are becoming redundant. Optimum utilisation of resources makes it necessary for a business to look for adaptive control systems. Unless the internal control and information systems are as efficient as the outside ones in the market, the business will not be able to survive. This will be the only key to success in the changing business scenario.

6. **Control system and human behaviour:** In order to design and deliver a good management control system, it is essential to note that it is going to operate in a human system. Hence the basic qualities of a human being such as rationality, creativity and morality should be kept in mind. In addition, the desire of a human being to control others makes the system loaded with individual's perceptions of control which often makes an organisational system to fail.

1.6 THE DESIGN AND PURPOSE OF FORMAL AND INFORMAL CONTROL SYSTEMS

1.6.1 Formal Control System

A management control system generally follows two paths: the formal and the informal system.

The formal control systems are laid down according to the need and goals of the organisation, which have to be realised through the control mechanics. The informal management control system originates out of the general socio-cultural milieu.

A formal control system consists of the following sub systems:

1. Management style and culture of the organisation
2. Infrastructure
3. Rewards
4. Coordination and integration
5. Control tools and process

Figure 1.3 shows the relationship between these subsystems effectively.

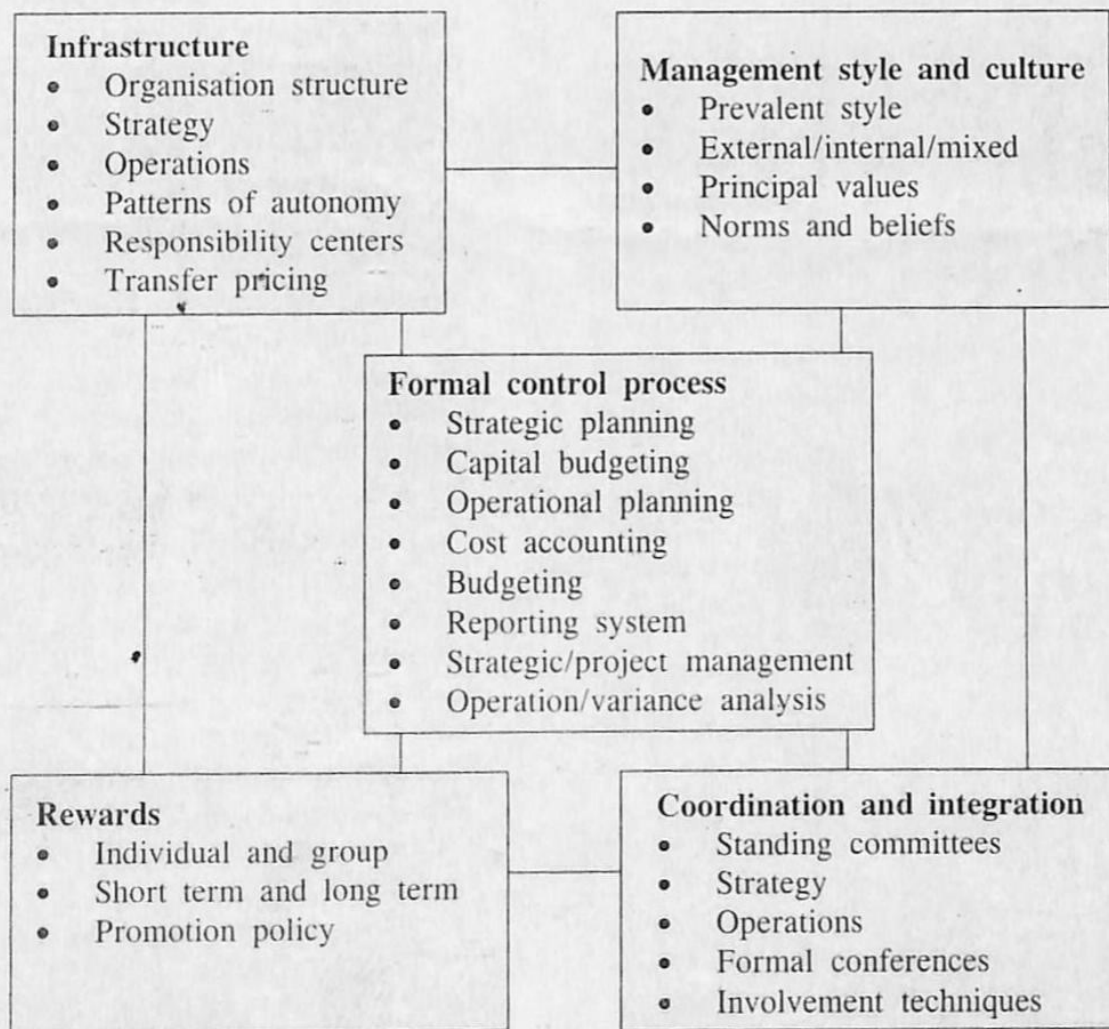


Fig. 1.3: Formal control system (Source: J.A. Maciarello, C.J. Kirby, *Management Control System*, PHI, 2nd Ed, 1997)

The formal control system focuses on the need of both the internal and external stakeholders. It is based on the information system established by the organisation. It is highly dynamic in nature

since it takes the basic forces of the market into consideration.

It is observed that the informal management control system uses the same backbone as the formal control system in its operation.

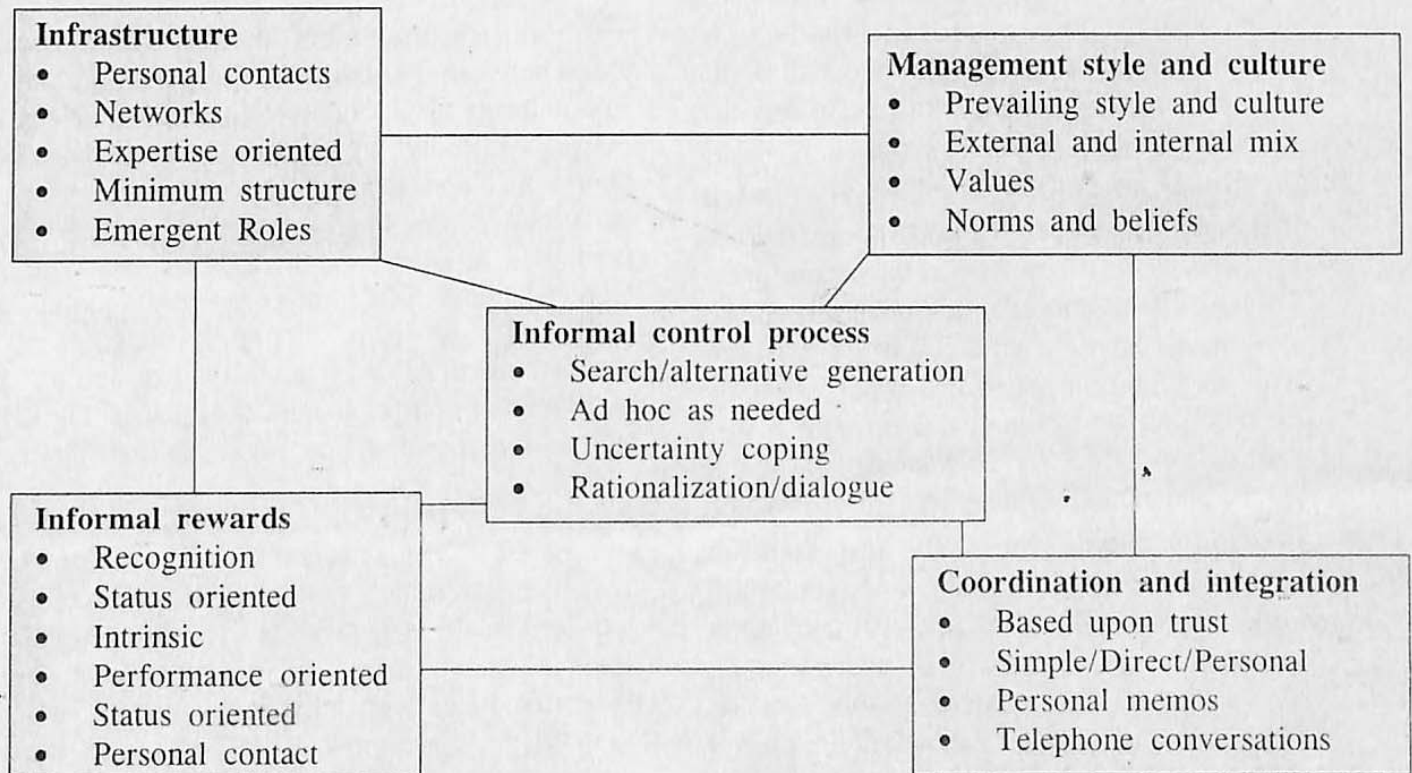


Fig. 1.4 Informal control systems (Source: J.A. Maciarello, C.J. Kirby, *Management Control System*, PHI, 2nd Ed, 1997)

1.6.2 Informal Control Systems

Organisations have their own informal systems in place. These consist of interaction between individuals and groups. These informal systems do not show up on the organisational chart of the business. However, such informal systems help to make the organisation more conducive to work and enhances the employees' willingness to work for the organisation. Figure 1.4 above shows the relationship that exists in an informal control system within the paradigm of the formal control system.

The informal control system is dependent on the expertise, experience and trust amongst the people working in the organisation and the stakeholders. The availability recognition based on informal coordination makes the mechanism

sound. Such informal control systems are highly dependent on the style and culture of individuals and the group.

The informal control system emerges from informal interaction and socialisation between people in the organisation, and thus makes the organisation adaptable to changes. Since in an informal system, there is free flow of information cutting across hierarchical levels, it makes the organisation more open and responsive to the environment for technical innovations and change.

1.7 MANAGEMENT CONTROL SYSTEM AND SUBSYSTEMS THAT AFFECT IT

The management control system is affected by several subsystems which are given in the following sections.

1.7.1 Organisational Style and Culture

A control system should be such that it coordinates the management's culture and helps in blending the styles of work of the top level management. A good control system should serve as a continuum from highly autocratic to highly participative function of management.

1. **Organisational culture:** Corporate culture depends primarily on the shared values and common perception in an organisation. The larger the premise of a shared value the greater is the strength of the corporate culture.
2. **Organisational culture as a control mechanism:** The better the corporate culture, the lower is the dissonance in the organisation. This facilitates the adaptation of the control system. A corporate culture must be consistent with the requirements of the organisation and the environment of the business. A process of self control through acceptance of shared values boosts the organisation's performance.
3. **Coaching people for skill and common values:** In order to increase the acceptability of the control process the management should enable processes that lead to the understanding of common values, procedures and policies. This enables the people within the organisation to appreciate the system and rise to the cause of the organisation.

1.7.2 Processes of Formal Control

The formal control process has two dimensions as given below.

1. **Formal planning process:** The formal planning is dependent upon strategic planning and operational planning. These are supported by the strategic budget and operational budget. In common terms, the strategic budgets are long term capital budgets. The formal planning process supports the formal control system internally.
2. **Formal reporting process:** The formal reporting system is designed to guide an organisation using the relevant information collected continuously from the organisation.

It forms the backbone of the corrective actions that need to be taken. Formal reports serve as background material on which the strategic planning is carried out. In fact, the strategic planning substantially depends on the current business occurrence. Hence, strategic planning needs to be changed and should accommodate the current operational plan.

1.7.3 Infrastructure

The infrastructure refers to the relationship that exists between the subsystems and their autonomy. The patterns of autonomy relate to the delegation of responsibility to the subunits. When both operational and strategic autonomy are given to the subunits, the subunit is termed as a Strategic Business Unit (SBU). Such SBUs increase customer responsiveness and entrepreneurial skills and garner more profit by integrating the goals of the organisation. A key issue in designing the management control system is to locate the SBUs at the right point in the organisational chart.

1.7.4 Rewards

One of the essential functions of an executive is to induce individuals to participate in the various activities of the organisation. The best method of doing this is to use an appropriate incentive program. Incentives may be monetary or non-monetary. Non-monetary compensations include acceptance, status, desired associations, pride of workmanship and desirable physical conditions.

Rewards may be individual rewards or group rewards. Individual rewards include compensation based on individual performance. Group rewards are tied to the overall performance of the organisation. Group rewards may be based on short-term or long-term performance.

1.7.5 Coordination and Integration Mechanism

Organisations need specific vehicles for communication to help in coordination, decision-making, conflict resolution and development of commitment and trust amongst the employees. In order to achieve this it is essential that there are committees that look after such issues. Such committees should have formal meetings and conferences to discuss issue based agendas and

also for general development in areas of their interest. The larger the shared value through such committees and conferences the greater is the chance of successful implementation of the formal control system.

1.7.6 Informal Control Process

Management decisions are based upon experience, intuition and feeling.

Informal control processes are formed as a result of interaction between people based on such experience, intuition and feeling.

Informal groups help in resolving a problem at the root level by forming ad hoc teams. Such an informal process helps in improving the productivity of the organisation. Besides, informal control processes uphold the values of the organisation. It has been observed that informal reward systems also help in developing a strong morale in the employees of the organisation. The respect that the individuals enjoy in an organisation also develops a strong bond in the organisation.

1.8 PROCESSES OF ACCOUNTING AND MANAGEMENT CONTROL

It is an established fact that the accounting system provides the most data in a business. This is partly because of the fact that accounting is quasi legal in nature and hence mandatory for the business.

Accounting collects critical information about the business over a regular period of time in several forms, and thus facilitates the control process.

An accounting system can be broadly classified into financial accounting, cost accounting and management accounting. The financial accounting and cost accounting collects the critical data about the business. The data are diverse since financial data are more or less based on transactions and the cost data are based on activities. The management accounting in turn helps in making meaningful reports about the business, such as the health of the business and strength of the business. We will see later, that management accounting, along with the other two systems, is a vital system of control tools in the business.

1.9 COMPLEX INDUSTRIAL DYNAMICS, DISASTER AND MANAGEMENT CONTROL SYSTEM

Until now we have discussed the control system for a business under normal circumstances. We need to understand that a business is a set of complex processes which work as an interlocking system of information network. This network emerges at various points of the control and affects the physical processes of the business. A well managed management control system identifies the flow of information through the physical activities of the organisation. By facilitating such an identification of the interlocking network of information, the management control system enables right decisions to be taken.

A business may often encounter a disastrous situation. A disaster is an abnormal situation, and hence calls for diversion of all resources to mitigate its effect. It is desirable to incorporate an appropriate

A good management control system should be enabled with a system so that a disaster has the least effect on the business processes.

built in system in the management control process, which can identify a disaster, prepare for it and deal with it correctly, so that the post disaster effect is low. A good management control system should be enabled with a system so that a disaster has the least effect on the business processes. It is a well known fact that the modern day information technology organisation has a separate cell to keep it in readiness to face any disaster. These include physical location preparedness and system level preparedness.

1.10 CYBERNETICS AND SYSTEMS APPROACH TO MANAGEMENT CONTROL SYSTEM

The word cybernetics has its origin in the Greek word 'Kybernetes' which mean the person who steers a boat. Thus cybernetics is the science

Cybernetics has its origin in the Greek word 'Kybernetes' which mean the person who steers a boat.

of control which steers the activity of a system by coordinating all the subsystems and leads to the desired result. Norbert Weiner coined the term in the 1940s and defined it as "The entire field of control and communication theory, whether in the machine or in animal".

"The entire field of control and communication theory, whether in the machine or in animal".

Cybernetics deals with the self regulatory principles in a variety of systems, which range from human and biological systems to mechanical systems. Cybernetics processes view a complete system as a collection of many subsystems which are unique in nature but work in tandem and depend upon each other to deliver the ultimate function or result of the system. Cybernetics is greatly dependent on complex information and a feedback network, which act as a reference to improve the initial actions and results. The science of cybernetics has been used in various fields such as radar technology, human genetics and artificial intelligence, to name a few.

In a management control system, cybernetics is used as a tool to set up norms or targets for a decision making information system. The actions are taken pursuant to the goals set. Cybernetics is used to establish the fact that in a business organisation there are subsystems which influence the greater system and which themselves are influenced by the environment and by each other. These complex relationships being influenced by each other and the environment and the corrective actions, which are mostly self regulated, answer some of the complex questions of the control mechanism of an organisation, which is almost like a living organism.

In a management control system, cybernetics is used as a tool to set up norms or targets for a decision making information system.

SUMMARY

A business organisation pursues diverse activities aimed at meeting a common goal which is ultimately reflected as the nature of the business. Since these activities are drivers they need to be

controlled to get the desired results. A management control system serves this purpose and integrates and coordinates the various activities of the business to a common goal. Each management system works in the context of the organisational structure it functions in. The design and purpose of the management control system varies from business to business. A business organisation can opt for an open end control or a close end control depending on what it desires to achieve. Within an organisation, both formal and informal control systems are established. The formal control systems are established keeping in mind the business need and are accompanied by a suitable reward system. On the other hand informal systems are more or less created from the interaction of individuals and the system in the organisation. Both these control systems help in development of the organisation. It may be noted that the business actually operates through complex industrial dynamics and it is necessary to be prepared for any disaster that may occur in the business. A good control system should be prepared for a disaster and post disaster recovery. Since, business organisations are seen as an interaction between a system and subsystem, cybernetics come into the picture to enable the process of control. The control mechanism is strengthened by the use of accounting processes, which primarily provide the information and the data base for processing the control mechanics.

Review Questions

1. Why is management control important to a business?
2. Give a detailed historical perspective of the management control system. How did the management control system evolve?
3. What is the scope of the management control system?
4. What are the close and open control systems of management control?
5. What are the components of the management control system? Describe them in detail.
6. What are the needs of the management control system?

7. What are the functions of the management control system?
 8. How is the effectiveness of an organisation different from its efficiency?
 9. What are formal and informal control systems?
 10. What are the subsystems that affect the management control system?
2. A manager was newly appointed to supervise the floor work in a factory. He found that the workers reported only to the works head of the factory for all their needs and factory related problems, which included the production process. He thereafter segregated the work and factory related problems and identified various persons to which each kind of problem was related. The workers were confused and this slowed down the process of work.

Analytical Questions

1. A European bank wants to start operations in India. What are the various factors that it has to keep in mind in order to ensure an effective control system?

Do you think that the approach was correct? Would it yield results in the short term or long term and how?