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Management control in modern organizations

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Abstract

This paper deals with management control as an important instrument for managing performances in modern organizations. The paper indicates to the circumstances in which classical theory of management control was created, and describes its process of functioning, with the specifics in large organizations. The aim is to point to some open questions and directions of further development of the management control, as well as to at least partially fill the gap that exists in the domestic literature. The conclusion is that the existing management control framework remains still valid. Open questions can be best resolved within the concept that observes this matter as a "package" of different control systems, not just those that are oriented to accounting-based performance measures.

KEY WORDS: *management control, planning and control cycle, performance measurement*

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Introduction

In economics there are few issues that could be said to have universal significance. One of them is: how to ensure that managers and workers do their jobs in the interest of their owners? Both, profit and non-profit organizations, managers and entrepreneurs, private, public and mixed owners etc., are equally interested for answers to this question.

During the 1960s, the classical theory of management control tried to offer systematic answers to the above question. The changes that have taken place in the coming decades have shown that these answers were too narrowly focused, both in terms of selection of key stakeholders (owners of large decentralized corporations), and in terms of control instruments (accounting-oriented).

Modern organizations communicate with a wide range of different stakeholders. For many of them, accounting-oriented control is neither the only, northe most important type of control. This is particularly true for organizations that are looking for new business models, based mainly on innovations, in order to adapt to changed external circumstances.

The need for a new framework of management control is obvious. Building this framework is slow and there is an evident gap between the theory of management control and managerial behavior. Unfortunately, one of the important consequences of this gap is the increase of financial scandals and unethical behavior of managers.

The subject of this paper is the basic elements of the management control process in modern organizations. The goal is to point out the limitations and perspectives of management control. In addition, the paper needs to at least partially fill the gap in the domestic literature.

The paper consists of five parts. The first part is literature review. The second part describes the basic elements of the management control process. The third part deals with the specifics of large corporations. The fourth part highlights some open issues and directions of further development of the theory of management control. The fifth part is the discussion and conclusions.

Literature review

Definitions

Management control is a process in which organization strives to achieve the planned or desired results, or "performances". In doing so, organizations may take various actions to minimize the negative effects arising from the external and internal environment. Management control represents a method for managing organization,s performances.

Clearly relationship exists between management control and accounting, but there are fundamental differences too. For example, the goal of financial accounting is the summary reporting on company,s performances. The information is primarily intended for external stakeholders and are prepared in accordance with accepted standards of financial reporting. On the other hand, the task of management control is to help managers of organizations to formulate key strategic objectives and plans and monitor their execution. In general, management control is an internal process. The techniques and tools used by management control are adapted to the specifics of each organization and are not subjected to any generally accepted standards.

On the other hand, there are also significant differences between management accounting (in particular cost accounting) and management control. Cost Accounting focuses on the measurement of costs in organizations. Management control is a broader concept than cost accounting. Management control focuses on company,s results, wherein costs are significant, but not the only measure of those results (ACCA, 2009).

Management control concept

Development of management control as a theoretical discipline is linked to seminal an paper entitled *Planning and Control System*, which was published by Robert Anthony in 1965. He defined management control as a function that links strategic planning with operational control (Otley, 1994). Management control was originally conceived as a solution to the managerial problems of large, decentralized corporations in developed industrial countries. Managers had the problem of how to coordinate and control the work of subordinate organizational units within the corporation. The task was to comply the activities of such units with the objectives of top management. In addition, it was necessary to provide information to help managers to be able to correct any deviations from the approved plans.

The classical theory of management control has offered a solution through the formation of so-called responsibility centers. These are cost centers, revenue centers, profit and investment centers. A special branch of management accounting, called responsibility accounting, was created on this basis.

So-called *Agency theory* developed by economists Jensen and Meckling during the eighties is very responsible for the formation of the classical theory of management control. Agency theory is based on the idea of a world in which operates a number of explicit and implicit contracts between two persons, owners and employees. In this world, both sides are behaving in a rational way and are motivated solely by self-interests. The agency relationship is reflected in the fact that the owner (or principal), delegates decision-making authority to the manager (or agent) which executes orders on behalf of the owner. Because of maximizing his personal utility, manager as an agent will not always act in the best interest of the owner. Consequently, the owner is required accounting and other control methods for controlling the behavior of managers. In addition to self-interests, the agency relationship between owners and managers is also influenced by other factors such as adverse selection, moral hazard, asymmetric information, and the like (Hewege, 2012).

Since the creation of the classical theory of management control in the 1960s until today, it has been more than half a century. During this period, major changes in the environment of organizations have been occured. Globalization, deregulation, the rise of powerful emerging economies such as China, India and Brazil, diffusion of new technologies, digitization of information, etc., are just some examples of such changes. It raised doubts among academics, managers and other stakeholders that the current system of management control has become irrelevant for doing business in changed conditions (Nixon, Burns, 2005).

Doubts were further intensified by other reasons. Series of collapses of corporations and financial scandals have highlighted the weaknesses of the external regulations and internal controls. More than ever, the managers of corporations were forced to take into account the interests of shareholders and other stakeholders. The position of managers in modern corporations became delicate; as internal stakeholders, they are the bearers of the control authority. Balancing the ethical role to do good for others, and equally for all, managers often face obstacles in the form of information and other interests of the dominant groups of stakeholders. Their single interests are not always aligned with the goals of the corporation. In addition, there are personal interests of managers such as bonuses, the desire for power, self-aggrandizement and the like. For all these reasons it is understandable why the motives for the unethical behavior of a manager in corporations is growing (Malinić, 2011; Stevanovic, 2011). In practice, this behavior is usually realized through contracting easily attainable planned objectives and by manipulation of data (Langevin, Mendoza, 2013).

In many ways the nature of the changes itself has changed. They have become pervasive and nonlinear, discontinuous and abrupt. Modern managers are forced to work in new kinds of business models such as alliances, clusters, partnerships, outsourcing and offshoring companies, e-commerce and the like. Some authors emphasize the potential of virtual organizations and the role of critical competencies of managers and team members for business success (Radovic- Markovic, et al., 2015). In addition, enterprises and entrepreneurs are inspired by open innovation as an emerging paradigm for creating new business models for the effective commercialization of new products, or services (Jevtic et al., 2014). Any such business model is a challenge to the existing system of management control.

Consequently, there is a strong need for the existing framework of management control to be supplemented with new knowledge, in order to respond to the challenges arising from the changing environment. This does not mean that the current framework has now become irrelevant; construction of a new framework for management control is a long-term process, but its basic elements are still valid (Nixon et al., 2005).

Process of management control elements

The process of management control can be represented by a planning and control cycle, as in Figure 1. The cycle consists of seven steps, of which the first five cover the planning process, and the last two steps are related to the control process. Planning is primarily a decision-making process. Control is implemented by means of measuring and correcting the results achieved, to ensure the realization of plans.

The purpose of the planning is to prepare managers of organizations for action. The first step is to define the objectives. In relation to the objectives, managers need to define two components, namely: (i) the type of objectives and (ii) the level of the desired goals. The first role of planning, therefore, is to determine so-called targeted objectives. The second role of planning is to predict how the organization can achieve the assigned targets.

In steps 2-4 in Figure 1, organization's managers consider different strategies for achieving the planned goals, evaluate their effects and choose the best alternative. A time-decomposing of selected long-term plans into annual plans or budgets is performed in step 5.

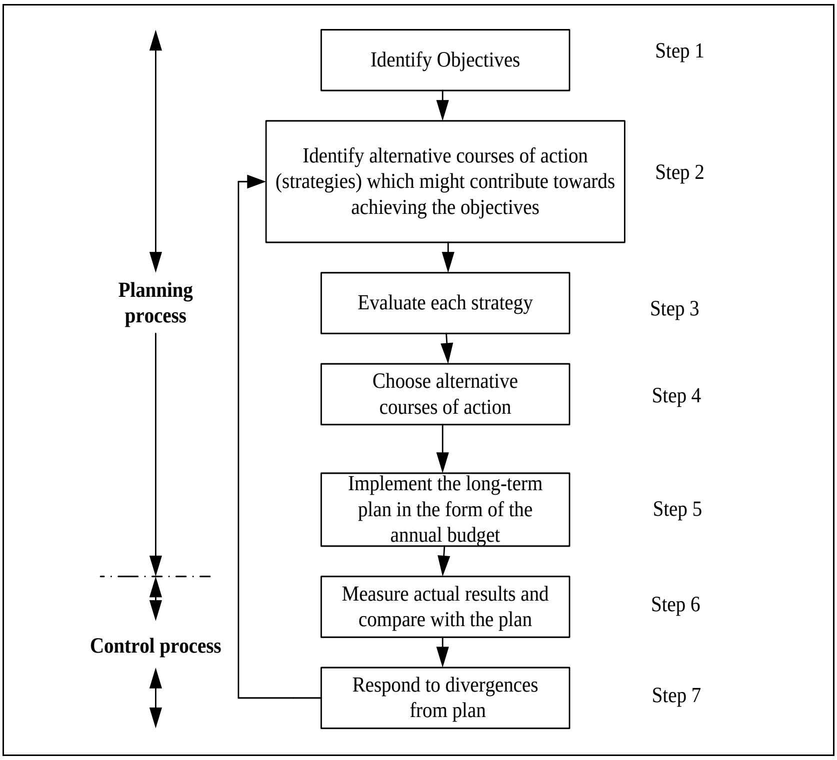

Figure 1:The Planning and Control Cycle

Source: ACCA, 2009

The control includes the steps 6-7 in *Figure 1*. The measurement and comparison of achieved results with the original plan are performed in the first of these two steps. In the second step, corrective action is taken in order to achieve the desired objectives, or to correct the plan. Control without planning is impossible, and vice versa; planning without control serves no purpose.

The process of control is not a linear process. The essence of control is not to "evaluate" whether the planned objectives have been achieved or not, but to monitor progress in achieving objectives. This progress is not determined at the end of the planning period, but rather during the implementation of the organization's plans. A feedback mechanism that is described by *Figure 2* serves for this purpose.

The feedback can have a dual role. First, due to the deviation of the achieved results from the planned targets, it could occur the action plans, i.e. strategy to be reviewed. Second, for the same reason it is possible to re-examine the objectives themselves.

Performance measurement is a very important issue in the process of management control. It is often simply considered that the performance measurement is in the exclusive jurisdiction of the financial (accounting) indicators.

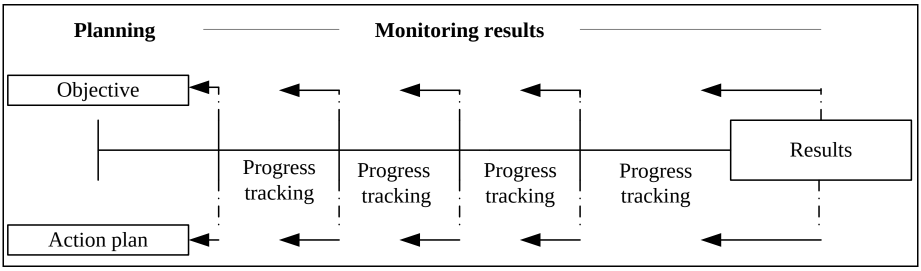

Figure 2: Feedback loop controol

Source: Giraoud, F. et al.

Management control, however, does not apply only to the profit-oriented organizations, but also in sectors such as health, public administration, humanitarian organizations, environmental protection, etc. Control process cannot begin until types, or qualitative dimensions of desired results are not defined. Then it is necessary to translate these qualitative dimensions into measurable units, or indicators, as in *Figure 3*.

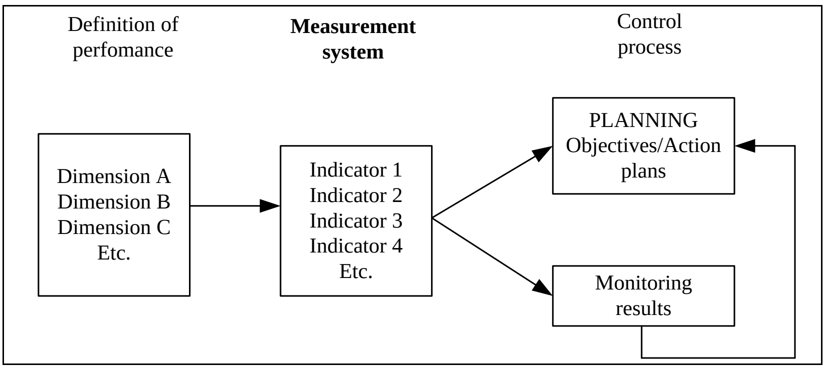

Figure 3:The structure of the control process: performance indicators

Source: Giraoud, F. et al

The organization may have a larger number of dimensions of desired performances, as well as individual indicators. In this case, we can talk about *measurement system*. The importance of measurement is that it increases the

likelihood that the planned objectives will actually be the subject of control. When selecting an appropriate performance measurement system, there is always a great subjectivity. Problems of this kind are particularly pronounced in the qualitative dimensions of performances and their indicators. Qualitative dimensions of the performances are not always clear and managers at different positions can perceive them in different ways. In practice it is not always easy for certain qualitative dimensions to be covered by appropriate indicator.

Modern management control systems use three groups of indicators for monitoring performances, as follows: (i) financial, (ii) non-financial and (iii) the combined (financial and non-financial).

Financial performance indicators are those relating to the measurement of profitability, risk and liquidity. When it comes to non-financial indicators, there are a number of reasons in favor of their use in practice. The general argument is that using only financial indicators focuses management action on a too narrow circle of variables that are important for the organization,s success. Therefore, the non-financial indicators focus on the contributions of those factors that may be equally important for business performance as much as material resources.

Balanced Scorecard is now the most popular approach when it comes to combined indicators for monitoring performances (Kaplan et al.,1996). The basic idea is that exclusive reliance on financial indicators leads to strategic myopia, because managers scarify long-term gains at the expense of short-term gains. The great weakness of traditional financial performance indicators is that they are so-called lag indicators. They talk about the performances that are a consequence of previous strategies and plans, and have nothing to do with the drivers of future performances, or lead indicators (Đuričin et al., 2005).

Large corporations specifics

Large, diversified corporations are faced with the question: when the power of decision-making is divided between the various entities and hierarchical levels within the corporation, at what levels and in what way should be implemented management control? (Giraud et al., 2011) .

In order to preserve the benefits of decentralization, managers of entities or "local managers" should have the freedom to implement an autonomous control process on their delegated level. The reasons for this are several. First, if there were no autonomous control at the entity level, the responsibility of local managers would no longer be "visible". Control would be realized at higher levels, such as senior managers. Such a practice would be inconsistent with previously performed decentralization of decision-making. Second, the senior managers would become overloaded due to large amounts of detailed information that is not relevant to their hierarchical level.

Management control at the level of individual entities is not, however, sufficient for effective control at the level of corporation as a whole. This is because the performances of entity do not guarantee that the corporation as a whole will achieve the planned performances. What is needed is to ensure good vertical coordination in the control process, top-down and bottom-top. This process is called strategic alignment. Agency risks that could arise in terms of vertical coordination are solved by using different incentive schemes. These incentive schemes may be formal, such as indexing earnings of managers and staff to the performances achieved, and/or informal in the various forms of reward or punishment.

Management control in large corporations is shown in *Figure 4*. Figure shows the three fundamental functions of performance management at the level of large corporations, such as horizontal coordination, strategic alignment and motivation of managers and workers. With this in mind, it follows that the main role of senior managers in the process of management control is to guide behavior and motivate employees.

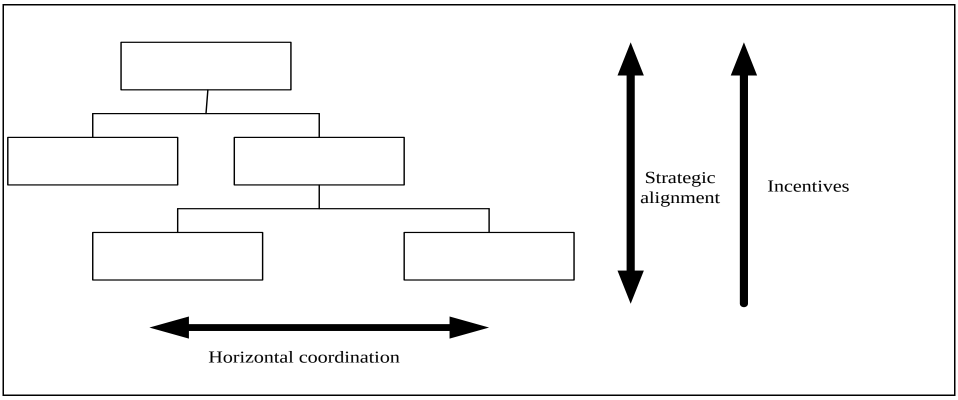

Figure 4: The control process in a decentralized corporation: the different dimensions of overall performance management

Source: Giraoud et al. 2011

Responsibility centers are a key mechanism for the realization of this triple function of senior managers in large corporations. Responsibility center is each entity in the organization that has substantial authority to make business decisions (Lanen et al., 2006). Responsibility centers are functioning somewhat like small businesses. They have to be directed to their own objectives, which are defined as a contribution to the general objectives of the company. It is therefore essential for large companies to create decentralized systems for measuring performances, not only for the company as a whole, but also for the responsibility centers (Weetman, 2010).

Open issues and future development of the theory of management control

The main issue that management control deals with is how to ensure that managers and employees work in the interest of the organization? The recent development of management control has shown that there are two aspects of this problem. One aspect includes information systems and accountability. Another aspect involves the behavior and motivation of employees in organizations.

The classical theory of management control puts the emphasis on information systems and accountability. This theory has experienced numerous criticisms in recent decades. The main complaint is that it has too narrow a focus of observation, which is almost exclusively based on accounting-based information. It is even criticized the concept of responsibility centers, because the assumption of their mutual independence has not been confirmed in practice. Namely, it is asked from responsibility center manager to be accountable not only for activities that are under his control, but also from the ones that are outside his control (Hewege, 2012). The problem with excessive reliance on accounting information was partially offset by the introduction of combined performance measures in the form of the Balanced Scorecard. However, many problems still remained.

Lasting problem related to the aspect of information and accountability is the issue of performance measurement. Performance measurement is a powerful mechanism for influencing the behavior of employees in organizations. It is said that what gets measured, gets done. The problem is that what is not measured, gets less attention. Because some performance measures are more difficult to quantify, modern systems of management control show signs of myopia in practice (Otley, 2003).

Another aspect of management control, one that relates to the behavior and motivation of employees, has developed under the influence of interdisciplinary and multidisciplinary researches in the fields such as anthropology, social theory, organizational theory and the like. Simon presented the idea of two types of control. The first type of control is called *belief systems* and is implemented through adoption of the vision and values, as well as the organizational culture of the employees. Another type of control is called *systems boundaries* and is based on the authority and discretion of managers. Organizations can combine both control systems in their operations, creating a wide range of possible controls (Otley, 2013).

Many authors criticize the excessive reliance of the theory of management control on agency theory. Thesis that between owners and managers/employees there is only rational relationship based on self-interests is excessive simplification of reality. What is ignored in this relationship is the factor of national culture, as an important context in which management control is implemented (Hewege, 2012).

For further development of management control theory it is important fact that modern organizations have a variety of control systems at their disposal. Therefore, the term control systems "package" is increasingly used in modern literature. If all these systems are created and coordinated from one place in the organization, then it might be talking about an integrated system of management control. *Figure 5* shows the typology of management control systems package.

The typology in *Figure 5* is the result of research work on systematization and analyzing management control systems, almost four decades long. The purpose of this methodological framework is to facilitate and motivate discussion on the topic of management control, rather than to suggest a final solutions.

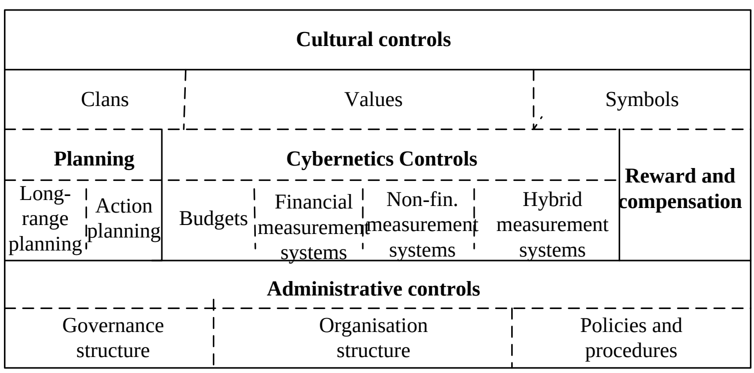

Figure 5: Management control systems package

Source: Malmi et al., 2008

At the top of the frame are cultural controls, which are broad and subtle. Given that change slowly, they can be seen as a contextual framework for other types of controls. In the center of the frame are planning, a cybernetic control and rewarding. In many modern organizations these types of control are tightly linked. At the bottom of the frame are administrative controls that should provide the structure for the implementation of planning, a cybernetic controls and rewarding.

The framework̓s idea in *Figure 5* is enabling managers to direct employees toward behavior that is in accordance with the interests of the organization (Malmi, Brown, 2008).

Discussion and Conclusions

Despite the controversies and doubts, management control persists as an indispensable tool for managing performances in modern organizations. The reason for this lies in the fact that the management control deals with the issue which is topical for all times: how to ensure that managers and workers perform in the interest of the organization?

The initial focus of management control was at large, decentralized corporations and the application of the accounting-based performance indicators. Changes in the environment, then in the internal structure of the organizations, and increasing unethical behavior of managers, have launched an avalanche of doubts about the ability of management control to respond to its basic task.

Contemporary literature tends to close this gap. An approach that understood management control as a "package" consisting of several types of control can be adopted as a good starting point in this direction. The classic theory of management control was able to "unpack" some parts of this package such as planning, a cybernetic controls and rewarding. Balanced Scorecard approach has fulfilled the gap when it comes to hybrid, or mixed performance measures. Other parts of the package such as cultural and administrative controls require a multidisciplinary approach. Until we come up with new solutions, the existing system of management control remains valid.

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