MANAGEMENT CONTROL SYSTEMS: A REVIEW OF THEIR COMPONENTS AND THEIR UNDERLYING INDEPENDENCE

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***Abstract**: Apart from governance and risk management, internal control is a third major component of corporate governance. Proper corporate governance relies upon risk management in order to identify the problems faced by the organization and on internal control in order to achieve its objectives. Internal auditors, apart from supporting the organization and enabling it to identify and monitor the risks lying ahead, must also understand and monitor the functioning of the internal control system which is the key to implementing the corporate governance principles. Internal control is a process implemented by the management of the public organization and directed at providing reasonable assurance in terms of meeting the organizational goals, which are grouped in the following categories: operating effectiveness and efficiency; reliability of financial reporting; compliance with the laws and regulations.*
The design of the control system is highly significant when the system is used, and the part it plays in the management of the business entity is fundamental. For instance, budget control is a measure of performance. A supervisor can use this variation with difficulty or with ease. Used differently, the same measuring system may convey different benefits.
The organization of the internal control system in a manner that is divergent with the principles of planned economy has led managers to believe that control activities are discretionary, and the subsequent lack of management responsibility has weakened the efficiency of internal control systems during the first years after 1989.

***Keywords**: internal management control, governance, risks.*

***JEL classification**: G28*

1. Introduction

Professional literature in the field of internal corporate governance control often emphasizes some of the following aspects:

- Horngren and Foster's definition underlines the importance of adequate information: "a management control system is a means of gathering information that would assist and help coordinate the process of making and monitoring the decisions within the organization". (Horngren, C.T., G. Foster, 1991)

•	Merchant describes control as “keeping things afloat” and “encouraging people to act as the organization would want them to”. He describes how behaviour is influenced by various control alternatives, such as focusing on results, actions or personnel and whether controls are the most appropriate.
•	In his work, Decentralisation: managerial ambiguity by design, Vancil (1978) addresses some of the key control issues, such as: how to better structure an organization in order to manage the two “conflicting elements”, i.e. the need for efficiency (promoted by centralization) and the need for adjustment (promoted by decentralization). (Vancil, R. F., 1978)

The design of a management control system that “*ensures that the organization is doing what the management wishes*”, is quite a difficult endeavour. In the opinion of certain professionals, an efficient system is made up of a number of interrelated elements, such as:

- performance measurement,
- motivation and
- organizational structure

These different approaches would suggest that certain manners of describing control systems are correct, while others are not or are less important. However, we believe that this perspective is less useful than the one that integrates various outlooks.

2. The correlation among the elements of the internal management control system

While each component of the diagram can be subject to analyses and conclusions, the key to understanding the control system is to comprehend the interdependence of its components. Interdependence affects all of these. None of them can be properly controlled without considering the impact on the other elements and the way they too need to be supported.

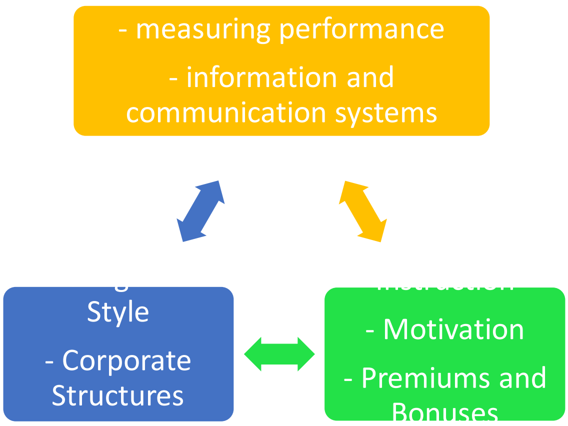

Figure 1: The components of the management control system

The relationship between performance assessment methods and direction has been analyzed from various angles. Euske (1984) mentions some of these approaches in his work *Management control: planning, control, measuring and evaluation*. (Euske, K.J. *1984).* Euske presents a bi-dimensional framework to describe the characteristics of control in any specific organization. The horizontal axis displays three ways of classifying control sources into organizational, informal or individual groups. The classification can also be found in Dalton and Hopwood (1971), Dalton and Hopwood (1974), (Dalton, C.W., A. Hopwood, 1974). The vertical axis displays three types of controls: steering controls, yes-no controls and post-action controls (Newman, 1975; Amey, 1979). Euske's framework, shown in Table 1, uses nine cells and each of these contains a description of the control process that would correspond to the targeted source and to the type of control. Each cell reflects a definition of performance, whether or not the budget is met, and compliance with the group's code of conduct or the achievement of personal goals. Steering controls influence behaviour before it happens. Yes-no and post-action controls use the results of the last behaviour in order to influence future conduct. Knowing whether the control system is post-action, yes-no or steering or whether it is managed individually, socially or on an organizational level is not enough, as shown in Table 1. In order to understand the influence of a particular control system within an organization, one must identify the unique combination of the control characteristics and the statistical contingencies.

Table 1: Control possibilities within the organisation

	Administrative or organizational	**Informal social groups**	**Individual**
Feed-forward or preliminary controls	Using forecasts in order to identify budget fluctuations	Advising the new employees on the group's code of conduct	Setting personal short-term performance goals based on the position targeted 10 years ago
Screening models	Quarterly revision of the budget if a project must be continued	Not being invited to socialize with the group after work	Asking to be promoted after successfully negotiating an important contract
Feedback or post-action controls	A bonus offered to a manager for not exceeding the budget of the previous year	Joking about a colleague having lunch with the boss too often	Leaving the organization after not being promoted

By developing this matrix, Euske focuses on understanding the correlation between the characteristics of management control and situational contingencies.
(Emmanuel et al., 1990) have made the following statements in their work, *Accounting for management control*: It is increasingly recognized that economic concepts represent only one part of the foundation upon which management

accounting rests. The internal functioning of the organization, the way in which people react to information and the design of the control systems to affect human behaviour are also fundamental to the operation of a complete accounting system.
Ansari's integrated model (Ansari Consulting Group) includes four major components that focus on the objectives of the organisation (Figure 2). However, Ansari emphasizes the leadership style and places personality on a second place in terms of importance in designing an efficient management control system.

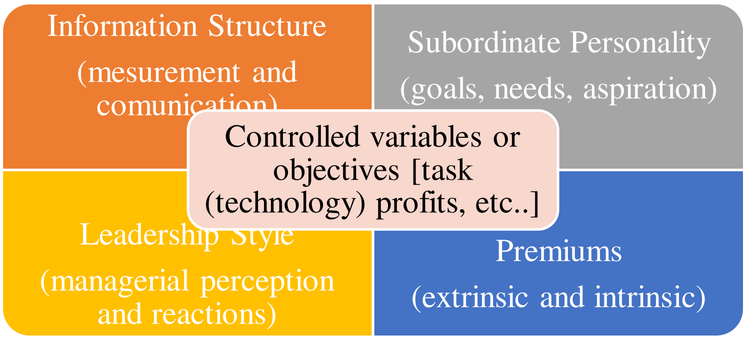

Figure 2:. Components of the control system

If we analyze the components outlined in the model shown above, we can trace the correlations occurring among the different structures of the control system, while the necessary measure to be taken is to minimize the procedural differences between managers and subordinates.

3. The manner of conducting internal management control within organizations

If the higher levels of management have manifested a risk-averse attitude in the organization and if certain other lower management levels or positions are risk-seekers, this may lead to confusion and even conflict within the organization. Certainly, the opposite scenario is equally alarming (Griffiths, 2005).
Risk-averse culture has the following characteristics:

- management tends to confine itself to what it knows for certain;
- stability, experience and knowledge are fundamental values and also the most sought after attributes;
- the organisation is very reactive, it tends to wait for something bad to happen and act afterwards;
- the hierarchical structure of the organisation has numerous levels and most decisions are made at the top levels;
- the management wastes a lot of time trying to determine how to develop activities in a mode efficient manner, instead of focusing on the consumers' needs for services;
- strategies do not change very often within the organization and when they do, it is a rather momentous occasion;
- mistakes/errors are personalized, thus causing the employees' lack of initiative, as this is a typical "shame culture".

On the other hand, there is also a risk-seeking behaviour, called the "*can do*" culture, that is mostly characterized by:

- innovation and motivation are the most sought-after values;
- interest is manifested for capitalizing opportunities and engaging the employees;
- major decisions falls within the duties of the general management, while the entire organisation assumes the task of making routine decisions;
- the main orientation of the organisation is towards the external environment, focusing on the provision of services to customers;
- strategies and policies change frequently in order to emphasize the changing circumstances;
- mistakes are accepted – and even encouraged – but hiding the mistake is unacceptable.

Risk theorists argue that it is very important to understand *the culture or the sub-cultures of the organisation you work for*. If you are part of a risk seeking culture but one where there is a lot of opposition, this image will have to be compared with the findings of the internal audit.

At the same time, it is equally important to identify risk preference in organisations that are otherwise risk averse, as risk seekers can act like "*loose cannon*", making the organisation vulnerable to unexpected threats.

In either of the two cases, the approach of the internal audit and their recommendations will have to provide a clear picture of such occurrences.

There are numerous benefits associated with the integration of the management control system in the corporate culture**,** among which:

- greater attention given to the issues that actually matter;
- reduced time spent by management in the settling of disputes;
- less surprises;
- more satisfied customers;
- safeguarded reputation;
- increased interest in doing the right things in the right way;
- increased probability of reaching the objectives set for the company;
- less complaints;
- increased probability of change initiatives and capitalization of the projected benefits;
- assuming risk and more informed decision-making;
- support for innovation;
- lower insurance costs.

According to the IIA (Institute of Internal Auditors), the main responsibilities of internal audit in terms of the implementation of the internal management control system are:

- provides assurance in terms of risk management processes;
- ensures that the risks are properly assessed;
- evaluates risk management processes;
- evaluates the reporting of significant risks;
- revises the management of significant risks;

Table 2: Statement on the relevancy of the internal audit activities performed in the organization

	YES	***NO***
Are there any internal audit procedures?	75 %	25%
Is there an audit plan based on risk assessment?	50%	50%
Is the information collected and processed?	66.7	33.3%
Is audit evidence collected?	50%	50%
Is the audit report prepared?	100%	-
Are recommendation considered for implementation?	100%	-

On the other hand, inadequate corporate governance impairs the efficient allocation of capital in the economy, hinders investment in administration and lowers the confidence of capital holders. James D. Wolfensohn, the former president of the World Bank once said: *corporate governance is more important for the world economy than the government of countries* (Cannon, D.M., Godwin, J.H., Goldberg, St. R., 2008).

Table 3: Correlation between the benefits and the disadvantages of implementing internal audit

Nr	***Statements***	***Rating***					
		1	***2***	***3***	***4***	***5***	***6***
A	***Internal audit conveys the following advantages/benefits to the organisation***						
1	It helps the business meet its objectives	5.3	8.8	17.5	43.9	10.5	14
2	It organizes and ensures the efficient functioning of the internal control system	5.4	3.6	19.6	41.1	16.1	14.3
3	It enables the proper running of external audit	3.8	1.9	15.1	39.6	17	22.6
4	It improves the efficiency and effectiveness of risk management	5.5	5.5	18.2	32.7	20	18.2
5	It helps diminish the costs of external audit	10	10	2	38	16	24
6	It issues recommendations that add value by improving the audited activity	5.6	5.6	18.5	31,5	22.2	16.7
7	Follow-up of the results after the management has implemented the recommendations of internal audit	5.8	3.8	7.7	40.4	25	17.3
8	Development of the quality assurance techniques	5.5	1.8	20	40	12.7	20

9	Constant bettering of professional competencies and experiences	7.1	3.6	10.7	39.3	23.2	16.1
B.	***Internal audit generated the following disadvantages for the public organisation***						
1	High costs related to the internal audit function itself	10.7	21.4	21.4	12.5	10.7	23.2
2	Likelihood that IA may generate management tensions and discontent in the organisation	12.2	25.5	14.5	20	7,3	20
3	Likelihood that IA may generate employee tensions and discontent in the organisation	13	20.4	18.5	16.7	11,1	20.4
4	IA does not perform its risk prevention and control function	17.3	19.2	9.6	11.5	15,4	26.9
5	Failure to identify in due time any evidence of fraud or error in the organization	17	20.8	17	5.7	15,1	24.5

(*1 = not at all; 2 =to a small extent; 3 = to an average extent; 4 =to a large extent; 5 = completely; 6 = don't know / don't want to answer)*

Internal auditors provide assurance in terms of the feasibility and relevance of informing an organisation and its internal control. In a rapidly changing environment, with global competition, new types of organisational structures and up-to-date information technology, the measures the government takes in relation to present business organisations and the recent past are relatively less important, while the information and the steps to be taken in the near or distant future are much more decisive.

Table 4: Relevancy of the missions accomplished by the internal audit service

Nr	***Statements***	***Rating***					
		1	***2***	***3***	***4***	***5***	***6***
1	Audit of the human resources function	3.6	7.1	14.3	33.9	19.6	21.4
2	Audit of the legal function	7.8	7.8	17.6	25.5	17.6	23.5
3	Audit of IT systems	6	14	16	20	24	20
4	Audit of financial and accounting activities	3.6	5.4	5.4	25	41.1	19.6
5	Audit of the purchasing process	3.8	5.7	11.3	22.6	37.7	18.9

A closer look at the above table will reveal that the subjects answering the survey believe that the main priorities are the auditing of the financial and accounting activities (41,1%), the auditing of public procurement (37,7%), the auditing of the human resources of the organization (33,95%) and the audit plan of the public authority should not overlook the audit of the legal function and of the IT systems (with 25,5% and 24%, respectively).
Basically, the focus has shifted from the internal audit function to the threats undermining the strategies.

The objectives set by the organisation for the internal management control system guarantee that:

- risk management is a key part in the strategic management of the business;
- there is a positive approach to assuming risk;
- risks are considered when any decision is made;
- opportunities are capitalized by actively managing the risks and threats that may postpone success.

In order to meet these objectives, the organization will adopt the following approach:

- definite responsibilities, roles and reporting rules for risk management will be delineated and observed in all functions and departments;
- a program for training and learning opportunities will be introduced in order to supply managers with the acquisition and development of the skills and competencies needed for risk management;
- risk assessments will be incorporated and treated as part of decision-making, planning and revision of company operations;
- the measures taken for managing individual risks will take into account the potential occurrence and impact of these risks on the successful completion of the set objectives;
- an updated record that will be accessible to all who need it will identify all the strategic and operational risks, will supply estimates/identification/assessment and recording of the current measures directed at managing these risks;
- risk management activities will be measured in relation to the company goals and objectives;
- all the levels of the organization, partners and majority shareholders will try to understand risk and its management, alongside risk treatment options within the organization.

4. Conclusions and suggestions

The design of an internal management system is a spontaneous procedure; it resembles the design of a car, which leaves the user no clue as to how the car can be driven. It can be driven aggressively or carefully. It can receive constant care, or it can be automatically controlled and benefit from temporary maintenance. The whole picture entails both the design and the instructions manual on how the car actually runs.

An actual scale of the process encompasses a cycle that runs from planning, operation, revision and back to planning. The main requirements for setting up and implementing internal control (GO no.119/1999) in an organization are as follows:

general requirements:

- to ensure the completion of the general objectives by systematically assessing the risks related to structures, programs, projects or operations and keeping these risks within acceptable levels;
- to guarantee the considerate attitude of the managing and administrative staff, as they are required to promptly respond to the requests of the management and to effectively support internal control;
- to guarantee the integrity and the competency of the management and administrative staff, as well as ensure that they know and understand the importance and the role of internal control;

- to set the specific objectives of internal control and ensure that they are adequate, comprehensive, reasonable and aligned with the mission of the organization and with its overall objectives;
- managing staff should constantly monitor all the activities and should comply with the obligation to take corrective, prompt and responsible measures whenever the law or the regulations are breached during certain procedures or when certain activities are performed in an immoderate, ineffective, and inefficient manner;

specific requirements:

- to keep written records on the organization of internal control, on all the operations of the entity and on all significant events, as well as to record and file the documents appropriately, so that they can be promptly accessed for analysis by authorized parties;
- to record immediately and accurately all the significant operations and events;
- to ensure that the approval and performance of the procedures is exclusively in the hands of specifically authorized parties;
- to separate the responsibilities related to operations between parties, so that the approval, control and recording should be adequately assigned to different individuals;
- to ensure competent management on all levels;
- documents and resources should only be accessed by authorized parties that also bear the responsibility of properly using and keeping these resources.

Basically, indirect reference is made to the generally accepted models of organizing internal control, i.e. the COSO and CoCo control frameworks, to the internal audit standards and to the international best practice principles.

COSO defines internal control as a process conducted by the Board of Directors, by the management and by the entire staff of the organisation, directed at providing reasonable assurance on the completion of the objectives of the organisation, in terms of:

- the effectiveness and the efficiency of the operations;
- the accuracy of the financial statements;
- compliance with the current legal standards and regulations;

The control framework developed by CoCo is relevant for the boards of directors, for the general and the first line management, suppliers and auditors as well. This framework had a much broader theoretical approach than the familiar COSO framework and employs the term of “control”rather than internal control.

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