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CONTROLLING INTERNAL SUBJECTS OF AN ORGANIZATION

In the article the nature and objectives of operational controlling have been discussed and subjects (internal segments) and objects (objectives and measures of assessment) of controlling have been characterized. There have been presented general procedure of controlling internal subjects as well as the principles for construction of a motivational system. Directions for changes necessary for the full introduction of operational controlling have been pointed out.

1. INTRODUCTION

Basically, controlling involves supervising the social and material processes in an organization (Steinle 1998, p. 6). Literal interpretation of the term leads to substituting it for the entire system of company management (controlling as meta-management). Controlling in its broader meaning is not possible to be separated from company management (Steinmann, Scherer 1996, p. 3).

Controlling can be perceived also in a narrower sense, as a result-oriented aiding of management (Hahn 1997). Controlling in such an interpretation, acceptable for the author of this paper, is only an aiding system (management service). Such aiding is performed through the co-ordination of management processes and information supply, so as to enable the realization of the decision-making process in accordance with the assumed corporate goals.

Controlling has strategic and operational dimensions. It relates to the company as a whole as well as to its different subsystems (buying, production, marketing, financial controlling, etc.) and organizational internal units (plant, division, department).

The aim of strategic controlling is to create business conditions according to long-term corporate objectives. It is directed towards the external environment of the organization. On the other hand, operational controlling is oriented to regulating the internal processes within a company, aiming at the optimization of total performance and a guarantee of financial liquidity. Operational controlling relates to events in a current year and the internal subjects in a company. Hence its short-term impact directed at the current potential in these subjects. It concentrates on

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components of operational result, i.e. the elements of revenues and costs, depending upon the decision of managers of the internal subjects in a company.

Internal control is connected with controlling. Its main task is to verify the necessity and rationality of decisions and activities executed in the organization. As a rule it has a resultant character (*ex post*) when controlling concepts also the past. It is not being made in a continuous way, which is the feature of controlling, but mostly by order of managers of the enterprise. Independently of the above mentioned differences, internal control can make the component of wide comprehended controlling.

The article focuses on operational controlling in the above interpretation, and presents the subjects, objects and other elements of such controlling.

2. INTERNAL UNITS OF A COMPANY AS SUBJECTS OF CONTROLLING

An important element of operational controlling are responsibility centres formed within a company in the form of quasi-autonomous mini business centres (cost centres, profit centres or investment centres). Economic separation of internal business subjects results mainly from management decentralization. This is necessary for the increase of management effectiveness and business efficiency.

In most cases cost centres are formed from these internal units (plants and divisions of core and secondary production, and functional departments in management) which do not sell their products independently and report only for the costs of commissioned production. On the other hand profit centres are formed from these company units which, through access to their market (both internal and external), can independently shape all components of their sales result (revenues and costs). These include units whose products are subject to systematic sales outside the company (real profit centres) and units which sell their product only to other units within the same company (quasi profit centres). In companies that implement controlling procedures, the core business plants are usually qualified as result centres (profit centres) (Mońka, Sołtys 1997, p. 132). Investment centres are separate segments of company activity (units consisting of many smaller parts, like for example plants with departments) whose managers are entitled to make decisions in the field of costs, revenues (and hence the operational result), and also have certain autonomy in investment decisions. Introduction of controlling to internal units of a company should start with the basic units of the logistic chain (supply-production-sales) because there the main reserves for business effectiveness are comprized. Only after division and department units have been subjected to controlling, can lower rank units be involved too, like offices, sections, posts.

The central position in business centres is occupied by managers of these units which are in charge of the realization of appointed material goals: they make current

decisions, administer the limits of financial resources for covering different cost groups, are responsible for the outcome of their decisions and actions. They are the main receivers of information generated by operational controlling and its most important subject.

3. THE SUBJECT OF OPERATIONAL CONTROLLING

The subject of operational controlling in internal units of a company are the objectives set in the form of absolute values and/or indices. These result from operational planning and budgeting. Operational (current) planning, determination of objectives and their decomposition in time and space is the basic condition of operational controlling. In such an interpretation planning, as well as other management functions, are beyond controlling: they are at the disposal of managers. Controlling activates these functions, if they have not existed in the company, and then actively (with methods and information) sustains their realization (Figure 1). Controlling coordinates the planning process in companies, so as to cover all fields of corporate activity, and to avoid friction between component plans.

Planning objectives for every internal subject requires taking into consideration their basic structure. Therefore it's necessary to fulfil the following:

1. objectives should guarantee realization of the corporate plan (budget),
2. too detailed objectives should be avoided, with preference for more synthetic ones (3–5 sentences),
3. objectives should be suited to the specific character of a subject (its function, position in the corporate organizational structure, organizational level, decision competence range),
4. objectives should be explicit, cover short periods (maximum 3 months), and be feasible.

The participation of employees in the process of planning objectives is very important.

Types of objectives for internal subjects should be:

- material and related to quality,
- related to effectiveness (costs, results).

For units in the logistic chain (mainly profit centres) the following material objectives and ones relating to quality can be suggested (Nowosielski 1998, p. 74): for the purchase department:

- provision of continuous supply of materials to production departments and other units,
- controlling the materials inventories (in all or chosen material groups, according to the ABC method);

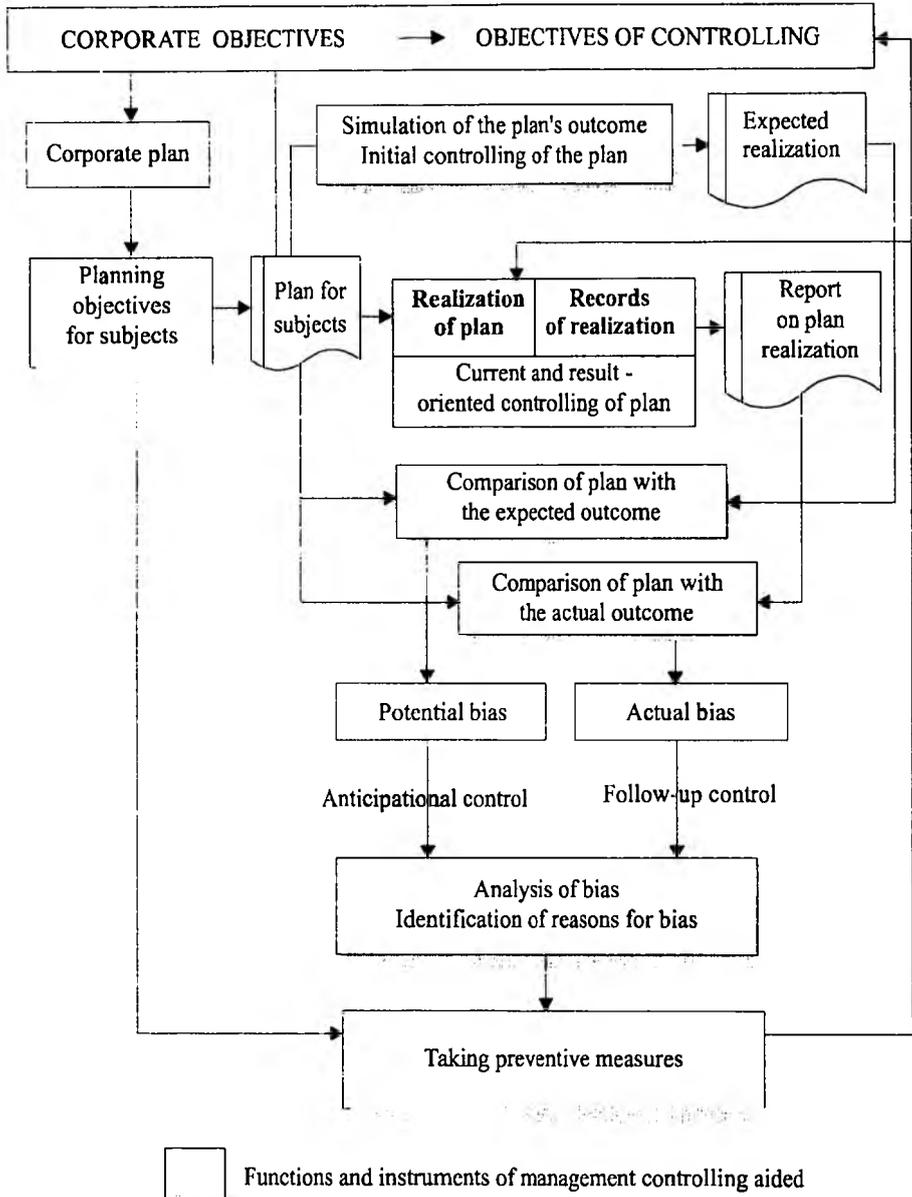


Fig. 1. Organization chart of a controlling procedure
Source: Nowosielski 1998.

for production departments:

- the number of products in every range in natural measure, with regard to the dates of order realization (transfer of completed products to storage) in all or chosen ranges of products,
 - control of work-in-process inventory;
 - for the sales department:
 - sales of products in quantity/range approach and quality approach,
 - control of the finished goods inventory (in all or chosen product groups, according to the ABC method).

An additional objective for every unit are costs over which budget control can be exercised. Budget (plan) of costs is established for three- or one-month periods, in the course of continuous (gradual) planning, as in the case of material objectives.

This should be created at the level of technical cost of production and separate costs on which the given unit has any influence (which largely depends upon the top management decision) and costs which are out of the unit's control. Including these kinds of costs which are beyond control in the budget has only an informative purpose. Additionally, for the sake of better information, production departments and the sales department can receive their cost objectives calculated against a multilevel accounting of profit margins, which will help understand the role of the unit in the total financial performance of the company.

Controlling an internal subject in a company gets more complicated in the case of multiple co-operative relations among subjects. In such cases for evaluation of objectives and assessment of subject effectiveness, internal prices are used. They take the form of so-called transfer prices reflecting the transfer of value between these subjects (for more see: Dobija 1997, p. 202; Sołtys 1995, p. 82). Without going into too much detail it can be said that centres of responsibility for costs (costs centres) are accounted for on the basis of price with margin. Incorrectly determined internal price may result in deformation of the unit's business results and discredit the feasibility of decentralization in general (Dobija 1997, p. 202).

The operation of internal business centres undergoes periodical audits by the company's Board of Directors, and such an audit is routinely connected with the incentive system. The objectives set for the centre at the beginning of plan period (1–3 months) are assessed first of all. Measures are used for that purpose. They are simultaneously the basis for making current choice decisions (criteria for decision optimization). Because of the problem's weight the choice and construction of measures should be regarded as the key issue by the company management.

In practice, measures for the assessment of the subject's performance can be roughly divided into quantitative and qualitative (Figure 2). A complex assessment is necessary both of the subject's short term business effectiveness and its activities aimed at future results, as well as an assessment of the quantitative and qualitative objectives of the subject's performance.

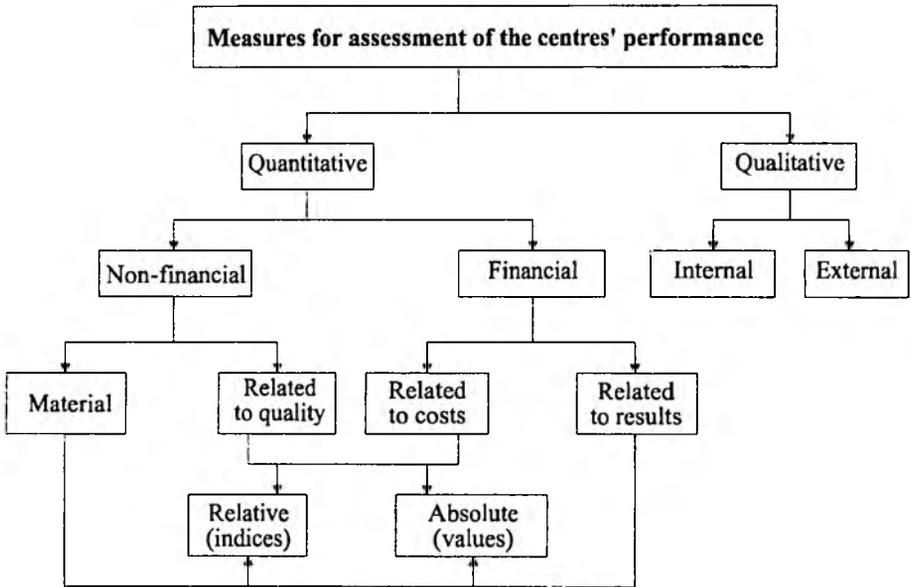


Fig. 2. General classification of measures for the assessment of centres' performance
Source: own concept.

The quantitative assessment criteria for judging the degree of their realization should be established according to objectives (partial measures for assessment). The construction of such measures generally resolves in comparing the planned values with actually achieved values in a given period. Another synthetic measure for the accomplishment of partial objectives by a given centre can be the arithmetic average of partial measures – simple or weighted.

In relation to individual production subjects in which the area of management responsibility is limited to the material sphere and costs (cost centres), the following measures can be applied:

- for material objectives, e.g. the degree to which the range or sales plans have been accomplished,

- for objectives related to quality, e.g. timely deliveries, ability to keep up the planned stocks of work in progress,
- for cost-related objectives, e.g. deviation of actual costs from planned costs,
- independent subjects, whose responsibility scope includes both costs and revenues (profit centres) can be assessed with the following result-oriented measures:
 - quasi financial result,
 - multilevel and multisegmental margin to cover overheads (profit margin),
 - return on investment from the independent subject.

The measures listed above help increase short term results. However, they focus on the quantitative and financial aspect of the assessment, overlooking these extra-economical aspects of the centre's management activities which have a great impact on future profits, like research and development, proper personnel policy, good working environment, company culture, good relations with customers, customer satisfaction, etc.

This problem can be remedied by supplementing the list of measures with additional control measures of a qualitative character. These measures can include customer satisfaction with co-operation with a given subject (external evaluation), or non-financial satisfaction of its employees (internal evaluation). For a global (e.g. annual) assessment of profit centre's management performance (or cost centres), a more complex method can be used, e.g. matrix portfolio (Figure 3). During such a complex assessment the internal subject is "located" in an appropriate field of such matrix. When the results of qualitative auditing as well as economic and financial results are very good, the centre receives the best estimate. A good quantitative result accompanied by poor outcome based on qualitative criteria (extra-economic) points out extensive possibilities of improving the extra-economic performance. Finally, low qualitative and quantitative results justify the necessity of undertaking a comprehensive restructuring processes.

The company's Board of Directors should apply differentiated and multilevel assessment criteria for auditing the internal subjects' performance. Such criteria should be clear, stable and known to the management of units throughout the planning-accounting period.

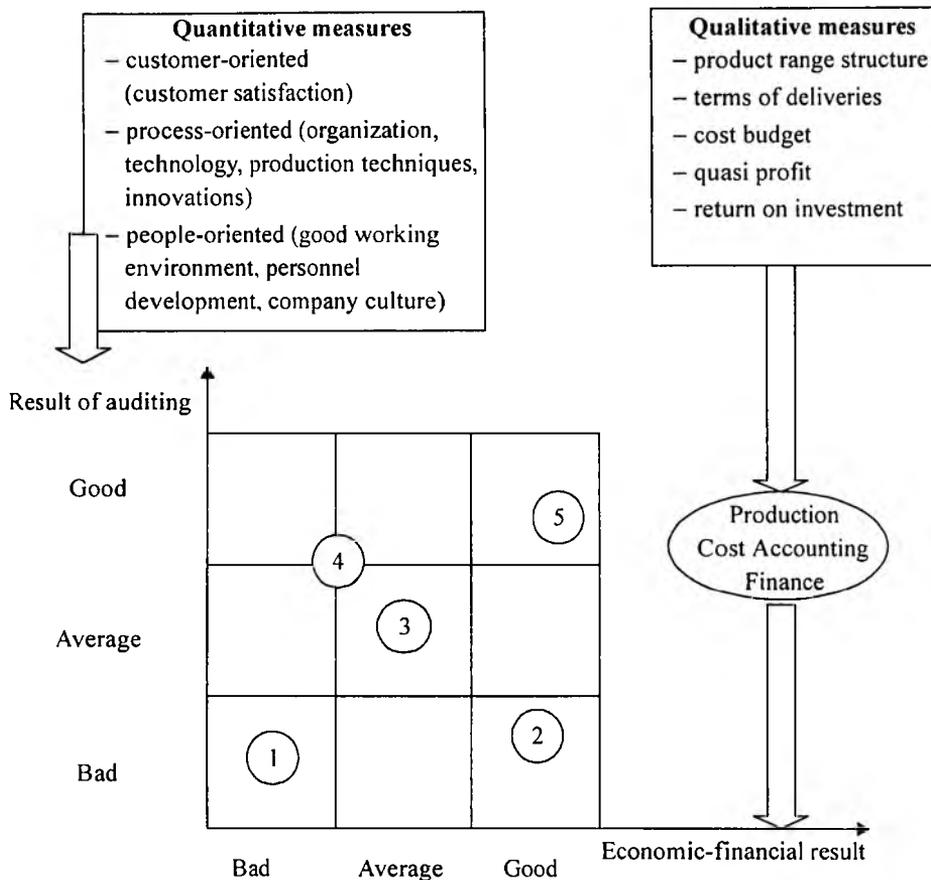


Fig. 3. Matrix portfolio of measures for assessment of centres' performance

Source: Wildemann 1994, p. 236.

4. INCENTIVE SYSTEM FOR INTERNAL SUBJECTS – BUSINESS CENTRES

When formulating the incentive system for business centres, the twofold character of their work should be taken into consideration. Quantitative measures should be used for shaping the current (e.g. quarterly) motivational bonus. On the other hand, qualitative measures should rather go with yearly bonuses, or other gratifications for the centre management, e.g. in the form of company's shares. Also other, non-material incentives can be used for stimulating types of behaviour favourable for the interest of the company as a whole.

The most difficult issue in the formation of an incentive system of a company is establishing the rules of connecting the measures for centre performance assessment with incentives. Before that the source from which money for incentives will come should be determined. This problem is actually very complex, because it touches issues which need an active and at the same time effectiveness-oriented approach of the local trade unions to be solved. When the source of money for incentives has been established, it is possible to formulate the rules of its relation to measures of assessment. For that purpose among others increment or participation formulas can be used, as proposed in literature on the subject (Borkowska 1987, p. 120 and ff.). As practice shows, the increment formula is better suited for calculating the due bonus funds for material objectives and ones related to quality. On the other hand, the participation formula, as strongly stimulating, is preferred for calculating the bonus fund for effectiveness objectives (for more see: Nowosielski 1998).

5. ATTEMPT AT ASSESSING OPERATIONAL CONTROLLING IN POLISH FIRMS

The present state of operational controlling, from the point of aiding internal subjects in a company, can be roughly assessed as not very satisfactory (Nowosielski 1998). The level of management decentralization is not high enough. The dominating form of economic diversification are cost centres and very ineffective profit centres, operating within the functional organizational structure. Real autonomy of decision making in managers on lower levels of management (in plants, departments, etc.) is lacking. Controlling is mistaken for planning, budgeting and budget audits. Materials planning (operational) causes many problems. As a consequence, planning (budgeting) costs and results is very difficult, also for methodical reasons. Controlling is limited to processing data from operational records and accounting, periodical comparisons and analyses, and presenting the results to those managers who are interested. The dominating approach is based on numbers and values, and data and analyses are based on past periods.

Controlling operations are carried out by a department which in most cases is a unit in the economic-financial division. In many companies it reports directly to the accountant general. In this division a lot of data is created, all in the focus of controlling. In some cases such allocation of the controlling department has a negative effect. Its scope of responsibilities is dominated by the issues connected by costs and finance. This brings about neglect in other, extra-economic aspects of controlling. In medium-sized and small companies controlling is a one-post job, in larger units hierarchical auditing services are created. Anticipating the consequences of planned activities (feed forward) is very rarely applied in practice. Auditors

mainly occupy themselves with the result audits (periodical) of the plan, and not so often with current monitoring. They are responsible for finding (the sort and size of) bias, analysis and cause of this bias, and also, although to a lesser degree, anticipating its consequences. The analyses are very narrow: contain a lot of numbers, less verbal comments and visualization of events. A significant reason for such a state of affairs is the frail system of documenting and monitoring the causes of bias, personnel shortages and the low qualifications of staff in charge of controlling, as well as a lack of adequate computer systems. All these factors negatively affect the co-operation of auditors with managers of internal subjects.

The set of tools for realization of monitoring tasks is rather modest, and clearly directed towards traditional instruments and cost accounting. Special interest is expressed with instruments of managerial accounting. However, in practice there are certain difficulties using them (e.g. division of costs into fixed and variable is not realized).

6. CONCLUSIONS

Controlling has become an immanent part of the management system in a contemporary company. However, in practice it is not fully realized. This also concerns operational controlling, which is clearly past-oriented. As a result, managers of internal units in a company treat controlling as just another audit, with all its traditional faults. But in the face of changing conditions of functioning a strong orientation towards the environment and future is necessary. This implies the need for further decentralization of management and enhancing operational management. Also it is inevitable to increase decision making independence and authentic engagement of unit managers in the process of planning objectives and goals for own units and the company as a whole. Synthetic measures for assessment of subject performance have to be determined, as well as their relation to staff and management incentives. In this way conditions can be created for direct and active participation of unit managers in the financial result of the company and the long-term commitment to the company's future.

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