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THE EFFECTIVELY CONTROLLED ORGANIZATION

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The establishment of effective controls should be one of management's important goals in every organization. Fulfillment of this goal requires the development of specific programs and systems that are identified and described, worded in one way or another, in every planning and control textbook. These programs and systems serve as a starting point in my talk tonight. The fact that they are public knowledge does not imply that they are functioning well in most organizations. If they were, the internal auditors' job would not be as demanding as it is.

An effectively controlled organization frequently will have the following programs and systems in effect:

Statement of objectives

Statement of policies that establish the broad framework or environment within which the organization will pursue the objectives

An organizational structure and assignment of functional responsibilities at all levels so that decisions can be made at the appropriate points in the organization

Standard practices, procedures, and decision-making techniques by which the functions of the organization will be achieved

Operating standards, guidelines and other criteria by which performance can be evaluated

A system of planning in which the organization's resources, procedures, standards and objectives can be integrated into a plan of action that will stimulate results

A system of accounting for the operations of the organization which will ensure that information can be gathered and reported to managers for planning and control purposes

A reporting system that will communicate the plans and results of operations in a format most useful to each manager on a timely basis.

MANAGEMENT CONTROL

Management's function is to set objectives and to establish systems of control in order to guide the organization's activities and to achieve the specified objectives.

It is natural to think of control in terms of safeguards that prevent losses rather than in terms of procedures that promote gains. However, all procedures that play a part in helping management achieve its objectives are a part of the control system. Therefore, the control system includes the mechanisms that guide the actions necessary to achieve an organization's objectives, as well as the procedures to safeguard corporate resources. And while we can easily recognize that objectives cannot be achieved if we do not have the resources, the tools, the skills, the materials, and the people to perform the tasks required to achieve them, let us not forget that control itself is perhaps the one most important item.

Management control is exercised in one of two ways: by observation and by information.

MANAGEMENT CONTROL BY OBSERVATION

The best means of control will always be direct observation by a capable manager. The manager who is where the action is, who can see what is going on, is the organization's first line of control. There is little you can do to improve a manager's control over the actions he observes provided he is a capable manager and understands how his area of responsibility fits into the overall organization framework.

However, management control can be weakened by requiring a manager to control too many activities by observation. Many organizations attempt to solve this problem by adding more managers as the organization grows. With continued growth comes added complexity, until eventually management by observation cannot meet the needs.

MANAGEMENT CONTROL BY INFORMATION

As an organization grows in size and complexity, management control by information must be introduced. This does not mean that management control by observation should be discontinued. On the contrary, management control by observation must continue as the first line method of control. However, management must also coordinate and integrate the efforts of the first line managers through an effective system of communication, a system that communicates information useful for management's planning and control purposes. For the most part, this system of information is the accounting system which you as internal auditors are constantly reviewing. It is not sufficient, however, just to audit the accounting system. The internal auditor should also be reviewing the overall practices, procedures and policies of his company so that the accounting system can be related more effectively to filling the information needs they impose.

ROLE OF THE INTERNAL AUDITOR

As an organization grows, the day-to-day activities that form the basic operating functions will begin to take place beyond the direct observation range of the managers who ultimately are responsible for the results of these activities. To some degree the internal auditor can extend management's ability to control such activities by observation.

Often, however, internal auditors fall short of the full potential to be observation posts for management. This happens when internal auditors are limited to auditing the financial and accounting functions and do not reach out into broader management areas. Internal auditors fall short of their full potential to be observation posts for control purposes when they merely verify whether or not prescribed procedures are being followed, rather than evaluating whether such procedures are appropriate. It is along these lines that internal auditors can make significant recommendations to help management develop the effectively controlled organization that we all wish to achieve.

INTERNAL CONTROLS

There are certain procedures that provide control and at the same time eliminate or significantly reduce management's need to observe operations for control purposes. These procedures include the separation of duties among several people with regard to cash transactions, physical constraints on inventory and other internal control procedures. It is the responsibility of internal auditors to recommend procedures that improve internal controls as management's areas of responsibility grow larger and management's ability to control by observation is reduced.

In addition, procedures that improve management control by information should be implemented as management control by observation becomes less effective. The objective of a system that provides management control by information is to present to each responsible manager an accurate, timely representation of the operations performed so that he can evaluate past performance, plan future operations, decide changes of direction and select new courses of action. The internal auditor can make a significant contribution by commenting upon the extent to which current systems satisfy management's needs and by recommending new procedures for improving management control by information.

INFORMATION SYSTEM VERSUS ACCOUNTING SYSTEM

I could use the terms "information system" or "management information system," but these terms unfortunately have been tarnished by overuse and underrealization in many instances. It is unfortunate that the term "information system" has been so tarnished, because I do feel that most of the expectations of information system advocates will ultimately be realized. Tonight I will use the term "accounting system" to represent the process that gathers and reports the data that management reviews for the purpose of controlling operations in place of direct observation of the actions performed.

My differentiation between an accounting system and an information system is in the measurements used. I subscribe to the definition that limits the unit of measure in an accounting system to monetary values. Of course, the dollar input to an accounting system may be derived by nondollar measurements, such as units of products produced or hours of labor expended. An information system, on the other hand, will utilize all types of measures, such as pounds, feet, gallons, hours, etc.

Others may place additional restrictions upon the scope of an accounting system. I define the scope of an accounting system according to how transactions are measured, not according to what transactions are measured. Often, the scope of an accounting system is limited to recording only certain kinds of transactions. In such cases, the accounting system is limited in its ability to serve management as a means of control by information.

For the most part, accounting systems are designed to process data for presentation in the basic financial statements, the income statement and the balance sheet. Many transactions that management normally controls may not be reflected in the accounting system if the accounting procedures are designed only to produce that all-important profit and loss statement.

ANTICIPATION ACCOUNTING

This approach often results in a disregard for many important transactions within the framework of the accounting system. Thus, the accounting system may not be the primary source of control information for the transactions that affect the status of purchase commitments, contingent liabilities, sales order backlogs, and even, in many instances, accounts receivable, unbilled work and accounts payable.

The fact that many of these transactions do not directly influence the profit and loss statement or the balance sheet should not justify their exclusion from the accounting system. Control is improved by recording purchase order information in an outstanding purchase order control account as well as in a detailed purchase order file, if you have the computer data processing facilities to do so. The receiving transaction has thereby been anticipated, and the subsequent recording of the receipt of merchandise will be better controlled. In most cases, the accounting entry to record the addition to inventories and the increase to accounts payable may be initiated by merely noting that the purchase order number 123456 was received as ordered without reentering the purchase order data except where variations occur.

I refer to this approach to accounting as Anticipation Accounting. Anticipation Accounting requires that data be recorded only once, at the time the data is first known, whether or not such recording has an impact on the profit and loss statement or balance sheet.

The scope of an accounting system should be determined by the nature of the business transactions that create the input data to the accounting system. Let us look at the design of accounting systems to see how the nature of business transactions can be reflected for management's control purposes.

CHART OF ACCOUNTS

The place to start is the Chart of Accounts. A good Chart of Accounts design exists when:

1. The classifications recorded in the accounting system are consistent with the classifications management uses to describe activities and functions when planning future operations. Management control by information will be seriously weakened, or rendered impossible, if the accounting system cannot

present the results of operations in the same format as that developed in the plans of operations.

2. The three basic elements necessary to describe the plans and results of operations adequately are incorporated in the following account classifications:

a. The functions or activities performed by the organization in fulfilling the organization's objectives

b. The resources consumed or utilized in the performance of the organizational functions and activities—these are also referred to as cost elements, such as labor, materials, etc.

c. The organizational units that represent managerial responsibilities for controlling the resources, performing the functions, and achieving the objectives. These are generally referred to as cost centers, profit centers, or responsibility centers.

BASIC FRAMEWORK

Let us consider these elements within the framework of a sample Chart of Accounts. A basic Chart of Accounts framework is as follows:

1000	Assets
2000	Liabilities
3000	Revenues
4000	
5000	
6000	Functional classifications of operations
7000	
8000	
9000	Other income and income charges

Nowhere on this Chart of Accounts have I indicated resource classifications or responsibility centers. Two additional code fields would be added to the functional classifications to represent resources and responsibility centers:

Function –	Cost Element –	Organizational Unit
4200	632	35

However, we should keep in mind that the size of the code is dependent upon the size of the organization. Therefore, the code 4263 could present all three elements as follows:

4 2 6 3	
4 2	Function
6	Cost Element
3	Organizational Unit

In designing or redesigning a Chart of Accounts, we must keep in mind what the classifications must communicate to management for planning and control purposes. The functional classifications express the activities that are taking place, such as manufacturing a specific product line, performing a specific operation, selling or performing administrative activities. Without additional information, however, management cannot control operations by reviewing only functional presentations of costs incurred.

To illustrate, management might plan to spend $100,000 on a project. The fact that $100,000 is spent on the project provides no indication that the planned objectives have been achieved. A measurement of the work accomplished is necessary to indicate whether the costs incurred fall within acceptable limits or not. But such a measurement is also not sufficient for management's control purposes.

The functional expression of the results of operations and the measurement of work performed will show management that costs have or have not been controlled but will not show which resources have been controlled and which have not been controlled. The Chart of Accounts, therefore, must provide the ability to express the results of operations in terms of cost elements as well as functions. We control costs by directly managing the organization's resources, not its functions, because it is the utilization or consumption of resources that determines the amount of costs incurred. The achievement of an organization's objectives, on the other hand, is controlled by managing the organization's functions.

The third element of the Chart of Accounts, the organizational unit whose manager is responsible for managing resources and achieving functional objectives, is perhaps the most important element. Managers who control by information must be advised where to seek explanations for variations from plans. The identification of the manager responsible for incurring costs provides a link between managers who control primarily by information and managers who control primarily by observation.

FINANCIAL ACCOUNTING VERSUS MANAGEMENT ACCOUNTING

A good Chart of Accounts may be ineffective if the accounting procedures that collect and process the accounting data do not make the accounting data available to management in the most appropriate form at the appropriate time. Management wants fast and accurate closing of the company books each month so that the overall results of operations are known in a timely fashion. But in designing accounting procedures to achieve this objective we often neglect the needs of managers to control internal segments of the company's operations. Several consequences may arise.

Reports may be provided for managers that include the same information as those used to present the overall results of operations to external parties. Usually such reports will not satisfy internal management control purposes because costs over which a manager has control are often combined with those over which he has no control.

Where such inadequacies are recognized, accountants have developed a variety of cost control systems that restructure the accounting data to suit management's internal needs for controlling operations. Often, these cost control systems are operated independently from the basic accounting system that prepares the overall financial statements, and management may have difficulty reconciling the various reports prepared from the different systems.

One approach that some accounting managements have taken is to try to justify different external reporting principles, such as direct costing, so that consistency with internal cost reports is maintained more easily. Instead, I prefer the development of accounting procedures that incorporate into one fully integrated accounting system the recording of transactions that reflect operations both for internal management control purposes and external reporting purposes. This approach may include certain short-cutting procedures to summarize and close the books rapidly to determine monthly operating profits, but basically it would provide "pools of accounting data" at critical points in the processing system.

ACCOUNTING DATA BANK

These pools of data that form an accounting data bank would be designed to provide the information required by managers at all levels in the organization. With the use of computers and related data storage devices today, these pools of data need not be lost during the data processing cycle, but instead may be maintained as sources of data for internal management control reports and supporting analyses, many of which may be undefined until the need to analyze certain costs or operations arises.

COST INCURRENCE VERSUS COST BENEFIT

How does management's view of internal operations differ from the results of operations prepared for external reporting purposes? Internally, management must control costs at the time of incurrence, that is, when the transaction involving the incurrence of costs takes place. However, external presentation of the costs of operation must consider the principles of cost benefit and matching costs with revenues.

Satisfying the principle of cost benefit often requires a redistribution of costs from the department responsible for incurring the cost to the departments benefiting from the incurrence of the costs. This redistribution of costs may take place at a point in time subsequent to the original incurrence of the costs. The redistribution of the costs is an accounting transaction that may more appropriately be the responsibility of the accounting manager than operating managers.

If the accounting system prepares reports that reflect the results of operations only after the accounting redistribution of costs, managers will be unable to evaluate and control by informational means the overall utilization of the resources for which they are responsible. The consequences of ignoring this approach to control by information will be to permit many areas of cost incurrence to take place without adequate review.

THE REPORTING SYSTEM

Proper attention to the design of the Chart of Accounts and the accounting procedures will make available a significant amount of information potentially useful for management's control purposes. A common error in many control systems, however, is to report an excessive amount of data. This may tend to confuse or overwhelm managers rather than to enlighten them.

Management reports design is as much a task of eliminating reported data as it is a task of identifying data to be reported. Reporting excessive quantities of data is usually the case when the reports are designed by the managers whose functions are being reported. There is a natural tendency for a manager in such a situation to want to tell everything there is to know about his operations, whether or not his superior needs such detailed information to evaluate his performance. "After all," a manager will say, "how is my boss going to know what a great job I am doing if he isn't advised of every detail of my work?" A subordinate manager will be reluctant to boil the results of his operations down to a few essential key performance indicators because "they don't tell the whole story." There is also the danger that a few essential key performance indicators will show only too clearly when operations are not going very well.

Management reports should be designed by the recipients of the reports according to their specific needs for reviewing the results of operations. The report recipient's information needs should be satisfied by a few essential key performance indicators which may change from time to time. When this happens, the maintenance of the pools of accounting data in the accounting system will permit development of new key performance indicators without major accounting systems redesign.

The volume of reported data may be reduced further by the use of exception reporting. Such reporting provides information only when there is unfavorable performance. It is usually better to defer exception reporting until managers understand what the positive reporting system provides, and what constitutes favorable and unfavorable performance. At that time, exception reporting may be effectively introduced. In this regard, I am tempted to coin the phrase, " out of sight, out of mind, out of control."

THE PLANNING SYSTEM

Understanding the mechanism of operations is invaluable for planning purposes. Management's planning system should mirror the accounting and reporting systems in terms of the classifications and key performance indicators used for operational control. The reporting system should be capable of presenting information regarding the plans of operations as well as the results of operations.

When performing internal audits, the auditor should consider how the activities being audited are planned. He should make recommendations where necessary for improving the planning procedures as well as the accounting and operating procedures.

Planning should not only include levels of operations such as sales and production, but should also include the desired levels of inventories, cash balances, receivables, etc., resulting from operations. Operating and financial models that utilize standard relationships developed from historical data, or from work measurements when considering detail work activities, or from desired performance rates will be helpful in the planning process.

Operational plans should not be expressed merely in terms of gross margins or other profit measurements. The full development of the amount and timing of expenses and revenues contributing to the planned profits must be made. A superficial projection of gross margin may look sound, but when actual gross profit results differ from the projections, it will be very difficult to determine whether the variances are caused by volume variations, resource rate changes, different efficiency factors, or the timing of sales and expenditures, if the plans are not stated in these terms.

Contrary to popular opinion, the profit and loss statement does not present the complete financial picture. A funds flow statement or even a more detailed cash flow statement is as important to project as profit and loss. The ability to plan and control cash, inventories, and receivables today will improve the planning and control of profit through utilization of these resources tomorrow. Many of us are probably only too acutely aware of how a profitable company can be on the verge of bankruptcy, or at best a significant dilution of ownership, because proper attention to funds requirements was not made. I am pleased to see the source and application of funds join the balance sheet and income statements in audited financial reports. You should help management recognize the value of this statement and include it among internal planning and control reports.

MANAGEMENT AUDITS

Objectives and policies should exist at all levels of the organization. They should be well documented or at least sufficiently communicated between managerial levels to be understood by everyone. It is not the role of auditors to set objectives and establish policies, but you can help management recognize the extent to which objectives and policies exist, are being followed, and are effective by conducting management audits. In such audits, managers must review the organization's objectives, policies and practices, as well as the systems and procedures by which the organization functions on a day-to-day basis. The audits may take varied forms. Here is a questionnaire we used recently in connection with an audit of an organization's objectives, policies, practices, systems and procedures.

The questionnaire provides space for identifying the manager's name, position title, department and immediate supervisor, and then lists the following questions and requests for information:

1. Name the individuals and positions that report directly to you.
2. Describe the duties and responsibilities of your position.
3. List the activities performed in your unit and the number of employees who perform these activities.
4. Describe briefly your department's operational duties, relationships with other departments and units of the company and with outside organizations, if any.
5. Describe the extent of your authority for establishing policy; for personnel matters including hiring, promotion, termination and compensation; for establishing systems, procedures and methods; and for approving expenditures, incurring expenses and controlling costs.
6. What techniques, factors and measurements do you use to plan, schedule and control operations within your area of responsibility and authority ?
7. What operation or procedure manuals are available to guide your employees in performing their assigned activities and duties?
8. What criteria do you employ to evaluate and measure the performance of employees within your area of responsibility?
9. What criteria are used by your immediate supervisor to evaluate and measure your performance?
10. List by title the regular reports you receive, where these reports are prepared, and their frequency.
11. What, if any, limitations or restrictions are imposed upon you, either by company policies or by other means, which affect your opportunity to improve overall company operations?

The answers to these questions will be most helpful in determining whether your company is an effectively controlled organization. ●