

Management Control Systems

Robert N. Anthony

*Ross Graham Walker Professor Emeritus
of Management Control*

John Dearden

*Herman C. Krannert Professor
of Business Administration*

*both of the
Graduate School of Business Administration
Harvard University*

Norton M. Bedford

*Arthur Young Professor
of Accounting
University of Illinois*

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Management Control Systems

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Preface

This sixth edition of our book follows closely the format of the fifth. Some of the text has been rewritten to incorporate new findings from the literature and observations from practice. The first four chapters have been largely rewritten. New cases have been added in many chapters, and several cases included in the fifth edition have been deleted.

The book continues to focus on the subject of management control. It does not deal extensively with topics such as cost accounting and budgeting procedures, which are discussed in separate accounting courses. Instead, its focus is on newer topics, not usually discussed in such courses—topics such as the control of discretionary costs, profit centers, and the programming process.

The book is designed for a one-semester course for students who have had a course in management accounting and who wish to study management control in greater depth. Few of the cases require a detailed knowledge of accounting or finance, and many of them have been used successfully in management education courses in which many of the participants have had no formal accounting courses.

Most of the cases have been used at the Harvard Business School. Many have also been used at other institutions. All have been selected for their interest and value as a basis for class discussion. They are not necessarily intended to illustrate either correct or incorrect handling of management problems. As in all cases of this type, there are no right answers. The educational value of the cases comes from the practice the student receives in analyzing management control problems and in discussing and defending his or her analysis before the class.

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for supporting our efforts in case collection and the development of this course.

Finally, we wish to acknowledge the contribution of Pauline B. Henault in preparing the manuscript for publication.

Robert N. Anthony

John Dearden

Norton M. Bedford

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PART ONE

An Overview

The Nature of Management Control

To start, we shall describe the nature of control in general and management control in particular. Control is the process of guiding a set of variables to attain a preconceived goal or objective. It is a broad concept applicable to people, things, situations, and organizations. In organizations, it includes various planning and controlling processes. A substantial portion of these processes takes the form of **management control**: the actions used by management to guide people, machines, and functions to attain organization goals and objectives. For the purpose of developing management control systems, we distinguish between management control and other planning and control activities. Also, we shall distinguish between the control function and other functions of management. After reviewing the nature of control and the control process, this chapter concludes with an overview of the management control structure and the steps in the management control process.

We shall use the following eight terms to introduce the subject of organization control. They will be defined more precisely later on.

1. *Organization*: An interacting group of people performing in a coordinated manner as a distinctive entity to achieve identified ends, missions, or goals.
2. *Strategy*: A broad general long-term plan of action that governs organization policy formulation and programs for action.
3. *Policy*: A broad rule or set of rules that guides actions throughout an organization.
4. *Programming*: The development and selection of a set of programs to be carried out.
5. *Strategy control*: All methods and analyses used to monitor, evaluate, and modify strategies in adapting organization activities to the requirements for survival imposed by the ever-changing external environment.
6. *Organization control*: Guiding a set of variables (machines, people, equipment) toward a preconceived goal.

7. *Management control*: All methods, procedures, and devices, including management control systems, that management uses to ensure compliance with organization policies and strategies.
8. *Management control system*: An organized systematic process and structure that management uses in management control.

These terms are related to each other in organizations in the following manner. The first thing management needs to do when forming or changing an organization is to determine what the organization should do and how it should do it. The result of this strategic planning is a set of goals for the organization and various *strategies* for attaining the goals. The strategies developed include both *policies* to guide ways of acting and broad *programs* of activities to pursue goals. These decisions are reexamined continuously using various *strategic control* processes to adjust strategies to changed technological, social, political, and economic conditions. Once these programs and policies are in place, management needs some way to ensure that people in the organization do what they are supposed to do. *Control* is the process used to do this. It spans both *strategy control*, which aims to ensure appropriate strategies, and *organization control*, which aims to ensure that people in organizations do what management wants them to do. The management role in control is called *management control*, and the system used to do such things as collect and analyze information, evaluate it, and use it and other devices to control activities is a *management control system*.

THE NATURE OF CONTROL

Most of us think we have our lives under reasonable control. We guide ourselves to reach goals or objectives, and we correct our actions when we stray from the path to our goals. The driver strives to keep the automobile under control to reach a destination on time, to stay on the road, to avoid an accident, or to gain some other goal. Using various mechanical control devices such as an accelerator, a steering wheel, and a brake pedal that respond to the driver's direction, the automobile is guided to perform as the driver wishes. These same control devices are used to correct the movements of the automobile when it drifts from the desired speed or slips to the side of the road. Should the driver let the automobile go out of control, undesirable things happen.

In a similar manner, an organization of managers and workers must be motivated and guided to do the things its leaders want it to do and must be corrected when it departs from the pursuit of management goals. Just as the automobile driver must keep the automobile under control, management must keep an organization under control so that it will do the things it is supposed to do. If management loses control and the organization goes out of control, undesirable things happen to

many people. The control devices used in business are many and much more complex than those used to control an automobile, primarily because control of an organization is a much more complicated process. Routine control devices include physical barriers to prevent inventory slippage; authorization forms for ordering or using equipment; inspirational leadership; and other processes, among them a formal management control system. We shall lead up to a discussion of control in organizations by first describing the control process in simple situations.

Introductory Control Situations

Underlying all control processes is the idea of directing a variable, or set of variables, to realize a goal, whether that variable is an individual, a machine, or an organization. In an organization, people are the variables to be directed, guided, or motivated to pursue goals. Those people who do the directing represent management. While management performs other functions, the management control function pervades an organization. Control systems also are used in nonorganization situations, but any control system has at least these four components:

1. An observation device that detects, observes and measures, or describes the activities or other phenomena being controlled. The term for this component may be *observer*, *detector*, or *sensor*.
2. An assessing device that evaluates the performance of an activity or organization, usually relative to some standard or expectation of what should be, and identifies out-of-control activities and conditions. The term for this component is *evaluator*, *assessor*, or *selector*.
3. A behavior modification device for altering or changing performance if the need for doing so is indicated. This component may be called a *director*, *modifier*, or *effector*.
4. A means of transmitting information within and among the three parts. This component is called a *communication network*.

The transmission of information from the detector through the selector to the effector is termed *feedback*.

Collectively, these components may be structured as a *system*: They are a set of interrelated processes serving a common purpose. Each component of the system affects and is affected by others. The bare bones of all control systems are diagrammed in Exhibit 1-1.

The control system may take various forms and serve various purposes, as illustrated by three representative examples: an electrical control system—a thermostat for room temperature control; a biological control system—a human body for body temperature control; and a mental control system—a brain and sensing organ for human behavior control.