Chapter 11
CONTROLLING

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What is Controlling

- *Controlling* refers to the process of ascertaining whether organizational objectives have been achieved; if not, to determine why not; and determining what activities should be taken to achieve objectives better in the future.

Importance of Controlling

- When controlling is properly implemented, it will help the organization achieve its goal in the most efficient and effective manner possible.

- In any organization, deviations, mistakes, and shortcomings happen once in a while.

- When they occur, they contribute to unnecessary expenditures which add up to the cost of producing goods and services.
- The introduction of effective control measures minimize the ill effects of such negative occurrences.
- An effective inventory control system, for instance, minimizes if not totally eliminate losses in inventory.

Steps in the Control Process

- The control process consists of four steps, namely:
  1. establishing performance objectives and standards;
  2. measuring actual performance;
  3. comparing actual performance to objectives and standards; and
  4. taking necessary action based on the results of the comparison.

Establishing Performance Objectives and Standards

- For effective controlling, what has to be achieved must first be determined.
- Typical examples of objectives and standards are as follows:
    1. *Sales targets* – which are expressed in quantity or monetary terms;
    2. *Production targets* – which are expressed in quantity and quality;

3. *Worker attendance* – which are expressed in terms of rate of absences;
4. *Safety record* – which is expressed in number of accident for given periods; and
5. *Supplies used* – which are expressed in quantity or monetary terms for given periods.

- Once objectives and standards are established, the measurement of performance will be facilitated.
- After the performance objectives and standards are established, the methods for measuring performance must be designed.
- Every standard established must be provided with its own method of measurement.

Measuring Actual Performance

- There is a need to measure actual performance so that when shortcomings occur, adjustments could be made.
- The adjustments will depend on the actual findings.

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Comparing Actual Performance to Objectives and Standards

- Once actual performance has been determined, this will be compared with what the organization seeks to achieve. Actual production output, for instance, will be compared with the target output.

Taking Necessary Action

- The purpose of comparing actual performance with the desired result is to provide management with the opportunity to take corrective action when necessary.

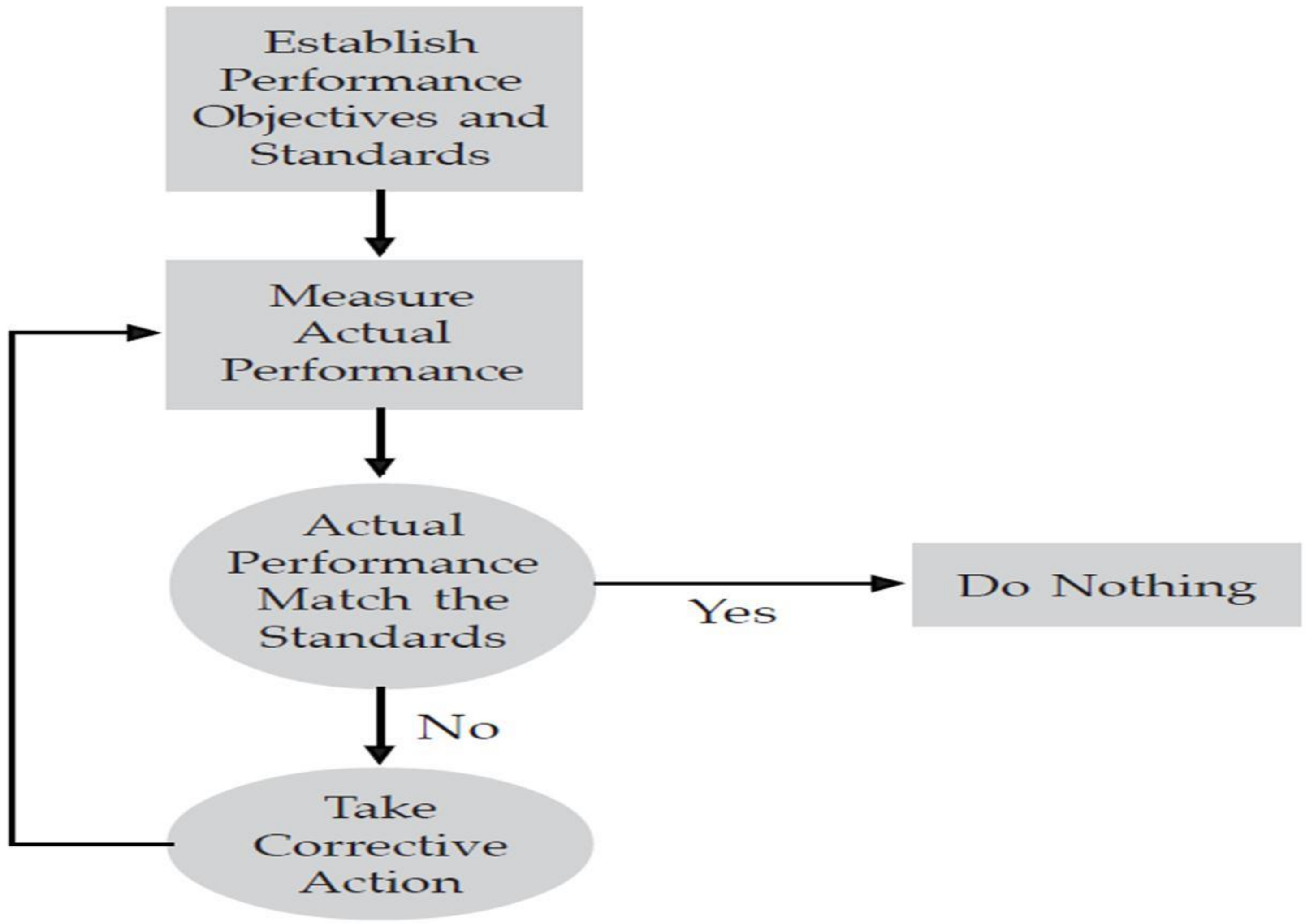

Figure 54. Steps in the Control Process

Types of Control

- Control consists of three distinct types, namely:
  1. Feedforward control;
  2. Concurrent control; and
  3. Feedback control.

Feedforward Control

- When management anticipates problems and prevents their occurrence, the type of control measure undertaken is called *feedforward control*.
- This type of control provides the assurance that the required human and non-human resources are in place before operations begin.

Concurrent Control

- When operations are already on-going and measures to detect variances are made, concurrent control is said to be undertaken.
- It is always possible that deviations from standards will happen in the production process.
- When such deviations occur, adjustments are made to ensure compliance with requirements. Information on the adjustments are also necessary inputs in the pre-operation phase.

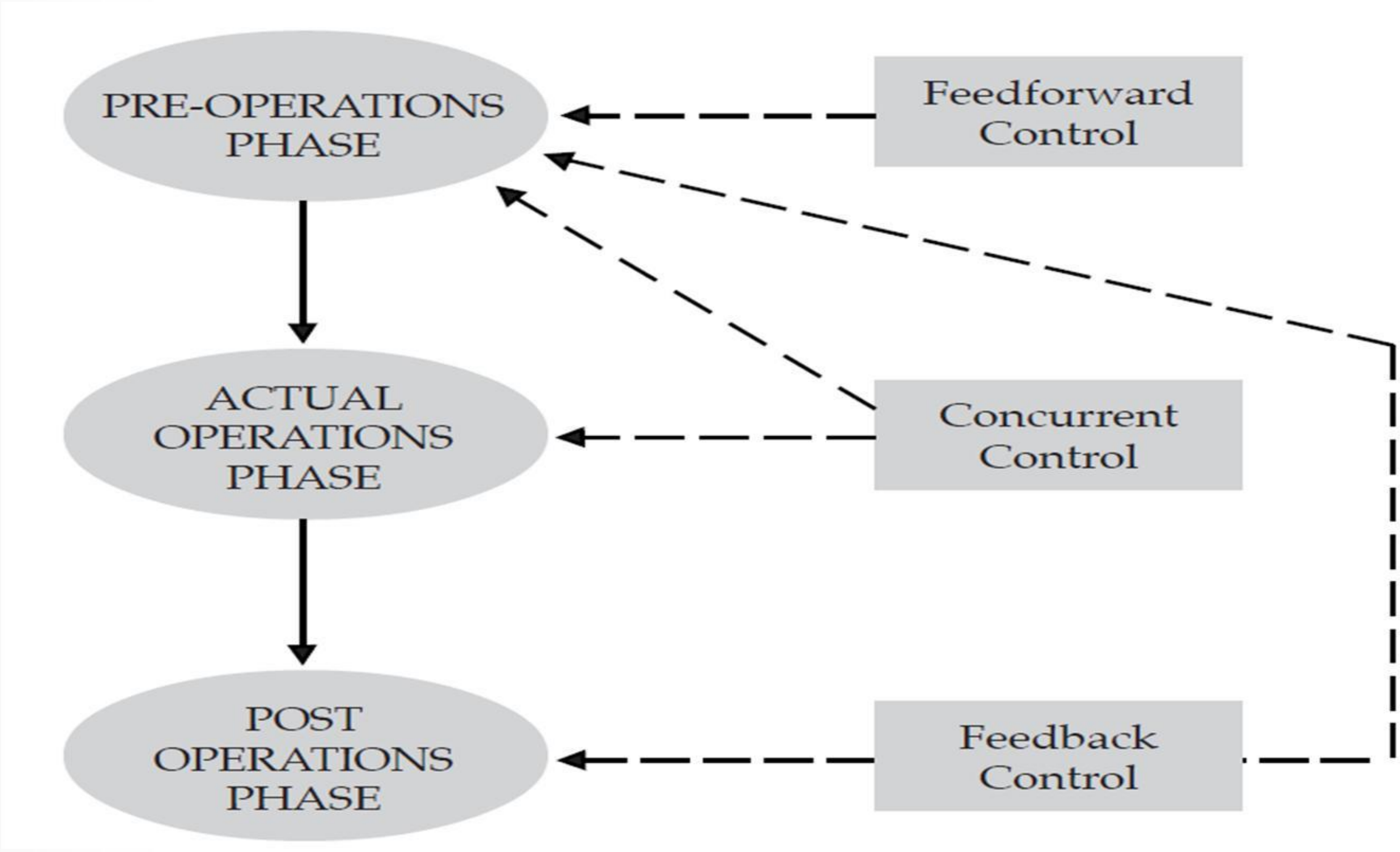

Figure 55. Types of Control and their Relation to Operations

Feedback Control

- Feedback control validates objectives and standards.
- If accomplishments consist only of a percentage of standard requirements, the standard may be too high or inappropriate.

Components of Organizational Control Systems

- To effectively control activities, organizations adapt control systems consisting of the following components:

  1. the strategic plan
  2. the long-range financial plan
  3. the operating budget
  4. performance appraisals
  5. statistical reports
  6. policies and procedures

Strategic Plans

- The strategic plan provides the basic control mechanism for the organization.
- When there are indications that activities undertaken do not facilitate the accomplishment of strategic goals, these activities are either set aside, modified, or expanded.

The Long-range Financial Plan

- The planning horizon differs from company to company. Most firms will be satisfied with one year.

The Operating Budget

- The operating budget indicates the expenditures, revenues, or profits planned for some future period regarding operations.

Performance Appraisals

- Performance appraisals measure employee performance.
- As such, it provides employees with a guide on how they could do their jobs better in the future.
- Performance appraisals also function as effective checks on new policies and programs.

Statistical Reports

- Statistical reports are those that contain data on various developments within the firm.

- Among the information which may be found in a statistical report are the following:
    1. labor efficiency rates
    2. quality control rejects
    3. accounts receivable
    4. accounts payable
    5. sales reports
    6. accident reports
    7. power consumption report

BILLY BOY MANUFACTURING COMPANY Sales Report for the Six-Month Period Ending June 30, 2006		
	Amount	Percent
Sales Volume	P 6,800,000	
Sales Expenses		
Salaries	181,600	15.0
Commission	340,000	28.1
Promotion	160,600	13.3
Travel	275,400	22.8
Entertainment	40,300	3.3
Freight	179,200	14.8
Depreciation, taxes, and insurance on service vehicles	17,500	1.4
Miscellaneous	15,400	1.3
TOTAL SALES EXPENSES	P1,210,000	100.0

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Figure 56. A Sample of Statistical Report

Policies and Procedures

- Policies refer to the framework within which the objectives of the organization must be pursued.
- The procedure is a plan that describes the exact series of actions or steps to be taken in a given situation.
- It is expected that policies and procedures laid down by management will be followed.

Strategic Control Systems

- To be able to assure the accomplishment of the strategic objectives of the company, strategic control systems become necessary.

- These systems consist of the following
  1. financial analysis; and
  2. financial ratio analysis.

Financial Analysis

- The success of most organizations depends heavily on its financial performance.

- It is necessary that certain measurements of financial performance be made so that whenever deviations from standards are found out, corrective actions may be introduced.

ATTABOY MANUFACTURING COMPANY Balance Sheet Statement As of December 31, 2006	
Assets	
Cash	P 70,450
Accounts receivable	2,406,130
Inventories	2,608,791
Prepaid expenses	9,437
Net fixed assets	289,003
Total Assets	P5,383,811
Liabilities and Shareholder's Equity	
Notes Payable	P 497,643
Accounts payable	2,638,737
Accrued liabilities	112,164
Long-tern debt	47,665
Total Liabilities	P 3,296,209
Common stock	250,000
Retained earnings	1,837,603
Total Liabilities and Shareholders' Equity	P 5,383,811

Figure 57. A Sample Balance Sheet Statement

Financial Ratio Analysis

- Financial ratio analysis is a more elaborate approach used in controlling business activities.
- Under this method, one account appearing in the financial statement is paired with another to constitute a ratio.

- The result is compared with a required norm which is usually related to what other companies in the industry have achieved, or what the company has achieved in the past.
- When deviations occur, explanations are sought in preparation for whatever action is deemed necessary.

- Financial ratios may be categorized into the following types:

  1. liquidity ratios
  2. efficiency ratios
  3. financial leverage ratios
  4. profitability ratios

Liquidity Ratios

- These ratios are used to assess the ability of a company to meet its current obligations.

- The following ratios are important indicators of liquidity:

  1. Current ratio. This shows the extent to which current assets of the company can cover its current liabilities. The formula for computing current ratio is as follows:

$$\text{Current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

2. ***Acid-test ratio***. This is a measure of the firm's ability to pay off short-term obligations with the use of current assets and without relying on the sale of inventories. The formula is as follows:

$$\text{Acid-test ratio} = \frac{\text{current assets} - \text{inventories}}{\text{current liabilities}}$$

Efficiency Ratios

- These ratios show how certain assets or liabilities are used efficiently in the production of goods and services.

- Among the more common efficiency ratios are:

1. ***Inventory turnover ratio***. This ratio measures the number of times an inventory is turned over (or sold) each year. This is computed with the use of the following formula:

$$\text{Inventory turnover ratio} = \frac{\text{cost of goods sold}}{\text{inventory}}$$

2. ***Fixed assets turnover***. This ratio is used to measure utilization of the company's investments on its fixed assets, such as plant and equipment. The formula used is as follows:

$$\text{Fixed assets turnover} = \frac{\text{net sales}}{\text{net fixed assets}}$$

DANNYBOY CHEMICAL COMPANY
Income Statement for 2006
(000)

Sales (9,200 units)	P 92,000
Cost of Goods Sold:	
Initial inventory	none
Manufacturing costs (9,900 units mfg.)	
Materials	8,990
Labor	12,160
Plant overhead applied	24,750
Plant overhead underapplied	2,000
Total manufacturing costs	47,900
Final inventory – 700 units	3,388
Cost of Goods Sold	44,512
Gross Profit	47,488
Operating Costs:	
Distribution costs	17,880
Administrative costs	17,940
Total operating costs	35,820
Net profit (pretax)	P 11,668

Figure 58. A Sample of Income Statement

Financial Leverage Ratios

- This is a grouping of ratios designed to assess the balance of financing obtained through debt and equity sources.
- Some of the more important leverage ratios are the following:

1. ***Debt to total assets ratio***. This ratio shows how much of the firm's assets are financed by debt. It may be computed by using the following formula:

$$\text{Debt to total assets ratio} = \frac{\text{total debt}}{\text{total assets}}$$

2. ***Times interest earned ratio***. This ratio measures the number of times that earnings before interest and taxes cover or exceed the company's interest expense. It may be computed by using the following formula:

$$\text{Times interest earned ratio} = \frac{\text{profits before tax + interest expense}}{\text{interest expense}}$$

Profitability Ratios

- These ratios measure how much operating income or net income a company is able to generate in relation to its assets, owner's equity, and sales.

- Among the more notable profitability ratios are the following:

  1. ***Profit margin ratio***. This ratio compares the net profit with the level of sales. The formula is as follows:

$$\text{Return on assets ratio} = \frac{\text{net income}}{\text{assets}}$$

2. ***Return on assets ratio***. This ratio shows how much income the company produces for every peso invested in assets. The formula used is as follows:

$$\text{Return on assets ratio} = \frac{\text{net income}}{\text{assets}}$$

3. ***Return on equity ratio***. This ratio measures the returns of the owner's investment. It may be determined by using the following formula:

$$\text{Return on equity ratio} = \frac{\text{net income}}{\text{equity}}$$

Identifying Control Problems

- Recognizing the need for control is one thing; actually implementing it is another.

- When operations become complicated, the manager must consider useful steps in controlling.

- The following approaches may be useful:
  1. executive reality check
  2. comprehensive internal audit
  3. general checklist of symptoms of inadequate control

Executive Reality Check

- Employees manning the frontlines often complain about management's imposition of certain requirements that are not realistic.
- This happens because, most often, the manager is inaccessible to his subordinates and he has no way of knowing what is really happening inside the workplaces.

Comprehensive Internal Audit

- An internal audit is one undertaken to determine the efficiency and effectiveness of the activities of an organization.

- Among the many aspects of operations within the organization, a small activity that is not done right may be done continuously and without noticing it until it snowballs into a full blown problem.

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Symptoms of Inadequate Control

- If a comprehensive internal audit cannot be availed of for some reason, the checklist for symptoms of inadequate control may be used.

- Some of the more common symptoms of inadequate control are the following:
    1. an unexplained decline in income and profits;
    2. customers complaining about poor service they get from the company;

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3. employee dissatisfaction characterized by complaints, grievances, and resignations;
4. cash shortages caused by overstocking of inventories or delinquent accounts receivables;
5. idle facilities or personnel;
6. disorganized operations characterized by work flow bottlenecks, excessive paperwork, and others;
7. excessive costs; and
8. evidence of waste and inefficiency such as scrap and rework.