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   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

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- Sharma T., Kwatra, G. (2008) Effectiveness of Social Advertising: A Study of Selected Campaigns, Corporate Social Responsibility, Edited by David Crowther & Nicholas Capaldi, Ashgate Research Companion to Corporate Social Responsibility, Chapter 15, pp 287-303.

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IMPACT OF MANAGEMENT CONTROL SYSTEMS ON YEAR ON THE YEAR GROWTH OF OPERATING PROFITS OF MANUFACTURING COMPANIES IN SRI LANKA

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ABSTRACT

Management Control Systems are essential mechanisms supporting organization, organizational learning, and innovation, as the main premise of Management Control Systems is to ensure the attainment of organizational objectives. The manufacturing industry in Sri Lanka is the biggest contributor to the industry sector, which in turn is the second largest contributor to the country's GDP, has continuously shown improved financial results. This study analyzes the influence of Management Control Systems on the year on year growth in operating profit of manufacturing companies in Sri Lanka. A structured questionnaire was developed and sent to a sample population of 83 manufacturing companies in Sri Lanka. 71 of the companies responded to the questionnaire. Structured interviews were subsequently conducted with selected personnel in these 71 companies to ensure proper completion of questionnaire and to validate the data provided. Based on analysis of data it was found that there is a statistically significant relationship between Management Control Systems and year on year growth in the operating profits of manufacturing companies in Sri Lanka

KEYWORDS
Manufacturing Companies, Management Controls, Management Control Systems, Year on Year Growth in Operating Profit.

1. INTRODUCTION

The manufacturing sector in Sri Lanka, which is the main contributor to the industry sector of the country's economy has developed significantly since the country's independence in 1948. Before its independence and in the immediate post independent period the sector was primarily involved in the manufacture of agricultural produce for export and domestic consumption. A majority of the dominant firms in the industry were engaged in the manufacture and packaging of the primary commodities of the country, namely, coconut, rubber and tea for export. The manufacturing of these primary produce during this period was typified by moderate investments in machinery, limited technological knowledge and basic sequential processes and procedures. A decline in the country's foreign exchange reserves and a change in the economic policies of the country, to socialist economic policies in 1960, resulted in a majority of the foreign owned companies which dominated key sectors such as banking, education, finance, health, plantations and transport exiting the economy.

A reintroduction of open economic policies and the liberalization of the economy in 1978 resulted in significant changes in all sectors of the economy, including the manufacturing sector. The replacement of inward focused protectionist policies with market oriented policies resulted in a rapid increase in private sector participation and investment in the manufacturing sector in the late 1970s and throughout the 1980s. Participation and confidence of the private sector in the local economy during this period was enhanced further via the creation of Free Trade Zones and the Greater Colombo Economic Commission, which made possible foreign participation in most sectors of the economy including the manufacturing sector. As a result of these open economic policies manufacturing output which had averaged approximately 1.7% per annum during the 1970 to 1978 period, increased exponentially to 5.6% per annum during the period 1978 to 1990, whilst capacity utilization in the manufacturing sector also increased significantly from 63% to 75% during this same period. These open economic policies also contributed to an increase in manufacturing output from 15% of GDP in 1990 to 17.5% of GDP in 2010.

Given the significant improvement in the performance of the manufacturing sector of the country since the opening up of the economy in 1978, it is vital to analyze the influence and contribution of Management Control Systems (MCS) to this increase in organizational efficiency. MCS are integral for the control and management of all organizations regardless of their size or ownership structure. MCSs include a range of mechanisms and tools created to ensure that a company performs according to expectations, i.e., that all policy decisions of the company are implemented accordingly, ensure effective utilization of resources, eliminate or at the very least minimize instances of fraud mismanagement and waste within the organization, and ensure that performance data is obtained and used effectively in the decision making process. Whilst MCS have traditionally been identified as formal feedback and control systems to measure organizational performance and rectify any deviations in performance vis-a-vis established standards, in recent times, they have been recognized as vital mechanisms supporting the organization, organizational learning, and innovation (Simons, 1990; Knights & Willmott, 1993; Bisbe & Otely, 2004). The reason for this importance of MCS for organizational success can be attributed to the fact that the key theme of MCS entails ensuring that a company achieves its goals (Otley, 2003). The main objective in this study is to measure the influence and contribution of MCS to year on year growth in the operating profit of manufacturing companies in Sri Lanka.

2. LITERATURE REVIEW

Management Controls (MCs) are a vital component of management in today's vibrant business environment. MCs include a wide variety of mechanisms and tools. The usage of MCs enables companies to measure the extent to which objectives are achieved; identify divergences in performance for which corrective measures need to be implemented. MCs Also help ensure more effective and efficient use of resources in an organization. This chapter presents the most appropriate findings from previous research on this subject.

2.1 DEFINITION OF MANAGEMENT CONTROL SYSTEMS
Anthony (1965) defines MCSs as the processes which managers use to make certain that resources are obtained and utilized effectively and efficiently in the achievement of organizational goals and objectives. According to Merchant and Otley (2007), the main goal of MCSs is to generate information that can be used by organizations for planning, evaluation and decision making in a company. Simon (1995) defines MCSs as formal information based processes and procedures that management utilizes to evaluate and change patterns in organizational performance. These process and procedures include a range of mechanisms and tools developed to ensure that policy decisions of the company are implemented accordingly, ensure optimal utilization of resources, eliminate if not at best reduce the instances of fraud, mismanagement and waste, and generate information that can be utilized by management for decision making. As per Chow, Shields and Wu (1990) MCSs are intended to assist organizations to motivate employees to make informed decisions and to implement appropriate practices that are in the best interest of the company.

2.2 IMPORTANCE OF MANAGEMENT CONTROL SYSTEMS
MCSs are a vital management mechanism enabling organizational learning and innovation (Bisbe and Otely, 2004; Chenhall and Langfield, 2003; Knights and Willmott, 1993; Simons, 1990). The principal premise of MCSs entail supporting an organization achieves its stated objectives (Otley, 2003). MCSs can therefore be described as management activity that connects strategic planning and operational control (Otley, Broadbent and Berry, 1995). In today's dynamic business environment, where the likelihood of companies encountering complex business challenges is extremely high, given the nature of today's the global economy, exponential development in technology, intense globalized nature of rivalry and the increasing diffusion of information across the globe (Drucker, 1997), management's ability to foresee and successfully respond to challenges and opportunities influenced by change is vital for organizational survival and success (Abernethy and Brownell, 1999). Management accounting systems and data generated by these systems are vital in supporting management decision making, which is turn is crucial in enabling the organization to develop comparative advantages (Chenhall and Langfield-Smith, 1998). As per Argyis (1990) MCSs process of measuring performance and correcting divergences in performance has resulted in MCSs becoming a key influencer in organizational transformation.
MCSs are not utilized to their potential in Sri Lanka (Abesinghe, 2009; Fonseka, Manawaduge and Senaratne, (2005). As per Abeysinge (2009) MCSs are mere rituals in Sri Lankan public companies, as political interest supersedes all other interests including financial interest in the management of these companies. According to Fonseka et al (2005), MCSs are mostly used in listed companies in Sri Lanka for planning, control and internal control purposes only. The most common MCs used in these listed companies include budgetary control, cash flow planning, capital budgeting techniques, management costing, internal audits, performance evaluation, ratio analysis, re-order levels, absorption costing, variable costing, standard costing & variance analysis. Ekanayake (2004) in his research "Agency Theory, National Culture and Management Control Systems" defines MCs as the structured facet of management that is the formal vehicle by which the management process is implemented with the main goal of accomplishing corporate objectives. According to Ekanayake (ibid) MCs are important because employees are not always motivated to perform optimally, necessitating MCSs to align organizational (principal) objectives with the objectives of the employee (agent).

2.3 MANAGEMENT CONTROLS: IMPACT ON ORGANIZATIONAL PERFORMANCE
Sandino (2004) classified the initial MCS used in an organization into four distinct categories i.e., "Basic MCSs", such as budgets, pricing and inventory systems; "Cost MCSs", whose main objectives are to enhance operational efficiencies, establish control and minimize cost; "Revenue MCSs", which concentrate on collecting non-financial data and responding to consumers; and "Risk MCSs", which are a set of process and procedures designed to minimize risk and protect asset integrity. According to Sandino (idib) "Basic MCS" are utilized by all organizations, whilst the use of the other categories of MCSs is subject to the specific requirements of the particular organization, its strategy and organizational structure. In addition, as per this researcher, organizations implementing differentiation strategies adopt revenue MCSs with an emphasis on sales productivity controls and marketing databases; whilst decentralized firms and firms offering a more diverse assortment of products and services are inclined to place more emphasis on risk MCSs. Akroyd and Kober (2010) in their investigation on the emergence and utilization of MCSs in growth firms concluded that belief systems are the first MCs to be implemented in a firm and that these organizational belief systems are constantly reinforced, and developed throughout the start-up and growth stages of the firm. The conclusions from this study are in contrast to the findings of other researchers (Simons, 1994; Sandino, 2004) whose research identified diagnostic financial controls and internal controls as the initial control systems implemented in young companies. As per Ho, Huang and Wu (2011) organizations with tight MCSs exhibit better quality and higher efficiency as opposed to institutions with loose MCSs. As per Bloom et al (2011) who investigated the impact of management controls on selected companies in the textile industry in India, management controls have a positive impact on organizational performance, in addition, according to these researchers in organization with multiple plants or subsidiaries, there is a distinct transfer of expertise from subsidiaries or plants with superior MCs to subsidiaries with weak MCs. According to Jankala (2007), whilst MCSs are used by all types of organizations, the impact of MCSs on the performance of small organizations is extremely limited.

2.4 USE OF MANAGEMENT CONTROLS IN SRI LANKAN COMPANIES
In the Sri Lankan context two notable studies are available on management controls and their impact on companies. Samudrage (2007) in her study analyzed the relationship between strategy and management control systems in Sri Lankan companies. However, the scope of this research is limited as it is based on the analysis of one semi-private telecommunication company. Wickremasinghe (2003) in his study analyzed the state of management control systems in Sri Lankan companies post independence, this study is also limited in scope as it is based on the analysis of two companies; a semi-private telecommunication company and a privatized textile mill in Sri Lanka. These two studies are limited in depth, as they focus on only one company (the Samudrage study) and two companies (the Wickremasinghe study) in sectors which are not as economically significant as the manufacturing sector.

3. IMPORTANCE OF THE STUDY
Research on the use and impact of MCSs on Sri Lankan companies is extremely limited. In addition, as mentioned in the previous section, the scope of existing research is limited and highlights the need for further comprehensive studies on this subject. This research undertaking will address this gap in research on the use and impact of MCSs on Sri Lankan companies. In addition, companies in the manufacturing sector of the country will significantly benefit from this study as its findings could be used by sector companies to modify existing MCSs and introduce new MCSs which will have a positive impact on the financial performance of these companies.

4. STATEMENT OF THE PROBLEM
MCSs have developed from basic control and feedback systems to vital mechanisms supporting organization, organizational learning, and innovation. Although MCS have traditionally been recognized as vital mechanisms for organizational success from an academic perspective, the actual usage of MCS among organizations, according to Otley (2003), is rather limited. In addition, review of literature indicates that the use of MCS in organizations is in most cases is limited to traditional mechanisms such as budgetary controls. This is also factual from a Sri Lankan context, where the use and implementation of traditional MCSs is a common practice in most organizations (Fonseka et al., 2005). Inappropriate and weak MCS have a damaging impact on organizational performance, whilst strong effective MCSs have a positive impact on organizational performance and profitability. Given this importance of MCSs in organizational performance and profitability, the problem statement can be presented as "**what impact do MCSs have on the year on year growth in the operating profit of manufacturing companies in Sri Lanka?**"

5. OBJECTIVES OF THE STUDY
The main objective of this study is to identify and understand the impact of MCSs on the Year on Year Growth in the Operating Profit of manufacturing companies in Sri Lanka.

6. HYPOTHESIS

$H1_0$: MCSs have no statistically significant impact on the year on year growth in the operating profit of manufacturing companies in Sri Lanka
$H1_A$ - MCS have a statistically significant impact on the year on year growth in the operating profit of manufacturing companies in Sri Lanka.
The hypothesis will be tested against th**e significance of 0.05**

7. RESEARCH METHODOLOGY

7.1 POPULATION SAMPLE

Population is the total collection of elements about which the researcher wishes to make some inferences (Cooper & Schindler, 2006). The research population for this study consist of 83 companies in the manufacturing sector in Sri Lanka. The composition of the population for this study is indicated in Table 1. Based on the results of the pilot study, it was decided to consider 71 companies or 85.5% of the population as the research sample for the study.

TABLE 1: MANUFACTURING COMPANIES IN SRI LANKA SELECTED FOR THE STUDY

Industry	No. of companies
Manufacturing	39
Beverage, food and tobacco	21
Chemicals and pharmaceuticals	12
Footwear and textile	07
Construction and engineering	04
Total	83

7.2 DATA COLLECTION METHODS

Both primary and secondary data collection instruments were used to collect data for this study. The unit of analysis for this research was at company level. Primary data for the study were collected from Chief Operating Officers of the companies studied.
For primary data collection, the study used both questionnaire and interview methods. A questionnaire was developed and forwarded to the respective Chief Operating Officers of the selected companies. The questions were framed to collect data on MCSs used in the sample companies, the financial objectives of the sample companies and the achievement of these financial objectives. The MCSs for primary data collection were identified by referring to recently published textbooks on management controls. In addition, one open ended question was used to identify those MCSs used by the companies, which were not in the list of MCS provided to them. Subsequent to the completion of the questionnaire, interviews were conducted with the respondents to authenticate the information provided.
Secondary data was collected through the Central Bank of Sri Lanka and the annual reports of the companies studied. The information collected through secondary sources was used to analyze the performance of individual companies and the manufacturing sector as a whole. In addition, company reports were used to measure the extent to which the companies had achieved their financial objectives identified through the primary data collected.

7.3 DATA ANALYSIS

The hypothesis was tested using Analysis of Variance (ANOVA), Correlation Test and Regression Analysis. In order to present summaries of data, case summaries and descriptive analysis were used. Analysis of mean, range, standard deviation and the variance in data were carried out to identify how clustered or dispersed the variables are and to understand how well the questions were framed for tapping the concept questioned in the survey instrument.
Pearson correlation test was applied **to test the strength of association** between MCSs which are identified as the independent variables and year on year growth in operating profit which is the dependent variable. The dependent variable; year on year growth in operating profit is recognized through the aggregate average value over a five year period.
Scatter plots were utilized to identify if the relationship between two variables is linear or not. According to the constructed scatter plots, all the MCSs are **approximately linear** with year on year growth in operating profit. Thus, Pearson Correlation test was used to test the strength of association between variables. **Statistically Pearson Correlation Coefficient lies between -1 and +1.** If the value of correlation coefficient is close to -1, it signifies that there is a strong negative correlation between variables. Similarly if the value of correlation coefficient is close to +1, it can be interpreted as a strong positive correlation between variables. If the correlation coefficient value is close to -0.5 or +0.5, there exists a moderate negative or moderate positive association among variables. Finally, if the coefficient value is very close to 0, it signifies that the relationship between variables is weak.
The sig. (2-tailed) value which is the p-value was used to determine the significance of the relationship among variables in the study. As the alternative hypothesis (H_1) is non-directional, a 2-tailed test was applied. The used confidence interval was 965% and therefore the desired level of significance was 0.05 in the analysis. A sig. (2-tailed) value less than 0.05, is recognized as a statistically significant relationship, if not (sig. > 0.05) the relationship is recognized as statistically insignificant.

8. RESULTS AND DISCUSSION

Results from the data analysis indicate a **moderate positive correlation** between MCSs and Year on Year growth in operating profit in the selected domain. That relationship is also statistically significant, as sig. (2-tailed) value is less than the significant level. Hence, the alternative hypothesis i.e., there is a significant moderate relationship between MCSs and Year on Y growth in operating profit is accepted.

TABLE 2: CORRELATIONS – CAPITAL EXPENDITURE TO SALES RATIO AND MCS

		Management Controls	Y to Y growth in Operating Profit
Management Controls	Pearson Correlation	1	**.515**
	Sig. (2-tailed)		**.001**
	N	71	71
Y to Y growth in Operating Profit	Pearson Correlation	.515	1
	Sig. (2-tailed)	.001	
	N	71	71

9. FINDINGS

Basic MCSs such as budgeting and inventory management are used in all the sample manufacturing companies. In addition, a majority of companies (75%) implement some forms of Cost MCSs, whilst Risk MCSs are also used by a large number of the surveyed manufacturing companies (68%). Revenue MCSs were evident in only 4 of the companies surveyed. Findings from the data analysis also reveal that firm size has a significant influence on the number and types of MCSs used. Large firms (firms with more than 500 employees) implement a variety of management controls ranging from basic MCS, to cost and risk MCSs, whilst in small companies (companies with less than 100 employees) the use of MCSs was limited to basic MCSs. In terms of MCSs impact on organizational performance, data analysis indicated a distinct relationship between MCS and organizational performance, with the financial performance of organizations having tight management controls being clearly superior to firms with loose MCSs. Of the categories of MCS identified by Sandino (2004), findings indicate that cost and risk MCSs have a significantly higher positive influence on organizational performance in comparison to basic MCSs.

10. RECOMMENDATIONS/SUGGESTIONS

MCSs have a distinct impact on the performance of manufacturing companies in Sri Lanka. Companies in this sector of the Sri Lankan economy particularly the smaller companies should focus on introducing more MCSs in order to improve performance. In addition, companies should focus on implementing more risk and cost MCS, as these MCSs have a positive influence on organizational performance.

11. CONCLUSIONS

The present study was conducted with a view to assessing the impact of MCS on the year on year growth in the operating profit of manufacturing companies in Sri Lanka. The data obtained from the questionnaires, interviews with the sample population have been analyzed and interpreted using various financial ratios as well as applied statistical tools. Findings from the analysis of the data indicate that MCSs have a statistically significant impact on the year on year growth in operating profit of manufacturing companies in Sri Lanka. The findings of this study support the research carried out by Ho, Huang, & Wu (2011) and Bloom et al (2011) which found MCSs have a positive influence on an organization's performance, and contradict the findings of Jankaka (2007) whose research founded that MCSs have little impact on the financial performance of an organization.

12. LIMITATIONS OF THE STUDY

Management controls used by the companies can be broadly categorized as quantitative and qualitative. However, taking into consideration that the bottom-line of a profit oriented company is to operate profitably and achieve its financial objectives; the study limits its concentration to the financial controls adopted by manufacturing companies in Sri Lanka. Furthermore, although the study considered the entire population consisting of 83 companies for this study, reluctance and unwillingness of some companies to participate in the study and to divulge correct information, limited the ability of the study to arrive at accurate conclusion for the sector as a whole. In addition, given that this study only focuses on the public quoted manufacturing companies in the country, research needs to be conducted on other companies in the sector, such as state owned enterprises and private manufacturing firms in order to develop a comprehensive understanding on the use and impact of MCSs on the manufacturing sector of the country.

13. SCOPE FOR FURTHER RESEARCH

This study focused on the impact of MCSs on the financial performance of manufacturing companies in the Sri Lanka. Further research needs to be carried on the impact of MCSs on other aspects of these companies, such as employee performance, achievement of overall goals and objectives, impact on the strategies of these organizations, etc. In addition, studies needs to be conducted on other manufacturing companies in the country such as state owned companies and privately owned firms particularly small and medium scale manufacturing enterprises to understand the use and impact of MCSs on these organizations and compare the findings of these studies with the findings of this study. This will provide a comprehensive understanding on the use and influence of MCS on the manufacturing sector of the country and will also enable companies to implement effective MCSs which will have a positive influence on the entire industry.

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