YOUR SOURCE FOR SCIENCE-BASED BUSINESS KNOWLEDGE AND IDEAS

MERC

REPRINT 0714092096

Finance: Studying Controllership

by Frank G. H. Hartmann

Mercury Magazine 2014, Summer/Autumn
(Special Issue on Sustainability),
Issue 7-8, pp. 092-096.

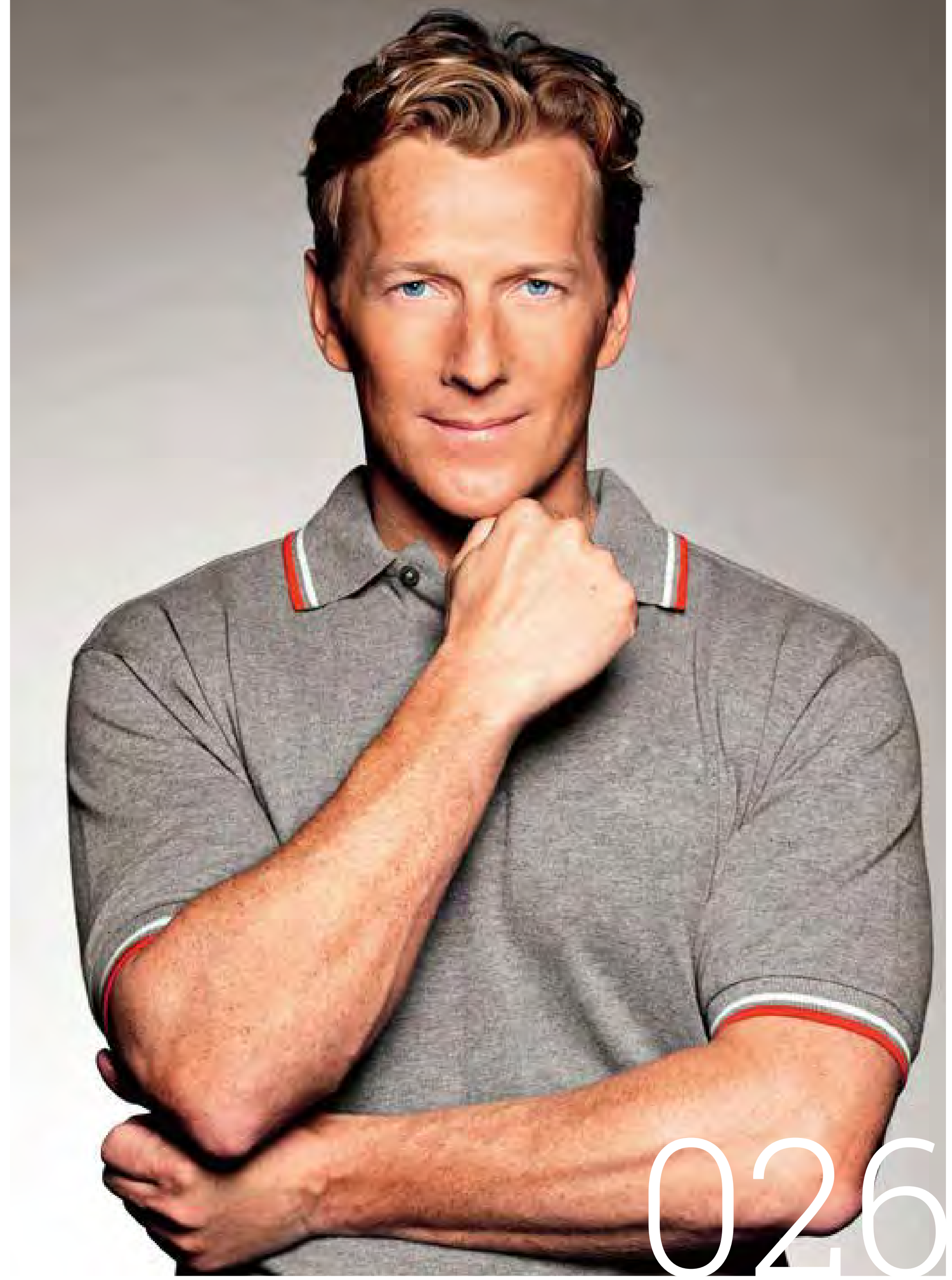
Mercury Magazine is the official magazine of the Department of Business Studies at Uppsala University

UPPSALA UNIVERSITET

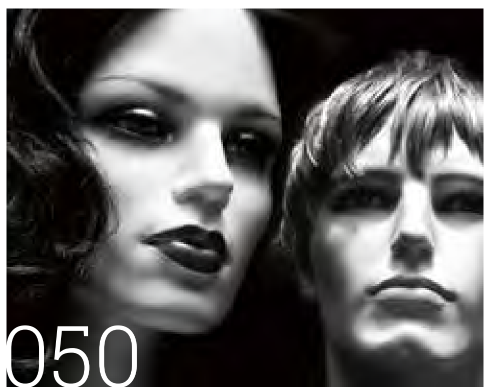
Department of Business Studies

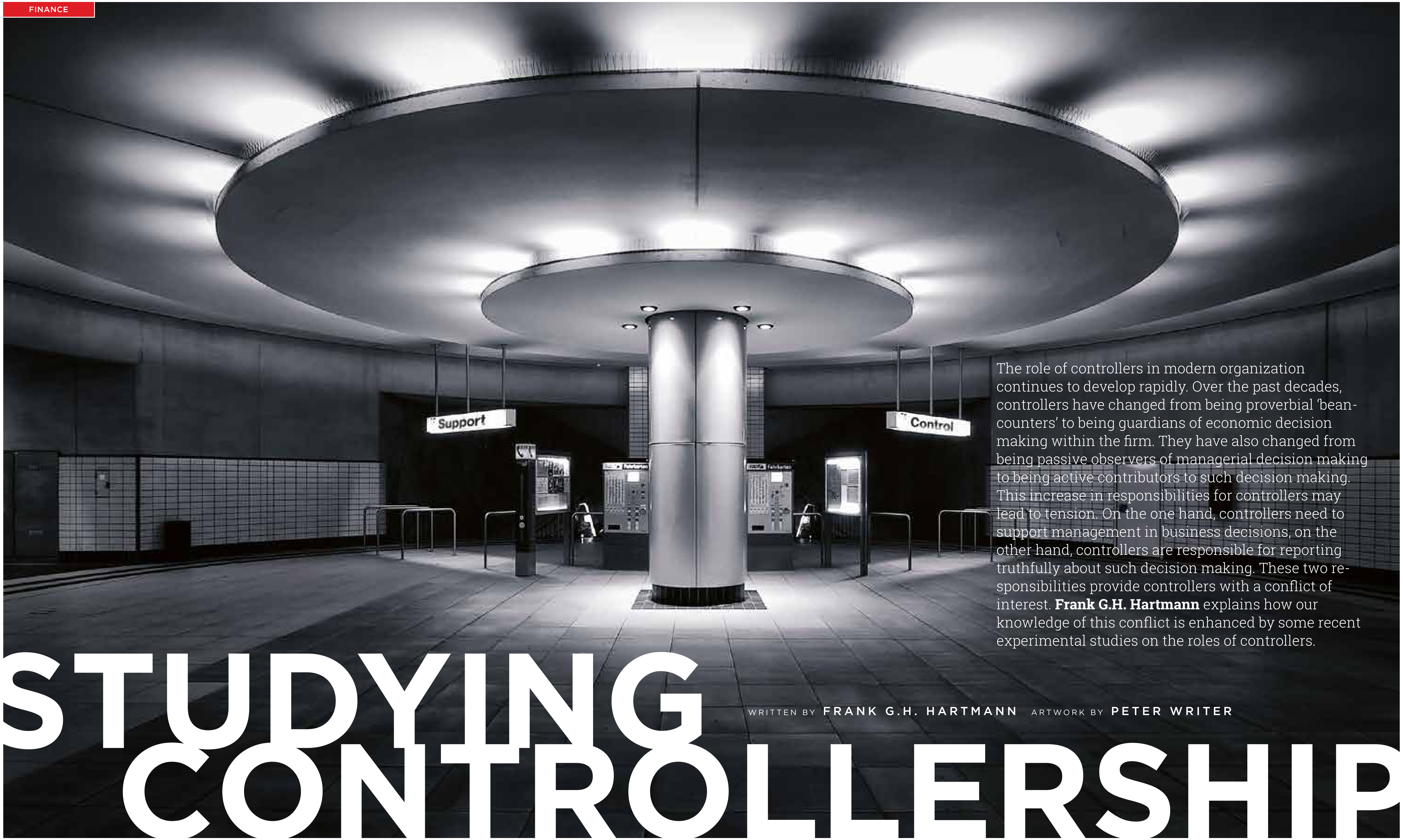
CONTENTS/
SUMMER/AUTUMN

PHOTO BY JOHANNA HANNO



CONTENTS/
SUMMER/AUTUMN





STUDYING CONTROLLERSHIP

The role of controllers in modern organization continues to develop rapidly. Over the past decades, controllers have changed from being proverbial 'bean-counters' to being guardians of economic decision making within the firm. They have also changed from being passive observers of managerial decision making to being active contributors to such decision making. This increase in responsibilities for controllers may lead to tension. On the one hand, controllers need to support management in business decisions, on the other hand, controllers are responsible for reporting truthfully about such decision making. These two responsibilities provide controllers with a conflict of interest. **Frank G.H. Hartmann** explains how our knowledge of this conflict is enhanced by some recent experimental studies on the roles of controllers.

WRITTEN BY **FRANK G.H. HARTMANN** ARTWORK BY **PETER WRITER**

Many accounting and control practitioners may not be very familiar with academic research in these fields. Unlike such fields like medicine and psychology, the relationship between academic research and professional practice seems rather weak. On the one hand, this may indicate that accounting and control practice is fully developed, without any big questions left, that seems highly unlikely. On the other hand, this may mean that research in these fields fails to deliver useful insights. That may be closer to the truth. In any case, the lack of mutual interest between practice and theory is a pity, and requires our attention. Indeed, since researchers and practitioners share the objective of enhancing the quality of accounting and control in their organizations and firms, mutual inspiration will be beneficial.

Such mutual interest will be particularly useful if we want to understand one of the big contemporary challenges in accounting and control. This challenge concerns the 'right way' to design the function of organizational controllers. Such job design should ensure that controllers are able to perform well in their dual responsibilities of serving local management and serving the firm. In this article I present an example of how academic research has aimed to increase our understanding of these roles of controllers in practice.

Controllers and their dual responsibilities

One does not need much of expertise to observe the increased attention in society to financial scandals. In particular, financial scandals that originated in misreporting have put a critical spotlight on the quality of financial reporting by firms and other organizations. In many of these critical accounts, blame is placed on a relatively small set of professionals. Typically, audit firms are criticized for their violations of professional and legal norms, or general management gets blamed for engaging in earnings management. It is interesting, however, to look into the role of accounting professionals that work inside the firm, in order to better explain the incidence and perhaps the gravity of the breaking of accounting rules. In particular, it is worth investigating the roles that decentralized controllers play in contemporary firms.

It is now generally believed that the organizational roles of controllers can be captured in two major responsibilities. One responsibility concerns the so-called fiduciary obligations that the controller has towards higher level managers and other stakeholders. This obligation pertains to the requirement that controllers report truthfully about the economic performance of their unit. The adherence to applicable legislation, internal norms and guidelines, and a strong professional ethic, should contribute to the controllers' fulfillment of this obligation. Above all, it requires a relatively high level of independence.

LOCAL CONTROLLERS ADD THEIR SPECIALIST FINANCE AND ACCOUNTING KNOWLEDGE TO THE DETAILED KNOWLEDGE THEY HAVE ABOUT THEIR UNIT. THIS IS A POWERFUL COMBINATION. HOWEVER, INVOLVEMENT IN MANAGERIAL DECISION MAKING, AND THE ASSOCIATED RESPONSIBILITY FOR THE OUTCOMES, IS LIKELY TO CAUSE STRONGER SOCIAL RELATIONSHIPS BETWEEN THE CONTROLLER AND LOCAL MANAGERS. THIS, IN TURN, MAY BE A CAUSE OF REDUCED INDEPENDENCE AND REDUCED INTEGRITY AND OBJECTIVITY OF UNIT REPORTING.

A second responsibility, however, that controllers increasingly have is their loyalty and support for local managers. Business Unit controllers are typically and heavily involved in local decision making. Local managers, reversely, typically and heavily rely on controllers' judgments about the economic viability of different courses of actions. These judgments may range widely. They may concern setting up the Net Present Value model to evaluate an investment proposal, exploring tax legislation in a new foreign country to explore saving options, or even involve the calculation of performance metrics that affect the manager's bonus. What is central to these obligations is the controllers' actual involvement in the operational and strategic decision-making processes in their units. This also means that they carry responsibility for the outcomes of these processes.

While it seems generally accepted that management benefits from the active involvement of unit controllers in decision making, the net benefits to the firm are less clear. Indeed, local controllers add their specialist finance and accounting knowledge to the detailed knowledge they have about their unit. This is a powerful combination. However, involvement in managerial decision making, and the associated responsibility for the outcomes, is likely to cause stronger social relationships between the controller and local managers. This, in turn, may be a cause of reduced independence and reduced integrity and objectivity of unit reporting. In sum, therefore, we have a strong reason to suspect that the development of controllers' roles into active supporters of business has created a potential tension between independence and involvement. The question is whether this tension is a cause of some of the reporting problems discussed before.

Exploring tensions in the role of controllers

Although there are few people that would deny the existence of this tension, there are also relatively few people who have wondered about the effects of it. Typically, the literature on the design and roles of the controller function in organization has taken a rather normative perspective. The literature is full of advisory claims and recommendations about controllers' behaviors. Controllers should be 'independent', while also being 'committed'. They should develop into 'strong controllers', who are able to balance between involvement and independence, and withstand any dysfunctional inclination. Such normative claims, however, are not helpful. One important reason is that they simply neglect the fact that controllers are humans, and subject to all the forces that are known to influence human behaviors. In particular, such forces could work silently and have the form of a bias or social pressure. Indeed, unit managers may try to influence controllers' factual judgments. Also the mere involvement of controllers in business decisions may cause them to be less factual and more subjective when reporting about those decisions. In any case, this is typically an issue that research may shed some light on.

In one study we invited controllers to take part in an academic study on their behavior in such a situation. We presented the following case to the controllers, and asked them what they would do. We designed a case of a firm, with several business units. In one of the business units, called Splash, the unit controller faces a request from his unit manager.

"Splash produces sodas, lemonades, and ice cream. Gerard van Dinkel has been the general manager of Splash for three years. Wouter Simons has been Splash's BU controller for five years. [...] Over the years 2002 to 2004, Splash has gradually divested its activities in the soda market. Instead, it has changed its focus to ice cream and desserts. This change of focus also implies a change from customer products to intermediate products sold to restaurant chains and other companies in the food and beverages industry. In October 2004 it becomes clear that the results of this strategic change are somewhat disappointing and the chance that Splash will be able to reach its 2004 ROI target is very small [...]. In October 2004, the Splash management team has a meeting to decide about the 2005 budget proposal. Gerard van Dinkel, Splash's general manager, suggests basing the proposal on conservative estimates. Both he and BU controller Wouter Simons believe Splash should be able to make a ROI of 13.5% in 2005. However, Gerard van Dinkel asks Wouter Simons if he can come up with a proposal of a ROI target of 11%, because he feels it would be bad for the business unit to miss its targets two times in a row and he therefore does not want to take any risks. He also mentions that it would be undeserved if Splash's managers miss their bonus again next year. BU controller Wouter Simons realizes that the only way to come up with a ROI proposal for 2005 of 11% is by making unrealistically low sales estimates and unrealistically high cost estimates. [...]. We would like to know how likely you think it is that Wouter Simons proceeds to develop a budget proposal that contains the unrealistically low ROI target of 11%. In making your assessment of this likelihood please also note the following: BU controller Wouter Simons is aware that the chance that corporate headquarters will find out that the ROI proposal of 11% is founded on unrealistically low estimates is negligible."

When confronted with this case, controllers showed interesting reactions. First of all, we found large differences between controllers' willingness to go along with the unit manager's suggestion to use a conservative percentage. This suggests that the ideal type of controller, who would always react consistently, probably does not exist. These differences were explained by three additional factors that we included in our study. First, we differentiated the extent to which the controller in the case was involved in the development of the unit's strategic decision making. Second, we differentiated the amount of social pressure that the unit manager put upon the controller to go along with the suggestion. Third, we measured, in a separate survey, a personality construct (Machiavellianism) which could explain individual inclination to give in to the demands of hierarchically powerful people. Together, these three factors, so common to actual situations and people, allowed quite an accurate prediction about controllers' responses in this situation. Controllers who were more involved in the strategic decision making, experienced higher pressure from the unit managers and were more inclined to give in to powerful people, were also more likely to go along with the unit manager's suggestion. Obviously, the combination of high social pressure and heavy strategic involvement, is typical of the high pressure situation that contemporary controllers are advised to thrive in. If combined with certain personality characteristics, however, this may result in violations of accounting principles and eventually, the reduced quality of earning statements by firms.

Conclusions

The study that is summarized in this paper is only an example. However, I believe it is a good example on how practice and theory could be combined to provide useful insights. Critics may argue that understanding controller behavior should not be the goal, but that research should focus on delivering practical and implementable advice. But I believe that the role that research has to play is more fundamental and that the knowledge produced has a longer life expectancy than typical practical and implementable advice has. However, what the example does make clear is that the relationship between practical problems and theoretical answers is not an easy one, and requires deliberate cooperation. On this particular topic, researchers are willing to further explore the pros and cons of today's roles of controllers and to understand how practical considerations may translate into fundamental and useful insights. There are indeed, still many big issues left for us to figure out. ■