Summer 2004

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VOL.5 NO.4
Management Accounting Quarterly
Summer 2004

How Corporate Culture Impacts **Unethical** Distortion of Financial Numbers

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MANAGING BY OBJECTIVES AND RESULTS (MBO/MBR) COULD BE COUNTERPRODUCTIVE AND CONTRIBUTE TO A CLIMATE THAT MAY LEAD TO DISTORTION OF THE SYSTEM, MANIPULATION OF ACCOUNTING FIGURES, AND, ULTIMATELY, UNETHICAL BEHAVIOR.

The recent accounting scandals have highlighted the critical role that investor confidence in the accuracy and lack of distortion of accounting data plays in the health of capital markets and, indeed, the whole economy. The legal and moral culpability of top-level company managers (as well as auditors) is an issue that will be addressed by the nation in the coming months. Whether or not legal sanctions are imposed on managers, it would be well to examine some of the reasons managers may feel compelled to distort accounting numbers as well as engage in other actions that damage the interests of company stakeholders, such as stockholders, employees, and the community.

Tom Morris, in his poignant book *If Aristotle Ran General Motors*, makes a compelling case that creating an ethical climate in the workplace is about more than promulgating clear guidelines for ethical behavior and developing codes of conduct. He argues persuasively that creating an ethical climate must transcend a compliance approach to ethics and focus instead on fostering *socially harmonious relationships*.[1] While Morris does an outstanding job of defining and illustrating these socially harmonious relationships that not only lead to more productive effort but ultimately to a more ethical climate, we believe most organizations may fail to see how current management policies and practices, in fact, may defeat or inhibit development of the kind of climate Morris is advocating. Consequently, we explore here those policies and managerial practices that militate against a culture of socially harmonious relationships in the workplace.

MANAGING BY OBJECTIVES AND RESULTS

Managing by Objectives and Results (MBO and MBR) is the prevailing style of management in most organizations. This approach entails giving employees goals/targets, measuring their performance against these targets, and then ranking them against their peers or some other performance appraisal system. Usually, employees

are rewarded or sanctioned based upon the outcome of this process.

It has been enlightening to note that while most of our graduate students report that the above process is fairly typical in their organizations, most also indicate that their organizations are attempting to foster a climate of teamwork, cooperation, and employee empowerment, which are all important factors in creating a climate of socially harmonious relationships. It is apparent to us that most organizations have not considered the disconnect between MBO/MBR and attempts to create a culture that fosters teamwork, cooperation, and harmony—all ingredients necessary for creating socially harmonious relationships.

The Fatal Flaw in MBO/MBR

Organizations develop systems of interdependent processes to accomplish some aim or purpose (for our purposes we will be using the terms *process* and *system* interchangeably). What is crucial in understanding this process/system view of an organization is to recognize two very important features common to all systems. First, all processes/systems demonstrate significant interdependencies. The individual processes have a significant influence/effect on each other and the total system's output. Consequently, the whole (the system effect) is not equal to the sum of the parts (the contribution of each individual process). Rather, the whole is greater than the sum of the parts due to the interdependent effects. MBO/MBR, with its emphasis upon component unit (i.e., individual, department, profit center, division) goal/target attainment, may hinder this system view of an organization.

The second crucial issue in understanding the process/system view of an organization is that all processes have a given capability that can be measured. Just as important, all processes exhibit variation. The variation that can occur may be the result of how the process was designed. This inherent or common cause of variation occurs randomly. Another type of variation, special cause variation, results from forces/events outside the system. The focus on variation and the process/system view are central elements of the Deming Philosophy based on the writings of W. Edwards Deming and others who generally subscribe to his framework.

A performance measurement system rooted in an MBO/MBR philosophy fails to distinguish common from special cause variation. This fundamental flaw leads management to conclude that all variation of actual from budgets, standards, or other targets is, in fact, the responsibility of those being held accountable for some process output. If the variation is the result of common causes, and only the use of statistical process control charts can make this determination, then management—not employees—is responsible for the output because it designed the system. If the variation is from special causes, then employees and management should investigate the reason for the variation in the hope of eliminating undesirable results or, in the case of favorable results, to determine how to change the system to perpetuate this outcome.

Traditional MBO/MBR approaches also fail to consider process capability. Goals and targets are set without statistically determining whether they are beyond the capability of the existing process. Hence, employees are often held accountable for results that cannot be achieved without distortion of figures or the system. Many of our students have recounted instances of these distortions that would certainly fall under the definition of unethical behavior. The irony is that top management may be inadvertently laying the groundwork for an unhealthy ethical climate through the use of MBO/MBR in spite of all their attempts to achieve just the opposite.

Socially Harmonious Relationships

Assuming that an organization is using an MBO/MBR approach to motivate employees and measure performance, why would the failure to understand the system view of business, process capability, and variation also defeat attempts to develop an ethical climate that would promote socially harmonious relationships? Morris makes the point that employees become self-protective when put in an environment of perceived unfairness.[2]

Often the perceived unfairness experienced by many employees is the result of what Morris calls pervasive pressures that make it difficult to foster an organizational climate rooted in ethical decision making. Three of

the more prominent pressures Morris noted are exclusive short-term thinking, narrow bottom-line thinking, and completely self-centered thinking.[3] We believe that a culture rooted in MBO/MBR, with its accompanying failure to understand a system's capability and variation, is at the heart of these pervasive pressures. Furthermore, we believe that it seriously reduces any chance of creating the kind of socially harmonious relationships necessary for creating a healthy ethical climate and for meeting the needs of both customers and employees.

Student Work Experiences

Since most of the students in the MBA program where we teach are employed full-time, and many are in firms whose stock is publicly traded, it is not uncommon for students to provide examples from their own work experience in response to written assignments and class discussions. A number of these assignments ask students to respond to questions about their own experiences with the MBO/MBR style of management in their organizations and the use of accounting-based targets to motivate and control employee behavior.

The following examples, garnered from student reflection papers, case questions, and class discussions on these subjects, not only illustrate many of the points raised by Morris but also our view that the MBO/MBR style of management seriously inhibits an organization's efforts to create the socially harmonious relationships so necessary for a healthy ethical climate.

For example, one of our students worked in an organization where regional managers were responsible for ensuring that the region as a whole achieved sales goals set up by top management. Although team efforts were emphasized and promoted by regional managers, individual quotas and rewards were used as a key motivation. As a result, "team members" were in competition with one another to make sales and reap the benefits of recognition and reward. Questions often arose as to whether credit for a sale should go to the one who simply talked to a potential customer *first* or the one who closed the sale. Intense internal competition often resulted.

The situation described by this student highlights several important points. First, even though the regional manager wanted to view his/her region as a team with an emphasis on everyone working together, the use of individual quotas and targets, a centerpiece of MBO, had the opposite effect. Attaining one's goal became the primary focus. Second, internal competition invariably results as "team members" strive to meet their individual targets. Protection of accounts and arguments over who gets credit for sales is the inevitable consequence and seriously undermines efforts to create a climate of socially harmonious relationships. Alfie Kohn reinforces this very point in his article, "Why Incentive Plans Cannot Work." Kohn points out that reward systems often harm relationships as employees compete for rewards.[4]

Another student worked for a firm that sold computer software. Top management set very ambitious monthly sales targets in order to meet annual revenue goals. Sales could not be booked as revenue until the product was shipped to customers. As it got closer to the end of a month and it appeared that monthly goals would not be met, salespersons were asked to call customers and ask them to take receipt of their orders earlier than anticipated. If these efforts did not produce enough revenue, there were instances where products were shipped to customers who had not ordered, knowing that customers would immediately ship them back to the company. The revenue, however, would already be recognized for the current month, which resulted in meeting the monthly sales goal. Even worse, the student reported that in some cases a product was shipped from the firm's warehouse to storage sites in order to book revenue in a given month. The problem only got worse. In the next month, the student reported that they not only had to meet that month's goal but also had to make up for the revenue that was being reversed due to returns from customers. These practices began to adversely impact customers, the company's bottom line, and eventually the people who lost their jobs. The student ended the story by noting that if management had understood the capabilities of the system, many of the issues that were causing problems could have been addressed earlier.

This example illustrates in a very cogent manner the three pervasive pressures noted by Morris: short-term thinking, bottom-line thinking, and self-centered thinking. It is also a classic example of the failure to understand a system, its capabilities, and variation. Worse, it

illustrates that when employees are confronted by goals and targets that fail to take systems into account, as well as their capability and variation, distortion of the system or figures more often that not is the result. Clearly the culture of MBO/MBR in this case led to unethical behavior. Morris points out that the unethical point of view is often narrow and shortsighted while the ethical point of view is broad and long range. Often the unethical person has an allegiance either to self or to something that has captured the self.[5] In our example, the target or goal has captured the self, leading to an atmosphere of self-centered thinking. Employees begin to think: *Management has set the target. They expect me to achieve it. My future, my job could be on the line. I want to succeed, and I want to please my boss, management, and the company. I want to look good when compared to my peers*. These are all enormous pressures. Certainly every organization wants good results. The question is, by what methods? Top management surely did not intend for employees to distort the system or figures to achieve the targets set. But by failing to understand the interdependencies of the system, its capabilities, and variation, the stage was set for manipulation and distortion of the system to achieve the target. Unethical behavior soon followed.

Our final student example shows how the use of arbitrary goals and targets, another distinguishing feature of MBO/MBR, contributes to a lack of socially harmonious relationships in the workplace. This student worked for a loan company where loan officers were given monthly targets. These targets contributed to an environment of intense competition among the loan officers because awards were given to the top-performing employee. Fear for one's job was also a by-product of this process. If an employee did not make his/her numbers, it was viewed solely as the loan officer's fault. Usually one or two loan officers consistently came out on top. The student indicated this was probably the case because they were the most knowledgeable and best trained. But he also pointed out that they were not about to reveal their secrets to the other loan officers because of the competition among them. Again, Kohn warns that cooperation is harmed when employees compete for rewards or recognition and are ranked against each other.[6]

The previous example certainly did not contribute to a culture of socially harmonious relationships. Rather than cooperate to help each other and improve the total system, management had created through their MBO process an atmosphere where the focus was on individual goal attainment to get the reward. Not only is this another example of Morris' self-centered thinking, it is also an illustration of failure to optimize the entire system. Creating a climate of socially harmonious relationships in this instance would clearly put the focus upon trying to create a climate where loan officers worked together to increase total loans. This would only be possible if employees cooperated, sharing ideas and knowledge, and management were committed to improving the system. MBO/MBR, with its emphasis on individual goal achievement and reward, contributes instead to internal competition, fear, and barriers between individuals and departments.

The stories told by our students are not isolated examples. In *Free, Perfect, and Now*, Robert Rodin, CEO of Marshall Industries, chronicles his company's transformation to a new style of management that focused the organization's efforts on delighting customers and creating an employee-centered culture. As part of the training necessary to accomplish the transformation, Rodin's management team shared stories of how the existing management philosophy and policies had encouraged internal competition, a lack of cooperation, and manipulation of the system. One branch manager admitted to hiding parts for his customers even though another branch may have needed them more. Another sales manager even admitted to hiding $30,000 worth of inventory over a weekend in his Chevy Blazer. In each case the motives seemed to be designed to take care of their customers, please their boss, or make their monthly numbers. Such distortions of the system had been hurting the company and prevented a real focus on what had to be done to bring about real improvement.[7]

The Sarbanes-Oxley Act of 2002 requires that the CEO and CFO of publicly traded companies certify the fairness of the financial statements. Just as important, these corporate officers are subject to criminal prosecution if they knowingly sign off on misleading or fraudulent financial statements. While the CEOs and CFOs will need to carefully check the data underlying the financial statements to assure themselves that the state-

ments are accurate, they must also give substantial consideration to the corporate culture they create, i.e., the "tone at the top." As the previous examples indicate, a corporate culture rooted in fear, barriers to cooperation, and intense internal competition becomes a fertile ground for distortion of processes and distortion of numbers. Certainly organizations want good results. The question is now going to become: By what methods? A healthy culture will be essential to ensuring that the methods to achieve results are sound and a reflection of high ethical standards.

Cultivate Cooperation, Not Competition

Good people in a good environment do good work.[8] If we accept this premise, then the real role of top management is to create an organizational climate where people can join together to accomplish some noble purpose. To this end, it is essential that this climate include a focus upon what must be done to promote an atmosphere of socially harmonious relationships. Essential to such efforts must be a commitment to drive out fear, break down barriers between individuals and departments, and replace competition win-lose with cooperation win-win. In short, management must be willing to call into question all policies and practices that inhibit organizational efforts to support socially harmonious relationships.

MBO/MBR, with its focus upon individual goal accomplishment and reward and its failure to understand a system and its capability, is incompatible with a true commitment to creating a climate of socially harmonious relationships. Not only does it defeat these efforts, but it also contributes to a climate that may lead to distortion of the system, manipulation of accounting figures, and, ultimately, unethical behavior. That climate of competition among individual managers may also lead to attitudes that sacrifice the interests of other company stakeholders, such as stockholders, employees, and the community. The recent accounting scandals involving major companies may thus be as much a reflection of deficient company climate as of individual moral failures on the part of managers. ■

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1 Tom Morris, *If Aristotle Ran General Motors*, Henry Holt and Company, New York, N.Y., 1997, pp. 118-145.
2 Morris, p. 123.
3 Morris, pp. 132-145.
4 Alfie Kohn, "Why Incentive Plans Cannot Work," *Harvard Business Review*, September/October 1993.
5 Morris, p. 139.
6 Kohn, p. 5.
7 Robert Rodin, *Free, Perfect and Now*, Simon & Schuster, New York, N.Y., 1999, pp. 80-81.
8 Morris, p. 126.