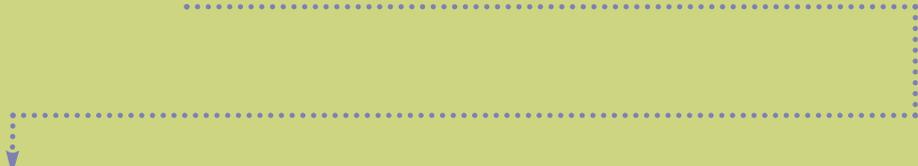


When Formal Controls Undermine



Trust and Cooperation

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IN TODAY'S BUSINESS ENVIRONMENT, control systems are *de rigueur* for safeguarding a corporation's assets. With regulatory requirements at a fever pitch, corporate leaders must assess the effectiveness of various controls, and they need to understand how the interplay of formal and informal controls impacts the overall effectiveness of these same checks and balances. Explicit mechanisms, such as formal procedures, audits, financial reporting methods, and performance standards, prevent mistakes as well as outright fraud on the part of employees, management, and business partners. Informal controls, such as the corporate culture, institutional values, and interpersonal trust in an organization, are also essential to promoting cooperation, which serves to complement and support more formal efforts.

In choosing the most appropriate formal controls, an organization must consider the benefits as well as the costs, both economic and psychological. A potential psychological cost is the deterioration of an important informal control—trust. Interestingly, some formal controls can erode trust more than others. While no one would suggest tossing aside needed oversight, it appears that controlled parties, such as employees, will construe formal controls with suspicion and as a signal of mistrust in their competence and integrity. They also may consider certain formal controls as an intrusion into their privacy.

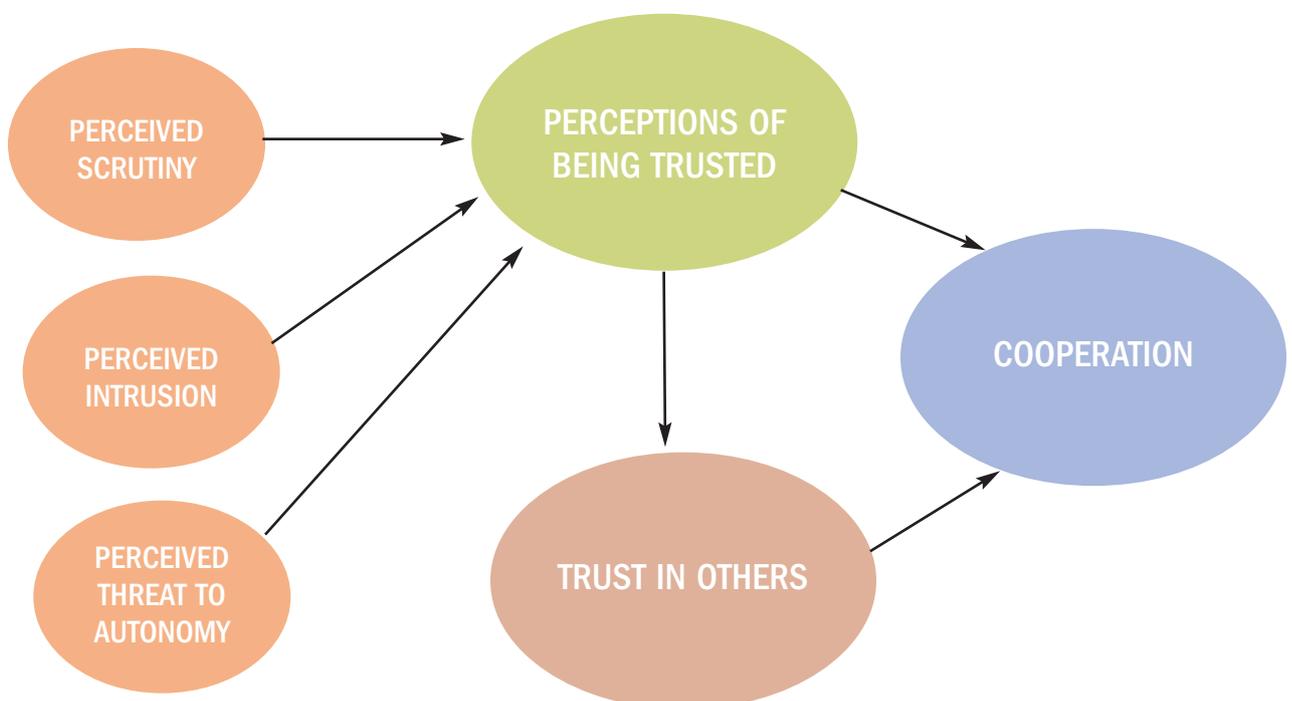
Coauthors Christ, Sedatole, and Towry conducted a study, which was sponsored by the Institute of Management Accountants (IMA®), to understand how formal controls affect trust and cooperation. After all, if formal controls become a bitter pill to swallow for management, employees, and/or business associates, then trust, cooperation, and the overall control environment can be compromised. Collaborative relationships, such as alliances between organizations, are particularly at risk of falling prey to this phenomenon. With no common principle to stand behind, cooperation sometimes becomes difficult to ensure. Yet trust is often the key determinant of successful alliances and cooperative behavior. That's why getting a handle on the relationship between the various organizational controls and their impact on cooperation and trust becomes a serious cost consideration for today's corporate managers.

We'll now describe our causal model, experiment, and conclusions on how formal controls affect the bottom line.

THE CONTROL-TRUST-COOPERATION CAUSAL MODEL

We developed a control-trust-cooperation causal model linking formal controls to three perceptions: scrutiny, intrusion, and threats to autonomy (see Figure 1). As the model shows, as the level of scrutiny, intrusion, and loss

Figure 1: Control-Trust-Cooperation Causal Model





Trust is reciprocal in that if people don't feel trusted, they in turn don't trust the other party.

of autonomy increases, so, too, does a sense of distrust. With trust in the organization decreasing, cooperation diminishes. Consequently, appreciating the types of formal controls that undermine trust will affect cooperation in almost any type of interorganizational or intraorganizational alliance. Let's look at how these three perceptions affect trust.

Often, the sense of mistrust rises as the *perception of scrutiny* increases. The controlled party may perceive scrutiny of the operations and/or operational outputs (e.g., products produced) as a violation of the psychological contract needed in any working relationship or alliance. Prior experimental and field research in organizational behavior investigated employees' responses to and acceptance of awareness monitoring systems. Such systems come in the form of a video camera in the workspace that continually captures and transmits an employee's image and activities to remotely located observers. This research found that such systems appear to breach psychological boundaries important to individuals' perceptions of privacy and sense of fairness. It also made it clear that respect for privacy in business dealings is an important consideration for employees and business partners. Our new research indicates that increasing scrutiny via formal control mechanisms can erode the controlled party's level of trust.

The *level of intrusiveness* of the formal control is another important consideration because formal controls can potentially interfere with the controlled party's processes and activities. Change management research documents the disruptive effects of various mandatory management innovations. In particular, what has been characterized as a "loss of routine" or a "destruction of existing habit"

resulting from a management innovation plays an important role in the process of change and in the level of resistance to that change. Similarly, we found that the intrusiveness of a control system will also determine the extent the control erodes trust. Intrusion provides a distinct signal of mistrust separate from that conveyed by mere scrutiny, but both have the potential to negatively impact the level of trust in an intraorganization or interorganization setting.

Formal controls may also reduce the *autonomy* of the controlled party—either in fact or perception. That is, a formal control can limit the decision rights of the controlled party by specifying behaviors, operations, and activities of the controlled party, and this threat to autonomy can provide a signal of mistrust separate from that conveyed by scrutiny or intrusion. A large body of research documents a generally negative reaction—often hostility—when individuals feel that their freedoms are being restricted.

In summary, we determined that three aspects of formal controls—scrutiny, intrusion, and a reduction in autonomy—will each negatively impact the degree to which the controlled party feels trusted by the controlling party. Of course, trust is reciprocal in that if people don't feel trusted, they in turn don't trust the other party. As the controlled party feels mistrusted, reciprocity will lead to a cycle of mistrust, which increases the risk of noncooperation—the exact opposite of the effect intended by the implementation of the formal control. Through its effect on cooperation, mistrust between partners will begin to affect the bottom line, so it isn't simply a theoretical issue. That's why control systems that establish reciprocity in trust are essential to gaining needed cooperation from management, employees, and business partners.

In our study, we performed experimental tests to examine the effects of the causal model on three distinct formal control types. We found that various types of formal controls are likely to have differing effects on scrutiny, intrusion, and autonomy and, hence, differing effects on trust and cooperation. Consequently, the psychological costs of various formal controls differ, so this should, in turn, affect decisions about using them.

Now let's take a closer look at the experiment.

THE EXPERIMENTAL METHOD

Our research involved 121 participants—individuals with an average of 6.73 years of full-time work experience and pursuing an MBA from Emory University. We gave them a

Table 1: Three Types of Formal Control Mechanisms

| CONTROL TYPE | DEFINITION AND EXAMPLES | IMPACT ON... | | | |
|-------------------------------|---|--|------------------------------------|--|--|
| | | SCRUTINY | INTRUSION | AUTONOMY | TRUST-COOPERATION |
| Behavior Controls | Personal surveillance of the controlled party's activities (e.g., specific evaluation and measurement of job activities and processes) | Perceived to require the most scrutiny | Perceived to be the most intrusive | Perceived to pose the greatest threat to autonomy | Most damaging to the trust environment and, ultimately, cooperation |
| Output Controls | Focus on the after-effects of instituted controls (e.g., performance measurements) | Perceived to require less scrutiny | Considered less intrusive | Considered to have little to no impact on autonomy | Less likely to create an environment of distrust, and, thus, cooperation should be greater |
| Inspection of Controls | Observation, measurement, and evaluation of financial and operational controls (e.g., controls over accounting and financial reporting, as well as controls over billing, asset security, etc.) | Perceived to require little to no scrutiny | Considered the least intrusive | Considered to have no impact on autonomy | Little to no impact on trust factor, and, thus, cooperation should be the greatest |

set of instructions, including details of a business scenario in which they would have to make a cooperative decision. Similar to an interorganizational setting, the scenario provided an opportunity to test the level of cooperation that occurs when two parties don't necessarily have a common authority (i.e., a boss) to ensure cooperation.

Our objective was to examine the effects of different types of formal controls on trust (via scrutiny, intrusion, and autonomy). Specifically, we gave each participant a written narrative describing the formal control imposed at one of four possible levels:

- ◆ No controls (i.e., for comparison to the other scenarios, some participants weren't subjected to any formal control),
- ◆ Behavior controls (written policies regarding the alliance and monitoring of partner operations),
- ◆ Output controls (performance measurement systems), and
- ◆ Inspection of controls (control assessments from third-party providers, such as Statement on Auditing Standards (SAS) No. 70, "Service Organizations," reports from external auditors).

We asked participants to assume the role of a manager in a firm involved in a strategic alliance with a customer, the customer being the controlling partner firm. The stated objective of the alliance was to develop a more cost-effective production process that would reduce product

defects and result in significant cost savings for the firm. In return for its expertise and experience developing production processes, the partner firm (the customer) would receive a price discount equal to the per-unit cost savings resulting from the improved process. We also told participants that the partner firm had decided either to not implement a formal control mechanism or to implement one of the three control mechanisms that we described earlier to ensure the product met its quality standards.

A questionnaire offered the participants the chance to react to the controls. In particular, we asked them about their perceptions of scrutiny, intrusion, and autonomy resulting from the formal control. In addition, we asked about the extent to which they trusted the controlling partner and felt trusted by the partner. Finally, we asked the participant to decide whether they would cooperate with their existing partner in a new venture by sharing their firm's proprietary information.

EFFECT OF THE FORMAL CONTROL TYPE

Our research suggests that different types of formal controls involve varying degrees of scrutiny, intrusion, and perceived threats to autonomy and thus impact trust and cooperation in differing ways as well (see Table 1). Of course, formal control types vary within an organization and between organizations. For employees, effective formal controls include budgets, performance reports, or

incentive compensation plans. In interorganization settings, such as in joint ventures or partnerships, formal controls include established written policies, audits of partner operations, and others to manage the risks inherent in this type of business relationship.

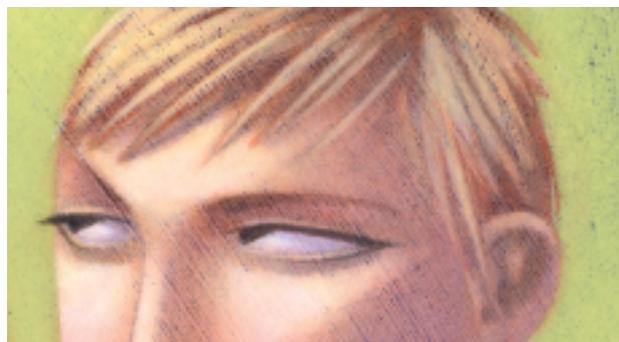
We found that behavior controls, for instance, have a greater impact on the controlled party's cooperation than many other types of formal control mechanisms, partly because of the level of scrutiny they impose. Behavior controls include techniques such as direct observation of employees or business partners or specific evaluation and measurement of their job activities and processes. We asked survey respondents, "To what extent do you feel that [the controlling party] is *scrutinizing* your firm's operations?" On a scale of zero to 100 (where zero is not at all and 100 is a great deal), survey respondents subjected to a behavior control reported an average level of perceived scrutiny of 70 as compared to respondents subjected to an output control (average of 61) or no control (average of 31).

Partly because of the scrutinizing nature of behavior controls, the level of trust (the informal control environment) is often compromised. We asked survey respondents, "To what extent do you trust [the controlling party]?" and "To what extent do you feel that [the controlling party] trusts your firm?" Respondents subjected to a behavior control reported an average level of trust in the controlling party of 56 (on a 100-point scale) as compared to 65 and 70 for those subjected to an output control or no control, respectively. Similarly, respondents subjected to a behavior control reported an average level of feeling trusted by the controlling party of 50 as compared to 60 and 79 for those subjected to an output control or no control, respectively.

To measure cooperation, we asked participants to respond yes or no to a question regarding whether they would share proprietary information with the controlling party. When subjected to a behavior control, only 32% were willing to share information with the partner as compared to 37% of those subjected to an output control and 63% of those subjected to no control. Nonetheless, despite the negative psychological effects of behavioral controls, their pervasive use suggests that they're vital to a strong control environment.

On the other hand, output controls focus on the after-effects of instituted control policies. Unlike behavior controls, output controls by their very nature are less intrusive and aren't perceived to require as great a level of scrutiny of the controlled party's role. Specifically, survey respondents subjected to an output control reported an

average level of perceived intrusion of 56 as compared to an average of 70 for those subjected to a behavior control.



But reported intrusion resulting from output controls was greater than the intrusion level reported by respondents experiencing no control (average of 25). While a necessary formal control, output controls are less likely to create an environment of distrust since the regular flow of activities isn't interrupted (i.e., intruded upon) as it might be when a company institutes behavior controls.

In addition, output controls preserve the decision rights of the controlled party. By focusing on outputs, the controlled party is more likely to believe they're freer to make decisions and to go about their responsibilities as long as the output meets the requirements of the other party. We asked the survey respondents, "To what extent do you feel that your firm has the autonomy to make decisions regarding operations?" Survey respondents subjected to an output control reported an average level of autonomy of 73, which was close to the no control average of 72 and higher than the average of 65 for respondents subjected to a behavior control.

Finally, although perceptions of being trusted induce cooperation on the part of the controlled party, the controlled party's reported trust of the controlling partner (i.e., the "reciprocal trust") didn't affect cooperation. Thus, cooperation may be driven more by reciprocity or a sense of obligation rather than expectations of the controlling party's future behavior.

INSPECTION OF CONTROLS

Of course, not all formal controls fit neatly into one category or another, so classifying all formal controls as a behavior control or as an output control may not be possible. Inspections of controls, for instance, are control mechanisms for evaluating the effectiveness of a controlled party's control systems. The inspection involves the observation, measurement, and evaluation of financial controls (i.e., controls over accounting and financial

reporting), as well as the review of the organization's operational controls (i.e., controls over quality, billing, asset security, etc.).

Consider the Sarbanes-Oxley Act (SOX). For organizations required to comply with SOX Section 404, inspection of controls is a needed and required formal control mechanism. Management must assess, attest to, and report on the organization's internal control structure, making inspection of controls an increasingly important formal control mechanism. Companies now expend significant resources in complying with SOX, especially since the financial reporting requirements must also include the review of any and all third-party relationships.

Despite the increase in the significance of inspecting controls, it's unclear how controlled parties may perceive this. On the one hand, since the inspection of controls requires no direct observation of the operational activities or the output generated, it generally requires less scrutiny than other controls. And since the inspection of controls doesn't usually interrupt normal processes and activities, respondents viewed this mechanism as less intrusive than many other control mechanisms.

On the other hand, when control behaviors (e.g., carrying out control activities) and control outputs (i.e., audit plans) are assessed, inspection of controls may then be perceived as a hybrid of the traditional behavior and output controls, albeit with a focus on controls rather than operations. This may lead some to perceive inspection of controls as involving more scrutiny and intrusion and a greater threat to autonomy than other types of formal control. In this sense, the trust factor and cooperation may be compromised. Nonetheless, in general, respondents said that inspections of controls have the least negative impact on cooperation as compared to the other types of formal control. When we asked about their willingness to cooperate (i.e., to share proprietary information) with the controlling party, 45% subjected to inspection of controls reported a willingness to cooperate as compared to 37% subjected to an output control and 32% subjected to a behavior control.

TRUST AND THE CONTROL DECISION

Considerations of the effects of trust are important as indicated by survey respondents who noted a high level of reliance on trust—an average score of four on a five-point Likert rating scale—and research identifies trust as an informal control system critical for strategic alliance success.

For managers responsible for instituting and reviewing

control mechanisms, this current research into the control-trust-cooperation relationship serves as a guide in choosing the appropriate formal controls and the implications of instituting them. We found behavior controls to be more likely to compromise both trust in the organization and the cooperation of the controlled parties. This was after considering three issues: the increased level of scrutiny, a heightened sense of or actual intrusion into the controlled party's organizational role, and the impact on their autonomy. Behavior controls have greater negative psychological effects than output controls and inspection of controls. Moreover, in terms of psychological cost, we found inspections of controls to be the least costly formal control mechanism to achieve oversight and still retain trust and cooperation from the various players in an organization or partnership. We conclude that once the hidden cost of erosion of the trust environment is considered, output controls and inspections of controls may be more effective from a cost-benefit perspective than previously recognized. A more complete cost-benefit analysis that incorporates the psychological costs identified in our study will ultimately affect decisions regarding which controls will be used in a given intraorganizational or interorganizational setting. Perhaps firms should take the next step and incorporate this analysis into their control system planning. ■

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This article is based on the collaborative research paper "All Control is not Equal: The Effect of Formal Control Type on Trust & Cooperation," by Christ, Sedatole, and Towry.