The Gatekeepers' Tools

By David Hurtt, CMA, CPA; Michael Robinson; and Martin Stuebs, CMA, CFM

Recent financial crises and scandals raise serious questions about the reporting mechanisms in the U.S. financial system. They draw attention to reporting failures by various reporters—the informational gatekeepers in our economy. These reporting shortfalls serve as sobering reminders to accounting and finance professionals of the importance of their gatekeeping responsibilities. Lessons from these reporting breakdowns may help management accountants—the information reporters within a business—avoid similar mistakes.

We'll look at three topics: the ideal reporting environment, recent reporting failures, and lessons for management accountants. We encourage these accountants to protect their essential gatekeeping and trust-building tools of technical competence and professional character, and we conclude by reinforcing the importance of building and maintaining the virtues of an accountant detailed in the *IMA Statement of Ethical Professional Practice* of the Institute of Management Accountants (IMA®).

The Ideal

Figure 1 shows a model of the general reporting process, which involves three parties: the reporter, the reportee, and the report users.

The reporter assesses the performance of the reportee and issues a report. Based on the information in the report, a report user analyzes the reportee's performance and makes decisions. The reporter fills the role of trusted informational gatekeeper and has two important gatekeeping responsibilities—deciding what information to gather about the reportee and how to communicate that information to report users.

The gatekeeper's task is to report trustworthy, useful information. After all, both report users and reportees rely on the reporter's trustworthiness. Reporters need two essential internal (personal) gatekeeping tools to fulfill this trust: competence (the ability to do something) and character (the integrity to do something). The effectiveness of the reporting process, then, relies on the reporter's willingness to understand, accept, and commit to his or her gatekeeping responsibilities and to fulfill these responsibilities with professional competence and character.

In the internal reporting environment, management accountants measure, process, and communicate information. Products, business units, and territories are among the reportees, and managers are the report users. For example, accountants design systems for allocating indirect costs to products, jobs, and other cost objects (reportees). The resulting allocations affect many managerial decisions, including pricing, product design, product emphasis, and sourcing. An accountant who lacks competence may unintentionally design a system that fails to use the drivers of costs as their allocation bases. An accountant who lacks character may report misallocated costs in such a way as to intentionally deceive a manager in order to influence the manager's decision. In both cases, the result is that the company's resources aren't put to their most profitable use.

As a second example, consider capital budgeting decisions. The accountant reports estimates of both the

Figure 1: The General Reporting Environment Process Structure

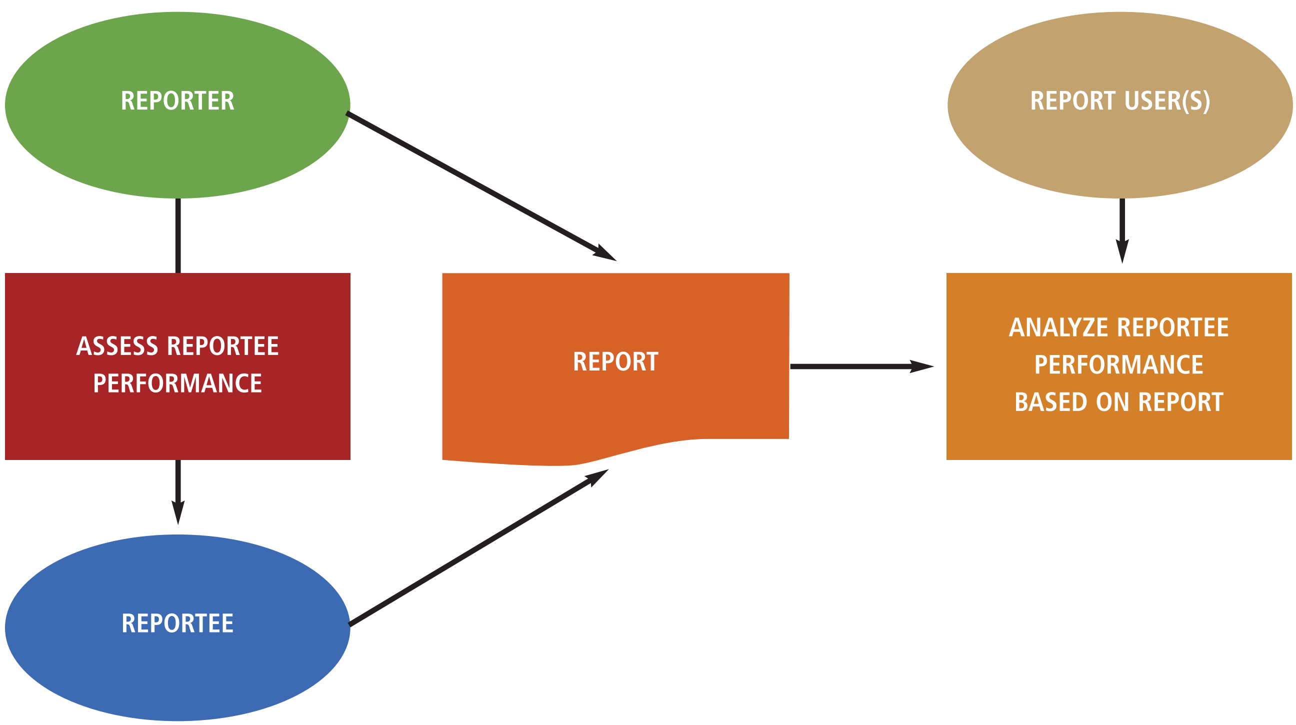

Table 1: Parties and Reports in Reporting Environments

	REPORTING ENVIRONMENT				
REPORTING ENVIRONMENT ITEM	ACADEMIC ENVIRONMENT	CREDIT RATING ENVIRONMENT	EXTERNAL/ FINANCIAL REPORTING ENVIRONMENT	TAX REPORTING ENVIRONMENT	INTERNAL/ MANAGERIAL REPORTING ENVIRONMENT
Reporter	Professors	Credit Rating Agencies	Financial Accountants and Auditors	Tax Accountants	Management Accountants
Report	Grades	Credit Ratings	Financial Statements	Tax Returns	Various Internal Reports
Reportee	Students	Financial Services Firms	Companies	Taxpayers	Products/ Business Units/ Territories/ Strategies
Report User(s)	Employers	Investing Public	Investing Public	IRS/ Government/ Public	Managers

future cash flows of assets that managers are considering and the appropriate discount rate(s) for computing present values. An accountant lacking competence may prepare an analysis that doesn't properly communicate the uncertainty that underlies these estimates. One lacking character may report only optimistic or pessimistic estimates in order to influence the manager to choose the action the accountant prefers. Either way, the accountant's choices in reporting information affect capital acquisition (and disposition) decisions. If the reported information is inaccurate or incomplete, these decisions may result in lower profits for the company.

As a final example, consider the balanced scorecard, a set of performance measures that provides a framework for implementing an organization's strategy. Management accountants design the scorecard and periodically report the organization's performance on the various measures. A properly designed balanced scorecard is based on cause-and-effect linkages: Gains in learning and growth measures lead to improvements in internal business processes, which lead to higher customer satisfaction, which leads to superior financial results. An accountant who lacks competence may design a set of measures that doesn't include these linkages, so improvements in nonfinancial performance measures don't lead to improvements in financial results. An accountant who lacks character may take a shortcut and implement a scorecard that was developed for another company with a very different strategy. In either case, the company invests time and money on a system that doesn't provide the intended benefits.

As these examples demonstrate, the management accountant is an informational gatekeeper within the reporting environment of a business. The effectiveness of this reporting environment depends on the competence and character of the individuals who perform this function.

The Actual

The general reporting structure and the reporter's corresponding gatekeeping duties apply to many reporting environments (see Table 1). For example, consider the academic reporting environment. Professors (reporters) issue grades (reports) on student (reportee) performance. Employers and other report users rely on this information in making hiring, graduate school admission, and scholarship decisions. This example shows the role of reported academic information in influencing decisions.

In reporting environments, the reporter has an informational advantage over the user. Because the user relies on reported information, the reporter has the opportunity to manipulate the information in order to capture personal benefits.

Reporters in several of the reporting environments in Table 1 misused informational advantages for personal gain and violated users' trust. For example, credit rating agencies (the reporters) and credit ratings (the reports) were at the center of the subprime mortgage and financial crisis. Wall Street financial services firms (the reportees) used "financial alchemy" to package thousands of mortgages into mortgage-backed securities and collateralized debt obligations. These securities needed quality credit ratings to make them more marketable to the investing public (the report users). Credit rating agencies were the gatekeepers of the reported credit rating information. These agencies were paid by the issuing companies and accordingly experienced a conflict of interest. Rating agencies were willing to manipulate ratings because they profited by helping issuing firms sell more products. Information on the credibility of securities that entered the market wasn't accurate or trustworthy. (For articles on the credit crisis, see the Ethics columns in the December 2007 and January 2009 issues of *Strategic Finance*.)

In their gatekeeping role, management accountants help managers identify what information is relevant for a particular purpose and what information is irrelevant.

WorldCom and Enron (reportees) experienced financial reporting breakdowns. Each company's audit firm (reporter) was paid consulting and auditing fees by its client, and the desire to protect this lucrative relationship made the auditor reluctant to challenge the client's reporting decisions. The financial accountants (reporters) of the reporting firms also were unwilling to sacrifice personal gain by challenging the integrity of their firm's financial statements (reports). Both groups of accountants neglected their responsibilities as gatekeepers. The financial statements that were published were inaccurate and thus untrustworthy.

Preparing tax returns that incorporated abusive tax shelters is another example of a recent reporting environment failure. Tax accountants (reporters) employed by public accounting firms and client companies prepared tax returns (reports) for the government (report user) on taxpayer (reportee) income. Some returns featured tax shelters that were works of fiction with no economic substance. When these shelters were challenged in court, they were found to be fraudulent, and the integrity of the firms' tax-reporting positions was shattered.

These failures in the credit rating, external financial reporting, and tax reporting environments contain lessons for management accountants. In their gatekeeping role, management accountants help managers identify what information is relevant for a particular purpose and what information is irrelevant. They are responsible for reporting information that is accurate, clear, concise, and timely. A failure to fulfill their gatekeeping responsibilities could be as damaging as gatekeeping failures in other reporting environments.

Consider the planning and budgeting process. In *Beyond Budgeting*, Jeremy Hope and Robin Fraser give examples of managers' dysfunctional behaviors that are driven by fixed performance contracts. Their list of problematic comments made by managers includes, among others:

- Always negotiate the lowest targets and the highest rewards;
- Always make the bonus, whatever it takes;
- Always ask for more resources than you need, expecting to be cut back to what you actually need;
- Never share knowledge or resources with other teams; and,
- Never provide accurate forecasts.

These comments indicate that individuals provide self-serving input into the budgeting process. If management accountants accept these inputs, they may issue budget reports that lead to inefficient resource planning and allocation as well as poor coordination of activities across different segments of the company.

The Moral

What can be done to ensure that management accountants, the reporting linchpins within organizations, provide accurate and trustworthy information? Recent work, which is featured in the December 2008 issue of *Strategic Finance*, calls for additional control in the form of an external assessment and certification of the quality of reported managerial information. (See "Let's Certify the Quality of a Manager's Information" by Gary Cokins, K.J. Euske, George Millush, Peter Nostrom, and Alan Vercio.) The integrity of the information in this proposed external report ultimately would depend on the competence and character of the external examiners—the reporters in this new process. Adding an external control while neglecting

Table 2: Leadership Virtures of the Comprehensive Ethical Leadership Model™

Purpose driven: The gatekeeping purpose of management accountants is to provide accurate, relevant, and timely information to managerial decision makers. This purpose facilitates the pursuit of the greater public good rather than the pursuit of only corporate or personal wealth. Management accountants should develop the character to promote ethical choices by communicating trustworthy information. They should maintain the professional competence required to do so.

Courage of conviction: Management accountants are responsible for reporting trustworthy, useful information. They may have powerful incentives and face strong pressures to do otherwise. These include a boss who exerts pressure for information that furthers his or her personal agenda, the desire for power or personal gain, pride and the desire to be perceived as a winner at any cost, and conflicting personal and organizational priorities. Professional competence is needed to know what's right; courage is needed to do what's right even though the costs are high.

Whole person approach: The professional development of ethical leaders in the internal reporting environment requires a comprehensive approach. Strong professional character is as important as technical competence. Both are essential tools for the modern management accountant who is passionate about his or her ability to contribute to the well-being of the organization's stakeholders.

Empowerment: Empowered individuals can think and behave in autonomous ways. Empowerment enables leaders to emerge naturally within teams and functions. Competence and character are among the tools management accountants need in order to be trusted to make important gatekeeping decisions.

Succession planning: Organizations should strive for a culture of lifelong learning that fosters the development of values-centered leaders. Experienced management accountants should mentor their eventual successors and provide training that focuses not only on developing technical competence but also on strengthening professional character. The process of ethical decision making should be included in this tutoring.

Emotional intelligence: To be ethical leaders in their organizations, management accountants must be self-aware and in tune with their coworkers. Social competence makes possible many character virtues that build loyalty and a sense of fair play, which in turn facilitate business success. Management accountants are aware of the importance of their role to both their organization and society as a whole.

the examiners' internal controls could do little more than create an "illusion of control." (For more information on this topic, see "The Ethics of Management Control Systems: Developing Technical and Moral Values," by Josep Rosanas and Manuel Velilla in the *Journal of Business Ethics*, March 2005.)

An external assessment may lead to needed improvement, but we believe that developing the management accountant's personal trust-building controls is fundamental to reporting high-quality information. Ultimately, the integrity of any reporting environment depends on the continual diligence of the reporter in maintaining competence and protecting integrity. In his January 2009 Ethics column in *Strategic Finance*, Curtis Verschoor supports this point that external controls, while necessary, aren't sufficient when he observes that "the subprime lending crisis…involves the banking industry, probably the most highly regulated industry in the United States." The external regulatory controls failed to prevent the crisis. The professionals involved needed to pay more attention to developing their own *internal* controls.

What specific dimensions of competence and character should management accountants exhibit? As gatekeepers in the internal reporting environment, they should be **ethical accountants.** The *IMA Statement of Ethical Professional Practice* (www.imanet.org/about_ethics_statement.asp) outlines standards of competence and three dimensions of professional character: confidentiality, integrity, and credibility. A continual commitment to these standards creates accountants who are trusted gatekeepers—reporters who are capable of protecting the integrity and sustainability of internal decision-making processes.

Since management accountants are the gatekeeping leaders in internal reporting, they also should develop and nurture the virtues of **ethical leaders**. In the February 2009 issue of *Strategic Finance*, Kasthuri Henry presents a Comprehensive Ethical Leadership Model™ that provides a roadmap for building a culture of value-centered leadership. Henry recognizes that legislation can't prevent moral lapses or impaired judgment. Rather, solutions to ethical problems that have led to reporting breakdowns must come from *within* ethical leaders in the workplace. Table 2 explains how Henry's six ethical leadership traits can be mapped into the competence and character development of leaders in the internal reporting environment.

The gatekeeping role of providing trustworthy, useful information is crucial in creating value within organizations. Individuals who are committed to this foundational purpose are more likely to act selflessly for the greater good. They require courage to resist the financial incentives and organizational pressures that tempt them to compromise the integrity of their reports. Management accountants should focus on developing the attributes of the whole person—both competence and professional character—and not simply on maintaining their technical skills. Armed with these attributes, the gatekeepers of the internal reporting environment may be empowered to make key decisions regarding the form, content, and use of their reports. As they develop emotional intelligence and other leadership skills, they'll be able to contribute to the company's sustained success by nurturing its future financial leaders.

Gatekeeping in Action

Consider a situation one controller faced at a company that has a manufacturing plant located on the banks of a river. Since the plant is several miles upstream from a small town where most of the plant's employees live, the town depends on the plant to provide many jobs and support the local economy.

A company engineer recently discovered that the waste water the plant discharges into the river contains a high level of an industrial chemical that's a suspected carcinogen. Neither the state nor federal agencies currently regulate the discharge of the chemical into the environment. Several studies have suggested a possible link between the chemical and health problems, but there's no proof. It's well known in the community, however, that local doctors are concerned about the high rate of miscarriages, respiratory disorders, and certain cancers.

The engineer has suggested that the company consider installing a new technology that would not only remove all waste material from the discharge water but also enable the company to sell the reclaimed material to chemical firms. This technology would pay for itself eventually, but in the short run it would be very expensive. The initial capital investment would be substantial, and the plant would have to operate at dramatically reduced levels for about a year.

The company's CEO opposes the technology. Her response to environmental concerns is reactive; the company always has waited until governmental agencies issue regulations limiting the emissions of particular compounds and then complies with them. Also, her bonus, as well as the controller's, is tied to income, and installing the technology would cause a short-term decrease in activity and profitability. She knows that several members of the company's board of directors are aware of the engineer's recommendation and that she'll have to present a detailed decision analysis to the board. The controller, who's well aware of the CEO's position, will provide the analysis.

The controller initially computed the net present value (NPV) of the plant's expected cash inflows and outflows over the company's standard five-year decision horizon. The NPV of the technology-installation alternative was large and negative, indicating that the technology shouldn't be purchased and installed. He then factored in the fines, environmental cleanup costs, potential lawsuits by local residents, and mandated installation of the technology that could occur if regulatory agencies later decide that the chemical is a health hazard and that the company should have acted at this time. Assigning a dollar value to these considerations was difficult, but the controller's purpose is to conduct a comprehensive, unbiased analysis.

The analysis requires the controller to consider *all* the effects on the company's stakeholders of installing, or failing to install, the new technology. These stakeholders include the stockholders, employees, suppliers, and customers of the plant as well as the residents of the town, both born and unborn. (Some people consider the environment itself to be a stakeholder.) If the technology were installed now, the company's suppliers would lose business over the next year, some of the plant's employees would lose their jobs, and the town's economy would suffer.

On the other hand, continuing to release the chemical into the river would violate the townspeople's right to live in a healthy environment, and the company would benefit financially by taking advantage of the people of the community. By installing the technology, the plant's managers would build trust with their employees and neighbors, begin the process of cleansing the river, and also take an important step to help ensure the company's future economic viability and the town's economic vitality.

This example illustrates why it's important for an accountant to develop the foundational virtues of competence and character. Conflicting incentives and stakeholder interests present biasing pressures and challenges for accountants. In this situation, pressure to maximize his personal bonus and pressure from the CEO could bias the controller's judgment. The controller needs integrity and courage to handle these pressures and needs competence to appropriately weigh all the factors in his analysis. By communicating all relevant information fairly and objectively in a situation characterized by apparent conflicts of interest, the controller will foster the development of values-centered financial leaders in the company, which is a vital aspect of sustainability and succession planning.

Continually Sharpen the Gatekeeping Tools

To summarize, recent failures within reporting environments provide useful reminders for management accountants. First, they are leaders in their internal reporting environments and informational gatekeepers with the duty of reporting trustworthy information. Second, they must strive to maintain and increase their technical competence and professional character. Specifically, they must exemplify the character traits of ethical accountants and ethical leaders. Continually sharpening these essential gatekeeping tools is critical to maintaining trust and reducing the likelihood of costly reporting failures. **SF**

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