# RSM DISCOVERY 19

*Management Knowledge*

3rd Quarter 2014

ROTTERDAM SCHOOL OF MANAGEMENT, ERASMUS UNIVERSITY

- Future trends in reputation management
  *Rebecca Morris talks with Cees van Riel*
- Honesty presents a challenge in performance reporting
  *By Marcel van Rinsum*
- Putting servant leadership to the test
  *By Milton Sousa*
- Identity and identity conflict in the workplace
  *By Kate E. Horton, P. Saskia Bayerl and Gabriele Jacobs*
- Mapping strategic consensus within and between teams
  *By Murat Tarakci*
- Trade-offs in the adoption of sustain-ability standards
  *By Frank Wijen*
- Making better partner matches in brand alliances
  *By Bram Van den Bergh*

The business school that thinks and lives in the future

RSM Erasmus ERASMUS UNIVERSITY

# Honesty presents a challenge in performance reporting

By ***Marcel van Rinsum***

**New research into the honesty of business unit managers when reporting performance shows that they have a tendency to overstate results when financial rewards are at stake.**

Honesty in the presentation of financial performance figures by bonus-driven executives presents a continuing challenge to modern business. The bad news is that its requirements can easily be sidestepped by unscrupulous individuals or groups of individuals determined to maximise their own financial return at the expense of colleagues.

The good news is that there exist effective potential remedies for the condition. This has clear implications for all stakeholders in any commercial operation. Greater transparency can deliver positive results, as demonstrated in the paper *How Control System Design Influences Performance Misreporting* that I co-wrote with Victor S. Maas and which was published in the *Journal of Accounting Research*.

The inspiration for the paper was the belief that managers who benefit from an information advantage will tend to exaggerate the results they have achieved in order to be awarded larger bonuses than would otherwise be the case. The recent news that UK supermarket chain Tesco had overstated profits by £250m provides a timely example of managers exaggerating results (see box).

Those who know and understand the underlying numbers better than anyone else in the organisation are well placed to overstate income or understate costs for their own short-term financial benefit. Putting it simply and bluntly, people have a tendency to lie in their own self-interest; a recurring theme throughout our experiment and the subsequent ongoing analysis.

Different questions arise with different forms of bonus payment. In the case of group bonus systems, for example, the incentive exists for a broader number of people to lie in order to boost evenly distributed group bonus payments. Even a partly trained moral philosopher could probably argue that this particular tendency towards what some might label as social lying is acceptable; a full-blooded utilitarian might even go further and argue that it is in fact right to lie in order to generate the best result for the greatest number of people. In the reverse situation, where a group bonus is divided proportionally based on individual performance, one manager might lie in order to increase his/her own stake at the expense of others. This might be labelled anti-social lying.

Reporting profits can at times appear to be as much an art as a science. The existence of a range of variables such as product and maintenance costs that can be changed almost arbitrarily creates opportunities and temptations to be economical with the truth. Ambiguity in accounting standards can further complicate the issue, presenting opportunities for non-fraudulent dishonesty.

Spending less on the maintenance of plant and machinery, for example, will boost short-term profits at the expense of longer-term issues. But by the time those issues force themselves to the top of the agenda, the managers involved will likely have moved elsewhere (and might well have repeated the trick elsewhere, boosting their own managerial reputation without delivering true added value).

Our experiment confirms that a considerable proportion of participants will report dishonestly to increase their payoff, although not to the maximum possible extent (they might be dishonest but they are not all greedy). The problem to solve, then, is to reduce the propensity to lie and therefore to reduce the number of liars and the volume of lies they tell.

## A case in point

**The *Financial Times* (FT)** highlighted how the timing of recognition of commercial income can affect published figures.

"Typically the central finance department will send emails to individual Tesco managers, asking them what rebates they expect to receive from their suppliers in relation to first-half trading," the FT explains. "This is a judgment made by the managers, who will not necessarily have to provide evidence for their assessment. This means there could be a temptation to be overly optimistic when estimating the rebates."

***Source:* Financial Times*, 22-09-2014, "Q&A: What went wrong at Tesco", by C. Barrett, H. Agnew and A. Felsted***

## Increasing honesty

Organisations seeking to increase honesty in reporting should not only pay greater attention to monetary incentives and selection policies in order to help them to hire "more ethical" managers, but also to the social setting in which performance-reporting decisions are made. Organisations can use the two control system design variables from our study, related to transparency and group bonus type, to influence this setting and the social norms that govern the reporting decisions of managers.

In summary, our results suggest that performance misreporting by managers is influenced by the design of the management control system itself. First, overstatements can be seen to be lower in a group bonus system in which managers reduce the monetary payoff of their peers if they report a higher performance figure. In practice, this can be the case when a fixed bonus pool amount is distributed to managers based on their individual relative performance.

In contrast, when a group bonus grows with group performance, and is distributed evenly among managers, performance is much more often overstated. This dishonesty constitutes a "social lie": it helps the individual manager, but also the group, by increasing the available group reward. This can happen under certain profit sharing arrangements.

Second, overstatements are reduced if companies adopt an open information policy with regard to individual performance reports, such that everyone knows exactly what everyone else has reported. Thus, deciding to be transparent in internal reporting systems seems a viable path for companies wishing to reduce dishonesty in managerial reporting.

The topic lends itself well to future study. Further research is needed to investigate, for example, how robust our results are in settings that differ from our own. In general, we believe that future accounting research should continue to incorporate insights and models from behavioural economics.

As our study shows, design variables of accounting and control systems – which are trivial within the traditional agency framework – can be very relevant from this broader perspective. Therefore, our understanding of the antecedents and consequences of such systems in real-world organisations is likely to be enhanced if researchers start out from a more comprehensive model of man than the *homo economicus*. ■

**This article draws its inspiration from the paper *How Control System Design Influences Performance Misreporting*, written by Victor S. Maas and Marcel van Rinsum and published in the *Journal of Accounting Research*, Vol. 51 No. 5, p1159-1186, December 2013. http://doi.org/10.1111/1475-679X.12025**

***Marcel van Rinsum*** *is Associate Professor, Department of Accounting & Control, Rotterdam School of Management, Erasmus University.* EMAIL *mrinsum@rsm.nl*

### RSM Discovery videos

***A video discussion in which Marcel van Rinsum talks about this research can be seen at* WEB *http://bit.ly/1BrR4W3***

### RSM Expertise

**The Department** of Accounting and Control is a compact powerhouse of international and influential faculty members. It has a very strong research orientation and an equally strong practitioner orientation. Stakeholders range from academic researchers to the business community of accountants, controllers, and financial advisors. The department's research approach is interdisciplinary, integrating both economic and behavioural aspects of accounting.

WEB ***www.rsm.nl/research/departments/accounting-control/***