FINANCE AND ACCOUNTING

BALANCING DIAGNOSTIC AND INTERACTIVE CONTROL SYSTEMS

IN UNCERTAIN TIMES, CHIEF FINANCIAL OFFICERS AND BUSINESS CONTROLLERS ARE MORE IMPORTANT THAN EVER

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The COVID-19 pandemic with its far-reaching consequences forces organizations to quickly adjust to new circumstances and take appropriate measures to deal with the current crisis. Management control systems (MCS) can support managers in this challenging endeavor. MCS such as planning, budgeting, costing, performance measurement and incentive systems are the formal, information-based routines and procedures managers use to maintain or alter patterns in organizational activities. These systems should thus not only focus on goal-oriented activities and the achievement of set objectives but also facilitate the search for new opportunities and innovations. Crises usually confront managers with a great deal of uncertainty because it is difficult to predict what will happen in these situations and what managers should do to secure, achieve or avoid certain results. In addition, managers often experience uncertainty regarding the objectives as such. In a situation like the current COVID-19 crisis that dramatically changes the entire business environment, it is often not clear what goals an organization can pursue. Should managers stick to the targets set before the COVID-19 crisis kicked in or should they refocus their attention towards developing new objectives? The question that arises in this context is how managers should adapt their organizations' MCS to address the COVID-19 crisis.

Valuable insights can be gained from empirical research that focused on what consequences previous crises had for MCS. Based on this research, we will argue that organizations need to skillfully balance strict MCS that focus on target achievement (diagnostic controls) with more flexible systems that facilitate learning and target adjustment (interactive controls). This balanced approach also has implications for business controllers who need to support managers in finding the right control balance in times of the current COVID-19 crisis.

Using management control systems in times of crisis – what does research tell us?

Studies show the need for a multi-faceted use of MCS during crises

and that the way top managers use these systems has a profound effect on the organization's chances to survive. Becker et al. (2016), for instance, distinguish between three different roles of budgeting, namely, planning (such as forecasting and coordination), resource allocation (such as authorization of spending), and performance evaluation (including rewards based on budgetary targets) and analyzed whether specific roles become more important than others during a crisis. They found that, in times of crisis, organizations focus especially on the planning and resource allocation role of budgeting and place decreasing importance on the performance evaluation role. The latter is due to the difficulty in identifying realistic goals and predicting the future in times of crisis. Relying too much on budgetary control might create the problem that organizations are not sufficiently responsive to the changed circumstances. It is thus crucial to focus more on continuous planning through re-budgeting or the rolling forecasts.

Bourmistrov and Kaarbøe (2017), who studied a crisis in a telecommunications company, further extend Becker et al.'s ideas by pointing to the importance of balancing tight budgetary control based on short-term financial information with a more flexible approach drawing on non-financial information. Top management in this company implemented tightened budgetary controls as a response to their perceptions of the crisis as well as demands from investors and board of directors to improve short-term financial results. Incentive systems were changed accordingly to reward cost-cutting behavior. Although relying mainly on tight financial controls is a quite typical top management reaction, a clear downside to this action is that organizations can easily lose agility and flexibility and miss important opportunities to learn about their changing environment and fail to adjust their strategic objectives accordingly. Line managers thus started to protest and voice that blind cost cuts were not a proper way to deal with the situation and took a stand for serving markets, emphasizing quality and maintaining customer loyalty. The line managers saw the downward financial trend but argued that the only possible solution was to make strategic adjustments and frequently referred to non-financial performance indicators when talking about the crisis and how to deal with it. In the end, there was a compromise between keeping constant track of the liquidity issues while, at the same time, staying agile and flexible through the intensive use of non-financial performance indicators. The case study further illustrates how important it is in economically prospering times to set up MCS that, if needed, allow for proper crisis management. In the studied telecommunications company, the multi-dimensional performance scorecard and the traditional budget co-existed already before the crisis escalated and were both accepted. Had the scorecard not been in place before the crisis, the line managers would have had less opportunity to use the non-financial information to provide arguments against the tight budgetary control.

Finding the right balance between 'diagnostic' and 'interactive' control systems

Existing research on the use of MCS in times of crisis demonstrates the importance of a 'balanced' control approach that combines elements of both tighter and more flexible forms of management control. There is hence a need to implement both 'diagnostic' and 'interactive' control systems (Simons, 1995) to prepare for potential crises and manage them if they emerge. Diagnostic controls refer to more "traditional" forms of control through a small set of critical performance variables or key performance indicators that top managers regard as crucial for the achievement of the set targets. This type of control draws on the concept of the 'cybernetic control process' that consists of the following steps: setting targets, working on target achievement, evaluating performance, identifying deviations from initial goals, providing feedback (what can be improved to achieve the targets in the future) and – ideally – feedforward (how can we develop better plans in the future). The strengths of the diagnostic approach are that it provides employees with clear guidance as to what is expected from them and allows top managers to actively engage themselves only in those issues where significant

deviations have been identified. As outlined above, however, especially now in times of the COVID-19 crisis, diagnostic controls do tend to hit the wall. The main problem is that the level of perceived uncertainty is quite high, which makes it difficult for top managers to know what reasonable objectives are or how realistic it is to achieve certain targets that were set before the crisis. Thus, especially in uncertain times of crisis, top managers tend to struggle with formulating clear and unambiguous performance expectations for their employees. If they try and employees feel that the objectives are unreasonable (especially if top management focuses too much on short-term financial results), it might create tensions and spark conflict. This can add another layer of complexity to an already difficult COVID-19 crisis.

It is therefore critical to complement diagnostic controls with interactive controls. The role of these systems is to trigger organizational learning through debate and dialogue. Interactive controls focus explicitly on strategic uncertainties and hence the main assumptions underlying an organization's strategy. They try to capture senior managers' perceptions of those contingencies that might invalidate the current strategy. In other words, interactive control systems are crucial for identifying not only how a current crisis might affect an organization's strategic objectives but, in the first place, for detecting potential crises. The idea is to develop a profound understanding of these contingencies and to use this knowledge to adjust the strategy accordingly. Simons (1995) provides detailed guidance on how to set up interactive controls: Ideally, only one system (e.g. a sales analysis or a balanced scorecard) should be used interactively. The information this system creates should then be a recurring topic on higher-level managers' agendas and regularly brought to the attention of operating managers at all organizational levels. It should be discussed in face-to-face meetings between superiors, subordinates and peers and accepted by all of them as a catalyst for challenge and debate of underlying data, assumptions and actions plans. This, in turn, calls for a productive discussion culture where managers on lower organizational levels have a clear 'obligation to dissent' as well as trust each other. The discussions should focus not only on current information but also on forecasts of future states including different scenarios.

In contrast to the mechanically functioning diagnostic controls where employees are confronted with pre-defined targets and plans, interactive controls provide employees with opportunities to be involved in formulating new strategies. Since interactive controls give employees an active role in tackling a crisis they can be seen as an empowering element in the overall management control infrastructure and the management of the COVID-19 crisis. But there is a further enabling aspect that should not go unnoticed. Due to their interactive nature and focus on face-to-face meetings, interactive control systems can allow top managers to account for the emotional dimension of management control. The COVID-19 crisis can lead to performance-related stress, insecurity, frustration and even anger. Interactive control systems bring together different views and opinions and enable managers from different functions to develop compromises that lead to more widely accepted control strategies in organizations. Our research shows that such social forms of control play a crucial role for the development of flexible strategies that take into account current circumstances without compromising the deeply rooted and long-lasting values and beliefs of an organization (Carlsson-Wall et al., 2020). However, a particular challenge during the COVID-19 pandemic is that interactive control can in many cases not be performed through face-to-face meetings due to the social distancing requirements. Organizations hence need to learn to utilize digital means to enable meaningful organizational debate and dialogue and to engage employees in discussions about strategic uncertainties, their consequences and appropriate actions to address them.

In the process of finding a balance between diagnostic and interactive control systems and skillfully using digital means to account for the emotional dimension of MCS, CFOs and business controllers play a critical role. Those actors often rely on diagnostic controls like traditional budgets and, even more, gain legitimacy through these systems.

Business controllers, for instance, often find satisfaction in identifying negative deviations from targets and reporting those to senior management. This, however, demotivates operational managers and leads to inter-departmental conflicts. Thus, not only in times of crisis, controllers need to rethink their role and rather than relying on diagnostic controls and short-term financially oriented results need to support interactive controls in their organizations. Business controllers need to broaden their scope and find ways to proactively contribute to organizational learning but also to encourage and enable others to do the same. Thus, in times of the COVID-19 crisis controllers have to even more than usual take their business partner role serious and help managers from different functions and on different organizational levels to tackle an uncertain future and to develop reasonable strategies that – despite the urgency to secure the financial results – do not sacrifice the expectations of key stakeholders.

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