

Determinant Controllability of Responsibility Accounting in Profit Planning

Evans O. N. D. Ocansey^{[a],*}; John A. Enahoro^[b]

^[a] Valley View University, School of Business, Accra, Ghana.

^[b] Senior Lecturer, Babcock University, Babcock Business School, Ilishan, Nigeria.

* Corresponding author.

Received 15 August 2012; accepted 26 November 2012

Abstract

The issue of stewardship and scarcity of resources have brought about the need to attach responsibility to activities. Systems designed expected to accumulate costs for the purpose of ascertaining product and period costs in order to plan profit have failed to identify responsibility managers who should control these costs. This study sought to review literature on the controllability principle in responsibility accounting concept as a determinant of profit planning. Arising from this study, controllability establishes and reports the cause and effect relationships between activities of specific managers and the performance of their activities. It is also observed that in addition to assigning costs to specific responsibility centres, two extreme levels of the application of the controllability principle exist. These are the low level and high level controllability accounting application systems. Nonetheless, there are some organizations that fall within the continuum of these application systems.

Key words: Controllability; Principal-Agent model; Profit planning; Responsibility accounting

Evans O. N. D. Ocansey, John A. Enahoro (2012). Determinant Controllability of Responsibility Accounting in Profit Planning. *Canadian Social Science*, 8(6), 91-95. Available from: <http://www.cscanada.net/index.php/css/article/view/j.css.1923669720120806.7676> DOI: <http://dx.doi.org/10.3968/j.css.1923669720120806.7676>.

INTRODUCTION

In the past, planning was extremely casual to many large and prosperous corporations as they were getting

somewhere. The concept of profit planning has not received the needed attention. Although managements consider profit planning to be logical, it will not work in practice (Katzenbach, 1967). According to Robbins and Foster Jr. (1959), profit planning had not received the desired attention in business finance as well as in finance function. This understanding was in varied occasions corroborated by Ludy (2009), Millians (2002) and Hay (2002) that many corporations only cut down costs but would not plan for profit building and hence their profits sag. It is further observed that in many corporations, managers discuss about improving profit but they limit their ability to formulating plans that will improve profit without determining controllability of responsibility and this is profit planning paradox. In contrast, Hill (1959) had indicated that, a number of corporations have successfully implemented long-range profit planning and there is a growing use of long-range planning concept in most developed economies.

In today's dispensation, most successful managements are firmly committed to planning. They would plan and control their functional operations and as efficiently as possible. In the opinion of Babson cited in Millians (2002), in his study for what makes an organization successful, commented that for about five thousand years, men and corporations have succeeded by guesses, and that while a few succeeded, others floundered and died but men continued to fumble along unplanned and uncharted course to profit. Profit planning and control as a predetermination of financial objectives and the preparation to attain the set financial objectives is crucial in all organizations.

Responsibility accounting as a tool for controlling and tracing cost to individual managers, involve assessing controllable and non-controllable factors. However, determining the controllable and non-controllable factors in practice or in real life is dynamic and complex. Larmande and Ponssard (2007) accept that, in eliminating

external factors, the application of the controllability principle remains problematic in practice. As Bevan and Messner (2008) rightly put it, “what should managers be made responsible for?” In such of determining what managers should be made responsible for, few researchers used principal-agent modeling to establish controllability and informativeness (Holmstrom, Baiman & Demski, Antle & Demski, 1988; Merchant, 1987; Rowe *et al.* all cited in Bevan & Messner, 2008). This gave a clear indication that empirical studies on responsibility accounting have not been well espoused in accounting and control literature.

The Issue

In responsibility accounting, the debate as to the scope of appropriateness of responsibility continues to rage. Bevan and Messner (2008) identify that much of the debate revolve around the controllability principle which states that managers should be made responsible only for those activities, objectives or outcomes with which they have influence or control. Consequently, the issue of the appropriate measurement and evaluation of the controllability principle has not been clearly defined. The issue of stewardship and scarcity of resources have born the need of attaching responsibility to all activities, especially those entrusted to resource management. Although, cost accounting systems were designed to accumulate cost for the purpose of ascertaining product and period costs but they failed to identify individual managers who incurred these costs. Responsibility accounting seeks to hold managers accountable for a specified set of activities or decisions and indecision in connection with specified objectives based on their actual performance. Responsibility accounting is an indispensable tool in managing cost especially in large organization which is practicing decentralization. To hold managers accountable, there is a need to measure and evaluate their performance based on specified objectives (Bevan & Messner, 2008; Fowzia, 2011).

Based on desk literature review, this study aims at profit planning, significance of profit planning, and their implications.

1. LITERATURE REVIEW

Planning and control are often confused, and these are intermittently used to suggest that they are synonymous or have same meaning. Essentially, planning and control are complementary but not synonymous. Planning embroils the development of objects and putting in place various budgets to accomplish those planning. According to Lucey (2009), Planning establishes the objectives, and formulate, evaluate and select policies, strategies, tactics and actions required to achieve these objectives. It comprises long term and short term strategies.

Control involves the steps taken by management

to increase the likelihood. The objectives that were established at the planning stage are accomplished. And all parts of the organization are working together toward the goal. Effective budgeting system provides for planning a control. Good planning without control can be time wasting and hence, budgeting forms an integral part of planning. In planning and controlling effort, and irrespective of the nature of the organization, basic concepts and long range objectives of the organization should be defined (Beightler & Street, 1967).

Budgeting process provides means of communication of management's operating and strategic and motivational implementation process. Budgeting aids management in eliminating waste and direct organizations along profit lines. Budgeting provides means of effective resource allocation and discovers potential challenges before they occur (Brewer, 2006; Millians, 2002).

According to Hay (2002), Profit planning as performed by successful business involves setting overall long-range corporate objectives and determining the means to reach these objectives; setting specific corporate objectives from the long-range objectives and determining what is required to accomplish the specific objectives.

Profit planning has the objective of maximizing long term financial wellbeing of an organization. Profit planning will provide a clear picture of the financial expectations of business actions and activities before they are executed. These enable management to assess if its profit objective will be accomplished by the planning, and they give management the opportunity to change the plan to accomplish the objective. Profit planning can also serve as benchmark for evaluating performance (De Vos, H., Isenberg, M., & Jones, R., 1967; Hay, 2002). Katzenbach (1967) suggested that profit planning has abilities to provide more reliable predictions to possible outcomes of several alternative strategies and consequent returns on stockholders' investment, the profit impact of possible changes in selling price, market share, distribution methods, consumption patterns and product mix; the potential profit impacts of different operating and marketing policies. Ludy (2009) suggests that in order to succeed in profit building or planning, employees must be developed and be involved profit planning process.

Profit planning of a business involves the expression of expected financial results of certain courses of action. It is not a passive projection as in profit forecasting; rather it involves a specific commitment to influence events to achieve economic result (Rust & Huang, 2012; De Vos *et al.*, 1967). Although modern concepts of budgeting incorporate profit planning, budgeting per se is not necessarily profit planning if the development of budget allowances is based on prior period expenditures without a consideration of the economic impact of spending on profitability. Profit planning will entail using several tools such as activity-based costing, direct costing, flexible budgeting, zero-based budgeting, linear programming and

quantitative planning tools, marketing matrix and other budgeting approaches.

Profit planning can serve as pressure device imposed by management. Profit and control have behavioral implications on employees and managers such that specific goals are imposed where there are measurements for system, goal orientation, participation, pressure and performance. More often rewards for attaining goals are few and punishments are readily available for failure. At extreme cases, managers may resign, discourage and even sabotage the system. To avoid the negative effects, profit planning and control should involve managers at all levels. Welsch (2001) indicated that without these ingredients, profit planning and control could induce inflexibility, stifle change and initiative which will eventually produce needless pressure. It had therefore been suggested that, profit planning should be comprehensive in areas of stability, structure and consistency.

On the other hand, responsibility accounting represents a system which specifies a set of activities or objectives through which managers are held accountable by their actual performance in relation to this set of objectivities measured and evaluated (Bevan & Messner, 2008). Responsibility accounting is also designed to accumulate and report costs, revenue and profit by individual levels of responsibility. In each area or level of responsibility, a manager is charged only with the cost for which he is responsible and over which he has control (Fowzia, 2011).

In organizations, managers are assigned authority and responsibility for actions taken within their specific areas. Responsibility accounting is therefore, is a management control system designed to make various responsibility managers accountable based on the principles of delegation and location of their responsibility. The authority and responsibility are based on responsibility centres (Venkatrathnam, Reddy, & Fowzia, 2011). To determine how to evaluate a manager, the manager should be evaluated based on profit center if he controls costs and revenue (Antle & Domski, 1988); he should be evaluated on cost center if he controls cost and should be evaluated on revenue centre if he controls revenue. It is further suggested that, a clear-cut definition of a manager's control and the best possible manner of evaluation should be given.

Furthermore, in looking at the controllability principle, they explained it through the principal-agent model. The principal-agent model has two settings. First setting is where the principal has full powers of commitment and does not supply productive inputs but the agent supply the productive inputs and has no full commitment. The second setting has multiple acts of both the principal and the agent. That is, the principal and agent acts are substitutes. The principal can intervene by supplying his or her acts after observation of the acts of the agent. The first setting has one-sided moral hazard while the second setting has two-sided moral hazards. That is, the principal-

agent model provides a framework where the evaluation of the manager can be explicitly endogenous, but the problem is whether the desire behavior of a manager can be achieved (Arya, Glover, & Radhakrishnan, 1998). Antle and Demski (1988) therefore concluded that, a manager should be held responsible if he can control the probability distribution of a variable in question.

In support of the notion of control and evaluation, the American Accounting Association Committee on cost accounting concepts and standards quoted in Callen and Livnat (1989), the following statement regarding costs as a device for motivation has spelt out the following guides

In deciding the appropriate costs to be charged to a manager (responsibility center), a manager should be held accountable with the cost of such services if the manager has authority over both the acquisition and the use of specific services. Also, if the manager can significantly influence the cost through his own actions or inactions, such costs may be charged to him. More so, if it is considered that the manager should have influence over those responsible, he may be charged with those elements.

It is the opinion of Dury and EL-Shishini (2005) that, although limited empirical researches have been conducted, the controllability principle often does not appear to be applied in practice in responsibility accounting. Hence, the allocation of uncontrollable costs is prevalent. Further, it is observed the traditional two-fold classification of costs being controllable or non-controllable is too simplistic and that the application of the controllability principle lies along a continuum. At one extreme, there is no application of the controllability principle and at the other extreme, there is the full application of the controllability principle. In other words, there are organizations which hold managers responsible for all uncontrollable factors and tend to hold divisional managers responsible only for controllable factors. That means, between these extremes, organizations may hold managers accountable for some uncontrollable factors.

Responsibility accounting has been well expressed as a system which spells out qualifying plans by budgets and actions through which actual results of each responsibility centre are measured and whose manager is responsible for the pre-established set of activities (Horngren, Srikant, & George, 2006). This makes responsibility accounting a functional accounting system which classifies all information regarding the reported expenses and incomes according to the responsibility areas allocated to managers with respect to the managers' functions (Adrian & Romana, 2009).

Arya, Glover and Radhakrishnan (1998), had introduced a dimension to the controllability principle which they referred to as conditional controllability. Conditional controllability is the situation where certain measures are included in a manager's performance evaluation and reward system so that though the manager might not have direct control over the measures, he is held accountable. Antle

and Demski (1988) had referred to this informativeness. The issue of conditional controllability or informativeness is complex and hence it is necessary to set required parameters before a manager is assigned responsibilities which parameters should be clearly explained. Hansen and Mowen (2005) and Fowzia (2011) identify responsibility accounting model as characterized by four essential elements specified as assigning responsibility, establishing performance measures or benchmarks, evaluating performance and assigning rewards. These elements may have been further categorized into three, namely functional-based, activity-based and strategic-based responsibility accounting systems.

Responsibility accounting as a control device emphasizes responsibility centers. These are subunits of an organization under a specific manager's control and hence having direct responsibility for its activities (Fowzia, 2011). There are five main responsibility centers for the purpose of cost control. These are cost center of which a manager is held accountable for the costs in the subunit; revenue center of which a manager is held accountable for the revenue subunit; profit center of which a manager is held accountable for the profit subunit; investment center of which a manager is held accountable for the profit and the capital invested to generate that profit in the subunit; contribution margin centre of a manager is held accountable for the contribution in that subunit.

2. FINDINGS AND DISCUSSIONS

Findings are that the concept of controllability of responsibility accounting has the purpose of establishing and reporting the cause and effect relationships between the activities of specific managers and the financial results of their activities. To this effect, it is suggested that the application of two fundamental concepts is important. Firstly, in responsibility accounting system, all costs and revenue should be assigned to specific responsibility centres; and secondly that the system should reflect the operating results of each segment and product or service in order to establish the responsibility centres through the organization (Fowzia, 2011). However, most of the researchers have not espoused the responsibility accounting system but rather the controllability principle which are still debatable.

In a research conducted in Bangladesh, on practice of responsibility accounting systems in certain service organizations, all the organizations sampled were limited to three responsibility accounting systems namely, functional-based responsibility accounting system, activity-based responsibility accounting system and strategic-based responsibility accounting system. Also some organizations follow more than one type of responsibility accounting system. This means that organizations use integrated system of responsibility accounting, but not in any unique responsibility

accounting system (Fowzia, 2011).

From findings, two extreme levels of the application of the controllability principle are identified. One is the low level of the application of the system which has the following characteristics: all, or most of the uncontrollable common resources costs such as group general and administrative costs are reallocated to divisions; and when measuring divisional managerial performance, the effects of uncontrollable environmental factors and divisional interdependencies are not taken into account. Nevertheless, when measuring divisional managerial performance under the high level of application of the controllability principle, the uncontrollable common resources costs such as group general and administrative costs are generally not allocated to divisional managers; and to a considerable extent, the effects of uncontrollable environmental factors and divisional interdependencies are taken into account (Dury & EL-Shishini, 2005).

In this research however, the appropriate level of the application of controllability has not been determined. Furthermore, when the application of the controllability principle was examined, it was discovered that, 70 % of divisional managers were not held accountable for actual allocated uncontrollable common costs, which means that managers were protected by the controllability principle. Nonetheless, most companies do apply the controllability principle partially. In another field study of 109 corporations conducted by Simons (2007) where he used the concepts of span of control and span of accountability. Here, it was revealed that, in the organizations using competitive operations for customer-focused markets, the applicability of the controllability principle holds only in the relatively small number of situations and only where work is predictable and in these situations, innovation was not important.

The controversy remains on managerial accounting literature, the choice of appropriate measure and evaluation of divisional managers' performance with respect to the controllability principle. It is also still unclear whether or not different criteria should be used to measure divisional manager's performance and the economic performance of the division (Dury & EL-Shishini, 2005; Bevan & Messner, 2008).

3. CONCLUSION AND RECOMMENDATIONS

It has become obvious that management of organizations should understand the need for pragmatic profit planning and prior misconceptions be clarified how to plan profits and activities to achieve the profits. Management should consider the tools of profit planning, the implications and challenges, and the successes of profit planning in organizations. Also, since the ultimate objective of profit planning and control is to maximize profits, profit planning and control should be integrated into operational planning

with financial and profitability goals of the long term or strategic plans of every organization – to contribute to the basic management objective of every business.

In responsibility accounting, although, the principle of controllability in responsibility accounting seems to be quite important and not many researches have been conducted in this area, controllability factors may have depended on several factors. Some researchers have used diverse management theories to determine when controllability should apply in responsibility accounting. Therefore, there should be clearer definitions of controllability based in further researches into varied industries and setting the necessary parameters that require the application.

It is further recommended that, research should be conducted to find out the appropriate situation where the principle of responsibility accounting should be applied.

It is also important to investigate whether there are variations of responsibility accounting systems practices and whether more responsibility accounting systems exist.

REFERENCES

- Adrian, G., & Romana, R. P. (2009). Study Regarding the Organization of Management Accounting in the Context of Responsibility Centers (p. 967). Retrieved from <http://steconomice.uoradea.ro/anale/volume/2009/v3-finances-banks-and-accountancy/164.pdf>
- Antle, R., & Demski, J. S. (1988). The Controllability Principle in Responsibility Accounting. *The Accounting Review*, 63(4), 700-718. Retrieved from http://www.cob.ohio-state.edu/~young_53/Antle_Demski.pdf
- Arya, A., Glover, J., & Radhakrishnan, S. (1998). The Controllability Principle in Responsibility Accounting: Another Look. Retrieved from <http://wenku.baidu.com/view/e3f4d669561252d380eb6e25.html>
- Beightler, C. S., & Street, R. L. (1967). Profit Planning in Non-Life Insurance Companies Through the Use of a Probability Model. *The Journal of Risk and Insurance*. Retrieved from <http://www.jstor.org/stable/pdfplus/251323.pdf>
- Bevan, D., & Messner, M. (2008). Responsibility Accounting and Controllability: A Deconstructive Reading. Retrieved from http://www2.le.ac.uk/departments/management/documents/research/research-units/cppe/conference-pdfs/derrida/derrida_bevan.pdf
- Brewer, G. N. (2006). *Cost and Management Accounting* (11th ed.). New York: McGraw-Hill Companies Inc.
- Callen, J. L., & Livnat, J. (1989). Responsibility Accounting and Asymmetry of Information. *Managerial and Decision Economics*, 10(1), 81-84. Retrieved from <http://www.jstor.org/stable/2487184>
- De Vos, H., Isenberg, M., & Jones, R. (1967). Management Services: Financial Management and Control. Retrieved from http://content.ebscohost.com/pdf13_15/pdf/1967/JAJ/01Mar67/4582470.pdf?T=P&P=AN&K=4582470&S=R&D=bth&EbscoContent=dGJyMNxb4kSepRQ4yOvsOLCmr0qeprdsqa4Sq%2BWxWXS&ContentCustomer=dGJyMOzprkmzr65MuePfgeyx44Dt6fIA
- Dury, C., & EL-Shishini, H. (2005). Divisional Performance Measurement: An Examination of the Potential Explanatory Factors. Retrieved from http://www.accountingnet.ie/artman2/uploads/research_full_report_divisional_performance_2005_1_.pdf
- Fowzia, R. (2011). Use of Responsibility Accounting and Measure the Satisfaction Levels of Service Organizations in Bangladesh. *International Review of Business Research Papers*, 7(5), 53-67. Retrieved from <http://www.bizresearchpapers.com/4.%20Rehana-FINAL.pdf>
- Hay, L. E. (2002). Planning for Profits: How Some Executives Are Doing It. Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=1ece447c-2ae4-402d-8c89-db0d6b0d8b70%40sessionmgr110&vid=10&hid=12>
- Hill, W. E. (1959). Planning for Profit: A Four Stage Method. Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=1ece447c-2ae4-402d-8c89-db0d6b0d8b70%40sessionmgr110&vid=6&hid=119>
- Katzenbach, J. R. (1967). Can Companies Plan Their Profit? Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=1ece447c-2ae4-402d-8c89-db0d6b0d8b70%40sessionmgr110&vid=8&hid=14>
- Larmande, F., & Ponssard, J. P. (2007). Responsibility Accounting with a Privately Informed Agent. Retrieved June 21, 2012 from <http://hal.archivesouvertes.fr/docs/00/24/30/68/PDF/2007-10-01-1690.pdf>
- Lucey, T. (2009). *Costing* (7th ed.). London: BookPower.
- Ludy, P. J. (2009). Profit Building: Cutting Costs Without Cutting People. Retrieved from <http://www.scribd.com/doc/19200510/FREE-EXCERPT-Profit-Building>
- Millians, P. M. (2002). Profit Building: Cutting Costs Without Cutting People. Retrieved from http://www.bkconnection.com/static/Profit_Building_EXCERPT.pdf
- Robbins, S., & Foster Jr, E. (1959). Profit-Planning and the Finance Function. Retrieved from <http://web.ebscohost.com/ehost/pdfviewer/pdfviewer?sid=1ece447c-2ae4-402d-8c89-db0d6b0d8b70%40sessionmgr110&vid=10&hid=12>
- Rust, R. T., & HUANG, M. (2012). Optimizing Service Productivity. Retrieved from http://www.marketingpower.com/aboutama/documents/jm_forthcoming/optimizing_service_productivity.pdf
- Simons, R. (2007). Revisiting the Controllability Principle in the Twenty-First Century. Retrieved from <http://www.hbs.edu/units/am/pdf/Rethinking%20the%20Controllability%20Principle.pdf>
- Wesch, G. A. (2001). Behavioral Implications on Profit Planning and Control. Retrieved from <http://connection.ebscohost.com/c/articles/6043447/behavioral-implications-profit-planning-control>