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THE ESSENTIAL CONTROLLER

An Introduction to What Every
Financial Manager Must Know

SECOND EDITION

STEVEN M. BRAGG

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The Essential Controller

An Introduction to What Every Financial Manager Must Know

Second Edition

STEVEN M. BRAGG



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Preface

THE TITLE OF *The Essential Controller: **An Introduction to What Every Financial Manager Must Know*** clearly specifies its purpose; a person newly hired into the controller position needs this book in order to understand the demands of the position and to succeed in the role.

The book describes the role of both the controller and chief financial officer within the corporation, as well as how these roles vary between companies of different sizes.

These issues are addressed in Chapters 1 through 3.

[Chapter 4](#) describes a variety of efficient practices for managing the accounting department. [Chapter 5](#) turns to internal accounting, also known as cost accounting; it takes the new controller through traditional costing concepts, such as job and process costing, as well as the most recent costing systems, such as throughput, target, and activity-based costing.

[Chapter 6](#) shows the new controller how to analyze information through the use of ratio and trend analysis, which is also a good way to pinpoint the control problems that can be resolved through the control systems changes noted in [Chapter 7](#). It is also useful to understand the process required to issue reliable financial statements, which is covered in [Chapter 8](#). The new controller may work with an internal audit department; [Chapter 9](#) describes the composition and role of the audit committee, as well as the general functions of the internal audit group.

The book then moves on to more general management topics. [Chapter 10](#) turns to the accounting department staffing—how to recruit, hire, promote, and motivate employees. [Chapter 11](#) delves into the new controller's role

in dealing with company investors—the information needs of the various investor groups, various methods of communication with them, and the use of a standard disclosure policy. The book concludes with an analysis of tax strategy in [Chapter 12](#), where the impact of a number of key issues on a company’s tax liability—the cash method of accounting, inventory valuation, acquisitions, net operating loss carryforwards, transfer pricing, and so on—are covered.

In sum, the book is designed to give the new controller a firm foundation in the concepts of managing the accounting department, analyzing and knowing what to do with key accounting information, and setting up control systems that reduce a company’s risk of loss. Knowledge of these core issues is central to the new controller’s success in the position.

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Centennial, Colorado
March 2012

CHAPTER ONE

Accounting in the Corporation

Importance of This Chapter

Though this chapter is relatively short, the new controller should read it carefully and ponder the key topics of discussion. We point out that the accounting function is extremely complex, both in terms of tasks and global reach as well as in its impact on other parts of the business. In many respects, the controller position has the most far-reaching impact of any management position, so the new controller must spend time considering how he or she will fit into the complex gearing of the modern corporation in order to achieve the greatest positive impact. Further, ethical issues arise more frequently in the accounting field than in most other areas, so the controller must be aware of these issues and understand the process for dealing with them.

The role of the accounting staff used to be simple enough—just process a basic set of accounting transactions and convert them into financial statements at month-end. The role has undergone a vast change in the last few decades, as technological improvements and a shifting view of management theory have resulted in a startlingly different accounting function. This chapter describes how the accounting function now incorporates many additional tasks and can even include the internal auditing and information technology functions in smaller organizations. It then goes on to describe how this functional area fits into and serves the needs of the rest of the company, and how the controller fits into the accounting function. Finally,

there is a discussion of how ethics drives the behavior of accounting employees, and how this shapes the way the accounting staff and controller see their roles within the organization.

In short, this chapter covers the high-level issues of how the accounting function and its controller fit into the modern company, not only to process its transactions, which was its traditional role, but also to provide additional services.

TASKS OF THE ACCOUNTING FUNCTION

The accounting function has had sole responsibility for processing the bulk of a company's transactions for many years. Chief among these transactions have been the processing of customer billings and supplier invoices. Though these two areas comprise the bulk of the transactions, there has also been a long history of delegating asset tracking to the accounting function. This involves all transactions related to the movement of cash, prepaid assets, inventory, and fixed assets. Finally, the accounting staff has been responsible for tracking debt, which can involve a continuous tracking of debt levels by debt instrument, as well as the payments made to reduce them.

A multitude of changes in the business environment have altered the role of the accounting function. One change has been the appearance of the information technology function. In a larger company, this function is managed within its own department and does not fall under the responsibility of the controller. However, it is common for the information technology group to fall under the management umbrella of the controller in a smaller

company. Likewise, the internal auditing function frequently falls under the controller's area as well. This function has expanded in importance over the last few decades as companies realize the benefits of having an internal watchdog over key controls. Though it should report directly to the board of directors or the chief financial officer (CFO), it is common for a small internal auditing staff to report instead to the controller.

Besides adding new functional areas, the accounting staff has other new responsibilities that have arisen due to the increased level of competition. With worldwide barriers to competition crumbling, every company feels the pinch of lower competitive prices and now asks the accounting staff to provide analysis work in addition to the traditional transaction processing. These tasks include margin analysis on existing or projected product lines, geographic sales regions, or individual products.

Targeted Financial Analysis

One of the controller's key tasks is proactively analyzing company issues and recommending changes. In one case, a new controller solved a company's low-profitability problems by preparing a one-page grid showing the sales volume and profitability of every customer. The president promptly dropped most of the customers having low volume and low margins, resulting in the company deliberately losing 1/3 of its customers—and raising its profitability. ■

Also, different organizational structures complicate the job of the controller. For example, there may be a number of subsidiaries that were created specifically to reduce the taxes on newly acquired businesses, or to take advantage

of tax rates in different government jurisdictions. These situations greatly complicate the accounting work of the accounting staff, particularly in regard to consolidating the results of the various entities.

There are also continuing changes to the various accounting frameworks, such as generally accepted accounting principles (GAAP) or international financial reporting standards (IFRS), which require considerably more complicated accounting for some situations. For example, the controller may be called on to capitalize the interest expense associated with a fixed asset under construction, or to accrue a liability for an asset retirement obligation.

In addition, the accounting staff may even be asked to serve on new product design teams, so that they can determine the projected cost of new products, especially in relation to target costs. Further, the accounting staff must continuously review and report on nonproduct costs, which can range from advertising to utilities. This level of cost review and reporting calls for highly trained cost accountants and financial analysts, almost always with college degrees and professional certifications, to conduct the work.

The world of business has become more international. Many companies are doing an increasing volume of business with companies based in other countries. This greatly increases the complexity of accounting, for a company must now determine gains and losses on sales to other countries. In addition, if there is no separate finance function, the accounting staff may be called on to handle letters of credit and hedging transactions that are designed to reduce the level of risk that goes with foreign exchange dealings.

In the face of more intensive competition, many companies are also merging or acquiring subsidiaries. This adds a great deal of complexity to the accounting staff's work, for it must now coordinate a multitude of additional tasks in other locations. This includes setting up standard procedures for the processing of receipts, shipments, and cash. Also, closing the financial books at the end of each reporting period becomes much more complex, as the accounting staff must now coordinate the assembly and consolidation of information from multiple subsidiaries. Even if a company decides to consolidate all of its accounting facilities into one central processing location to avoid all this trouble, it still requires the management expertise to bring together the disparate accounting systems into a smoothly operating facility. This is not an easy task. The environment of mergers and acquisitions greatly increases the skill needed by the accounting staff.

The tasks of the accounting function are itemized below. The tasks that belong elsewhere—but are commonly given to the accounting staff in a small company—are noted under a separate heading.

- *Traditional accounting tasks*

- Accounts payable transaction processing
- Accounts receivable transaction processing
- Asset transaction processing
- Debt transaction processing

- *New accounting tasks*

- Coordination and consolidation of accounting at subsidiaries
- Currency translations
- Margin analysis

- Nonproduct cost analysis
- Selection, implementation, and operation of accounting software and related systems
- Target costing
- *New tasks assigned to the accounting function of smaller companies*
 - Information technology systems installation and maintenance
 - Hedging, foreign exchange, and letter of credit transactions
 - Internal auditing programs

Given today's highly volatile and ever-changing business environment, the only safe statement to make about the new activities presented in this section is that they will only become more complex, requiring even greater levels of skill by the accounting staff and its management team.

ROLE OF THE ACCOUNTING FUNCTION

Having noted the expanded number of tasks now undertaken by the modern accounting function, it is important to also note how the role of the accounting staff has changed in relation to the rest of the company.

When the number of accounting tasks was more closely defined around transaction processing, it was common for the accounting staff to be housed in an out-of-the-way corner of a business, where it would work without being impeded by other functions. Now, with a much greater number of tasks, the accounting staff finds itself involved in most major decisions. For example, the cost accountant is

expected to serve on product design teams and to let other team members know if new designs will have costs that will meet targeted cost goals. An accounting analyst may be asked by the sales manager to evaluate the profitability of a lease deal being extended to a customer. The controller may be involved in integrating the accounting functions of an acquired business. The accounts receivable clerk may work with the sales staff to collect overdue invoices from customers. And in general, the entire accounting staff may be called on to issue financial reports to other parts of the business, possibly with accompanying formal presentations. For these reasons and others, the accounting function now finds itself performing a variety of tasks that make it an integral part of the organization.

A particularly important area in which the role of the accountant has changed is related to processes. When another area of the company changes its operations, the accounting staff must devise alterations to the existing accounting systems for processing transactions that will accommodate those changes. For example, if the manufacturing function switches to the just-in-time production methodology, this has a profound impact on the way in which the accounting staff pays its bills, invoices customers, monitors job costs, and creates internal reports. Also, if the materials management staff decides to use material requirements planning or integrated distribution management systems, the accounting software should be interfaced to these new systems. To alter its processes, the accounting staff must first be aware of these changes, requiring the accounting staff to engage in more interaction with other parts of the company to find out what is going on.

A company may find that it has to streamline various aspects of its operations in order to lower its costs and remain competitive. This can be a problem for the

controller, who may find key controls being eliminated at the same time. This requires a fresh view of which controls are really needed to mitigate risks, and a considerable amount of diplomacy in extending the viewpoint of the controller regarding this issue to the rest of the company. The result may be that some controls must be modified, replaced, or eliminated.

It is very important to develop strong relationships with key suppliers and customers. These business partners will demand extra services, some of which must be fulfilled by the accounting staff. These changes may include the online submission of invoices, providing special billing formats to customers, or paying suppliers by electronic transfer. If these steps are needed to retain key business partners, then the accounting staff must be willing to do its share of the work. Too frequently, the accounting staff resists these sorts of changes on the grounds that all transactions must be performed in exactly the same manner with all business partners. The accounting department must realize that altering its way of doing business is sometimes necessary to support ongoing business relationships.

In short, altering the focus of the accounting staff from an introverted group that processes a few traditional transactions to one that actively works with other parts of a company and alters its systems to accommodate the needs of other departments is required in today's business environment.

ROLE OF THE CONTROLLER

The controller has traditionally been the one who supervises the accounting department, reviews systems, and delivers financial statements. Though the details of the position are covered in [Chapter 2](#), suffice it to say here that

the position has expanded to a great extent. As noted earlier in this chapter, the accounting function as a whole is now required to take on additional tasks, to work with other departments more closely, to continuously offer advice to senior management, and to alter systems and controls to match the changing needs of other areas of the company. All of these changes have had a massive impact on the role of the controller within the organization.

The key factor is that, due to the vastly increased interaction with other departments, the controller must be highly skilled in interdepartmental dealings. This involves constant interactions with fellow department heads, attendance at meetings, and the issuance of opinions on a variety of topics regarding the operation of functions with which the controller previously had no connection. Because of this changed role, the controller must now have top-notch interpersonal and management skills—the former to deal with other departments and the latter to oversee the expanded role of the accounting department.

Forming Alliances

The controller position impacts nearly every part of the company. If the new controller is to succeed in the position, it is extremely important to build strong relationships with the managers of other departments. For example, if there is a large inventory investment, be sure to form a strong bond with the warehouse or materials manager. Also, do not ignore informal lines of communication; in many instances, a very senior person in an innocuous job may have considerable informal control over key functions. In one instance, the author found that the person in charge of developing sales proposals had the best overall knowledge of company operations! ■

In addition, the controller must govern a group of employees that is much more educated than was previously the case. This requires constant attention to the professional progress of each person in the department, which requires goal setting, mutual discussion of training requirements, and continuous feedback regarding employee performance. This clearly calls for management skills of an order far higher than formerly required of a controller that presided over a clerical function.

Also, the wider range of functions managed by the controller now requires a wider range of knowledge. A controller now needs at least a passing knowledge of computer systems, internal auditing, and administrative functions, because this area frequently falls under the controller's area of responsibility. In addition, traditional accounting functions have now become more complex; a controller must know about all of the following:

- The costs and risks associated with outsourcing various accounting functions.
- The impact of tax laws on how the department collects and aggregates information.
- Changes in accounting standards and their impact on accounting reports.
- Changes in the reporting requirements of the Securities and Exchange Commission (for publicly held companies).

It would take a perpetual student to have an in-depth knowledge of all these areas, so it is more common for the controller to manage a cluster of highly trained subordinates who are more knowledgeable in specific areas, and who can provide advice as problems arise.

In short, the role of the controller has expanded beyond that of a pure accountant to someone with broad management and interpersonal skills who can interact with other departments, as well as manage the activities of an increasingly well-educated group of subordinates, while also working with them to further their professional careers. This is a much more difficult role for the modern controller, requiring someone with at least as much management experience as accounting knowledge.

IMPACT OF ETHICS ON THE ACCOUNTING ROLE

With the globalization of business, competition has become more intense. It is possible that the ethical foundations to which a company adheres have deteriorated in the face of this pressure. There have been innumerable examples in the press of falsified earnings reports, bribery, kickbacks,

and employee thefts. There are vastly more instances of ethical failings that many would perceive to be more minimal, such as employee use of company property for personal use, “smoothing” of financial results to keep them in line with investor expectations, or excessively robust sales or earnings forecasts. The controller and the accounting staff in general play a very large role in a company’s ethical orientation, for they control or have some influence over the primary issues that are most subject to ethical problems—reported earnings, cash usage, and control over assets. This section discusses how the accounting function can modify a company’s ethical behavior—for good or bad.

The accounting function can have a serious negative impact on a company’s ethical standards through nothing more than indifference. For example, if the controller continually acquiesces to management demands to slightly modify the financial statements to achieve certain targets, this may eventually lead to larger and larger alterations. Once the controller has set a standard for allowing changes to reported earnings, how can the controller define where to draw the line? Examples of such modifications are:

- Allowing sales from the next period to be included in the preceding accounting period.
- Not charging an inventory item to expense, knowing that it is obsolete.
- Spreading recognition of an expense over multiple periods, when it should be recognized at once.
- Maintaining an inadequate allowance for doubtful accounts.

Another example is when the accounting staff does not enforce control over assets; if it conducts a fixed-asset

audit and finds that a television has been appropriated by an employee for several months, it can indirectly encourage continuing behavior of this kind simply by taking no action. Other employees will see that there is no penalty for removing assets and will then do the same thing. Yet another example is when the accounting staff does not closely review employee expense reports for inappropriate expenditures. Once again, if employees see that the expense report rules are not being enforced, they will include more expenses in their reports that should not be included. Thus, the accounting staff has a significant negative influence over a company's ethical standards simply by not enforcing the rules.

The previous argument can be turned around for an active accounting department. If the controller and the rest of the accounting staff rigidly enforce company policies and procedures and acquire a reputation for no deviations from these standards, the rest of the corporation will be dragged into line. It is especially important that the controller adhere closely to the *highest* standards, for the rest of the accounting staff will follow the controller's lead. Conversely, if the controller does not maintain a high ethical standard, the rest of the accounting staff will have no ethical leader and will lapse into apathy. Accordingly, in a sense, the controller is a company's chief ethics officer, since the position has such a strong influence over ethics. It is a rare week that passes without some kind of ethical quandary finding its way to the controller for resolution.

Drawing the Line

A new controller may have been specifically hired due to lack of experience, with the management team hoping they can steamroll ethically suspect business practices past the new hire. Thus it is useful to promptly inquire into the reason for the last controller's departure, and to also call the internal and external auditors to discuss their views of how far the company has stretched accounting rules in the past. ■

It is not sufficient to merely say that the accounting staff must uphold high ethical standards, if the standards are not defined. To avoid this problem, the controller should create and enforce a code of ethics. This document may not originate with the controller—many chief executive officers (CEOs) and CFOs prefer to take on this task. However, the controller can certainly push for an ethical code to be developed higher in the organization. Some illustrative topics to include in a code of ethics are:

- Bidding, negotiating, and performing under government contracts
- Compliance with antitrust laws
- Compliance with securities laws and regulations
- Conflicts of interest
- Cost consciousness
- Gifts and payments of money
- Leave for military or other federal service
- Meals and entertainment
- Preservation of assets

- Restrictive trade practices
- Use of company assets

Once the code of ethics has been created, it must be communicated to all employees. Once again, this is the CEO's job, but the controller should constantly reinforce it with his or her staff. It is especially helpful if the controller visibly refers to the ethical code whenever an ethical issue arises, so that the accounting staff knows that the controller is decisively adhering to the code.

A code of ethics becomes the starting point in the series of judgments a controller must follow when confronted with an ethical issue. The decision tree is:

- **Consult the code of ethics.** Use the code of ethics as the basis for any ethics-related decision. A senior company officer would have difficulty forcing the controller to adopt a different course of action than what is prescribed by the code. If the controller feels it is necessary to take a course of action contrary to what is stated in the code, then document the reasons for doing so. If there is no code, then proceed to the next step.
- **Discuss with immediate supervisor.** The controller's immediate supervisor is probably either the CFO, chief operating officer (COO), or CEO. Consulting with them for advice is a reasonable second step in the absence of a code of ethics. However, if the supervisor is the one causing the ethical problem, then skip this step and proceed to the next one.
- **Discuss with a trusted peer.** There is usually someone within the company in whom the controller places a great deal of trust. If so, consult with this person in regard to the proper course of action. Be more circumspect in doing so with a person outside the