

Behavioural aspects of budgeting

Objectives

By the end of this chapter you will be able to:

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| 1 | Describe the purpose of budgeting systems | xxx |
| 2 | Explain the role of budgeting as a means of planning and control | xxx |
| 3 | Discuss the use of budgets in performance measurement | xxx |
| 4 | Discuss the use of budgets as a motivational tool | xxx |

Introduction

Budgeting is a method of communicating the goals of the organisation to the appropriate managers in order to facilitate, coordinate and control various sections of the organisation so that the desired outcomes are achieved.

It is important for managers to develop attitudes and strategies that cultivate and maintain supportive and cooperative relationships with subordinates. Budgets must not only be used as a computational tool to control costs: the behavioural aspects must also be considered so that staff will be motivated enough to achieve the budget's goals. This can only be done if staff have a sense of ownership of the budget.

Purposes of budgets

The use of budgets is vital if the organisation is to correctly perform necessary management functions. Budgets aid in the planning process. When employed appropriately they facilitate communication and can act as a motivational tool. They are also used as a basis for control and performance measurement.

Planning

Planning necessitates the selection of goals and the establishment of those actions needed to attain the goals. Budgeting forces people in the organisation to plan. Preparation of the budget for the administration department of Clarenza Home Building Products' Brisbane branch means that the administration manager must plan for the staffing and other resources needed to adequately perform administrative functions.

Organising

Organising involves the acquisition and allocation of resources so that the goals of the organisation are efficiently achieved. This includes the arrangement and allocation of work between employees.

Budgets aid the coordination of activities by ensuring different parts of the organisation are working towards the same objectives. For example, the production department will manufacture sufficient quantities to satisfy the demand required by the sales department.

Leading

Leading is primarily aimed at getting organisational members to perform their required tasks in a manner that will help to achieve the organisation's goals. Two important aspects of leading are communicating and motivating.

- **Communicating:** Budgets help to communicate the organisation's objectives, and how they are to be achieved, to all levels of the business. Where staff members are allowed to participate in the budget process all parties are more aware of requirements. Budgets also authorise actions to be taken and advise permissible limits, for example ceilings for expenditure.

- Motivating:** Budgets provide a target at which group members can aim. They provide a focus for each individual's efforts. When participation is allowed during budget setting those involved in the discussion are more receptive to the decisions made and are more likely to cooperate in achieving the budget.

Controlling

Controlling is the process of setting standards, measuring current performance and comparing it against the standards and, where necessary, taking remedial action.

It is normal for an organisation to compare actual results with budgets by preparing performance reports. Performance reports are discussed in Chapter 8.

A simple performance report for Trendy Fashions follows:

Trendy Fashions
Performance report for the month of November

	Budget \$	Actual \$	Variance \$
Sales	50 000	48 000	2 000 U
less Cost of goods sold	30 000	29 500	500 F
<i>Gross profit</i>	20 000	18 500	1 500 U
Marketing expenses	7 500	7 000	500 F
Administration expenses	6 000	6 100	100 U
Financial expenses	1 500	1 500	—
<i>Operating expenses</i>	15 000	14 600	400 F
Net profit	5 000	3 900	1 100 U

A variance is the difference between budget and actual. Variances are identified as *F* for **favourable** or *U* for **unfavourable**. Note that actual marketing expenses were \$500 less than budget and thus the variance was favourable. However, the actual sales were \$2000 less than budget, giving an unfavourable variance.

Not all variances will require corrective action. Some variances may be considered immaterial. Others may occur because of faulty budgeting or a change in circumstances, both of which require an amended or new budget.

Self-test problem 9.1

Big 'n Beefy Butchery in Jerramungup, Western Australia, provides you with the following figures for May:



	Budget \$	Actual \$
Sales	40 000	41 500
Cost of goods sold	25 000	24 000
Marketing expenses	1 000	1 200
Administration expenses	750	850
Financial expenses	500	450

Required

Prepare a performance report for May.

The role of budgets in planning and control

Budgeting is an integral part of the management function of planning, organising, motivating and controlling. One of the central tools used to carry out the management function is a budget.

Need for planning

All organisations attempt to use scarce resources to achieve their goals. Goals may be long term or short term. To achieve long term goals (usually five to ten years) it is necessary to develop long term strategic plans. These plans are concerned with broad objectives and goals—for example to expand into Asia—so they do not indulge in too much specific detail.

To achieve long term goals we need to develop short term strategies that are incorporated into annual budgets. These short term plans are more detailed and consider the means to attain goals. The means by which these short term plans are converted into action is through the budgeting process.

Short term plans tend to use more quantitative data to estimate the future. These include dollar values, sales quantities, production units, inventory levels, number of personnel and financial ratios.

Need for controlling

Whether planning is done formally (by the use of budgets) or informally (in the manager's head) it does not in itself guarantee business success, as it needs to be monitored and adjusted. This function of monitoring and adjustments is called controlling.

Keeping in mind that all plans (budgets) are best estimates of the future, management needs to monitor its progress at regular intervals. It needs feedback on achievements and shortfalls so that it can take remedial action. To facilitate this process of monitoring, yearly budgets are broken down into smaller chunks such as months or even weeks so that if remedial action needs to be taken it will not be too late.

The promptness and accuracy of feedback reports is essential to the whole process of controlling. The reports should compare actual results against the budget. These reports are known as **variance reports**. They require analysis to assess the progress of budget outcomes. Minor variances are usually ignored but significant variances must be investigated so that appropriate corrective action can be undertaken.



You should now be able to do Question 9.1

The use of budgets in performance measurement

Budgets are prepared for all areas of the organisation and all levels of management are responsible for their success. Until recent times most organisations were extremely reluctant to provide financial or statistical information to members of middle or lower management. Even now some items of information are regarded as confidential and available to top management only. It is recognised that managers at the lowest level must be given some basic information about their area of operations if they are to be held accountable for their department or unit. There is also an accompanying need to supply the manager with details of both actual performance and the criteria by which the budget performance was calculated.

The result is that both middle and lower management are now far better informed about their spheres of activity, which makes all management more efficient if the principle of management by exception is followed.

The management by exception principle puts forward the proposition that the manager should not waste time supervising or investigating those areas of responsibility that are already performing at or above the acceptable standard of performance. The manager should concentrate on the *exceptions*, that is those areas that are performing below standard efficiency.

Where budgetary control systems are used, the management reporting will be able to highlight those exceptions. The time saved by managers can be used for forward planning and better coordination of activities under the manager's control.

The use of budgets as a motivational tool

Budgeting is a method of communicating the goals of the organisation to the appropriate managers so that, with their involvement, the desired budget outcomes are achieved. It should follow that budget managers develop attitudes and strategies that cultivate and maintain supportive and cooperative relationships with staff.

The level of support and participation depends on the management's approach to budgeting.

There are two behavioural aspects of budgeting. On one end of the continuum management adopts an authoritarian approach that relies upon a hierarchical organisational structure comprising numerous layers of supervisory management to ensure that the requirements are implemented. Under this management approach budgets are designed on a 'top-down' basis, that is budget targets and standards are imposed by top management onto workers. The authoritarian approach is consistent with many of the traditional models spearheaded by Henri Fayol between 1916 and 1929.

The assumptions under the traditional model are that the employee cannot be relied upon to be self-motivated or innovative. While budget outcomes are only achieved by strict adherence to budgetary controls, the employee is likely to be lazy and wasteful and require constant supervision.

On the other end of the continuum management adopts a participative approach. Under this approach management realises that individuals play the most important part in the budgetary process. It is recognised that workers typically have access to

information concerning the operation of their areas of responsibility that is not available to their superiors. By having their subordinates participating in budget setting, superiors have the opportunity to incorporate that information into budgets to enhance accuracy. This approach is typically known as the **bottom-up** approach.

The bottom-up approach enhances employees' motivation and commitment to goals and targets. When subordinates are asked to participate in setting budgets, the goals of the organisation are internalised, that is they become the individual's goals.

The achievement of organisational goals is greatly affected by the level of employees' motivation. An understanding of motivation helps to explain why individuals act in specific ways.

Motivation refers to those factors that influence an individual to act in a goal-directed manner by addressing the question of how behaviour is started, stimulated, maintained, guided and ceased.

Of all the modern theories of human motivation, Maslow's provides the best explanation. Maslow proposed that motivation comes from within the person and cannot be imposed on an individual. People are viewed as goal seeking all through life. These needs are arranged in a hierarchy: each level must be satisfied before an individual can be motivated by a higher-order need. Once the needs of a level are satisfied, the needs of the next level come into play and act as further motivators of behaviour.

The authoritarian approach and the participative approach lead to two budget setting processes: one uses the top-down process and the other uses the bottom-up process. In reality neither model works perfectly, therefore the actual process depends on the country's culture, the organisational culture and the management control techniques used.



You should now be able to do Question 9.2

Behavioural aspects of budgeting

The way in which budgets are administered impacts on their effectiveness in helping to achieve an organisation's goals. 'The budget in any company has a dual role of being a forecast of the year and a yard stick of managerial performance.'¹

It can also be argued that by using the budget to measure managerial performance there is an attempt to use it as a tool for control. If this is linked with a reward and/or punishment system '[t]here is a general tendency for managers to distort the information they pass on to their superiors, so that the unfavourable items are under-emphasised'.²

Such distortion of information is undesirable and counter-productive.

Some organisations use sanctions and punishment to encourage adherence to budget. The use of sanctions and punishment is synonymous with an authoritarian style of management. Typical responses to this use of budgets are:

- *Manager*: 'The important thing for us to do is to follow up. The supervisor's interest lags unless someone is constantly checking up on him ... I think there is a

need for more pressure ... I think that man is inherently lazy and if we could only increase the pressure budgets would be more effective.³

- *Supervisor:* ‘You’ve got to outwit that son-of-a-bitch ... Remember the bastards are out to screw you, and that’s all they’ve got to think about.’⁴

The use of sanctions and punishment is more likely to lead to resentment and further attempts to beat the system. At best it will result in a defeated and less than enthusiastic employee. It will certainly encourage behaviour such as ‘padding the budget’.

Padding the budget

Bill Smithers is the manager of the administration department at Clarenza Building Products’ Brisbane branch. Bill is responsible for ensuring that costs for the administration department do not exceed budget. Knowing this Bill always submits estimates to the budget committee that exceed what he believes the true costs will be.

Margaret White is the manager of the sales department at the Brisbane branch. Margaret submits a conservative estimate for sales knowing that if the branch’s sales exceed budget she will appear in a favourable light to senior management.

These are examples of padding the budget. **Padding the budget** means overestimating costs and/or underestimating revenue. The difference between the padded estimate and a realistic estimate is known as **budgetary slack**. For example, if Bill Smithers believes that a realistic estimate for administrative salaries for the year is \$160 000 but he submits \$180 000 to the budget committee, he has built \$20 000 slack into the budget.

An additional reason why managers pad the budget is that in many organisations the submitted estimate is changed by the resource allocation authority, that is budgeted costs are reduced and budgeted revenues increased.

You should now be able to do Questions 9.3 and 9.4



Participation in the budgetary process

Hopwood reports on a series of experiments conducted by Bass and Leavitt. Managers were given two plans, one developed by themselves and the other created for them. Half of the managers operated their own plan first and half operated their own plan second. ‘The results of the experiment showed that the managers were both more productive and more satisfied with their job and their colleagues when operating their own plans ... they had a greater commitment to making them work.’⁵

It was also found that less time was wasted on competition between the planners and doers when the managers implemented their own plans.

While not advocating that lower level managers be given carte blanche to set their own plans it is suggested that they should be included in the budget setting process and their opinions be sought and carefully considered.

Advantages arising from participation are:

- improved communication
- greater understanding of the factors involved
- the opportunity to thrash out problems at budget meetings before the budget is set
- increased acceptance of the budget
- improved commitment
- a real likelihood of an improvement in the quality of the budget because the manager's expertise is used.

Argyris⁶ suggests that participation may help ease the pressure and tension created by budgets. He also makes the point that if top management is going to use participation it should be used in the true sense of the word. Any watering down or pretence will lead to distrust and suspicion by subordinates.



You should now be able to do Question 9.5

Other factors affecting behaviour

Dysfunctional behaviour may be caused by the following budgetary problems:

- Budget targets that are perceived by employees as too difficult to attain will result in resentment and a feeling of stress.
- Budget targets that are perceived by staff as too easy to achieve do not provide a challenge and may lead to a slipshod performance by staff.
- Managers may experience a loss of autonomy by being hemmed in by the budget and not having sufficient flexibility to use their own initiative.
- Managers may become narrow minded, focusing only on their own department, and create disadvantages for the organisation as a whole.
- The emphasis on financial goals to the detriment of non-financial goals may have a debilitating effect on the organisation.

Non-financial measures of performance

Horngren and Foster⁷ advise that variances should be used for attention directing, not as problem solvers. Variances indicate areas that require further investigation; they do not necessarily indicate that the manager involved is a problem that needs to be fixed.

To overcome a reliance on financial measures for performance evaluation Horngren and Foster go on to suggest that non-financial measures should be considered. They give two examples: 'first-time through yield—the percentage of products manufactured "right" (to specification) the first time, and throughput time—the time that a product takes from the first stage of manufacture to completion.'⁸

Finally, they suggest that many companies use a combination of both financial and non-financial measures when evaluating the performance of their managers. The latter makes sense considering that there are many factors that are not directly measurable in dollar terms, for example personal problems and reliance on other departments.

You should now be able to do Questions 9.6 and 9.7



Checklist

Before finalising this chapter, complete the checklist below. This will identify whether you have an understanding of the important aspects of the chapter.



Can you do the following?

- Identify the purpose of budgeting
- Identify why it is important to plan
- Identify why there is a need for control
- Explain how budgets are used in performance measurement
- Explain how budgets are used as motivational tools
- Explain the terms ‘padding the budget’ and ‘budgetary slack’

Questions

- 9.1 (a) Explain how budgets facilitate communication and coordination.
(b) Explain how budgets assist management in carrying out the control function.
- 9.2 Explain the difference between top-down and bottom-up budgets. Which of these approaches provides for greater staff involvement?
- 9.3 Define the term ‘budgetary slack’ and briefly describe a problem it can cause.9
- 9.4 What are some behavioural aspects of creating budgetary slack?
- 9.5 What are the advantages and disadvantages of budget participation from the employer’s point of view and the employee’s point of view?
- 9.6 Why is participative budgeting often an effective tool?10
- 9.7 Should ‘padding’ be avoided at all costs? Give reasons for your answer.

Endnotes

- 1 Schiff, M. and Lewin, A., ‘Where Traditional Budgeting Fails’ in DeCoster, D., Ramanathan, K. and Sundem, G. (eds), *Accounting for Managerial Decision Making*, 2nd edn, New York, USA: John Wiley & Sons, 1978, p. 349
- 2 Lamberton, G. and Harvey, D., *Advanced Management Accounting*, Course Notes, East Lismore, NSW: Southern Cross University, 1991
- 3 Hopwood, A., *Accounting and Human Behaviour*, London, UK: Haymarket Publishing Ltd, 1974, p. 66
- 4 Hopwood, p. 6
- 5 Hopwood, p. 75
- 6 Argyris, G., ‘Human Problems with Budgeting’, *Harvard Business Review* 31(1), Jan—Feb 1953, pp. 97—110
- 7 Horngren, C. and Foster, G., *Cost Accounting—A Managerial Emphasis*, 7th edn, Englewood Cliffs, USA: Prentice Hall Inc., 1991
- 8 Horngren and Foster, p. 272
- 9 Hilton, R., *Managerial Accounting*, 2nd edn, New York, USA: McGraw-Hill Book Company, 1994
- 10 Hilton