BEHAVIOURAL ASPECTS

RELEVANT TO ACCA QUALIFICATION PAPER F5

A BUDGET CAN BE DEFINED AS A 'QUANTIFIED PLAN RELATING TO A GIVEN PERIOD'. ALTHOUGH BUDGETS ARE OFTEN STATED IN TERMS OF MONEY, THEY NEED NOT BE AND CAN RELATE TO OTHER VARIABLES.

A budget can be defined as a 'quantified plan relating to a given period'. Although budgets are often stated in terms of money, they need not be, and can also relate to quantities made and sold, numbers of employees to be recruited, or weights of material to be consumed.

Quantification is important because it adds precision and clarity to a plan. However, it can cause problems as budgets inevitably end up being human obligations and we worry about how the budget was determined, if it is fair, what happens if we fail, are there political dimensions to it, should we 'cheat', or will account be taken of factors outside our control? Perhaps most importantly, how are we to reconcile the pressure to achieve short-term budgets (usually carefully monitored) with ambitions for long-term improved performance which may not be successfully captured by financial statements?

Budgets should not be conjured up out of thin air. Without getting too far into the details of long-term strategic planning, organisations will have ambitions which should take into account the wider environment (for example, what is happening in the economy), their markets (for example, what their competitors are doing), and their products (perhaps a certain product is old and its sales declining). This information, often speculative, should allow an organisation to plot its long-term future and then it can dissect this long-term objective into detailed, shorter-term plans. These plans are usually communicated through budgets: what volume of sales do we hope for, what will power costs be, how many employees will we need, what corporation tax will be levied by the government?

This article looks at three aspects of budgeting, though there is considerable cross-over between them:

- the purposes of a budgets, including motivation and evaluation
- budgets as objectives
- how to set a budget.

THE PURPOSE OF A BUDGET

Budgets can accomplish the following:

Forecasting

Inevitably, if an organisation is going to draft a budget which will be of any use whatsoever, it will have to make forecasts. These forecasts will not always be correct, but at least the organisation has had to look ahead. It won't see every danger or opportunity, but looking ahead must be better than moving forward with eyes closed.

Forecasts are often based on the results of previous periods, updated for known changes. Statistical methods are sometimes used to forecast seasonal effects. Occasionally, specialist data might be purchased to help organisations take economic effects into account as economies improve or deteriorate.

Organisations need to beware of forecasts becoming self-fulfilling prophecies. For example, if a downturn is anticipated, and because of that production budgets are cut thus reducing employees' ability to sell, then there will be a downturn in sales. We will discuss later the difficult issue of budgets which motivate as opposed to a budget which we hope to achieve.

Studying Paper F5?
Performance objectives 12, 13 and 14 are relevant to this exam

OF BUDGETING

Planning

Once forecasts are completed, planning can be carried out. For example, if the forecast suggests a dramatic increase in demand, then new production facilities might have to be planned. However, it is important to be aware at the planning stage that the forecasts might not be correct, or even if they were correct at the time they were made, things can change. Detailed planning might even require the forecasting stage to be revisited to check estimates or to try to gather more evidence for estimates. Even if forecasting does not have to be reviewed, planning should, as far as possible, remain flexible, just in case the forecast isn't fulfilled. So, perhaps instead of acquiring new production facilities, it might be better to hire or subcontract initially to see if the forecast is right. If it is, then the organisation can go ahead and buy production facilities for the following period.

The planning of cash flows is particularly important. Cash flow forecasts are routinely produced but the organisation which believes them unconditionally will have a short life. Plan for possible shortfalls; build in flexibility; have short term financing facilities planned and on call should things not turn out as well as expected.

Coordination

In many ways, coordination is an aspect of planning (making sure the company delivers what it has budgeted to sell), but it is worthy of a separate mention. What this heading really highlights is that there has to be a match between the organisation's structure and ambition and the requirements for its success.

In some businesses it is important to meet well-understood customer demands quickly and reliably, and in this context, strict budget targets and measurement can be vital to success. Other businesses might find that flexibility, adaptability and technical innovation are more important. If you don't know what customers require, then setting targets through budgets is less applicable – and might even be counter-productive because it can limit responses: it's not in the budget, so we can't do it.

Communication

A budget is a succinct and precise way of communicating targets to departments and employees – or at least some aspects of what should be achieved. The problem is not what is specified in the budget, it's what's not specified. The budget might state explicitly that 2,000 units should be made in a period, but implicit in the target is that the units should be of a certain quality. The budget might be explicit about the labour rate per hour to be paid, but might not specify the skills that employees should have. Unfortunately, but inevitably, employees will take most notice of explicit requirements and are liable to downgrade other important but unspecified factors. Of course, a lot will depend on how the budgets are imposed and how results are interpreted, but it is important for budgets to communicate requirements as comprehensively as possible.

A BUDGET IS A SUCCINCT AND PRECISE WAY OF COMMUNICATING TARGETS TO DEPARTMENTS AND EMPLOYEES – OR AT LEAST SOME ASPECTS OF WHAT SHOULD BE ACHIEVED. THE PROBLEM IS NOT WHAT IS SPECIFIED IN THE BUDGET, IT'S WHAT'S NOT SPECIFIED. IT IS IMPORTANT FOR BUDGETS TO COMMUNICATE REQUIREMENTS AS COMPREHENSIVELY AS POSSIBLE.

Authorisation

A budget can be an authorisation to spend, and can, therefore, be a powerful way of delegating power within an organisation. For example, once you give a department a capital expenditure budget you then let that department get on with it, buying new equipment as it sees fit. The only alternative is to have the departmental head keep coming back for permission for bits and pieces of expenditure. Of course, before the budget is 'given' to the department, that department needs to make a case for the expenditure. It will put forward arguments as to why it needs certain capital expenditure (as will other departments), and the budget committee that oversees the budgeting process will have coordinated matters as best it can. So the budget represents pre-authorised expenditure and combines delegation to spend with restraints as to the maximum that should be spent.

Motivation

A budget represents a target, and aiming towards a target can be a powerful motivator. However, whether the target will actually cause employees to do better is thought to depend on how difficult the target is perceived to be. Employees have different perceptions of targets, but generally it is thought that:

- if targets are very low, actual performance can be pulled down from where it might naturally have been
- if targets are habitually very high, then employees might give up and, again, performance can be reduced – if you know that no matter how hard you try you will fail to meet the target, it's easy to conclude that you might as well not try at all.

So, the aim is to set budgets which are perceived as being possible, but which entice employees to try harder than they otherwise might have done. Of course, two employees can look at the same budget and have quite different impressions about how difficult it is, but we are unlikely to develop individual budgets tailored to individual psychologies. The concept of a 'motivating budget', however, is a powerful one, although the budget which is best for motivating might not represent the results which are actually expected. Managers can, and perhaps should, build in a margin for noble failure.

The relationship between budget difficulty and actual performance is typically represented in **Figure 1** on page 4, which shows the following:

- When the budget is very easy, actual performance is low. It has been pulled down by the low demands made of employees.
- When the budget is very difficult, actual performance is low. Why try when you are doomed to failure?
- When a budget is set at the level of the expectations (the best estimate of what performance will actually be), employees are likely to perform as expected.
- If a more difficult aspirational budget is set, employees will try harder, and if the budget is judged just right then their actual performance will be at its maximum, though often falling short of the budget.

The last situation can give rise to what's known as the 'bottom drawer phenomenon'. Managers issue a public, motivational budget, but then have a secret budget ('kept in the bottom drawer') which more accurately reflects what they think will actually happen. One is forced to wonder what happens to motivation when the existence of the hitherto secret budget becomes known. What baroque dance of bluff and counter bluff will occur?

Evaluation

Once budgets have been set as performance targets, inevitably performance will be evaluated. This can be simply a comparison of actual with budgeted performance or alternatively can be a more elaborate comparison of actual performance with flexed budget performance, as is found in variance analysis and operating statements.

The evaluation stage is often one of the most contentious as it is here that performance is likely to be criticised and employees will be sensitive. There are many potential difficulties:

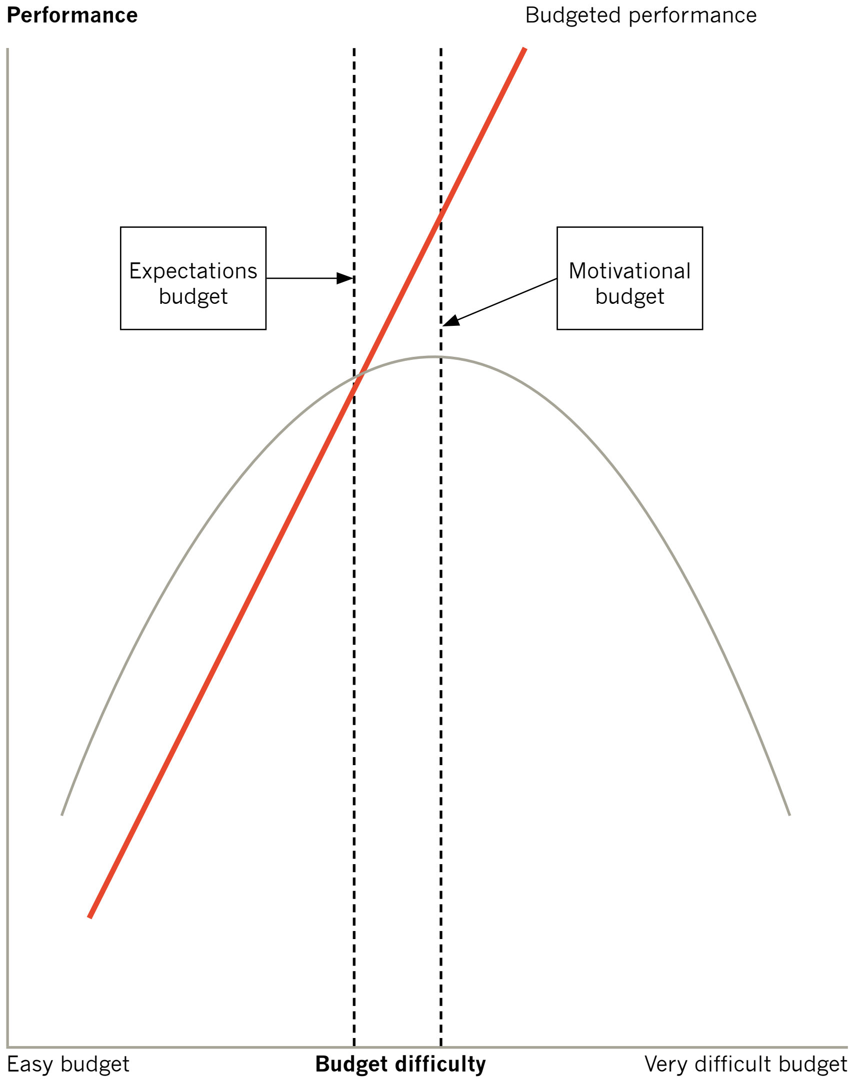
A BUDGET REPRESENTS A TARGET, AND AIMING TOWARDS A TARGET CAN BE A POWERFUL MOTIVATOR. WHETHER THE TARGET WILL CAUSE EMPLOYEES TO DO BETTER IS THOUGHT TO DEPEND ON HOW DIFFICULT THE TARGET IS PERCEIVED TO BE.

- The budget might simply have been wrong, unachievable from the outset.
- The budget might have become unachievable as the period progresses.
- Departments' performances could interfere with each other's.
- Elements of the budget could be incompatible so meeting one target means missing another.
- Although the right decision was made for long-term profitability, this had an adverse effect on the short-term budget.

Hopwood[1] identified three distinct ways of using budget information when evaluating performance:

1 **Budget constrained style**. Here, an employee's performance is primarily judged on their ability to continuously meet their budgets on a short-term basis. This criterion is held to be more important than all other desirable outcomes. So, for example, over-spending to get a machine repaired quickly so that an important order is shipped would be criticised because the repair budget was exceeded. Not surprisingly, this approach leads to very poor manager–subordinate relationships and also encourages the manipulation and misreporting of information.

FIGURE 1: THE RELATIONSHIP BETWEEN BUDGET DIFFICULTY AND ACTUAL PERFORMANCE



THE BALANCED SCORECARD APPROACH OF KAPLAN AND NORTON, AND THE BUILDING BLOCK APPROACH OF FITZGERALD AND NORTON CAN BE A GREAT HELP IN ENSURING THAT OBJECTIVES (OR TARGETS), OR BUDGETS ARE SET FOR A VERY WIDE RANGE OF FACTORS, BOTH FINANCIAL AND NON-FINANCIAL.

2. **The profit conscious style**. Here, employees are primarily judged on their ability to increase the long-term effectiveness of their departments. Budgets are not ignored, but they are regarded more as guidelines than strict targets and are interpreted flexibly. In the above example, the employee would be more likely to be praised for getting the machine repaired as that enabled the organisation to meet customer requirements.
3. **Non-accounting style**. Here, budgetary information does not play a big part in evaluation. It's almost impossible to envisage any organisation which is not now subject to financial and therefore budgetary restraints, but from time to time there are elements of an organisations where money is relatively unimportant. An example might be the budget required by an airline company to meet health and safety requirements, because the consequences of not doing so would be disastrous.

BUDGETS AS OBJECTIVES

Budgets can obviously be used for setting organisational, departmental or individual objectives (or targets). It is often said that, to be successful, objectives should be SMART:

- **Specific or stated**. There's no point in simply telling a department to be 'better'. No one quite knows what is meant by 'better', so it is essential to be very specific about what is required, in terms such as units sold, travelling expenses, or development costs.
- **Measurable.** To be unequivocally communicated and later evaluated, measurement is essential and this usually means trying to derive a quantitative measurement. Accountancy deals with quantitative measures but that does not mean that accountancy holds all the secrets to successful operations. Quality of output is very important, and is relatively easy to quantify, but routine accountancy documents, such as monthly management accounts, do not usually report quality.
- **Agreed/accepted/achievable**. This desirable attribute of objectives relates to motivational budgets and budget acceptance. Suffice to say that if an objective is not agreed or accepted, or not thought to be achievable, it is unlikely to be very effective.
- **Relevant**. Objectives must be seen as being relevant to the organisation's purpose, whether that is to make profits, or for a not-for-profit purpose such as curing the sick or educating children. If objectives seem to have no connection with the higher purpose, then employees begin to feel that objectives are set purely as exercises of managerial power ('I will give you this objective, not because it is useful or necessary, but because it allows me to impose my will').
- **Time limited**. Fairly obviously, if a time limit is not defined, objectives are unlikely to be effective.

The SMART approach to objectives and budgets may seem uncontroversial, but there are several important behavioural aspects to take into consideration.

First, more than one objective is needed. As mentioned under 'Communication', above, employees know that whatever is set as an objective will be measured and will be used for performance evaluation. Naturally, that is what they will therefore concentrate on, unfortunately often to the exclusion of other important aspects of performance. It is vital, therefore, to try to set objectives for all important measures of performance.

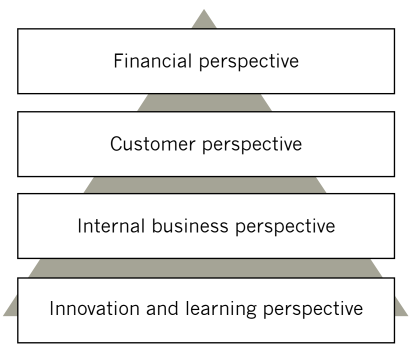
Second, not all aspects of desirable performance are easy to measure, but that doesn't mean you shouldn't try and that you shouldn't set objectives. Remember, most accountancy measures are of no interest whatsoever to consumers. Consumers do not care much how much it costs to make something, or how long production takes, or the cost of the machine on which the manufacturing was done. Consumers care about quality, reliable delivery, innovation, style, and how the price of the item and its features compares with competing products. If consumers don't like what they see they won't buy, and conventional accountancy will give no clues about why the organisation performs poorly.

Third, short-term budget pressures (measured meticulously) can muscle in on longer-term important aspects of performance (poorly measured).

The balanced scorecard approach of Kaplan and Norton, and the building block approach of Fitzgerald and Norton can be a great help in ensuring that objectives (or targets), or budgets are set for a very wide range of factors, both financial and non-financial.

Looking at the balanced scorecard in more detail, this approach considers a hierarchy of performance perspectives, as shown in **Figure 2**.

FIGURE 2: THE BALANCED SCORECARD – THE HIERARCHY OF PERFORMANCE PERSPECTIVES



Ultimately, businesses must perform well financially and there should be budgets and objectives set for measures such as return on capital employed, profit, growth, gross profit percentages and so on. This is the financial perspective. However, successful financial performance depends on pleasing customers and we should take care that budgets and objectives take account of factors such as customer satisfaction, repeat business, or market growth. This is the customer perspective. To do this, the organisation needs to ask:

- **Why do customers like us?** Presumably because we are good at what we do, in terms of adequate stock-holding, quality, efficient production, flexible responses to customer requests. Budgets should be set for these because they are important. This is the internal business perspective.
- **Finally, we ask, how can we keep up with competitors and customer demands?** Only through continual innovation, improvement and learning. This is the innovation and learning perspective.

So the organisation's financial success (easily and frequently measured by budgets) ultimately depends on more nebulous matters such as innovation, quality, style, and flexibility. Therefore, it is essential that budgets are set for these as well, otherwise they will be ignored as employees strive to meet the often more superficial and short-term conventional budget elements.

HOW TO SET A BUDGET

Broadly, when setting a budget, there are two choices:

- top down imposition
- bottom up participation.

Organisations should look for the most effective way of setting their budgets:

- How do they get employees to pay heed to a budget and to take it seriously?
- How can they get accurate budgets?
- How can they motivate employees to try hard?

In management theory, participation in decision making, such as in budget setting, is usually seen as bringing advantages to organisations. It allows information to be gathered from many sources, thereby increasing the chance that all pertinent factors have been considered. Participation usually increases motivation and commitment as it is very difficult subsequently to ignore the decisions or targets which one has helped develop.

However, the demand and expectation for participation and consultation may sometimes have more to do with the polemics of modern management than practical management, because participation:

- is time-consuming
- requires appropriate knowledge, skill and expectations
- may involve selfish motives (for example, building slack into timescales and targets).

Participation undoubtedly has it uses, but it is not a cure for all organisational problems. One only has to think of the difficult budgetary decisions that have had to be made by many organisations during the current recession, where cut backs, redundancies and restraint have had to be imposed as a matter of survival. As a result, there has recently been a swing back to more authoritative approaches to budget setting and performance evaluation. It is important to realise that the budget setting approach adopted for one department, for one set of employees, or for one economic or competitive environment, is unlikely to be universally acceptable and managers must be prepared to vary their approach to match the situation. This can be regarded as a contingency (or 'best-fit') approach to budgeting where there is no single correct method. It depends on the manager, the subordinates, the task and the environment.

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REFERENCE

1 Hopwood A G, An *Accounting System and Managerial Behaviour*, Saxon House, 1973.