

A large, dark blue ink splash or watercolor blotch is centered on a white background. The splash has irregular, feathered edges with some smaller droplets and splatters extending outwards. The text is centered within the main body of the splash.

ASEAN Workshop

Budgeting and Behaviour
Part I

Budget preparations, important trade-offs

- Assembling knowledge from managers within the organisation.
- Question:
 - Who is responsible for collecting and sharing the information of the standard cost calculation?

Standard Cost				
Direct Materials				
Ingredient per batch	Required		Price	Cost
Eggs	10	£	0.50	5.00
Milk	6 liter	£	1.00	6.00
Flour	3 kg.	£	3.00	9.00
				<u>£ 20.00</u>
Direct Labour				
Required per batch	Required		Wage	Costs
Chef	7 hours	£	4.00	28.00
Decorator	3 hours	£	12.00	36.00
	<u>10 hours</u>			<u>£ 64.00</u>

Budget preparations, important trade-offs

- Optimal decision making requires managers to fully reveal private knowledge about production and market conditions during budget negotiations.
- When budgets are also used for performance evaluation, managers have an incentive to make biased budget forecasts (to lie!) so that their actual performance will look good relative to budget.

Budget preparations, important trade-offs

If their actions lead to victory they all receive a higher rank.



To defeat the five enemy chariots we need information from our guys in the field.
With that information we can give them a budget.

Strategy

Ideal Budget:
Defeat 5 enemy chariots at a rate of 10 denarius (X-) per chariot.

Control

**Demand
for reliable
info**

I know how to defeat chariots.
I'm happy to share my expertise with the generals, but **they should give me a budget with sufficient resources.**



Operations



Participative budgeting (bottom up):

- The budgeting process depends on reliable information. Often the best information resides at lower level managers.
- Optimal decision making requires that managers truthfully reveal private knowledge during budget negotiations.

Sir! Defeating the 5 chariots is easy, sir. It will cost X- 50, ... sir!



Chariot commander, tell me how much funding you need to defeat the five enemy chariots.

Uh, oh. Telling the true requirement way not be smart. We may get less than we bargained for.

Top-down approach:

- Budgets are used to transfer information to individual decision makers in the organization.
- When budgets are also used for performance evaluation, **managers have an incentive to make biased budget forecasts** so that their actual performance will look good relative to budget.

We'll give you X-30. That's all we have. If you don't succeed, then you'll never become a general!



That budget is set too tight. The chariot commander will not feel motivated.

Sir, I object. With X-30, I can only defeat two chariots, sir!



See, he should have asked for X-80 at least!

If you do succeed you will be promoted to a higher rank.
It's up to you.

However, a budget of X-80 is wasteful and may not incentivize the chariot commander to preserve resources.

Conflict

- As more emphasis is placed on budgets and performance benchmarks ...
- managers will tend to report budget figures that are easy to achieve.



I took over command. I successfully negotiated with my superiors. They gave me a budget of X-75 to defeat 6 chariots.

I then managed to defeat 8!

That favourable variance will surely boost my career.

- Resulting behaviour: **under-promise and over deliver.**

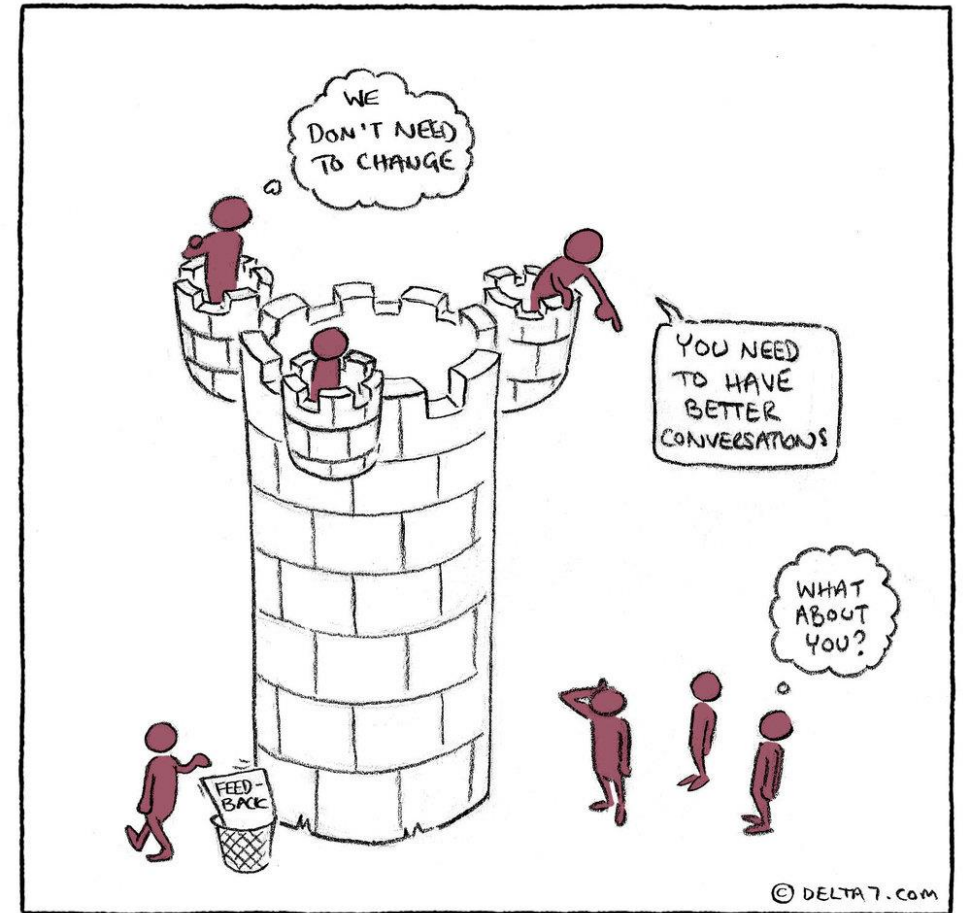
Consequences of poor budget systems

- Suppose you rely, for your planning, on a manager who deliberately under-promises.
- Your company will not be able to operate at full potential. (You lose)
- David will shirk. At the same time he will collect a reward for prompt and on-time delivery. (David wins)
- In fact, David receives a bonus for lying!
- Very inefficient.



Conflict and resolution

- In an authoritarian, top-down, style of budgeting,
 - senior management simply sets the targets and the budget for unit managers
 - unit managers have little say in the targets that are set.
- This may work if the top **really** knows best.
- In practice, however, the top does not always know best.
- Predictable consequences:
 - Employees are afraid and reluctant to share knowledge,
 - budgets reflect inferior information,
 - bad for planning and decision making,
 - bad for management control.



Conflict and resolution

- A participative, bottom-up, style of budgeting
 - targets and budgets are arrived at by a process of discussion and negotiation between senior management and unit managers
 - unit managers are seen to have had a say in the setting of targets and the budget
 - Superior information from managers reaches the top.
- However, once you start rewarding managers for meeting targets, they have an incentive to lie.
- Predictable consequences:
 - budgets reflect inferior information,
 - bad for planning and decision making,
 - bad for management control.



Conflict and resolution

- A solution:
 - Introduce *good cop, bad cop* system:
 - For example:
 - **CFO** as designated **good** cop. Managers will tell her the truth.
 - (facilitates planning and decision making).
 - **CEO** as designated **bad** cop. Will only take action when a CFO informs her/him about a manager's exceptional performance.
 - (facilitates managerial control).



ABOUT US

Conflict and resolution

- More solutions:
 - Use or establish units, systems, organisations that have no interest in biasing information.
 - Internal auditors, accountants, external auditors, actuaries, etc.
 - Risk management function within a bank.
 - Market research, such as Nielsen (pictured):
“Our approach marries proprietary Nielsen data with other data sources to help clients around the world understand what's happening now, what's happening next, and how to best act on this knowledge”
 - These systems are costly. Therefore, it is important to think carefully about their use.



DMP Consultants

You work in the finance department of a telecommunications firm with a large direct sales force selling high-speed fiber optics access lines to companies wanting telephone and Internet access. Your firm uses a top-down budget that sets the sales quota for each of its 180 salespeople. The salespeople are compensated based on a commission as well as a bonus whenever actual sales exceed their individual budgeted sales quota. Each salesperson's quota is estimated by senior marketing managers in the corporate office based on the size of each customer in that salesperson's geographic territory and projected growth of business in that territory.

DMP Consultants specializes in redesigning antiquated budgeting systems. DMP has made a presentation to your finance department after conducting a thorough analysis of your firm's sales force budgeting system. DMP Consultants has emphasized that your current budgeting system does not take advantage of what your salespeople know about future sales to their customer regions. By ignoring this information, your firm does not effectively plan for this growth, and you are at a competitive disadvantage when deciding to add capacity to your fiber optic network in a timely and efficient way. Moreover, DMP points to extensive research documenting that when people participate in setting budgets that are used to evaluate their performance, these people more readily accept the budgets and there is an increase in employee morale. That is, "participative budgeting" (where employees who are judged against the budget participate in setting the budget) results in happier, more motivated employees. DMP Consultants has made a proposal to implement a bottom-up, participative budgeting scheme to replace your top-down system.

You have been asked to write a short memo to the head of the finance department that analyzes the pros and cons of DMP's proposal.