

King Fahd University of Petroleum and Minerals

College of Industrial Management

Department of Accounting & MIS

ACCT 510: Managerial Accounting

MBA Program

Chapter 8 (Lecture notes)

Behavioral Aspects of Management Control Systems

Learning objectives:

- Explain the relationship between budgets targets, aspiration levels and actual performance;
- Differentiate between the planning and motivational aspects of budgeting;
- Explain the limitations of accounting information for performance evaluation;
- Distinguish between the three different styles of evaluating performance and suggest which styles is most appropriate;
- Describe the influence in the budgeting process;
- Explain budget bias and indicate the steps which can be taken to reduce the budget bias;
- Budgetary control and standard costing systems are essentially concerned with encouraging individuals within an organization to alter their behavior so that the overall aims the organization are effectively achieved
- Aspects of planning and control that influence human behavior include:
 - ✓ Setting of goals
 - ✓ Informing individuals what they must do to contribute to the accomplishment of organizational goals

- ✓ Motivating desirable performance
- ✓ Evaluating performance
- ✓ Suggesting when corrective actions must be taken

Human problems of producing budgets (Argyris, 1953)

- Budgets pressure tend to unite the employees against management
- The finance staff may feel that success can only be achieved by finding fault with factory people
- Feeling of failures among factory supervisors can lead to many human relations problems
- Supervisors frequently use budgets as a way of expressing their own patterns of leadership.

The use of budgets as targets

- Research studies provide evidence that the existence of a defined, specific, quantitative goal or target is likely to motivate higher levels of performance

If we accept the above conclusion (i.e. that the setting of targets can increase motivation), then what level of difficulty the targets should be set?

- Targets set above average are considered as difficult or high, and the those set below average are classed as easy or low

Research evidence:

- ✓ Setting specific difficult budget targets leads to higher task performance than setting specific moderate or easy targets (Stedry and Kay, 1966; Hofftede, 1968; Chow, 1983).

- ✓ The benefits arising from setting specific difficult budget target/goals are dependent on the level task uncertainty (Hirst, 1987). Hirst suggests that when task uncertainty is low, setting specific difficult budget goals will promote performance, and the subsequent use of difficult budget goals to evaluate performance will minimize the incidence of dysfunctional behavior, such as falsifying accounting information.

Conclusion:

- Targets must be accepted if managers are to be motivated to achieve higher levels of performance

Aspiration levels:

The relationship between budget levels, aspiration levels and performance.

Stedry (1960): found that formulation of a specific target improved performance, although the precise effect was determined by how the target influenced the participant's own personal goal or level of aspiration.

See Drury, p. 628-629.

The effects of budget levels on performance

Hofstede (1968)

- Budgets have no motivational effect unless they are accepted by the managers involved as their own personal targets

- Up to the point where the budget is no longer accepted, the more demanding the target the better the results achieved
- Demanding budgets are seen as more relevant than less difficult targets, but negative attitudes result if they are seen as too difficult
- Acceptance of budgets is facilitated when good upward communication exists. The use of departmental meetings was found helpful in encouraging managers to accept budget targets
- Managers' reactions to budget targets were found affected both by their own personality and by more general cultural and organizational norms.

Managerial use of accounting information in performance evaluation

Some dysfunctional consequences that occur with accounting measures of performance may not be due to the inadequacy of the performance measures, but rather may result from the way in which the accounting measures are used. The accounting information provided by an accounting system must be interpreted and used with care.

Hofstede (1968) found that stress on the actual results in performance evaluation led to more extensive use of budgetary information, and this made the budget more relevant. However, this stress was associated with a feeling that the performance appraisal was unjust. Too much stress on the results leads to a feeling of injustice, but too little stress leads to a budget being of little relevance and a poor motivational device.

Hopwood (1976) observed three distinct styles of using budget and actual cost information in performance evaluation in manufacturing division of a large US company:

1. Budget-constrained style: performance of a cost center is linked to meeting budget in the short-term

2. Profit-conscious style: performance is linked to ability in increase the general effectiveness of his unit's operations in the long-term.
3. Non-accounting style: accounting data plays a relatively unimportant part in the supervisor's evaluation of the cost center's head's performance.

Budgeting and Budgetary Control

A Budget: A quantitative expression of the money inflows and outflows that reveals whether the current operating plan will meet the organization's financial objectives.

Budgeting: the process of preparing the budget.

Planning and Control and the Role of Budgets

- Identify Organizational Objectives and Short-term Goals
- Develop Long-Term Strategy and Short-Term Plans
- Measure and Assess Performance against Budget
- Reevaluate objectives, Goals, Strategy and Plans

Benefits of the Budgeting

- Promote coordination and communication among subunits within a company
- Provide a framework for judging performance
- Motivate managers and other employees

Time Coverage of Budgets

Budgets typically have a set period, such as a month, quarter, year, and so on. The set period itself can be broken into sub-periods.

Overview of the Master Budget (see Exhibit 6-2- Lecture notes)

- Operating budgets: summarizes the level of activities such as sales, purchasing, and production, labor, Marketing and administration.
- Financial budgets: Those budgets that identify the expected financial consequences of the activities summarized in the operating budgets e.g balance sheets, income statements, and cash flows statements, identify the expected financial consequences of the activities summarized in the operating budgets.
 - To plan when excess cash will be generated so that it can be used to make short-term investments rather than simply holding cash during the short period
 - To plan how to meet cash shortages

Static Budget (Fixed Budget): It is the original budget set for a planned level of operations; once it is set it will not change (Exhibit 7-2).

Flexible Budgets: A flexible budget calculates budgeted revenues and budgeted costs based on the actual output in the budget period.

Variance Analysis: A set of procedures managers use to help them understand the sources of variances.

Variance: the difference between an actual amount and a target or planned amount.

First-Level Variances: Difference between the actual costs and the master budget costs

Decomposing the variances:

- Flexible budget variance: Reflects a cost target of forecast based on the level of volume that is actually achieved
- Planning variance: The difference between the planned and flexible budget amount for some item.
 - o Flexible variances
 - o Material quantity variance
 - o Material efficiency variance
 - o Wage Rate variance
 - o Labor efficiency variance

Cash Budgeting

- Cash Budget: is a schedule of expected cash receipts and disbursements. It predicts the effects on the cash position at the given level of operations
- Cash budgeting is critical for cash planning and control
- Cash budgeting helps in planning for dealing with cash surplus (idle cash)
- Cash budgeting helps in avoiding cash deficiencies

Preparing the cash budget

Forecasted Cash Receipts:

- Cash sales

- Collection from customers (Receivables): note for the terms of credit sales, collection pattern, discounts, bad debts.
- Issuance of shares or bonds
- Rental or receipts of royalties
- Bank loans

Add beginning cash balance = Total cash available before financing

Forecasted Cash Disbursements:

- Direct materials purchases. Note for credit purchasing terms and pattern of cash payments, discounts
- Direct labor and other wage and salary payments
- Others e.g. rent, insurance, sales commission etc.
- Ignore depreciation, amortization, and depletion as they are not cash outflows
- Interest on long-term borrowing
- Outlays for property, plant and equipment

Short-term financing requirements

Ending balance of cash