

Hopwood claims that there are three styles of management evaluation using budgets. Discuss these (using illustrations) and some of the dysfunctional effects of using budgeting control systems in large organisations. Comment on why you think budgeting is prevalent in organisations despite these consequences.

Budgets are one of the most frequently used devices for planning and controlling organisations. They are designed and used to provide management with a forward-looking perspective, with which they are able to exploit opportunities and anticipate future problems. A budget itself can be described as a quantitative expression for a set time period of a proposed future plan of action by management.¹ Budgets are used both as co-ordination mechanism, helping to co-ordinate efforts throughout the sub-divisions of the company and also as a motivational device as it provides incentives for correct action. However budgeting is a major feature of most management control systems and is widely used as a control tool for the following reasons: It provides a benchmark for activity and performance evaluations and it helps to analyse the consequences of particular actions and provides the necessary feedback to the initial plan. For instance, with regards to performance evaluation, budgets are used to provide lower-level managers with well-specified targets (feed-forward) and provide higher-level managers with information about the extent to which those targets have been met (feedback).

One of the principle ways in which senior managers motivate others managers and their employees towards effective performance is by linking organisational rewards to the level of their performance. The impact, which any accounting system has on managerial and employee behaviour, is dependent not only upon its design and technical characteristics but also upon the precise way in which the information is used. It would seem obvious that even a very sophisticated system would be of little efficiency to the company if the information is ignored. According to Hopwood there are three distinct styles of management evaluation using budgets: A budget-constrained style, a profit conscious style and a non-accounting style. The nature of the three styles is applicable to many situations, for the purpose of this essay, however, the following definitions give particular consideration to the use of accounting reports which show the actual and budgeted costs for a cost centre and the difference between them.

The Budget Constrained Style. This method of evaluation primarily adopts a short-term based evaluation of performance. It uses accounting information as a comprehensive measure of managerial performance. The criterion of performance is stressed at the expense of other valued and important criteria and the manager will receive unfavourable feedback from those above him if targets are not met. For instance if actual costs exceeded budgeted costs or if profits were well below those forecasted.

The Profit Conscious Style. This focuses on the aspects of performance that are, in the long run, more desirable to the organisation. If this style is adopted the managers performance is evaluated on the basis of his ability to increase the overall effectiveness of

¹ Horngren et al p.487

his department in relation to the long-term purposes of the organisation. However, in this case budgetary information must be used with great care, rather than in a flexible manner.

The Non-accounting Style. This is treated in Hopwood's classification as a residual category in which a low priority is accorded to accounting information in the context of performance evaluation². Many managers view this style as relatively unimportant.

Budgetary reports not only have to be used with care but also reinforced by other information, so that the manager's impact on the future (as well as on current operations) can be assessed. The budget constrained style is merely concerned with behaviours that can be measured, even if these measures are not desirable by the company. In contrast, the profit conscious style is concerned with behaviours that are desirable from a wider organisational perspective. The profit conscious style of evaluation is also concerned with the information content of the budget reports, not just with the strict analysis of the direction and magnitude of reported variances.³ In other words, the budget is seen to be a means to an end as opposed to an end in itself. Accounting reports show how effectively a manager has been in meeting his targets, however they do not show whether or not that manager is trying to reduce long run costs or whether or not his efforts are influencing any other determinants of effectiveness. Non-financial records and personal observations can be used in assessment as well as budgetary reports, but one must use their social skills to gain the insights and experience of his colleagues. With this in mind, it may be possible to state some of the conditions under which a more meaningful distinction between the budget constrained and profit conscious styles can be made: Firstly, the less important economic aspects of performance are to organisational effectiveness, the more the styles will differ. Secondly, they will tend to diverge when not all of the relevant costs are taken into account by the organisation's accounting system and when that system includes incorrect costing. Finally, in light of the last two conditions, the distinction may be influenced by the frequency of reporting deviations from the budget.⁴ (It is possible that inaccuracies will cancel each other out over time, however the period of time may exceed that which is required for regular feedback and control). Because the non-accounting style is a residual category, it implies a low relative importance and is hardly used for reporting or any other purpose. Hopwood (1973) claimed that this style could contain the following sub-categories:

1. A relative neglect of the accounting information where it is potentially relevant for assessing performance and managing the task.
2. A relative neglect of the accounting information where it is not very useful for assessing performance and managing the task
3. A relative neglect of the accounting information in performance evaluation but a use of the information in decision making and less evaluative feedback.

However, it can also be said that this style may well include the most interesting approaches to the use of accounting information and some promising means of improving practice.

² Ezzamel and Hart, p349

³ Hopwood, A , p. 111

⁴ Hopwood, A, p. 20

There are, however, some dysfunctional effects of using budgeting control systems in large organisations. Each of these specific styles have their own specific behavioural implications. The budget constrained style has resulted in a general consensus that the methods of evaluation are unjust. This is because the superior will view accounting information as a complete, unbiased indicator of managerial competence. However, if an employee perceives the same information to be biased or inaccurate, then disagreements between manager and employee are likely to be strong. The employee may see non-accounting information as being significantly relevant to his performance. Moreover, given a budget constrained style the imperfections in accounting information are likely to cause greater uncertainty in the employee's task environment. The presence of task and behavioural interdependencies would disguise the link between effort and performance. In this way, the employee can never be sure of the increased effort on performance; accounting measures fail to reflect in full the effects of interdependencies.⁵ Ridgeway (1956) has characterised this style as being susceptible to dysfunctional behaviour. It is also said that the budget constrained style can create various widespread tensions throughout a company for both managers and their employees. For instance, it is common for employees to feel like their performances are not properly evaluated and that the pressure to stay out of the red is unbearable. Such frantic and, at times, unsuccessful attempts only result in more problems, more tension and more worry.

In his analysis of a manufacturing division of one large American Company, Hopwood (1973) claims that, when the budget constrained style was employed, he "found manipulation of the accounting reports and people were making less innovative decisions, that at times, increased the total processing costs for the company as a whole. Costs were charged to incorrect accounts and repairs were delayed until money was available in the budget, in spite of this resulting in higher costs".⁶ However, manipulation and undesirable decision behaviour are not the only effects of using budgeting control systems in large organisations. Since performance evaluations are an important aspect of the development and maintenance of a person's self-esteem, disagreements and so-called "fiddling" of the accounts are most certainly capable of resulting in anxiety. However, even in cases where a manager excels himself in his performance, this can be overshadowed by other people. For instance, prior departments can send poor quality materials, allocated costs can unexpectedly change or an urgent order can mean unscheduled overtime. This is true even when using the profit conscious style. However, with this particular style it is costs that are the focal point. Employees can feel a great amount of pressure to keep costs low or to try and eradicate them completely. Because budgeting focuses upon measurable, quantitative elements of a situation, other elements may be ignored. Budgets may have the effect of making managers concentrate on only the economic interpretations, stifling the possibility of new and innovative interpretations.

Despite the varied dysfunctional effects shown above, budgeting is still prevalent in large organisations. This is because it provides a framework in which managers can plan and control the future of the organisation. Budgeting provides co-ordination and

⁵ Ezzamel and Hart, p.350

⁶ Hopwood, A p.112

communication within an organisation. Co-ordination forces executives to think of relationships among individual organisations, departments and the company as a whole. Hopwood's Budget constrained style does not agree to this effect, as relationships under this form of evaluation relationships tend to break down. For co-ordination to succeed, communication is essential. Having a formal document such as the budget is an effective way to communicate a consistent set of plans to the organisation as a whole.

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