

Reasons behind contemporary use of budgets

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‘Strategic learning among the workforce must replace control. Management reviews will need to shift from interrogations about ‘Why did you miss your target?’ to ‘What did we learn to explain why we have a performance gap?’
(Cokins, 2004)

The word ‘control’ is an ambiguous concept. There are two main streams of connotation, one emphasizing ‘*domination of one individual or group by another through the exercise of power*’ and the other stressing ‘*the idea of regulation and the monitoring of activities*’ (Otley and Berry, 1980). While the first strand of meaning appears to be more closely related to informal dimension of control, the second one is connected to formal, more mechanical controls through rules and standards.

The distinction between informal and formal controls has long been emphasized in the literature (Perrow, 1970, Ouchi, 1979, Mintzberg, 1983). Formal controls include such bureaucratic mechanisms as direct supervision, standardization of processes and standardization of outputs (for example performance measures or budgets) (Mintzberg, 1983, Anthony and Govindarajan, 2003). On the contrary, informal controls embrace clan control (control through socialization and group power) (Perrow, 1970, Ouchi, 1977, 1979, Merchant and Van der Stede, 2003), mutual adjustment through informal communication (Mintzberg, 1983, Anthony and Govindarajan, 2003), selection policies (Perrow, 1970, Merchant and Van der Stede, 2003), personnel training (standardization of skills) (Mintzberg, 1983, Perrow, 1970, Merchant and Van der Stede, 2003), management style (Brownell, 1983, Anthony and Govindarajan, 2003) and culture (Anthony and Govindarajan, 2003, Rogers, et al, 2006).

Otley and Berry (1980) claim that control theorists fail to detect the difference between human organizations and other systems. The corollary is that inappropriate control models are proposed. For example, in the cybernetic systems’ perspective organization is compared to a thermostat. In this model of control objectives are predetermined and then performance is measured against these objectives; action is taken when deviation from the objectives occurs (Boulding, 1956, Scott, 1992). The budgetary process in organizations fits very well within this model of formal control. However, this approach is somehow problematic. The crux of control is to ensure that objectives of an enterprise are met and employees ‘behave in the best interest of a company’ (Otley and Berry, 1980, Anthony, 1965, Ouchi, 1979, Merchant and Van der Stede, 2003). However, the biggest problem inherent in organizational control is possibly that unlike in the case of the thermostat, where the desired temperature is easily decided on and easily set, in organizations, what is the best for each company is very often ambiguous and subject to change. It is arguable whether control systems in organizations are able to change accordingly. For example, the inability of traditional annual budgetary control to quickly adapt to changes is the main argument of its opponents. Interestingly, the term ‘management control systems’ is more often replaced by ‘performance measurement/management’ in management accounting research studies (Otley, 2003). The question that arises is to what extent is it possible to exercise control in contemporary organizations and by what means? What are the roles of formal and informal controls? Understanding how different organizations actually go about controlling their activities would be beneficial for theory development (Otley and Berry, 1980).

There is a generally accepted proposition stemming from the contingency theory that organizations should adapt their control models to numerous contextual factors such as the operating environment (what they do and how they do it), organizational structure (including size), organization strategy and external environment (Hansen and Van der Stede, 2004). Hence, various organizations place different emphasis on the use of different types of controls. On the whole, it has been proven that in industries with lower pace of environmental change formal

controls will dominate over informal controls (Burns and Stalker, 1961). Budgets are recognized as important formal control tools (parts of management control systems) (Anthony and Govindarajan, 2003, Simons, 2000, Merchant and Van der Stede, 2003, Hongren, et al, 2002). They are believed to be best suited to mechanical companies, in which processes of transforming input into outputs are well known and organization work is relatively uncomplicated (Perrow, 1970, Mintzberg, 1983).

However, lately budgets have been heavily criticized by practitioners who suggest that budgets bring more costs than benefits irrespective of the settings (Hope and Fraser, 2003, Marshall, 2003, Neely, et al, 2003). The costs of budgeting systems not only include financial burden of lengthy budgetary processes but also negative influences on a company's culture, resulting in undesirable or unethical behavior of organizational members who are forced to deliver financial outcomes beyond their control (Hope and Fraser, 2003). The worldwide think tank, the Consortium for Advanced Manufacturing, through its Beyond Budgeting Roundtable (BBRT), is nowadays calling for abandonment of budgeting. Budgets are criticized for being out of kilter with the competitive environment (Hope and Fraser, 2003). The main argument is that in the age of discontinued change companies cannot afford to be locked into a rigid 'plan-make-and-sell' business model inherent in budgeting (Hope and Fraser, 2000). Budgets are 'fixed performance traps' because the budgeting process brings about commitment towards resources, actions and rewards. This commitment is made for the following year, which is far too long a period to ensure flexibility. On the contrary, in a 'beyond-budgeting' model line managers are empowered and encouraged to change the plans when new opportunities and threats emerge (Hope and Fraser, 2003).

New and advanced techniques are now available as potential replacements to budgets. For example, the Balanced Scorecard not only concentrates on financial dimensions of performance but also takes into account non-financial ones. This is achieved through incorporation of 'customer', 'learning and growth' and 'internal efficiency' perspectives. Sensitivity analysis and simulations provide feedforward control and rolling forecasts assist in managing the working capital for solvency purposes. However, although potential replacements exist, budgets are still widely used as control tools in companies worldwide. Understanding whether the critique of budgets is viable in all cases, as suggested by the proponents of the 'beyond-budgeting' approach, is vital. Academia is starting to respond to this critique of the budgeting systems (Ekholm and Wallin, 2000). The aim of the paper is to propose the way in which the critique of budgeting could be addressed.

First of all, the central concern of researchers trying to approach the critique of budgeting should be the roles of budgets, i.e. what roles budgets play and more importantly how. Different sources of knowledge (including both textbooks and empirical research) present different the researchers with different roles of budgets (Hansen and Van der Stede, 2004). The roles most often quoted are: intended strategy operationalization (Anthony and Govindarajan, 2003, Merchant and Van der Stede, 2003, Hongren, et al, 2002, Simons, 2000) allowing assessment of the strategy and resource allocation (Mintzberg, 1983, Hansen and Van der Stede, 2004, Walker and Johnson, 1999, Merchant and Van der Stede, 2003, Hongren, et al, 2002), coordination and communication (Anthony and Govindarajan, 2003, Hongren, et al, 2002, Merchant and Van der Stede, 2003), learning and strategy creation (Simons, 1990, 2000, Shields and Young, 1993), performance evaluation (Mintzberg, 1983, Hongren, et al, 2002, Anthony and Govindarajan, 2003) and motivation, mainly through reward systems based on budgeting (Govindarajan and Gupta, 1985, Walker and Johnson, 1999, Mintzberg, 1983). Institutional theory also proposes interesting explanations of roles of budgets. It stresses the importance of formal organizational structure, processes, rules and routines (like budgeting) in bringing order, security and minimizing

uncertainty experienced by boundedly rational and self-interested individuals (Covaleski, et al, 2003, Marginson and Ogden, 2005). Budgets, when used in a participative way, could also play the role of creating a culture of democracy (Shields and Young, 1993), or rather legitimizing organization by construction of an appearance of democracy (Covaleski, et al, 2003, Carruthers, 1995).

So far, the role of performance evaluation has been the most attention and research, while other roles of budgets have been given less interest (Hansen and Van der Stede, 2004, Hartmann, 2000). Lots of prior studies have focused on the behavioural and organizational effects of budgetary controls in the context of budgets use for performance evaluation (Hansen and Van der Stede, 2004, Hartmann, 2000, Marginson and Ogden, 2005). Research on this topic has been labelled 'Reliance on Accounting Performance Measures' (RAPM) (Hartmann, 2000) and it is claimed to be the only *'organized critical mass of empirical work in management accounting at present'* (Brownell, Dunk, 1991, as quoted in Otley, Pollanen, 2000). Budget emphasis in evaluating employees and its effects on job related attitudes is the central concern of this stream of research.

In fact, other than performance evaluation (in conjunction with budget emphasis) roles of budgets should also be scrutinized. This is vital because the current theory is often detached from empirical findings. For example, while 'strategy implementation' and 'strategy creation' are the roles very often quoted by academics, an empirical survey shows that 60 per cent of companies do not link their budgets to strategy (Kaplan and Norton, 2001). Hope and Fraser (2003) present a critical view on budget-strategy link and suggest that usually there are no plans beforehand and only at the time when budgets are created do companies make commitments to actions and resources for the following year. Hence, the only way to respond to the critique of budgeting is to show how budgets are used to fulfil certain roles.

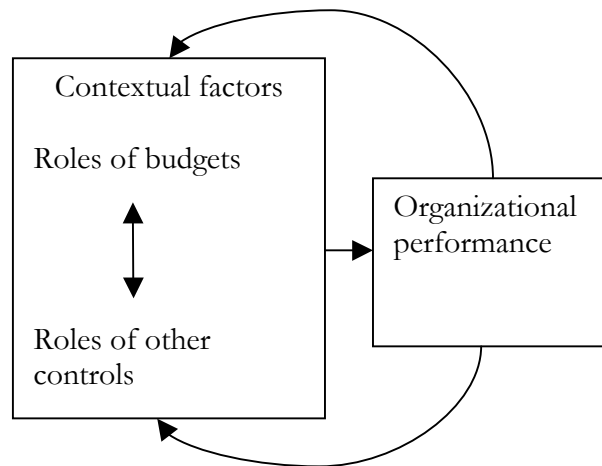
Secondly, the use of budgets should be analyzed in settings in which budgets have been so far theoretically deemed useful, so that theoretical modifications could be achieved through findings contrary to existent theory. Relatively slowly developing mature industries, in which processes of transforming inputs into outputs are relatively easily analyzed constitute ideal settings.

Thirdly, criticism towards budgeting research often points at the fact that budgets are analyzed by detachment from a broader control framework, encompassing other elements of control such as informal controls or integrative mechanisms (Chenhall, 2003, Hansen, et al, 2003, Otley and Berry, 1994). Can certain roles of budgets be better pursued by other elements of management control systems? There is no sufficient knowledge about whether and how combinations of controls can result in increased effectiveness in given circumstances (Chenhall, 2003, Hansen, et al, 2003, Ittner, Larcker, 2001).

The wider control framework embraces informal controls and other formal controls. When it comes to informal controls, what could be investigated is the interplay between budgets and culture. While some academics claim that budgets used in participative way create culture of democracy (Shields and Young, 1993), the opponents of budgeting suggest that budgets inexorably result in culture of inertia. Budgets block empowerment initiatives and in this way cause the company to forgo the opportunity to release energy and imagination of thousands of front-line employees (Hope and Fraser, 2003). The influence of budgets on culture and vice versa could be an interesting research topic. Investigation of the interplay between budgets and informal controls could rely on analysis of the roles played by the controls. Informal controls can seize some roles of budgets. For example, reduced role ambiguity and communication could be achieved by a certain management style and culture of 'passion and energy', 'desire to win' and 'desire to beat the competition' (Rogers, et al, 2006) could result in intensified search for

improved strategies by organization members. The same naturally applies to other formal controls. For example, rolling forecasts seize the role of operational planning, i.e. translating strategies into numbers and defining resource requirements. The challenge for researchers trying to address the critique of budgets is to develop understanding how certain roles played by budgets or seized by other controls result in enhanced performance.

The general proposition based on contingency theory is that the ‘interaction fit’ between control system and contextual factors will cause improved performance (Luft, Shields, 2003). Certain confusion stems from the fact that it is possible that also the organizational performance affects the design of the control system (Chenhall, 2003, Van der Stede, 2000). It makes causal relationships more difficult to discover. The theoretical framework for studying the use of budgets is suggested below:



It is crucial to recognize that certain roles fulfilled by budgets, although strived for by individuals in an organization, do not necessarily increase company’s performance. For example, Marginson and Ogden (2005) claim that positive perspective on budgets has been neglected in previous research. The authors point at ‘decreasing role ambiguity’ as an under-researched positive role of budgets and they investigate how this role is fulfilled. Role ambiguity occurs ‘when an individual is unsure about others’ expectations of him- or herself’ (Marginson and Ogden, 2005). It can be caused by empowerment, which gives lower management more freedom but also breaks ‘the chain-of-command’ characteristic of formal hierarchical structures (Bartlett and Ghoshal, 1993, King and King, 1990). The proposition is that when managers experience high role ambiguity, budgets are a source of structure and certainty, therefore creating commitment of managers towards meeting them. As positive organizational identity is gained through meeting budget, budgets prove to be beneficial for individuals in a company. However, whether this role can therefore be called as ‘positive’ is arguable. Hope and Fraser (2003) argue that this false security results in organizational inertia and inflexibility of adapting to opportunities and threats as they occur. The corollary is that decreasing role ambiguity should be reached by other controls.

A good question that arises is what methodological approach to choose in order to address the critique of budgets. The central concern should be to understand how different companies go about controlling their activities (Otley and Berry, 1980, Walker and Johnson, 1999) and to concentrate on the roles of budgets, i.e. how budget and other controls are used to fulfill certain roles. It seems that qualitative methods are more suited for such a research. For example, the case based research is suited to answer ‘how’ and ‘why’ questions and leads to more in-depth analysis than quantitative methods (Yin, 2003).

A possible research strategy is to choose a case company in an industry theoretically considered as best suited for budgetary control, for example a mature multinational manufacturing company. Analysis could then be performed on a business unit level. If business units' managers manage the units as independent profit centers, i.e. differentiation as opposed to integration (Lawrence and Lorsch, 1967) is emphasized, then, although different plants could face similar settings, control systems could differ, giving a fruitful area for comparisons.

To summarize, an interesting question is how can control be exercised in contemporary organizations and what are the roles of formal vs. informal controls? The critique of budgetary control by practitioners should be approached, especially in the settings in which it has so far been theoretically deemed useful. One should question the assumptions about roles that budgets play in contemporary organizations because empirical findings suggest that roles most often quoted are no longer fulfilled (Hope and Fraser, 2003). Investigating the interplay between roles of budgets and roles of other controls pose fruitful research opportunities and since an in-depth analysis of budget use is recommended, qualitative methods are seen as appropriate.

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