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EXECUTIVE DIGEST

Budgets and other lies: Evidence of bias in financial planning

Ron Messer

School of Business, Kwantlen Polytechnic University, 12666 72 Avenue, Surrey, BC, Canada

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Abstract Budgets are considered by many to be a necessary evil. Within organizations, budgets are used to allocate financial resources to individuals who are charged with managing funds. This allows them to accomplish corporate goals and objectives. When reviewing the differences between actual and planned spending for a number of cost centers evidenced in data covering a 4-year period, it was noted that favorable variances exceeded unfavorable ones more than 50% of the time, although probability suggests that favorable and unfavorable results are equally likely to occur. As budgets are only best guesses about the future, these results indicate that planned spending was intended to manage uncertainty. In other words, the budgets were intentionally misstated—that is, they were lies. This Executive Digest explores ways of uncovering these lies. The consequences of intentional misstatement of planned spending are serious. In such cases, financial resources are not only misallocated, but also allocated in a suboptimal way. This means that future borrowing costs may increase, important projects could be delayed, and necessary operating expenditures are not made.
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1. Your budget tells a story

> *"Never base your budget requests on realistic assumptions, as this could lead to a decrease in your funding."*
>
> — Scott Adams, creator of Dilbert

There are few things more certain in business than budgets and taxes. Taxes are imposed by focus outside the company; however, budgets are inflicted from within. A budget is many different things, depending on one's perspective. Some see it as a tedious chore that needs to be done (or nothing will get done because there will not be any money to do it). Others see it as an opportunity to plan and prioritize their activities for the coming year. At its most basic level, a budget is a tool for modifying behavior inasmuch as it tells people important information about you, such as where you spend your money and how much you have to spend. By monitoring and controlling someone's spending you can influence not only what they do, but also how they do it. Budgets are also a bunch of lies; no one can know with certainty what they will spend next year, or even tomorrow for that matter. For this reason, people make educated guesses about

E-mail address: ron.messer@kpu.ca

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how much they will need to do the things they have to do. Managers usually know that their guess will be wrong and consequently add a little extra, just to be sure (i.e., lie). In this way, confusion arises between what they expect to happen and what is most likely to happen. For example, simply saying that you expect inflation to increase your operating costs does not mean that this is likely (or even probable).

Since budgets tell others so much about us—and because we all want to look good—we stretch the truth (i.e., tell a bigger lie), which creates a big problem. If an organization uses its budget for business planning, then its usefulness is seriously eroded if the information is, at the outset, knowingly incorrect. If bad information goes in, then bad information comes out on the other end, informing bad decisions. Budgets are developed to help achieve corporate goals and objectives and should be based on the company's strategy. By using funds to achieve strategic goals and objectives, the activities of cost center managers can be monitored and measured.

Managing a budget follows its development. Consider, for example, a cost center manager who must ensure that spending is in line with the financial plan that has been drafted. The estimate of planned activity will likely be based on last year's actual results, adjusted for expected changes in the coming period. Because the future is unknowable, it is expected that cost center managers will spend more than their budget allocation approximately half of the time. This means that an analysis of cost center results should show favorable variances about 50% of the time and unfavorable outcomes in the other 50% of situations. If this is not the case, it suggests that the budgets do not, in fact, represent a true estimate of probable outcomes (i.e., they have been 'fudged'). Previous studies have called this type of behavior *budget gamesmanship* (Bart, 1988). For most companies, analyzing budget variances is a monthly exercise that is essential for proper financial management. Comparing actual performance with planned activity is an important management control. Favorable results typically receive relatively little scrutiny by senior executives; but unfavorable outcomes—sometimes regardless of magnitude—are viewed as a cause for concern. Budgets influence behavior by providing incentives to responsibility center managers that encourage good performance. It is not surprising that budgets are used by these same managers to influence expectations and that this is done by managing the truth. But expectations and probabilities are two very different things, as shown by the results of this investigation.

The analysis that follows compares actual spending with planned spending for a number of cost centers used by a company. The data is taken from the financial results of an active enterprise over a period of 4 years. The entity examined operates in the transportation sector and has hundreds of millions of dollars in revenue and expenses; its asset base is in excess of $1 billion. The company has operated profitably since its inception, having never recorded a loss. To manage its spending, about 60 cost centers are used (the number of cost centers utilized varies by year, depending on the needs of management). The data is analyzed from two perspectives: by cost center and by type of operating expense. Total planned spending by cost center is exactly equal to total planned spending by type of operating expense.

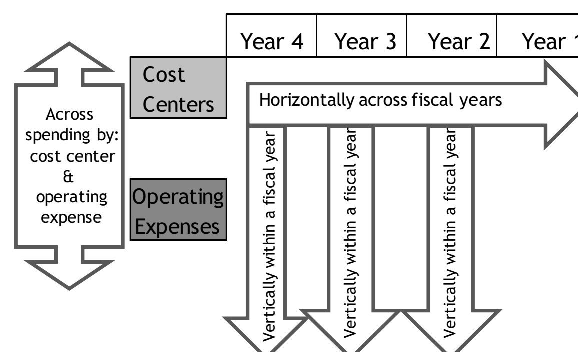
In this company, budgets are created for a number of responsibilities and these are aggregated at the level of the vice president—for example, the vice president of engineering or the vice president of operations. At a corporate level, variances are reviewed monthly by the senior management team, comprised of the CEO and the vice presidents. Top-level responsibility is assigned to each of the vice presidents and, in turn, they hold subordinates accountable for spending in their individual areas.

2. Evidence of bias

The analysis that follows is presented along three dimensions (see Figure 1).

- Vertically, favorable and unfavorable variances are analyzed by cost center and type of operating expense within a fiscal year.
- Horizontally, favorable and unfavorable variances are examined across fiscal years, again by cost center and type of operating expense.

Figure 1. Vertical, horizontal, and cross-sectional analyses of variances



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