



Using negotiated budgets for planning and performance evaluation: An experimental study [☆]



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ABSTRACT

Budgets are often simultaneously used for the conflicting purposes of planning and performance evaluation. While economic theory suggests that firms should use separate budgets for conflicting purposes this contrasts with existing evidence that firms rarely do so. We address two open questions related to these observations in an experiment. Specifically, we investigate how a planning task that is in conflict with the performance evaluation task affects behavior in budget negotiations and their outcomes. Additionally, we analyze whether a single budget can be effectively used for both purposes compared to two separate budgets. We develop theory to predict that adding a planning task that is in conflict with the superior's performance evaluation task increases the subordinate's cooperation in and after the negotiation of a performance evaluation budget. Moreover, we predict that subordinate cooperation increases even more when the superior is restricted to use a single budget for both purposes. Our results broadly support our hypotheses. Specifically, we find that when budgets are used for both planning and performance evaluation, this increases the subordinate's budget proposals during the negotiation and his performance after the negotiation. These effects tend to be even larger when the superior is restricted to a single budget rather than separate budgets for planning and performance evaluation, particularly with respect to subordinate performance. In our experimental setting, the benefits of increased subordinate cooperation even more than offset the loss in flexibility from the superior's restriction to a single budget. The results of this study add to the understanding of the interdependencies of conflicting budgeting purposes and contribute to explain why firms often use a single budget for multiple purposes.

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Introduction

Budgeting is one of firms' most important coordination and control mechanisms (Luft & Shields, 2003; Merchant & Van der Stede, 2011). Usually, budgeting functions are described as (1) operational planning and coordination, (2) motivation and performance evaluation, and (3) goal communication and strategy formulation (Atkinson, Kaplan, Matsumura, & Young, 2011; Horngren, Datar, & Rajan, 2011). Thus, budgeting functions encompass both decision-making and control-oriented purposes of management accounting information. As these purposes often

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conflict (Hopwood, 1972; Libby & Lindsay, 2010; Sprinkle, 2003), budget-setting can present firms with major challenges.

Our study investigates how a planning task that conflicts with the performance evaluation task affects behavior in budget negotiations and their outcomes. In our setting, the two tasks are in conflict because the need to provide subordinates with sufficient financial incentives counters the need for accurate planning and, thus, the two budgets should be set to different levels. We further analyze whether a single budget can be effectively used for the two conflicting tasks as opposed to a separate budget for each task because this restriction may cause more cooperation in and after the budget negotiations.

Surprisingly little is known about the simultaneous use of budgets for different purposes and the conflicts arising from their interaction (Sprinkle, 2003). Prior literature suggests that the budgeting purposes are not determined independent of organizational characteristics (e.g., Moores & Yuen, 2001) and Shields and Shields (1998) find that uses of budget participation for decision-making and control-oriented purposes are caused by different antecedents. However, most prior studies have focused on performance evaluation in isolation and have analyzed managers' slack creating incentives (Brown, Evans, & Moser, 2009; Shields & Shields, 1998; Sprinkle, 2003).¹ Only recently have studies begun to more closely analyze interactions between budgeting functions. For example, research suggests that flexible budgets may be beneficial for planning but detrimental for performance evaluation (Arnold & Artz, 2015; Ekholm & Wallin, 2011; Hansen & Van der Stede, 2004). Additionally, increased budget difficulty may help with performance evaluation but hurt the communication function of budgets (Hansen & Van der Stede, 2004). In contrast, positive externalities may arise when a firm combines the resource-allocation and performance-evaluation functions because a subordinate's monetary incentives to compete for resources can counteract his monetary incentives to create slack arising from performance evaluation (Fisher, Maines, Pfeffer, & Sprinkle, 2002).

While the conflict between different budgetary purposes has been analyzed from an economic perspective (e.g., Baiman & Evans, 1983; Christensen, 1982) little is known about their behavioral effects beyond monetary incentives. Our study aims to contribute to the understanding of the effects of budgets used for performance evaluation vs. performance evaluation and planning. Fisher, Mitchell, Pfeffer, and Webb (2014a) investigate subordinates' budget reports when the superior has a planning task and, in addition to the division's net profit, receives payoffs from accurate forecasts. They find that subordinates make higher cost reports when they become aware of the superiors' additional payoffs from increased accuracy but do not participate in them. In a related paper, Fisher, Mitchell, Pfeffer, and Webb (2014b) analyze how a superior's reliance on cost reports and her planning task performance depend on her

monetary incentives for planning accuracy when the subordinate is not aware of the superior's planning task. However, as in their research setting, the subordinate unilaterally determines the cost budget they do not investigate budget negotiations. Moreover, as the superior has no authority in determining the performance evaluation budget, planning and control are unlikely to be perceived as conflicting tasks for the superior in their setting.

In our setting, the budgeting purposes of performance evaluation and planning are in conflict from the superior's perspective because the need to provide subordinates with sufficient incentives to expend effort counters the need for accurate planning. We compare a condition with only a performance evaluation task to two conditions with an additional planning task. In all three conditions, superior and subordinate negotiate over the budget that is used for performance evaluation. In the first planning condition, the superior can set a separate second budget for the planning task after the negotiation over the performance evaluation budget. In the second planning condition, the superior is restricted to use a single budget for both tasks, i.e., the planning budget automatically equals the performance evaluation budget. As we focus on the subordinate's motives beyond monetary incentives, the subordinate's compensation function is never affected by the superior's planning task.

Because performance evaluation and planning are in conflict, budgets should be set to different levels in our setting, and so a single budget cannot be used for both tasks optimally. The superior therefore should be better off when she can use separate budgets unless this entails significant additional costs (Baiman, 1982; Barrett & Fraser, 1977; Churchill, 1984; Hopwood, 1972). This implication, however, contrasts with empirical evidence (Merchant & Manzoni, 1989; Umapathy, 1987) that firms rarely use different budgets for different purposes.

We develop theory to predict that with the additional planning task, the subordinate is likely to perceive that the superior has a more complex task and to have an increased interpersonal accountability to the superior, and that this makes the subordinate more cooperative in the budget negotiation. We further predict that increased subordinate cooperation extends to subordinate behavior after the negotiation, leading to an increase in subordinate performance in the presence of a planning task, particularly after negotiation impasse. Finally, we also develop theory to predict that the superior's restriction to a single budget can further increase the subordinate's cooperation during and after the negotiation.

In our experiment, participants assume the role of either a superior or a subordinate and negotiate a budget target for the subordinate's performance evaluation. After the negotiation, subordinates perform a real-effort task. The experiment uses three settings: a baseline setting where performance evaluation is the sole purpose of budgeting, a setting with separate budgets for planning and performance evaluation, and a setting with a single budget for both tasks. In the separate-budgets condition, planning is operationalized by making the superior forecast the subordinate's actual performance. In the single-budget condition, the performance evaluation budget simultaneously

¹ Govindarajan (1986) measures both decision-making and control dimensions of budgeting but collapses them into a single measure of firm performance.

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