

3.1 Budgeting

Agency Problem → conflicts between employees and owners based on their self-interest to earn a profit

Necessary Conditions: *employees have decision rights, private information, and motives that differ from that of owners*

How Owners Deal With This Problem

- Develop plan (budgeting)
- Compare performance to the budget (variance analysis)
- Employee incentives
- Evaluate employee performance

Budgets → detailed quantitative plans for acquiring and using resources over a specified future period of time

Advantages of Budgeting:

1. *Communicate plans to employees*
2. *Discipline managers to think about and plan for the future*
3. *Means for allocating resources*
4. *Uncover potential bottlenecks*
5. *Coordinate activities by integrating plans of various areas*
6. *Define goals and objectives that serve as performance benchmarks*

Three Features of Budgets

- Planning
- Control
- Motivation

Budget Slack → employee's intentional under-state their performance capabilities or they over-state the resources they need (negative effects on planning, control, and motivation)

Participation + Budget-Based Incentives = Opportunity & Financial Incentives To Generate Budget Slack

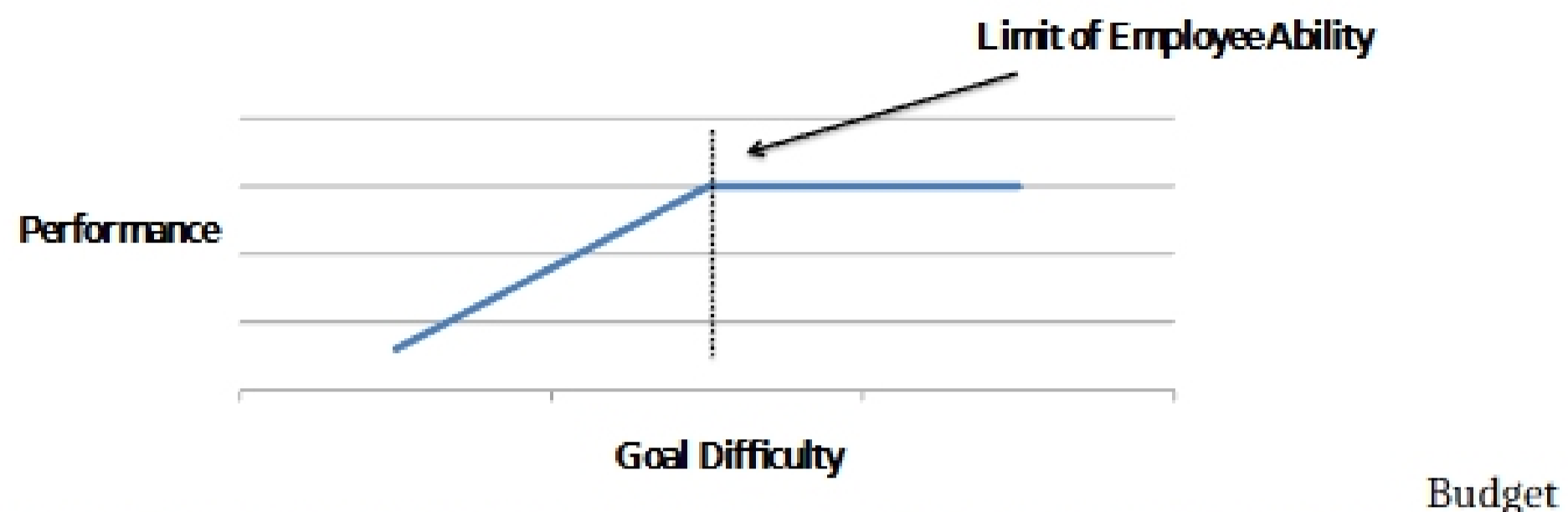
- Employees are guided by economic self-interest and will exploit their private information and maximize their personal wealth at the cost of the firm by creating budget slack (agency problem)
- Also motivated by factors other than economic self-interest such as fairness, reciprocity, and social status

Organizational Controls To Change Slack Creation

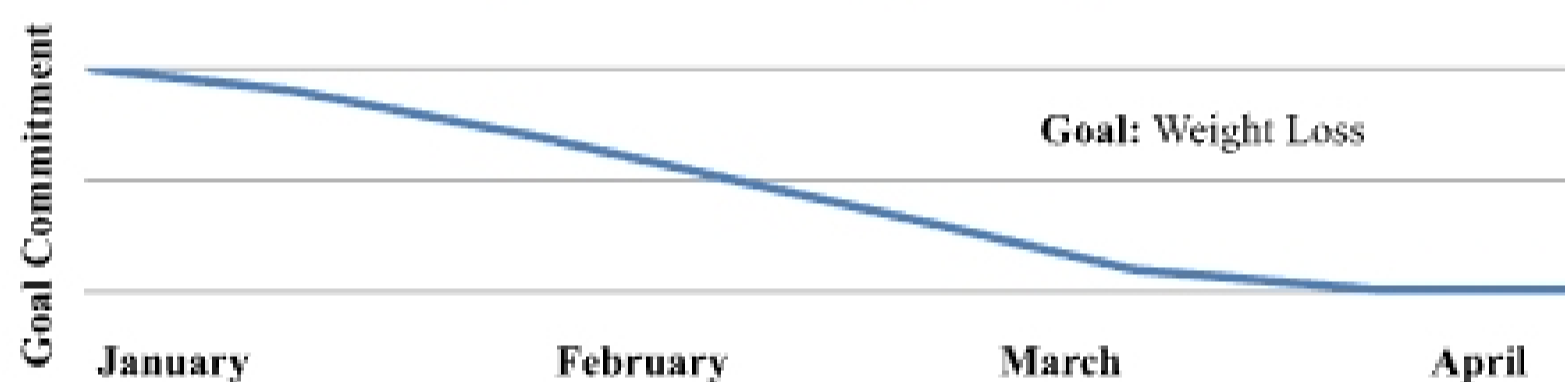
- Risk perceptions
- Negotiation or type of participation
- Moral compass
- Size of fixed salary

Effects Of Budgets On Motivation

- Provide employees with a performance goal
- Budget difficulty has a positive effect on performance, until employees reach the limits of their ability



- (or goal) commitment is a necessary condition for budgets to have a positive effect on performance
 - The determination to try or the desire to reach a budgeted target or goal
- Antecedents to budget commitment include:
 - The attractiveness or importance of budget attainment
 - The likelihood of budget attainment (expectancy)



Expectancy → the belief that ones effort will lead to a desired outcome (such as budget attainment)

Determinants: *actual ability, task-specific confidence (i.e. perceived ability), task complexity, feedback*

- Participation in the budget process can increase employees expectancy
 - Ownership of the budget (i.e. greater accountability)
 - Better alignment of budget target with ability

Choosing A Budget Period

- A continuous budget is a 12-month budget that rolls forward one month (or quarter) as the current month (or quarter) is completed

MC Questions

1. Past experience has shown that ending inventory for each month should equal 10% of the next months estimated sales. Actual inventory on Dec 31 was 400 units. Budgeted sales are as follows:

	<u>Budgeted Sales Units</u>
January	6,800
February	5,400
March	7,200

What is the expected production needed for February?

- a) 5,220
- b) 5,400
- c) 1,200
- d) 5,580**