DON'T BLAME THE BUDGET PROCESS: AN EXPLORATION OF EFFICIENCY, EFFECTIVENESS, AND ETHICS

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ABSTRACT
The budgeting process has been criticized to the point that some authors have suggested that budgets should be eliminated may lead executives to do “whatever it takes” to meet the analyst expectations, including turning a “blind eye” to potentially unethical behavior. Accordingly, the ethical ramifications of the budget process must be ascertained. Once the ethical issues associated with these forecasts have been addressed in a moral manner, there are a number of steps that managers can take to improve the budget process. The end result can be a budget process that encourages managers to plan to consider the stakeholders involved provides information for improved decision-making, increases and enhances communication and coordination among departments, and sets clear “benchmarks” for performance evaluation. Recommendations for a more efficient, effective, as well as ethical budgetary, decision-making process are provided.

Keywords: Budget, goal-setting, ethical decision-making, utilitarianism, forecasting, planning, and controlling.

1. INTRODUCTION
While there are definitely major problems with the way budgets are developed in some organizations, the maxim is true that the only thing worse than having a budget is not having one! As Emmanuel, Otley, and Merchant (1995) explain, “Budgetary planning and control is the most visible use of accounting information in the management control process. By setting standards of performance and providing feedback by means of variance reports, the accountant supplies much of the fundamental information required for overall planning and control” (p. 160).

As vividly demonstrated by the following declarations, the budgeting process is under attack!

1. Corporate budgeting is a joke, and everyone knows it (Jensen, 2001, p. 96).
2. Budgeting – as most companies practice it – should be abolished (Hope & Fraser, 2003, p. 108).
3. Today, many managers regard the traditional budgetary control model as outdated and believe that it
causes more damage than benefits (Baum 2011, para. 3).

4. People are taught to lie in these pervasive budgeting systems because if they tell the truth they often get punished and if they lie they are rewarded (Jensen, 2003, p. 380).

The problems that have been identified with budgets are many. For example, budgets are viewed as:

1. Time-consuming and expensive
2. Too rigid and narrow
3. Protectors rather than reducers of costs
4. Conducive to unethical behavior
5. Focusing employees on meeting the budget rather than satisfying customers and other stakeholders

A budget is simply a tool that can help management plan and control resources; and any tool can be misused. While it is true that the budgeting process can, and often does, seem to promote counterproductive and even unethical behavior, it is important to separate the symptoms from the illness. That is, are budgets the cause of these problems or are there other influences at work?

Budgets have two primary functions – planning and control. Organizations need to decide which to emphasize, since the budget’s effectiveness is a function of how top management uses it. If the budget is to be used as a planning tool, it must be closely linked to the organization’s strategic planning process; whereas if it is used for control, the level of flexibility to allow in the process is an important decision. As a general rule, large companies concerned with efficiency should emphasize the control aspects of the budget; whereas smaller innovative firms should stress planning (Churchill, 1984).

The budget process can be considered a continuum with no budget at one end and a time-consuming, expensive, inefficient, and unethical process at the other end. In between these two extremes would be a process that encourages managers to plan, to consider the stakeholders involved in the budget process and those ultimately affected by the budget, provides information for improved decision-making, improves communication and coordination among departments, and sets “benchmarks” for performance evaluation. In evaluating the budget process, it is important to remember that a budget is simply a written estimate or a plan of how an entity (organization, department, business unit, or project) will perform financially. Thus a budget should not:

- Be considered absolute or infallible – as President Eisenhower said, “In preparing for battle I have always found that plans are useless, but planning is indispensable.”
- Place managers in a financial “straitjacket,” but rather hold them responsible for keeping the organization on schedule in reaching its objectives
- Be an end to itself but rather a means to an end.

Typically, the budget process should begin by having a team of managers at the highest levels, who will be responsible for directing and coordinating the budget process, ensuring that the budget is linked to the strategic plan of the organization, and ascertaining the effect of the budget on the organization and its stakeholders. This team would also have the responsibility to provide policy guidelines and budgetary goals, review the budget, resolve differences that may arise as the budget is prepared, approve the final budget, and monitor the performance of the organization throughout the year. This function includes looking for “gaming” and unethical behavior by employees and having controls in place to prevent such misconduct. If this is accomplished in an objective and conscientious manner, the budget process can be a vital business as well as ethical tool for managers.
2. GOALS AND GOAL-SETTING

There has been much research on the usefulness of concrete objectives and goals in motivating employees to higher productivity. Studies conclude that employees with challenging, concrete, measureable goals tend to be more productive than those who do not have these goals (Jones and George, 2011). Employees also need “feedback” on how they are doing as they try to attain their goals. The concept of “self-efficacy” also is very relevant to proper goal-setting, planning, and controlling of budgets. Self-efficacy refers to one's perception that he or she is able to do a given task. If a person has concrete goals that he or she accepts, believes she or he has the ability to do the job, and is receiving adequate “feedback” from one’s supervisor or manager or through self-monitoring techniques, then this person is likely to have a higher degree of motivation than when these variables are not present.

Goal-setting can be very instrumental for performance and productivity. In order to create an organizational culture that focuses on high performance as well as ethical standards as one that promotes better planning and controlling mechanisms, then there must be a conscious effort to make the objectives and goals clear to everyone. Creating and maintaining an efficient organizational culture requires hard work, continuous learning, and proper communication mechanisms (Williams and Mujtaba, 2010).

More than 1,000 studies on more than 88 different tasks show that “specific high goals are effective in significantly increasing a person’s performance – regardless of the method by which they are set” (Latham and Locke, 2006, p. 332). In fact, researchers (Kahneman & Tversky, 1979; Thaler & Johnson, 1990) have proposed that absolute levels of performance seem to be less meaningful than those that are measured against an objective that can subsequently be not only met, but also exceeded. Thus objectives and goals increase effort, enhance persistence, and create and guide the establishment of strategies and tactics to attain them.

3. INVESTMENT ANALYST BIASES

Organizational problems usually start at the top. In the case of the budget process the difficulties can start outside of the organization with investment analysts. The role of investment analysts is to evaluate stocks and issue “buy,” “hold,” or “sell” recommendations to investors. However because analysts include earnings forecasts to justify their recommendations, they in essence provide executives with performance targets. Unfortunately, these forecasts are fraught with optimism and “herding biases” and consequently indirectly pressure executives to do “whatever it takes” to meet the expectations, including turning a “blind eye” to potentially unethical behavior.

“Optimism bias” is the general tendency for people to be over-optimistic about the results of their actions. In the context of an analyst’s forecast, however, it is not the optimism of the analyst’s action, but rather of the firms he or she follows and then forecasts. This “optimism” bias in analysts’ forecasts has been documented by Chopra (1998), who found that the average consensus 12-month EPS growth forecast was more than twice the actual growth rate. An examination of aggregate corporate earnings between 1985 and 2000 for companies on the Standard & Poor’s 500 Index also showed that while actual earnings grew by 11% a year, the average analyst forecast estimated a 22% growth (Goedhart, Russell, & Williams, 2001).

Reasons for this “optimism bias” include the incentive to maintain underwriting relationships (Chopra, 1998), pressures to increase trading commissions (Cowan, Groysberg & Healy, 2006), and the finding by Hong and Kubik (2003), that controlling for relative forecast accuracy, analysts with greater optimism bias experienced superior career progressions. Consequently, it is not surprising that Dreman and Berry (1995) found that despite evidence of “optimism bias,” analysts appear to ignore the industry’s poor forecasting record.

In addition to optimism bias, there is evidence of “herding bias” in analysts’ forecasts. “Herding bias” occurs when analysts temper their forecasts to be more in line with the norm, especially with forecasts released by analysts who may be viewed as more respected. In fact, this “herding” may occur even when the information gathered is contrary to the consensus (Trueman, 1994). The more the forecasts are similar, the more they are viewed as valid, and concomitantly the more pressure executives feel to meet the numbers. The thinking is that if the targets are not met, management must be to blame.

Perhaps more disturbingly, Hong, Kubik, and Solomon (2000) found evidence that while targets that were
“bold” and “bad” led to more severe career repercussions, targets that were “bold” and “good” did not significantly affect an analyst’s career. They also found that inexperienced analysts who deviated from the norm were more likely to be terminated. Similarly, inexperienced analysts were also found less likely to produce timely forecasts and also more likely to revise their forecasts than older analysts.

The analyst forecast situation then becomes similar to the children’s story of the Emperor’s New Clothes – wherein swindlers pretended to weave a robe made of material that could not be seen by anyone who was incompetent. Although there was never a robe, everyone in the kingdom described it as beautiful because admitting to not seeing it was admitting incompetence. In the case of the analysts, no one is willing to say that the forecasts are too optimistic for fear of having their career adversely affected.

4. AFFECT ON EXECUTIVE BEHAVIOR

While the accuracy of analyst forecasts is suspect, as explained previously, corporate executives feel pressured to meet and even surpass these forecasts. This mind-set frequently leads executives to make short-term and even “strategic” decisions designed to satisfy Wall Street expectations and, in some cases, to manipulate accounting practices to meet these targets. Although this concept of “earnings management” technically follows the “letter” of accounting standards and laws, this tactic is considered deceitful and fraudulent because the intent is to mislead stakeholders.

A survey of managers and board members of publicly traded firms found that 42% of the respondents strongly agreed that earnings expectations from equity managers led them to shorten their time horizon focus (McKinsey & Company, 2006). This belief is supported by Skinner and Sloan (2002), who found that missing earnings forecast by one percent could have a much larger negative effect on stock price (15% for growth stocks and 5 percent for value stocks). This change in stock value could not only negatively affect the executives’ stock options compensation, but possibly impact their job security, as failing to meet analysts’ earnings forecast is a strong predictor of Chief Executive Officer (CEO) turnover (Puffer & Weintrop, 1991).

A survey of financial executives by Graham, Harvey, and Rajgopal (2005) suggested that CFOs viewed earnings as the most important performance measure to outsiders. Even more enlightening, 73% of the respondents considered analyst consensus forecasts as an important benchmark; and 80% believed that meeting these benchmarks helped maintain or increase their firm’s stock price.

The pressure to achieve projected earnings levels is exacerbated by differences between the expectations of analysts and management as well as the perceived penalties for missing the earnings forecast consensus (Zhang & Gimeno, 2010). Furthermore, Fiegenbaum, Hart, and Schendel (1996) suggest that top executives with high relative performance may be more likely to engage in illegal actions.

To fully understand how analyst forecasts can affect the budget process one must refer back to the late 1990s, when “dot-coms” were the rage. Executives of a large telecommunications company began considering the company as being part of the “tech sector.” To set the company’s financial goals, they looked to Wall Street for direction. Wall Street was expecting double-digit, net income growth in the tech sector, so the executives decided the company would have a 12% net income growth year after year. They then decreed that expenses would remain flat. Based on these two assumptions, a detailed “budget” was then developed.

To make the numbers “work,” however, certain “liberties” had to be taken with the budget. For example, when one budget manager asked what would cause mid-year revenues to increase, he was told that the revenues would come from new products. When he pressed for more details, he was told the products had not yet been developed, but the revenue target would have to remain unchanged. As a result of this budget approach, sales targets were so high that by midyear over 60% of the sales force was receiving negative performance reviews for not meeting the sales targets.

5. RECOMMENDATIONS: WHAT CAN BE DONE?

While it would be unreasonable to expect analysts to withhold their earnings forecasts, there are a number steps that organizations can take to reduce the negative side-effects of budgets; and this process begins with an ethical
culture. As discussed earlier, it is important that the organization has controls in place to prevent unethical behavior, and that top management create an ethical culture by “setting an example” and by allowing employees the opportunity to practice ethical behavior (Gentile, 2010; Cavico and Mujtaba, 2009). As part of this culture, common rationalizations must be challenged. Among these rationalizations would be the thinking that unethical behavior is standard practice, that the ethical problem is not material, that handling ethical problems is someone else’s responsibility, and that loyalty includes going along with unethical actions.

One of the purposes of goal setting is to motivate employees to stretch their imagination and develop new ideas. Unfortunately, “gaming” seems to occur when compensation is lined with budgetary goal attainment. One way to reduce this “gaming” is to reward employees for accomplishments and not for just reaching targets. This can be done by implementation of a continuous linear bonus system after a minimum acceptable goal is reached. That way there is no loss for falling short of a high goal; and employees are paid for their accomplishments (Jensen, 2003). Similarly, Jack Welch suggests setting minimum goals and making managers accountable for their organization’s performance relative to an agreed-upon competitor, and not punishing managers for not meeting “stretch” goals (Latham & Locke, 2006).

Another approach to curb “gaming” is to link compensation and bonuses to critical success factors of an organization besides simply financial targets. These key performance indicators (KPI) will depend on the organization, but can include measurements such as customer satisfaction, quality, time-to-market, and employee turnover rate.

There are also several changes to the budget process itself that can improve its efficiency and efficacy. Management can reduce the time allowed to build the budget, the number of iterations, and the time horizon. Management can also implement the use of flexible budgets and “rolling” forecasts that are revised regularly and thus allow the targets to adapt to shifting market conditions. Lastly, managers can eliminate the “spend it or lose it” philosophy that leads to waste of resources and punishes, rather than rewarding managers for improving the “bottom-line.”

6. DECISION-MAKING PROCESS AS AN ETHICAL GUIDE

Planning and controlling decisions are impacted by many variables and one strong influence is a person’s values and perceptions regarding ethics. Ethics, fundamentally, is a branch of philosophy; it is the study of right conduct. Generally, ethics is defined as “the sustained and reasoned attempt to determine what is morally right or wrong,” whose rationale is to “develop, articulate, and justify principles and techniques that can be used in specific situations where a moral determination must be made about a particular action or practice” (Cavico and Mujtaba, 2009, p. 5). As a branch of philosophy, ethics contains many ethical theories and principles – some at times contradictory – and there is no “Supreme Court of Ethics” to tell one which ethical theory is the correct and true one. Nonetheless, there is one ethical theory – Utilitarianism, developed by the English philosophers and social reformers, Jeremy Bentham and John Stuart Mill, which resembles in many respects the budgeting process. The cardinal principle of Utilitarianism should be familiar to the readers of this article, to wit: an action is moral if it produces the greatest amount of good for the greatest number of people. First and foremost, Utilitarianism is known as a “consequentialist” ethical theory in that one bases a determination of morality or immorality by examining the consequences of an action. If there are more good consequences than bad produced by an action, it is a moral one; and the reverse, that is, if there are more bad consequences produced by an action then the action is immoral. The action itself, it is important to note, is neutral; rather the consequences are the key to determining morality. Moreover, another significant component of this ethical theory is that one may have to predict, like the budgeting process, the consequences of putting an action into affect. Of course, one can never be able to fully and definitely predict the consequences of an action; yet one must make a reasoned and objective attempt to predict the probable, likely, and reasonably foreseeable consequences of putting an action into effect. One, furthermore, in conducting a Utilitarian analysis should take a broad-based analytical stakeholder approach by considering all the stakeholders and constituent groups directly and indirectly affected by an action, including, of course, the company or organization involved and its immediate stakeholders, such as employees, but also the local community and society as a whole. This stakeholder component of Utilitarianism is also a key aspect of the budgeting process. Utilitarianism was
propounded and advocated by Bentham and Mill as a “scientific” and “mathematical” ethical theory. They called their ethical theory “accounting” or “book-keeping” ethics, again harking back to the budget process. The principal idea is for each stakeholder group, and then overall, to measure, weigh, and quantify the good versus bad consequences and then to determine which prevails, and thereby to determine the morality of an action. However, the Utilitarians did not provide any precise guidance as to how one “mathematically” should measure, weigh, and quantify consequences. Nevertheless, based on the work of DeGeorge (1999), authors Cavico and Mujtaba (2009) developed the Utilitarian Ethical Model that can be used “scientifically” to determine morality.

**The Utilitarian Ethical Model:**

In order to determine the morality of an action, practice, rule, or law pursuant to the stakeholder, pleasure v. pain, numerical model of the ethical theory of Utilitarianism, one can take the following steps:

1. Accurately and narrowly state the action to be evaluated (e.g., is it moral for a particular company or organization?);
2. Identify all people and groups who are directly and indirectly affected by the action (including the company's or organization’s constituent groups or "stakeholders" as well as society as a whole);
3. Specify for each stakeholder group directly and indirectly affected all the reasonably foreseeable good - pleasurable and bad - painful consequences of the action, as far as into the future as appears appropriate, and consider the various predictable outcomes, good and bad, and the likelihood of their occurring;
4. For each stakeholder group, including society as a whole, measure and weigh the total good consequences against the bad consequences, and determine which predominates for each stakeholder group;
5. Quantify the good and bad consequences for each stakeholder group on a numerical scale (-5, -4, -3, -2, -1, 0 +1, +2, +3, +4, +5) representing units and extremes of pleasure and pain;
6. Sum up all the good and bad consequences assigned to the stakeholder groups.

If the action results in an overall positive number, it produces more good than bad, and is a morally right action; and if the action results in an overall negative number, it produces more bad than good, and is morally wrong; based on this model of the Utilitarian ethical theory (Cavico and Mujtaba, 2009; DeGeorge, 1999). Utilitarianism as an ethical theory has many positive attributes. First, it is an egalitarian ethical theory in which everyone gets counted since everyone feels pleasure and pain, seeks happiness and satisfaction, and avoids unhappiness and dissatisfaction. Second, it is accord with the thought process of most people in that people contemplate the consequences of an action and its impact before acting. Furthermore, this ethical theory is in conformity with the way politicians think since they view, if they want to get re-elected, how an action will affect their constituents. Finally, this theory is in accord with the budget process of most businesses and organizations. However, it must be noted that there is one weakness in this ethical theory. That is, everyone gets counted, and everyone’s pleasure and pain gets registered; but when the “final counting” is done, if the good outweighs the bad, the action is moral. Those in the minority suffering the “bad” got counted; but, to state, as well as explicate a little bit, the old maxim: the ends (the greater good) justify the means (the action - neutral in itself). That is the nature of the ethical theory of Utilitarianism (Cavico and Mujtaba, 2009). However, though there are analytical aspects in common between this ethical theory and the budgeting process, it always must be remembered that the budget process is a means to set goals and to plan to achieve goals, but Utilitarianism is an ethical theory that will indicate whether these goals are moral ones. While Utilitarianism can be used by individuals or teams, due to the benefits of diverse perspectives, group decision-making can certainly be another excellent tool for effective and ethical outcomes.

**Group-Decision-Making:**

Group decision-making is another excellent tool to employ as an effective guide for better planning and controlling as well as for engaging in ethical analysis and making moral determinations; and group decision-
making is a widely considered to produce many benefits, including the aforementioned ethical ones. The two most important positive results are the opportunity for widespread expertise to be brought to bear on the problem, and the eventual ease of implementation of the solution when everyone has been involved. Group decision-making is also in keeping with the general shift in the United States toward participative management: evidently many workers feel better about decisions in which they participate, particularly those that directly affect them (Jones and George, 2011).

Three effective techniques in group decision-making are “brainstorming,” the Delphi technique, and the “nominal group” technique. “Brainstorming” is a well-known technique for generating, without evaluation, as many ideas as possible. The approach works by momentum, with group members stimulating each other's creative energy. For example, if a manager is trying to solve the problem of low department morale as evidenced by absenteeism and turnover, the group may be asked to name all items that serve to lower morale—that is, all problems they can imagine as having an impact on this problem. This procedure usually generates a long list of items that are written down for all to see. It is important to note that nobody is allowed to comment on anyone's idea at this time—all ideas are good ideas, and the objective is to generate as many of them as possible.

The Delphi Technique has been particularly successful in situations requiring forecasts of future events. Originally created by the Rand Corporation, the Delphi technique uses a panel of experts who never meet face-to-face to discuss the questions under review. The participants are given a questionnaire, and their answers are summarized and fed back to the members of the group. The participants then answer the questions again, this time using the responses of the first round as additional information. This process continues for four or five rounds, after which some unanimity is usually reached. The Delphi technique avoids the cost, time, and cohesiveness problems of typical group decision making, although it clearly takes longer to reach a decision.

The Nominal Group Technique (NGT) is a mixture of “brainstorming” and ordinary group processes. As part of NGT, the group meets and goes through four steps (Jones and George, 2011):

- Individual members answer a specific question by writing their answers without consulting with each other.
- Each member of the group shares one of her ideas with the rest of the group. This “round-robin” process continues without any discussion of generated ideas. All ideas are written on a blackboard or large sheet of newsprint.
- When all ideas have been posted, the group engages in an open discussion during which ideas are questioned, clarified, and evaluated.
- When discussion has been completed, members independently rank items or vote on priorities. The resulting tally of independent votes becomes the group decision.

Like the Delphi, NGT avoids group cohesiveness problems, although it maintains the face-to-face element. NGT spurs creativity but does require considerable time to run correctly. All three of these group decision-making techniques can be used to help facilitate and expedite the budget process and to formulate the ultimate budget.

7. CONCLUSION

The ethical issues associated with budgets and goal-setting are well documented. However, in many cases, over-optimistic budgets that lead to unethical behavior originate with analyst forecasts. These forecasts have been shown to have optimism and “herding biases” which make their accuracy suspect. Because they indirectly pressure executives to adjust their budgets they indirectly affect corporate financial targets and subsequently manager’s actions. By reinforcing an ethical culture throughout the organization, including stricter controls and by changing how budgets are developed and used, the budget process can be an indispensable business as well as ethical tool to managers. Suggestions for better decision-making regarding the planning and controlling of budgets as well as the creation of an ethical organizational culture are provided in the paper.
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