Risk distribution in
the budgetary process

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Budgeting has always been a problematic process. At the end of a budget period it is invariably found that some managers have been able to achieve their budget targets more successfully than others. But when senior managers come to evaluate their subordinates' performance they have to recognize that some apparent success is caused by certain managers having had easier budgets to attain in the first place. That is, the difficulty of budget targets is likely to vary between one manager and another. Further, it has often been recommended that budgets should be seen as targets that will be achieved only a proportion of the time. In order to motivate the best possible actual performance it is suggested\(^1\) that a budget should be pitched at a more difficult level than the performance actually expected. Although such a target will not, on average, be attained it is nevertheless believed that it will motivate managers to achieve a better result than if the budget had been set at a lower level. It is not the purpose of this paper to argue the case for or against the use of budgets as motivational targets. Rather we take as our starting point the observation that budgets are often, in practice, set at levels other than the performance which is expected to occur, and to examine some implications of this observation.

Motivational factors are not the only reason why budgets may be set at levels other than those expected to be attained. Even budgets which managers intend to be good estimates of expected performance (which we will call Expectation Budgets) may be subject to bias by their subordinates in both upward and downward directions.\(^2\) A number of studies have indicated that such budget bias is a common feature of the budgetary process in many types of organization and is essentially motivated by the

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\(^1\) Hofstede, G. *The Game of Budget Control* (London, Tavistock, 1968).

\(^2\) For the sake of clarity of exposition we will consider budgets, such as output and revenue budgets, where a higher figure represents better performance and a lower figure worse performance. For other types of budget, such as cost budgets, where the reverse is true, the argument is still valid but references to up and down, higher and lower etc. should be reversed.


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Fig. 13.1 Distributions of costs and revenues having positive and negative skewness.

desire of junior managers to be favourably evaluated by their superiors. Thus junior managers currently in a strong position may bias their budgets downwards in order to give themselves an easier standard to achieve in the subsequent period. Conversely, managers currently in a weak position may bias their budget upwards so as to make it appear that, despite current problems, the future is bright.

There may be a further reason for Non-Expectation Budgets. It has been suggested that the statistical distribution of costs and revenues in many organizations is likely to be skew rather than symmetrical. That is to say, errors to one side of a most likely outcome can be more extreme than on the other, as illustrated in Figure 13.1.

The argument for skewness is intuitively appealing. A certain level of cost is likely to be incurred; spending much less than this amount (at a given level of output) is increasingly improbable whereas almost any degree of overspending is possible. Similarly, a certain level of revenue may be thought likely, but it may not materialize; any great increase in revenue is rather less probable than a similar decrease. If such a situation exists then budgets set without any thought for motivational manipulation or any attempt at bias by subordinates (or superiors, for that matter!) may still not represent expectations. Typically the figure submitted as a budget will be the most likely outcome, for this represents a real event familiar to the manager in charge. But this most likely outcome differs from the long-run expectation of outcomes as shown in Figure 13.1. As an