Contingency Theory and Its Implications to Corporate Financial Planning and Organization Structure

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Abstract: *The development of the organization theory has existed for such long periods especially in terms of management theory. The driving force behind the evolution of management theory is that its efforts to look for better ways in managing organizational resources. Contingency theory which is a part of the organizational environment theories has brought many implications in management's decision at any organization. Especially in finance, contingency theory has been employed in some financial decisions including the decision of corporate financial planning as a part of the most important considerations, and those actions would certainly have implications to the corporate organizational structure. The contingency theory has been implemented by financial managers in decision making especially in strategic long-term and short-term financial planning regarding many assumptions that underlying the decision. In practice, financial managers can implement the contingency theory by using Scenario Planning. The advantages of the contingency theory are that the theory has enriched the management theories by addressing the environment as one of the keys for managerial decision making. The theory has also helped management of organizations in improving the quality of decision making by addressing the contingent variables. The limitation of the contingency theory is that the contingent factors are still in debates until nowadays so that we cannot determine the precise numbers of contingent factors.*

Keywords: *contingency theory, corporate financial planning*

Abstrak: Perkembangan teori organisasi telah berlangsung lama terutama dalam kerangka teori manajemen. Pendorong utama di balik evolusi teori manajemen adalah adanya upaya untuk mencari cara yang lebih baik dalam mengelola sumber daya organisasi. Teori kontingensi yang merupakan bagian dari teori lingkungan organisasi telah membawa banyak implikasi dalam pengambilan keputusan manajemen organisasi. Di bidang keuangan, teori kontingensi telah digunakan pada beberapa keputusan keuangan termasuk keputusan perencanaan keuangan perusahaan sebagai salah satu pertimbangan utama. Langkah itu tentu memiliki implikasi terhadap struktur organisasi perusahaan. Teori kontingensi telah dilaksanakan oleh manajer keuangan dalam pengambilan keputusan terutama dalam perencanaan keuangan jangka panjang dan jangka pendek terkait berbagai asumsi yang mendasari pengambilan keputusan tersebut. Dalam prakteknya, manajer keuangan dapat menerapkan teori kontingensi dengan menggunakan Skenario Perencanaan. Keuntungan dari teori kontingensi adalah bahwa teori tersebut telah memperkaya teori manajemen dengan mempertimbangkan lingkungan sebagai salah satu kunci dalam pengambilan keputusan manajerial. Teori ini juga telah membantu manajemen organisasi dalam peningkatan kualitas pengambilan keputusan dengan memasukkan

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variabel kontingen. Keterbatasan teori kontingensi adalah bahwa faktor-faktor kontingen masih dalam perdebatan sampai saat ini sehingga kita tidak bisa menentukan jumlah yang tepat dari faktor kontingen ini.

Kata Kunci: teori kontingensi, perencanaan keuangan perusahaan

The development of the organization theory has existed for the long period especially in terms of management theory evolution. The driving force behind the evolution of management theory is that its efforts to look for better ways in managing organizational resources (Jones, et al., 2003). The evolution itself could be viewed in a number of theoretical perspectives in management since the scientific management theory, and then followed by administrative management theory, behavioural management theory, management science theory, and the organizational environment theory.

Such theories have given many contributions to the development of the management theory as well as the contribution to managerial practices in many companies around the world. One of the most influential theories in terms of the organizational context in relation to environment is contingency theory.

Contingency theory which is a part of the organizational environment theories has brought many implications in management's decision making in any organization. Public and corporate sectors have been considering the environment when they make decisions for their organizations. The contingency theory has a significance influence on the managerial decision making in many areas of the corporation, such as in finance, managerial accounting, marketing, production, etc. Especially in finance, contingency theory has been employed in some financial decisions including the decision of corporate financial planning as a part of the most important considerations, and those actions would certainly have such implications to the corporate organizational structure.

Contingency Theory

There are many experts in organization's theories who gave the definition or the view of the Contingency Theory. The basic premise of the contingency theory is that " *effectiveness, broadly defined as organisational adaptation and survival, can be achieved in more than one way. For example, management theorists and researchers have recognised more than one way to organise effectively, more than one strategy that maximises profitability and market position, and more than one leadership style that achieves organisational goals. Each way is not equally effective under all conditions; certain organisational actions or responses are more appropriate than others, depending on the situation*" (Zeithaml, et al., 1988:39).

In other sentence we can say that contingency theory is one of management theories especially as one of behavioural theories which assert that there is no certain way to manage a corporation or a company, or to make decisions in organisations. Instead the optimal course of action is contingent (dependent) upon the internal and external situation.

If we take a look at the history of management theory, as Jones, et al. (2003) revealed that the important development in history of management thoughts has existed since researchers explored of how managers can influence behaviour within organizations by considering the relationship between organization and its external environment or organizational environment. They signed organizational environment as "the set of forces and conditions that operate beyond an organization's boundaries but affect a manager's ability to acquire and utilize resources" (2003:62). Based on that issue, it can be stated that in order to be successful in managing organizations especially in facing various conditions, managers should pay more attention and deeply think about or consider the environments.

Theoretically, there are two mainstreams in the organizational environment theories. Those are open-system views and contingency theory. Open system, which was developed by Daniel Katz, Robert Kahn, and James Thompson in 1960s, views organization as a system that takes in resources from its external environment and converts or transforms them into goods and services that are sent back to that environment, where they are bought by customers. Whereas

Contingency theory which was developed in 1960s by Tom Burns and G.M. Stalker in Britain, and Paul Lawrence and Jay Lorsch in the United States, states that " *there is no one best way to organize*". It means that the organizational structures and control systems that managers choose depend on or are contingent on characteristic of the external environment in which the organization operates (Jones, et al., 2003:62).

Daft (2004:32) has given his views on the contingency theory. He says that " *there are no universal principles to be found, and one learns about management by experiencing a large number of case problem situations, managers face the task of determining what methods will work in every new situation*". There is something important that he reveals regarding the importance of this theory. That is, managers should find the best way that would fit in their organizations with the contingencies or environments. This means that in order to manage their organizations well, managers should make contingencies or environments as main considerations in their decision making and some situations will enrich their knowledge and bring them up in making important decisions.

In addition to that, Certo (2000:36) gives the stressing that this approach emphasizes 'if-then relationships: ' if' the situational variable exists, ' then' this is the action a manager probably would take. He illustrates that in example, " if a manager has a group of inexperienced subordinates, then the contingency approach would recommend that he or she lead in a different fashion than if the subordinates were experienced". We can derive the conclusion from the Certo's statement that managers can determine a decision for a certain condition, but if the condition has changed, managers can determine a different decision (i.e different way, different style) that will gain the better result for their organizations.

One question rises up now is what are the conditions or the contingency factors that can influence the decisions in organizations in terms of organization structure and control system? Can we identify the truly conditions that would have influences on organizations and ignore other factors?

Robbins, et al. (2009:52–53) has revealed that researches in the area of management has been undertaken and are still continuing to work in identifying these situational variables or contingency factors that would influence organizational structure. They added that there are more than 100 different variables identified, but those that are more widely used are: *organization size, routines of task technology, environmental uncertainty, and individual differences.* From Robbins and Coulter's opinion, we can say that the contingency theory has been challenging us to identify what factors that can affect organizational structure. It will stimulate us to make some significant researches in the future about the contingency factors in many kinds of organizations, such as in public sectors as well as corporate sectors with different kinds of organization size.

In addition, Casey (2002:84) has pointed out that " Contingency theory emphasizes managerial strategy as being contingent on the relationships between the organization structure and a number of crucial variables, typically *environment, technology, goals and size*". It means that there are a couple of variables that would significantly influence on the managerial decision in organizational structure; especially those variables are environment, technology, goals, and size. We can see from both the two organization experts, that environment, technology, and size are the crucial variables in determining the organizational structure. Casey has also emphasized the important role of the managerial strategy as a part of decisions making in organizations.

Beside environment and strategy, contingency theory has also stressed on technology (Thomas, 1986). He states that there are many kinds of technologies that can be used by corporations, such as routine and non routine technologies, capital intensive and labour intensive technologies, etc. Those technologies can influence on managerial decision making especially in organization structure.

Several studies of organizational design also suggest that as size increases so does the development of formalized and specialized organizational structures (Thomas, 1986). That is why the size of the organization has also become an important aspect that is included in the contingency theory. He also added that most of the researches on organizational design have measured size by reference to the number of employees. Thus, we can say that the number of employees as a proxy for size variable will also influence the managerial decision making on organization structure.

Regarding the contingent variables, Daft (2004: 34) reveals that " the important contingencies that managers must understand include *industry, technology, the environment, and international culture*s. Management practice in a rapidly changing industry, for example, will be very different from that in a stable on". We can identify that from his opinion, the environment and international culture are also contingency factors that would influence the organizational structure.

Other variables which would be important factors are those which were identified by Donald S. Miller, Stephen, et al. (1996). They have revealed that " most managers agree that the following variables should be considered when attempting to implement various management techniques: *stability of external environment, complexity of tasks, skill and proficiency level of the workers, degree of participation desired, amount of risk and uncertainty, management-employee relation, and the size of organization"*. From their points of view, we can observe that not only external variables that can influence organizational structure, but also many internal variables, such as complexity of tasks, skill and proficiency level of workers, degree of participations required and so on.

From above discussion, we can also say that since the contingency factors are various and many experts has identified that the factors are various and different, we cannot ignore those variables that will be found by any other experts in the future.

Indeed when managers make business planning in terms of long-term or short-term planning, it requires the consideration of a number of the crucial variables that would influence the organizational structure. Those variables and any other variables should be addressed by managers in order to construct best corporate planning for their organizations.

In general, we can state that the advantages of the contingency theory are: the theory has enriched the management theories by addressing the environments as one of the keys for managerial decision making, and the theory has also helped management of organizations in improving the quality of decision making by addressing the contingent variables. The weakness of the contingency theory is that the contingent factors are still in debates until nowadays so that we cannot determine the precise numbers of contingent factors.

Organization Structure

One of the important messages from the Contingency theory beside " *there is no best way in managing organizations*" is that " *the organizational structures and control systems that managers choose depend on or are contingent on characteristic of the external environment in which the organization operates*"(Jones, et al., 2003:62). It means that the goal of the contingency theory or the dependent variable from the model of the contingency theory is the organizational structure. The next question that then comes up in this discussion will be: What kinds of organizational structures that can be employed by managers in managing their organization after considering the contingency factors?

There are many alternatives which have been offered by the organizations experts. Among other they are:

Mechanistic and Organic Structures were offered by Tom Burns and G.M. Stalker. Burns and Stalker have proposed two basic ways in which managers can organize and control an organization's activities to respond to characteristics of its external environment. They said that managers can use a mechanistic structure or an organic structure. *Mechanistic structure* is an organizational structure in which authority is centralized, tasks and rules are clearly specified, and employees are closely supervised. Whereas *Organic structure*, is an organizational structure in which authority is decentralized to middle and first-line managers and tasks and roles are left ambiguous to encourage employees to cooperate and respond quickly to the unexpected (Jones, et al., 2003:63).

Burns and Stalker has also said (Litterer, 1969: 345–346) that " the mechanistic management system is appropriate to stable conditions, which is characterized by: the specialized differentiation of function tasks, the abstract nature of each individual tasks, hierarchic structure of control, authority, and communication, the tendency for interaction between numbers of the concerns to be vertical, and so on.

Meanwhile the organic form is appropriate to changing conditions, which is characterized by the contribute nature of special knowledge and experience to the common task of the concern, the realistic nature of the individual task, the adjustment and continual redefinition of individual tasks trough interaction with others, a network structure of control, authority, and communications, a lateral rather than vertical, and so on". We can say from Burns and Stalker's model that mechanistic structure seems to be directive, and it would be fit for the big and very hierarchical organizations and the organic structure seems to be participative and appropriate for a dynamic and lateral organizations. John and George (2003) has revealed that Sony Corporation from Japan has been successful in implementing the organic structure with the characteristics of management are emphasizes on the lateral movement of people and ideas, communications between groups, self promotion and contribution for the engineers and so on.

The other alternative for organizational structure is provided by Henry Mintzberg (Stewart, et al., 2005). They pointed out that Mintzberg had argued the five natural configurations which can be fitting with the different tasks organizations. According to Mintzberg, for every situation and task an organization is facing, there is a specific structure that fits best. The five structures that he offered are: simple structure, machine bureaucracy, professional bureaucracies, divisionalised form, and adhocracy. For instance, *simple structure* is appropriate for entrepreneurial companies that are small and innovative but that work on relatively simple products. The structure consists of top management, a few middle managers, and task force. *The Machine bureaucracy* is fit for mass production companies which focus on simple products in fairly stable environment. The structure puts emphasis on standardization end employs low-skilled but highly specialized staff. *The Professional bureaucracy* is suitable for standardized skills organizations such as universities, consulting firms, and hospitals. *Divisionalised form* is a structure which is fit for the companies or organizations that produce specialized products for a particular market. The performance of each divisions would be measured by headquarter. The last one is *adhocracy*, which is a structure form that would be fit with the organizations that face a highly turbulent environment.

Joan Woodward, in 1965, has tried to verify that a certain kind of organizational structure or style of management was universally the most effective (Rosenfed, et al., 1999:259). The result of her study states that " the complexity of the production process determined the structural characteristics of the firm". She revealed that there are three categories of production process: *unit or small batch production*, *mass or large production*, and *process production*, which those of categories determines the structure of organizations such as number of level of management, span of control, ratio of managers, etc.

Those types of organizational structures can be chosen by managers in managing the organizations in accordance with the conditions which happened.

Contingency Theory and Its Implication to Corporate Financial Planning & Organization Structure

As Casey (2002:84) has stated that "contingency theory emphasizes managerial strategy as being contingent on the relationships between the organization structure and a number of crucial variables. Contingency theory has also promoted an emphatic role of strategic managerial decision-making". These imply that the strategic managerial decision-making should be employed after considering a number of crucial variables and those actions would have some implications to the organization structure.

The strategic management in organization is very important in order to reach the organization's goals (Jenkins, et.al, 2007). One of the most important aspects of the strategic management is about financial planning. Financial manager has a significant role in determining financial plan for the corporation.

Financial planning involves guiding, coordinating, and controlling the firm's actions to achieve the objectives (Gitman, 2009:115). The objective of the corporation in the view of financial manager is to maximize the shareholder's wealth. Therefore, the financial manager should prepare financial planning in order to be able to make it as guidance for managing the organization especially in financial aspect. The financial aspect of the organization will encompass all aspects such as for financing operations, marketing, human resources, etc. Financial planning that should be prepared by financial manager will comprise of long-term strategic financial plan and short-term tactical financial plan.

Long-term strategic financial plans lay out a company's plan financial actions and the anticipated impact of those actions over the periods ranging from 2 to 10 years. These plans are one component of a company's integrated strategic plan (along with production, marketing and human resources plans, etc.) that would guide the company toward achievement of its goal. Long-term financial plans consider a number of financial activities including: *proposed fixed assets investment, research and development activities, marketing and product development, capital structure, and sources of financing*. Meanwhile, short-term financial plans specify short-term financial actions and the anticipated impact of those actions for the period of one to two year. Those financial plans are related to the future time with uncertainty, that's why contingency theory can relate to this issue.

Some activities such as proposed fixed assets investment, research and development, assets acquisitions, etc will require some assumptions and predictions about the future conditions. Financial managers have to make a prediction of the future cash flows as long the project's life and that would definitely face uncertainty about the precise cash flows that will be generated by the project. There are two important sources in predicting cash flows; those are sales and costs prediction (Grundy, 1992). To predict the sales, financial managers have to forecast about the demands for company's products that variable will be closely related to some other factors such as economic condition, general price or inflation, and economic growth. Such many factors are external factors that should be addressed by managers in order to have best prediction in sales.

Financial managers should also predict about the interest rate that will prevail and that number will be used as discount rate for discounting the cash flows. Some factors that would be possible to influence the interest rate are average bank-borrowing rate, base-lending rate, and inflation rate. And again those variables are external variables that should be considered by managers in determining the discount rate for their valuation.

Other activities that should be considered in relation to the long-term strategic financial plans are determining the capital structure and sources of financing that will be used by company. To determine the capital structure that will be used by company, financial managers should make a prediction of cost of capital which covers cost of long-term debt, cost of retained earnings and cost of a new equity. Some external variables that would affect the cost of capital are inflation rate, bank interest-rate, risk-free rate, and any other variables so that financial managers should address those variables in their decisions (Grundy, 1992).

All those variables are contingent variables and that should be addressed by financial managers in making financial planning as a part of strategic managerial decision making.

The Mechanism of Contingency Factors in Determining Financial Planning and Organization Structure

The next question that would rise up in this discussion is how the contingency factors can determine the financial planning and organization structure?

As we all know that strategic management in organization has many steps such as determining the corporate mission, setting up its goals and objectives, determining corporate strategies, corporate programs, functional strategies and programs (Ward, 1992). When the corporation determines financial strategies and programs in which the financial planning is made, some factors should be addressed in order to have a good financial plan. Those factors are internal factors and external factors. The internal factors are factors which are originating from internal aspects such as the quantity and quality of employers and machines, prevail production capacity, the assets ownership, etc. The nature of internal factors is controllable. Meanwhile the external factors are the factors which come from outside the corporation. Those factors are uncontrollable and uncertainty.

When financial managers construct financial planning, they would need some factors including the past financial analysis. Ward (1992:9) describes that "financial analysis is required to establish where the business is and to ensure that the strategic objectives are realistic and meaningful". He also adds that " since business strategy is very concerned with the external environment, a large part of the required financial analysis focuses on external issues such as competitors, consumers, etc". Those factors and any other external factors are contingent factors that should be considered by managers in making financial planning.

Scenario Planning involves formulating plans that are based on "what if" scenarios. In the typical scenario planning exercise, some scenarios are optimistic and pessimistic. Teams of managers are then asked to develop specific strategies to cope with each scenario. Jones, et al. (2003) also mention about scenario planning as a tools for making alternative conditions that will be faced by organization. Scenario Planning, which also known as contingency planning, according to them, is the generation of multiple forecasts of future conditions followed by an analysis of how to respond effectively to each of those conditions. From that discussion, we can say that financial managers can provide some alternative financial plans to be offered to the top management and at last, the decision making would be made by top management regarding the chosen alternative one.

The purpose of using the scenario planning in making financial plan is in order financial managers to be able to anticipate about uncertainty in the future. Based on that financial plan, top management can then make adaptation to the organizational structure in regarding the financial planning in order to achieve the goals. Financial plan as a part of business strategy would need the organizational structure that will have a significant impact on the way the strategic plan is developed and implemented (Ward, 1992). He also added that many organizations operate in a fast-changing environment and therefore the most appropriate organization structure should be made in anticipating the rapidly change as the environment develops.

After determining the financial plan which comprises strategic long-run financial plan and tactical short-run financial plan, the next step is determining the most suitable organization structure that relate to the planning. The final financial planning would explain about how many people needed by organization in top level management, middle management and lower management. The planning will also revealed the total workers needed, the additional machines needed to attain the corporate production capacity, the new fixed assets that would be required. Those factors would have the implication to the total costs of corporation and organization structure that would be the best fit in the corporation.

Stacey (2003:61) has pointed out that the success will be secured when an organization secures a good match between its situation and its strategies and structure. For example, mechanistic bureaucracies are said to be appropriate for stable environments, but flexible, organic structures are required for turbulent environments. She also added "if an organization is small, then it requires a simple structure, but if an organization is large, then it requires a divisionalised structure". She then also revealed that contingency theory postulates a complex web of interconnections between the features of organizations and their environments in which the casual connections are linear in the sense that they run in one direction. She has an opinion that there is a linear association between environment and strategy and structure, hence a particular environment that causes a particular kind of successful strategy could cause a particular kind of successful structure.

Meanwhile Keith Ward (1992:175) revealed that "there are many different strategic types of organizational structures which have been used over the years with varying degrees of success". He pointed out that there is no 'right' or 'wrong' way for an organization to be structured, and success has far more to do with how well the chosen organizational structure is implemented and subsequently managed. From these statements, it could be stated that the success of an organization is not only based on the organization structure itself, but also depends on the implementation and management of the structure.

Conclusions

Organizations are open systems that need careful management to satisfy and balance internal needs and to adapt to environmental circumstances. The contingency theory has the characteristics of: *the* *environment* (focused on the condition and context in which organization operates). *There is a strategy* (different situations require different ways of managing) and *Technology* (to reach a goals, it needs technology). There are many crucial variables that influence organization structure; those typically are *environment, technology, goals and size* (Casey, 2002:84).

The contingency theory has been implemented by financial managers in decisions making especially in strategic long term and short-term financial planning regarding many assumptions that underlying the decision making. In practice, financial managers can implement the contingency theory by using Scenario Planning.

The advantages of the contingency theory are: the theory has enriched the management theories by addressing the environments as one of the keys for managerial decision making so that it can provide multiple ways in doing the organization, and the theory has also helped management of organizations in improving the quality of decision making by addressing the contingent variables. The limitation of the contingency theory is that the contingent factors are still in debates until nowadays so that we cannot determine the precise numbers of contingent factors.

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