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## **BUDGET PLANNING, CONTROL AND EVALUATION: AN OVERVIEW OF ITS PRACTICES IN MANUFACTURING**

MOHAMED FUAD AHMAD  
ABRARI SALLEH

### **INTRODUCTION**

The Malaysian economy expanded by 5.2% in 2003 and economic growth was broad based and balanced across all sectors, driven by strong domestic demand and augmented by a stronger export performance. The manufacturing sector grew at a rapid pace following the broad based recovery in the global economy and strengthening domestic demand (Bank Negara Malaysia, 2004).

Profit planning is essential in any organization and manufacturing establishments are of no exception. This can be accomplished through the preparation of a number of budgets, which focus heavily on future rather than on the past (Garrison and Noreen, 1997). In relation to the above this study attempts to determine and find out the specific purposes of budgets, the implementation of budget in companies, the extent of managers' participation in setting budget targets and the extent to which budget variance reports are used to measure performance and also other related issues.

### **LITERATURE REVIEW**

Budgets are applied in organizations as it can provide various uses and play different roles (Emmanuel and Otley, 1985, Ahmad et al.

2003). Several authors list down the purpose of budget. Sulaiman et al. 2004, for example, explained that budgets aid planning and facilitate interdepartmental communication and coordination. Meanwhile Drury 1998, Emmanuel and Otley, 1985 said that budgets can be used as a means of forecasting and planning in an attempt to shape the future by altering those factors that are controllable in the light of available forecast. Meanwhile according to Warren et al. (2002), budget provides the company a “game plan” for the year. Budgeting involves establishing specific goals where this is a part of the planning function, executing plan to achieve the goals which is the directing function of management and periodically comparing actual results with organization’s goals which is the controlling function of management.

With respect to this, Jones (1998) stated that there are two key elements of budgets namely planning and control. Budgetary planning is the financial plan for the future whereas budgetary control is the use of the set budgets to monitor and control actual performance. He further elaborated that an effective budgetary planning and control process could assist managers in achieving both short and long-term operational and strategic goals. Joshi and Abdulla (1995) meanwhile mentioned that budgets are an excellent control and evaluation tool, as they provide a set of criteria against which results are compared and corrective actions are initiated.

Emmanuel and Otley (1985) further stated that budget act as a channel of communication and co-ordination when it communicated related information that will enable managers in different parts of organizations to coordinate their activities more efficiently. Drury (1998) pointed out that to coordinate the activities of the various parts of the organization and to ensure that the parts are in harmony with each other the budget serves as a vehicle through which the action of the different part of an organization can be brought together and reconciled into a common plan.

Budget literatures also touched on participation by managers in the preparation stages. Drury (1988) defined participation within the budget and standard setting process as the extent by which responsible

managers are able to influence the figures that make up their budgets. Budget participation also relates to the extent to which managers participate in setting budgets and allowed to have a considerable say in how it is established (Subramaniam and Mia, 2001, Hansen and Mowen, 2003). Studies on relationship between budget participation and performance have shown mixed results. Lau et al. (1997) found that high budgetary participation (regardless of budget emphasis) in high task difficulty situations is associated with improved managerial performance. While Subramaniam and Mia (2001) found that there is a significant interaction between management control features such as budget participation and managers' organisational commitment.

However, according to Drury (1992) there are some limitations on the positive effects of participation in standard setting where he argued as performance is measured by precisely the same standard with which the budgetee has been involved in setting, and therefore an improvement in performance – in term of comparison with budget – may result merely in lowering the standard. He elaborated further that participation by itself is not adequate in ensuring commitment to standards without the belief that they can significantly influence the results.

Budget is normally being prepared on a yearly basis. However, Weygandt et al. (1996) suggested a budget might be prepared for any period of time. Factors such as the type of budget, the nature of the organization, the need for periodic appraisal, and prevailing business conditions will influence the length of the budget period. Joshi et al. (2003) found out that apart from annual budget companies in Bahrain also prepare long-range budget plans that cover a period of three to five years.

## **METHODOLOGY**

This study is a survey research that was carried out in the state of Johor to determine the relationship between budget practices and

budget attributes namely budget planning, budget implementation, budgetary control and budget participation.

The population of respondents comprised of manufacturing companies located in Johor. The main reason why this area of study has been selected is its strategic location with many industrial areas, which ranked number two in Malaysia after Selangor.

The research instrument used in this study is in the form of questionnaire. The research questionnaire is replicated from a study carried out by Joshi et. al (2003).

A total of 286 questionnaires were sent to manufacturing companies in Johor which were based on the list of manufacturing companies in Johor as per Federation of Malaysian Manufacturers (FMM) Directory 2004. A total of 37 companies responded however only 34 questionnaires were usable.

The research questionnaire for the purpose of this study was divided into four sections. Section A seeks to gather demographic information of respondents companies while the other sections focussed on budget practices in their organization which include planning, purposes, participation and implementation. Questions related to budgets variance, period of reporting, budget control and evaluation were also asked.

For the purpose of this study, Likert scale was used for respondents to express their level of agreement and disagreement on the statements put forward. The purpose of using the Likert scale in the questionnaire was it helps to compare a person's choice with a range of scores from a well-defined sample group (Cooper and Schindler, 2001).

## **FINDINGS AND DISCUSSION**

### **Company Characteristics**

Table 1 presents details of the characteristics of respondents companies.

	<b>Frequency</b>	<b>Percentage</b>
<b>Industry Sector</b>		
Foods	2	6
Chemicals	3	9
Metal/ Steel/ Aluminium/ Copper	3	9
Plastic/ Rubber/ Glass	4	12
Ceramic/ Clay/ Bricks	1	3
Textiles/ Apparels	1	3
Electric & Electronics	7	21
Wood & Furniture	2	6
Others	11	32
<b>Total</b>	<b>34</b>	<b>100</b>
<b>Total Assets</b>		
RM20 million and below	12	43
More than RM20 million	16	57
<b>Total</b>	<b>28*</b>	<b>100</b>
<b>Number of Employees</b>		
150 Employees and below	12	43
More than 150 Employees	16	57
<b>Total</b>	<b>28*</b>	<b>100</b>

**Table 1:** Companies Characteristics

### **Budgets Planning, Purposes and Participation**

Survey findings on long range plan and time dimension of respondents companies are exhibited in Table 2. Almost 100% of respondent companies prepare long-range plan and 93.4% of them prepared long range plans ranging from a period of three to five years. Only 2 companies or 6.6% prepared long range plans covering periods over five years. The survey findings seem to be consistent with other studies such as Joshi et al (2003), and Sinha (1990).

	Frequency	Percentage (%)
<b>Prepare long-range plan</b>		
Time dimension		
3 years	11	36.7
5 years	17	56.7
Over 5 years	2	6.6

**Table 2:** Long range plan and time dimension

Budget procedures data are shown in Table 3. The findings showed that almost 80% of companies prepared annual operating budget. The practice of issuing budgetary guidelines before budget is being prepared is implemented in 70% of the companies. Though this finding is consistent with the findings of Joshi et al (2003), it seems that the rate of issuing guidelines is lower as compared to Joshi et al 94.3%.

	Frequency	Percentage (%)
<b>Prepare annual operating budget</b>		
Yes	27	79.4
No	7	20.6
<b>Budgetary guidelines issued prior to preparing budgets</b>		
Yes	24	70.6
No	10	29.4
<b>Rolling budgets</b>		
Yes	10	31.3
No	22	68.7

**Table 3:** Budget procedures

## Budget Purposes

Respondents' opinions were sought regarding the purpose of budget implementation in their organizations. Related findings are depicted in Table 4 below. It seems that the budget purpose of assisting in profit maximization is rated highest followed closely by control performance and forecast future. Overall results showed that most of the budget purpose variables have an average mean of more than 3.0 where this is consistent with Joshi et al, 2003. The findings showed that budgets serve multiple purposes and this is consistent with Joshi et al, 2003 and Drury et al, 1993. However perception regarding budget purposes showed some differences in the rating while Joshi et al.(2003) rated to forecast future the highest followed by investigate variance and maximize profitability, this study rated maximize profitability followed by investigate variance and forecast future.

Budget Purposes	Average Mean	Extremely Not Important				Extremely Important
Rating Scales		1	2	3	4	5
1- To assist in profit maximization	<b>4.33</b>	1	0	3	13	16*
2- To control performance (variances)	<b>4.32</b>	0	0	3	17	14

**Table 4:** Respondents Perceptions towards Budget Purposes

<b>Budget Purposes</b>	<b>Average Mean</b>	<b>Extremely Not Important</b>				<b>Extremely Important</b>
3- To forecast the future	<b>4.30</b>	0	1	4	12	16*
4- To judge performance	<b>4.03</b>	1	1	8	10	14
5- For communication	<b>3.88</b>	1	2	11	5	14*
6- To motivate employees to do better	<b>3.62</b>	1	3	12	10	8
7- As a means of calculating rewards	<b>3.44</b>	0	10	8	7	9

\*1 not answered; and #3 not answered

**Table 4:** Continued

### **Participation in budget preparation**

Respondents were asked to give their opinion regarding participation in the preparation of budget in their organizations. Likert scale of 5 was used to determine the degree of participation in budgeting (1- Strongly disagree to 5 – Strongly agree). A large number (71 %) agreed that managers in their company actually participate in budget preparation and discussions where this is consistent with other studies. This situation may actually be planned by organizations to give favourable effects to their managers and according to Harrison, 1995, the addition of participation in the budget preparation produced positive effects. Table 5 below detailed the findings.



Strongly agree		Agree		Neutral		Disagree		Strongly disagree		Mean
N	%	N	%	N	%	N	%	N	%	
12	38.7	10	32.3	4	12.9	2	6.5	3	9.7	3.84

**Table 5:** Participation in budget preparation

### Budget implementation

Here various aspect of budget implementation is discussed. The study indicated that nearly 80% of companies have budget committee and members' composition included managing director, managers and financial controllers. Findings were also consistent with Joshi et al., 2003.

Survey findings also showed that nearly 63% of companies prepare both fixed and variable type of budgets while those that prepare only one type of budget were 15.6% for fixed and 21.9% for variable.

	Frequency	Percentage (%)
<b>Budget committee</b>		
Yes	27	79.4
No	7	20.6

**Table 6:** Availability of a budget committee

Issues relating to the implementation and budget planning were shown in Table 7. More than 75% agreed that a high degree of secrecy is maintained in budget allocation and flow of good

information is readily available in budgeting. Consistent with the literature that for the successful implementation of budgets companies need effective leadership and coordination, findings of the study showed that more than 75% agreed on these factors.

Statement	SA		Agree		Neutral		Disagree		SDA	
	N	%	N	%	N	%	N	%	N	%
High degree of secrecy is maintained in budget allocation	11	32.4	15	44.1	5	14.7	1	2.9	2	5.9
Good information flow is available for budgeting	8	23.5	18	52.9	8	23.5	0	0	0	0
Budget communication is accepted:										
with caution	2	16.7	5	41.7	1	8.3	3	25.0	1	8.3
with suspicion			1	9.1	2	18.2	5	45.5	3	27.3
with reception	2	10.0	7	35.0	7	35.0	5	45.5	3	27.3
Leadership provided is effective	7	20.6	20	58.8	6	17.6	1	2.9	0	0
Coordination among various departments during budget execution is achieved	9	26.5	17	50.0	7	20.6	1	2.9	0	0

**Table 7:** Issues relating to budget implementation and planning

Table 8 illustrates findings related to authority to evaluate budget variances. It seems that 50 % of companies give the authority to evaluate budget variances to their top management. Here the findings did not differ too much from that of Joshi et al, 2003.

Authority	Frequency	Percentage (%)
Top management	17	50.0
Any other	15	44.1
Departmental heads	2	5.9
Total	34	100.0

**Table 8:** Authority to evaluate budget variance reports

Data related to variance reporting periodicity were also gathered and shown in Table 9. A large number of companies (44.1%) prepared their variance reports on a monthly basis whereas only 20.6% prepared theirs on a quarterly basis. Findings related to reports prepared on a monthly basis is consistent with Joshi et al. (2003) however data related to reports prepared on a quarterly basis is much lower than of Joshi et al, 2003. The use of budget variances was also investigated and findings indicated that nearly 70% agreed that budget variances were used to evaluate managers' ability and forecasting ability.

<b>Periodicity</b>	<b>Frequency</b>	<b>Percentage (%)</b>
Monthly	15	44.1
Quarterly	7	20.6
Semi-annually	9	26.5
Other	3	8.8
Total	34	100.0

**Table 9:** Periodicity of variance reporting

Respondents were asked about the reasons for not being able to achieve the required target. They were asked to indicate their agreement or disagreement using a Likert scale of 5 (strongly agree) to 1 (strongly disagree). All the four reason were rated more than 3.0, the highest rated reasons were uncertainty followed by unattainable standards, inability in own department and lastly ineffective planning. Findings seem to indicate that element of uncertainty existed in these companies, may be this is in line with current business environment. Hard pressed by competition this may lead companies to set high standards hence standards set could not be attained. Details regarding the reasons are in Table 10.

<b>Reasons</b>	<b>Frequency</b>	<b>Mean</b>	<b>Std Deviation</b>
Uncertainty	34	3.91	0.83
Unattainable standards	34	3.59	0.86
Inability in own department	34	3.50	1.02
Ineffective planning	34	3.38	1.04

**Table 10:** Reasons for not being able to achieve the required targets

## CONCLUSIONS AND RECOMMENDATIONS

In summary, the overall evidence suggests that:

- Almost 100% of respondent companies prepare long-range plan that cover a period of three to five years and more.
- Only 80% prepare annual operating budget that covers a period of one year. A substantial portion of respondents companies do not prepare rolling budget.
- Majority of companies have a budget committee in their companies and members of budget committee included managing director, managers and financial controllers.
- A considerable portion of respondents issued budget guidelines prior to preparing budgets and budgets failed due to time and department.
- The use of budgets as a means of calculating rewards is not in the top list of budgets purposes. Companies agreed budgets purposes priorities are profit maximization, control performance by variance report, forecast future and evaluate performance.
- A fair percentage of the companies prepare both fixed and variable budgets. A large number of companies reported participation in budget preparation and discussions.
- Three quarter of companies agreed that a high degree of secrecy is maintained in budget allocation, flow of good information is readily available or budgeting, effective leadership is provided and coordination among departments during budget execution is achieved..
- Regarding performance evaluation, half of the companies indicated that their budget variance reports were evaluated by top management and monthly basis reports are frequently prepared. Uncertainty and unattainable standards are the main reasons for not achieving the required standard targets.

As this study is a replicate of Joshi et al (2003), findings are compared to identify similarities or differences between them. With the comparison, it can be concluded that findings related to budget have shown similarities and also differences. This study also indicated that the use of budget is still prevalent in manufacturing companies where this is in line with that of Ahmad et al. (2003). Attempts to link companies' demography profiles with that of budget practices and implementation failed to provide evidence of relationship between them.

### **Limitations of Study**

As the measurement of respondents' perception used Likert scale, there were possibilities of some bias. It is possible that some respondents do not want to commit themselves thus giving response in the neutral range of the scale.

This study was carried out in Johor therefore the findings may not explain budget practices by manufacturing companies in other parts of Malaysia and cannot be used for generalization.

As the study is done in the manufacturing sector only, results of this study may not be relevant to other industries such as banking, insurance, hotel and tourism industry.

### **Suggestions for future research**

Respondents of this study focussed only on manufacturing companies whereas Joshi et al. (2003) were diverse from five industry sectors. Future studies could be conducted to these industry sectors. This study also did not investigate the differences in budget practices between listed and non-listed companies. Therefore further studies could be conducted in these listed companies. The possibilities of conducting research in small medium sized industries should also be looked into.

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