“Budgeting in a Company is like navigation in a ship. On the ship, the crew keeps a log of the happenings on and the position of the ship from hour to hour. The captain learns valuable lessons by studying the factors that caused misadventures in the past. But, to pilot his ship safely, he requires his navigation officer to plan the course ahead and to constantly check the position of the ship against the plan. If the ship is off-course, the navigation officer must report it immediately, so that the captain can take prompt corrective action. In addition, the navigation officer should be in a position to foresee possible obstacles and deviations and to minimize losses by taking early corrective action in case the ship is off-course.”

Just as a ship that needs to be navigated properly to reach its destination safely, a Company needs a well-planned budget to help achieve its goals. The ship’s log is like the previous budgets of the Company. Just as the Captain refers to the log to learn valuable lessons and avoid repeating mistakes, managers also use previous budgets to help set benchmark in light of current business conditions. Planning the ship’s course in advance helps the Captain to expect and identify deviations from course and carry out salvage operations as early as possible. In the same way, preparing a budget helps the Company to meaningfully identify variances during the year.

(Axzo Press on Budgeting)
2.1 DEFINITION OF BUDGET, BUDGETING AND BUDGETARY CONTROL

The definition and interpretation of budget may differ among organizations, given particular objective and purpose the budget was established in an organization and its ensuant process. This section serves to clarify the perspective adopted by the author in this research by defining the term budget, budgeting and budgetary control.

2.1.1 Budget

To begin, the definition from Chartered Institute of Management Accountants (“CIMA”) Official Terminology is relevant. According to CIM A Official Terminology, a budget is defined as “a quantitative statement for a defined period of time, which may include planned revenues, assets, liabilities and cash flows. A budget provides a focus for the organization, aids the co-ordination of activities and facilitates control.”

To enhance understanding of the concept of budgets, the Australian National Institute of Accountant (“NIA”) provides two different yet quite extensive definitions of budget, offering different views on the purpose and form of a budget. The first definition has a big approach, emphasizing on the budget as a management tool, forming an integral and a necessary part of organizational stewardship. The second definition has a more immediate, functional approach within the overall plan.

Definition 1: A budget is a comprehensive plan in writing, stated in monetary terms, that outline the expected financial consequences of management’s plans and strategies for accomplishing the organization’s mission for the coming period.
Definition 2: A budget is a master financial document or a “blueprint for action” that set out the expected contribution from the operation or control of an organization in terms of anticipated cash flows or revenues and expected expenditures over a certain period of time.

It can be observed from these two definitions by the NIA that a budget essentially is a tool that forms part of the process of an effective management of an organization, especially in planning and control. Budgets induce management to think systematically and plan ahead about the future. They also serve as a device for coordinating the complex operations of the business, and provide a medium for communicating the financial goals of the firm.

There is also a simple definition of budget limiting its function only as a medium of resource allocation. In reality, most organizations viewed budgets as a statement of approved financial and operational resources allocated to each units, activities and investments. Blumentritt (2006) explained that budgeting is the process of allocating an organization’s available financial resources to its units, activities and investments and to monitor the performance of managers and employees.

2.1.2 Budgeting

Budgeting, like any other activity, is subject to the interpretation of each practicing organization. Budgeting is the process of preparation, implementation and operation of budgets decisions into specific projected financial plans for relatively short periods of time. In other words, budgeting is the process of “translating financial resources into human purposes” (Wildavsky, 1986). Budgeting is also viewed as a process of
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identifying, gathering, summarising and communicating financial information of an organization’s future activities. Blumentritt (2006) further explained that budgeting processes include a review and study of the prior period’s financial results, projections for sales, operating expenses (fixed, variable, and semi-variable) and financing expenses, examination of proposals for capital expenditures, and means of rolling up and rationalizing figures from different functional departments to ensure they meet company-wide profit expectations.

2.1.3 Budgetary Control

Dutta in his book titled “Management Control System” enunciates that budgetary control is a systematic and formalised approach for accomplishing the planning, coordination and control responsibilities of management. Merchant and Van der Stede (2003) agreed that budgetary control is a central device of management control. The use of budgets to control a firm’s activities is known as budgetary controls (Garrison and Noreen, 1997).

Budgetary control is defined by CIMA as “the establishment of budgets relating the responsibilities of executives to the requirements of a policy, and the continuous comparison of actual with budgeted results, either to secure by individual action the objective of that policy, or to provide a basis for its revision”. Budgetary control is a system of controlling costs and resources which includes comparing actual performance with the budgeted performance and subsequently acting upon the actual results to minimise variance and achieve maximum returns. In essence, budgetary control is purported to ensure that the activities carried out are providing the desired results.
In this paper, the following definitions are adopted:

- **Budget**: refers to a comprehensive plan in writing, stated in monetary terms, that outline the expected financial consequences of management’s plans and strategies for accomplishing the organization’s mission for the coming period.

- **Budgeting**: refers to the process of preparation, implementation and operation of budgets decisions into specific projected financial plans.

- **Budgetary control**: refers to any management approach that involves setting some kind of targets, regularly measuring variances between the original targets and actual outcomes, and motivating people to reduce those variances.

### 2.2 CHARACTERISTICS OF BUDGET

As stated earlier, a budget is a blueprint for management action. The following are the common features of budget:

- **A budget is quantitatively stated**: The figures in the budget are expressed in monetary terms. However, the monetary figures are supported by non-monetary information such as units to be sold, units to be purchased and others.

- **A budget is prepared in advance**: A budget must be drawn up before the period to which it refers. Figures produced during or after the period may be important, but they are not part of a budget.

- **A budget relates to a particular period**: Generally, the budget is prepared for one year. However, in the case of a seasonal business, there may be two budgets for each year – a slack season budget and a peak season budget.

- **A budget is a plan of action**: A budget is a plan because it concerns actions to be taken rather than a passive acceptance of future trends. Planning is the establishment of objectives and the formulation, evaluation and selection of the
policies, strategies, tactics and action required to achieve the objectives. Like all plans, budgets seldom turn out to be totally correct predictions of the future. Conditions may change during the budget period, which renders the budget to be inaccurate. Even so, budget is useful in guiding the actions of managers.

- **A budget is an estimation or prediction of profit potential:** The budget set forth the expenses and revenues planned during the budget period and thereby reveals its profit potential.

### 2.3 BUDGET AND ITS ROLES

A budget, if created and used properly, can provide valuable information about the direction, resources and expectations of the organisation. Budget is described as an integral part of management control systems that aims at promoting coordination and communication among subunits within the company, provides a framework for judging performance and finally motivating managers and other employees (Horngren et al, 2005).

The idea of multiple uses of budgets in organizations is not new. To serve as an effective tool, budget pursues different tasks such as planning, forecasting, controlling, coordinating, communicating, instructing, authorizing, motivating, delegating, educating, evaluating performance, facilitating decision making and managing subordinates. Hansen and Van der Stede (2004) has explored many sources, either from the perspective of management accounting and control textbooks, academic research and practice, to generate a list of why organisations adopted budgets, particularly on its purpose and roles. They contended that each source creates a slightly different list, and it is difficult to determine the best list.
Emmanuel, Otley and Merchant (1999) in their book on “Accounting for Management Control” explained that budget can act in different roles in organisations. Some possible roles involve budgets being used as a:

- **Means of Forecasting and Planning:** One of the functions served by most budgets is that of forecasting and planning. Forecasting refers to the prediction of events over which the organisation has little or no control of while planning is the attempt to shape the future by altering those uncontrollable factors in the light of available forecasts. Given a set of forecast, the budget model is able to operate in an optimising role, attempting to ascertain which plan of action will result in the greatest benefit of the organisation.

  Since planning is at the heart of a budgeting process, by employing the budgeting process diligently, companies can plan extensively on the best course of action to achieve the organization’s goals. As a planning aid, budgets allows for the refinement and quantification of the long-term business plan into short-term action plans whereby alternative planning scenarios may be examined and a “what-if” analysis applied. Without the annual budgeting process, the pressures of day-to-day operating problems may tempt managers not to plan for future operations (Drury, 2001). The budgeting process encourages managers to anticipate problems before they arise, and hasty decisions that are made on the spur of the moment, based on expediency rather than reasoned judgement, will be minimised (Drury, 2001).

- **System for Authorisation:** The responsibility of each manager is made amply clear as the budget would usually describe the amount of resources and degree of
authority managers need and have to achieve the organization’s goals. Thus, budgets serve as a formal authorisation for a manager to spend a given amount of money on specific activities. In this respect, budgets is used to ensure that organisational resources is utilised in the most productive and profitable way, to achieve efficiency required for the business operations thereby reducing costs and raising profitability (Australian Society of CPA, 1999). Such a system of authorisation must be supported by a suitable responsibility structure adopted by the organization

- **Channel for Communication and Coordination:** Evidently, budgets are an important channel of communicating certain type of information that will enable managers in different parts of the organisation to be fully informed of the plan and policies, and constraints, to which the organisation is expected to conform. Through the budgeting process, top management communicates its expectations to the lower level management, so that members of the organisation may understand these expectations and can coordinate their activities to attain them (Drury, 2001). In essence, preparation of the budgets facilitates the transfer of vital information among all levels in the organisation and thus, level of interaction are more enhance during the budgeting process.

The co-ordination of business activities will be aided through the budgeting process. Considering that all actions of the different parts of the organisation are brought together and reconciled into a common plan, the budgeting process assist to bind an organisation together towards the achievement the organisation’s goal. Without any guidance, managers may each make their own decisions, believing that they are working in the best interest of the organisation (Drury, 2001).
Budgeting compels managers to examine the interrelationships and dependency among different parts of the organisation, and in the process, to identify and resolve conflicts.

- **Motivational Device:** The budget can be a useful device for influencing managerial behavior and motivating managers to perform in line with the organizational objectives (Drury, 2001). A budget provides a standard that under certain circumstances may motivate managers to strive to achieve the standard. However, it is possible for manager to view the budget as a pressure device in trying to get them to achieve a level of performance that they do not see as achievable. Nevertheless, motivation would be enhanced through the feeling of involvement which participation in the budgeting process can promote. If individuals have actively participated in preparing the budget, and it is used as a tool to assist managers in managing their units, budget can act as a strong motivational device by providing a challenge (Drury, 2001).

- **Means of Performance Evaluation and Control:** A budget assists managers in managing and controlling the activities for which they are responsible. The control of business activities may be aided through the comparison and quantitative measurement of actual results against the budget plan. By doing this, managers can ascertain which activities do not conform to the original plan and require their attention. By investigating the reasons for the deviations, managers may be able to identify inefficiencies (Drury, 2001). Hence, appropriate control and corrective action can be taken to remedy the situation (Drury, 2001).
A budget is basically a yardstick against which actual performance is measured and assessed. Thus, a manager’s performance is often evaluated by measuring his or her performance in meeting the budgets. In view of this, budget thus provides a useful means of informing managers of how well they are performing in meeting targets that they have previously helped to set (Drury, 2001).

2.4 THE BUDGET PLANNING AND CONTROL PROCESS

As implied in the definitions provided above on budgets, budgeting and budgetary control, it can be seen that budget planning and control are virtually inseparable functions. Through numerical statement of plans and breaking of these plans into components consistent with the organization structure, budgets force and correlate planning and allow authority to be delegated without loss of control.

Budget setting is a process, not a specific formula or technique. Thus, understanding the intricacies and the dynamics of the budgeting process is essential. Budgeting is an iterative cycle which moves between targets of desirable performance and estimates of feasible performance until there is a convergence of plan which is feasible and acceptable (Emmanuel, Otley and Merchant, 1990). It usually starts with a forecast of future fundamental performance such as sales and net profits. A forecast is a prediction of future events and their quantification is used for the purpose of planning. A forecast relates to events in the environment over which the business has either no control or limited control. Budgeting process also involves the issuance of guidelines by top management, interaction among various departments, strategy analysis, preparation of preliminary budgets, review by departmental/business unit heads,
negotiation with top management, finalisation of each budget, preparation of the master budget and lastly, their approval by the top management. The following diagram gives a brief summary of a very complex process:

**Figure 2.1: The complete budgeting process**

The budget construction process will normally follow the organizational structure. The budgets process provides a system for coordinated planning among different functional areas (Ramsey and Ramsey, 1985; Bremser, 1988). Some organizations follow a top-down, or mandated approach. Others utilize a bottom-up
approach which is closely related to the participative philosophy of budgeting. The description of each budget construction process are as follows:

- **Top-down Budget:** Also known as “Imposed Budget”, this approach to budgeting will begin with upper level management establishing parameters under which the budget is to be prepared. Lower-level managers have very little, if any, input into the determination of the budget amount and setting the overall goals of the organization. The lower-level units involvement in the process are essentially reduced to doing the basic budget calculations and adhering to the directives of top management.

  One disadvantage of the top-down approach is that lower-level managers may view the budget as a dictatorial standard. Resentment can be fostered in such an environment. Further, such budgets can sometimes provide ethical challenges, as lower-level managers may find themselves put in a position of ever-reaching to attain unrealistic targets for their units. On the positive side, top-down budgets can set a tone for the organization. Top management can ensure that the budgets are aligned with the strategic plans. The budgeting process can be completed faster as less time is needed for budget administration.

- **Bottom-up Budget:** Bottom-up budgeting is also known as “Participatory Budget” mainly due to the nature and degree of lower-level managers’ involvement in the formulation of budget. Top management may initiate the budget process with general budget guidelines, but essentially bottom-up budgeting begins at the operational level. The operational units drive the development of budgets for their units. These individual budgets are then
grouped and regrouped to form a divisional budget with mid-level executives adding their input along the way. Eventually top management and the budget committee will receive the overall plan. The budget committee reviewed the budget components for consistency and coordination. This type of budgeting requires more time to move through the process and complete the budget, but ensures buy-in and commitment at all levels of the company.

- **Blended Approach:** Blended approach is a combination of top-down and bottom-up budget process whereby in this process, top management sets objectives for financial performance and submits these to operating managers, who then develop budgets based on these objectives. The budget is reviewed by top management and either approved, disapproved, or revised. The process may require several iterations of passing the budget back down the ladder for revision by operational units until a final budget is reached.

  The blended approach to budgeting is also known as “Negotiated Budget”. Negotiation in budgeting process will cause subordinates to behave more cooperatively. Thus, it follows that subordinates’ will have less incentive to build slack in their budget target which they are trying to negotiate and are more committed in transforming the plans into actions once approved by the top management. Blended approach is best suited for a company with a certain amount of sophistication in preparing budgets.
2.5 TYPE OF BUDGETS

The end product of a budgeting process is a master budget. The master budget summarises the objectives of all subunits of an organization. It quantifies the expectation regarding the future income, the financial position, cash flows and supporting plans. Cohen, Robbins and Young (1994) divided the master budgets into two primary components; operating budget and financial budget which is further described below. For more details on the different types of operating and financial budgets, refer to Appendix 1.

- **Operating Budget**: Operating budget consists of plans for all those income-generating activities that makes up the normal operations of the organization. The main components of an organization’s operating budgets are sales, production, inventory, materials, labour, overhead and research and development budgets.

- **Financial budget**: Financial budget is used to control the financial aspects of the business. In effect, it reveals the influence of the operating budgets on the financial position of the organization and its earnings potential at end of the budget period. They include a cash budget, capital expenditure budget and pro-forma balance sheet and income statement.

The following figure shows how the different types of budgets as described above are connected within the larger system of the master budget. This illustration confirmed that each individual budget is dependent on one another, whereby during the preparation of budget, one cannot proceed further if the pre-requisite budget is not
prepared. Thus, budgeting process is a systematic process, which shall be conducted in sequential and hierarchical manner.

**Figure 2.2: Major budgets and their relationship**

![Diagram of major budgets and their relationship](source: Banovic, 2005.)