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Budgeting Practices in Manufacturing Firms in Kenya

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Abstract
This study establishes the budgeting practices in the manufacturing industry in Kenya, their existence in the sector and the budget methods. A questionnaire was issued to 75 companies of which 45 (60%) responded. The majority of the firms in the sector prepare budgets. Incremental (prior year) budgeting is the most widely applied method. Budget's aid maximization of shareholders' value. Firms in this study did not agree with the reasons that support the introduction of "beyond budgeting," except one firm indicated that budgets stifle innovation. The conclusion is that in the manufacturing industry in Kenya, budgeting in its traditional form is still widely accepted. As a way forward, management should adopt more modern budgeting methods like zero based and activity-based budgeting.

Keywords: *Budgeting Practices, Beyond Budgeting, Manufacturing Firms*

Introduction

Globalization, intense competition, rapid advances in technology and shorter product life cycles have substantially transformed the environment in which businesses operate. As a result, various financial management systems, such as budgeting and standard cost management systems come under greater scrutiny. Businesses must have excellent control over their costs to remain competitive (Banham, 2000; Johnston, 1990 and Kaplan, 1988).

An organization's objectives are expressed in time frames (three to five years) as informed by its mission and vision. However, budgets come in after the strategic planning and action planning, and it about knowing how much money will be required to execute those plan's actions. The plans and budgets are aligned to strategies. Budgets enable performance measurement and evaluation, staff motivation, pricing decisions and cost control (Covaleski et al., 2003).

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Research Problem, Scope and Motivation for the Study

Budgets are used to control costs and cash flows resulting into increased profits to firms (CIMA, 2007). In their review of worldwide budget practices, a team from the center of business performance at Cranfield School of Management did several case studies on the effect of budgeting on financial performance. They found that forecast accuracy and management credibility influence market expectations. They conclude that budgeting systems have either a direct or indirect impact on profits and on share valuations. Some studies found positive and significant impact while others found no relationship. However, for strategic planning to be effective, certain preconditions must exist, e.g. sound financial reporting systems (Piest, 1994). The use of budgets helps implement a firm's strategy (Richards, 2006). McKernan and Morris argue that there is a consensus that formal strategic planning facilitates survival, especially in turbulent environments. Those who consider budget as not adding value might ignore them.

There are two divergent views on the usefulness of budgets. Proponents of budgets argue that they are still relevant and useful while critics see budgets are obsolete. Blocher et al., (2002) and Hilton et al., (2000) argued that budgets help allocate resources, coordinate operations and provide a means of performance measurement. In managing performance, budgets represent fixed-term performance contracts and as such a performance management system does not help ensure the teamwork and agility required for organizational success (Fraser and Hope, 2003). Traditional budgeting remains widespread, as many as 99% European companies have a budget in place (Dugdale et.al, 1999).

However, the information age characterized by intense competition, uncertainty and a need to respond quickly to changes in the market make traditional budgeting irrelevant. Others have cited budgets as dysfunctional and a hindrance to modern organizations. These opposing views suggest that some firms might use budgets, and others might not. There is a need to look at the traditional role of budgets, the potential for improving the budgeting process, the radical alternative of doing without them and in that situation the issues to be tackled beyond planning and control (Mourik, 2006). The question answered in this study is: What are the budgeting practices that the manufacturing industry in Kenya adopts?

The study covers companies in the manufacturing sector. Kenya's manufacturing sector serves both the local market and exports to the East African region. The sector is dominated by subsidiaries of multi-national corporations. It contributes approximately 13% of the Gross Domestic Product (GDP). It is a competitive sector, and the recent introduction of the EAC Customs Union provides Kenya's manufacturing sector, a greater opportunity for growth (PwC). At the same time, operating cost makes manufacturing costly. Therefore, the sector must employ proper tools to plan for success and efficiency.

Literature Review

Budgeting is a collective and closely coordinated exercise with each activity systematically related to the other. The company undertakes a thorough analysis of its previous experience, state of the economy, corporate objectives and available resources. Upon review of the budgets, if the CEO or the board finds the budgets unsatisfactory, the departmental heads make adjustments to achieve a desired objective (Biwott, 1998). Public budget is mainly intended for authorizing actions and providing ceilings for management actions (Horngren, 1983).

Budgeting facilitates performance measurement and cost control (Banham, 2000). Budget gives a sense of direction to organizational activities, and supports systematic and disciplined solutions (Blocher et al., 2002; Browhill, 1987). Budgeting compels management to anticipate the obstacles and risks facing the firm and identification of their mitigation.

Firms with more formal strategic planning have above industry average profits compared to those that do not. This is because budgeting enables control of income and expenditure; acts as a tool for monitoring and periodic evaluation of managerial policies and decisions; It facilitates optimal allocation of resources for maximization of profit, coordination and decentralization of tasks (Hapisu, 2003).

Goldberger (1991) wonder why manufacturing enterprises prepare budgets, yet prices are determined by the markets, governments and the recovery of costs. Wolf (2019) concludes that it is time to say goodbye to traditional budgeting because managers think that it is the most ineffective practice in management. Wolf (2019) wrote that 'the culture of budgeting is the single greatest barrier to change. The average corporation spends four months and 20-30% of senior executives' and financial managers' time on the company budget (with some organizations taking six to nine months). In 2003, the Hackett Group found that the average billion-dollar company spent as many as 25,000 person-days per billion dollars of revenue putting together the annual budget'.

Mitch Max of the specialist management consultancy, The Performax Group observed that "The budget is a relic from an earlier age. It is expensive, absorbs too much time and adds little value" For larger organizations. This process could take three or four months or more to complete because the financial manager needs sufficient time to coordinate the collection of the necessary departmental information to develop the budget (Hofstede, 1991; Banham, 2000).

The advocates of beyond budgets suggest that the budgets, as practiced in most corporations, should be abolished (Fraser, Hope and Bunce, 2003). Their argument is that most of the other building blocks are in place and only need to change organizations from centralized hierarchies towards devolved networks. Though Firms have invested huge sums in quality programs, IT networks, process reengineering, and a range of management tools, including balanced scorecards, and activity accounting, they are unable to realize the new ideas, because the culture that accompanies budgeting, (Fraser, Hope and Bunce, 2003).

There are flaws inherent in the budgeting namely cultural flaws – people ensure they set easily achievable targets and manage results closely to meet those targets to protect the positions; strategic flaws suggesting that budgets are a barrier to change (Bowhill, 1987; Hofstede, 1991; Banham, 2000), in any case, assets are increasingly intangible and organizations are becoming more accountable to the customer Bowhill, 1987; Hofstede, 1991; Banham, 2000). Financial flaws are expensive, low value adding and are barriers to growth. Budgets rely on forecasts, but the future cannot be predicted with complete accuracy; this makes budgeting inaccurate. Successful implementation of the budget implies cooperation and coordination between all managers, which may not always happen. Managers are made aware that in dynamic environments, the budget cannot take the place of management (Banham, 2000; Blocher et al., 2002).

The development of an organizational budget requires input from a variety of sources, including but not limited to upper management, customers, and historical cost data. As part of the service level agreement (SLA) negotiation process, prices must be established for all services provided. Inputs must be garnered from managers so that accurate prices can be negotiated. The financial manager should also examine trends from previous budget periods. Internal budgeting inputs and trends are used as inputs for the negotiation process where final prices are set from which the budget is developed (Bowhill, 1987; Little et al., 2002; Banham, 2000). Cost is a concept that is difficult to define and operationalize in a number of instances. However, accurate cost data provides a solid basis for negotiation. Without a complete understanding of the costs of providing a product or services, managers are unable to negotiate agreements that are fair to each customer and still completely recover the operating costs of operations and to prepare meaningful budgets (Clarke and Toal, 1999). Budgeting activity involves the review of existing SLAs to verify their relevance, after which SLAs are revised as needed to more accurately reflect the service requirements. Only then can accurate prices be set for these services (Hofstede, 1991; Banham, 2000).

Trends are historical data of similar costs from previous periods that can be used to extrapolate costs for the current budget Clarke and Toal, 1999). However, the financial manager must be careful not to underestimate the costs as to end up insufficient amount of funds to operate. It is equally unacceptable to overestimate costs, as these results in charging customers too much for the services being provided. Overestimating costs can lead to the loss of service requests for each department (Covaleski et al., 2003; Little et al., 2002).

Different approaches to budgeting have been causes of great disagreements in the perspective of accountability (Amate, 1986). In some organizations, the budget process begins with the updating of previous budget; then each organizational department provides justification for increases from the prior year’s budget or actual incurred costs (Karmarkar et al., 1989; McNally, 2002). Sometimes upper management provides direction to the budgeting process, in the form of challenges or a percentage change in business (McNally, 2002).

Zero-based budgets are built from the ground up, with all funds appropriately justified before they are included in the budget (Prendergast, 2000; Little et al., 2002; Pierce and O’Dea, 1998). The major advantage of this technique is that the budget developed is not simply a reworked version of the prior period’s budget. All external support costs should also be assessed, and their usefulness evaluated so that operational and financial improvements be made (Pierce and O’Dea, 1998; Prendergast, 2000). Priority based budgeting, which is a modification of the incremental budget incorporates a sensitivity analysis (Muleri, 2001).

Activity-based budgeting (ABB) focus on activities to quantitatively estimate work load and resource requirements (Dierks & Cokins, 2000). The logic is to authorize only resources needed to perform value adding activities. The budgeted output drives the necessary activities used to estimate the resources required.

Beyond Budgeting is meant to solve the limitations of traditional budgeting (Hope and Fraser, 2003). Beyond Budgeting (BB) is more adaptive and devolved. It replaces the budgeting model with a more adaptive and devolved alternative. It is an attempt to describe principles to guide leaders towards a new management model that is lean, adaptive and ethical. The approach has the benefits of; more innovative strategies, lower costs, more loyal customers and faster response. This is because the focus is on reducing complexity, clear governance principles and value to the customer. (Fraser, Hope and Bunce**,** 2003**)**.

Beyond Budgeting is an attempt to combine the hard fact side in form of new performance management processes (typically the responsibility of finance) with the soft fact side of a new performance management climate and a "devolutionary framework", where the people at the front, working with customers, get the freedom to decide and act real time (Hope and Fraser, 2003).

Research Methodology

This is a survey of budgeting practices to establish the budgeting practices used in the manufacturing industry in Kenya. The practices include: techniques, methods, uses, perceived limitations and factors considered while budgeting. The target population is found in the Kenya Association of Manufacturers members register, totaling five hundred and forty nine. Four hundred and twelve members were in Nairobi and was chosen due to the geographical convenience to the researcher, cost of collecting data as well as the time saved. Furthermore, over 75% of the KAM members are in Nairobi. Stratified sampling design was employed to ensure that all categories are adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample. At a confidence level of 95%, a sample size of 75 was used as suggested in Cooper, Schindler (2003).

A semi-structured questionnaire was administered to reach respondents. The drop and pick method has been chosen because the questions are simplified and unambiguous making it easy for the respondent to answer on his own. The first set of questions, (Section A) is general in nature to gather some basic information about the firm. The second section (B) captured the budgeting practices. The questionnaire

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combined two types of questions; yes or no and a five-point scale, i.e. Strongly Agree, Agree, Undecided, Disagree, and Strongly Disagree.

Findings, Interpretation and Analysis

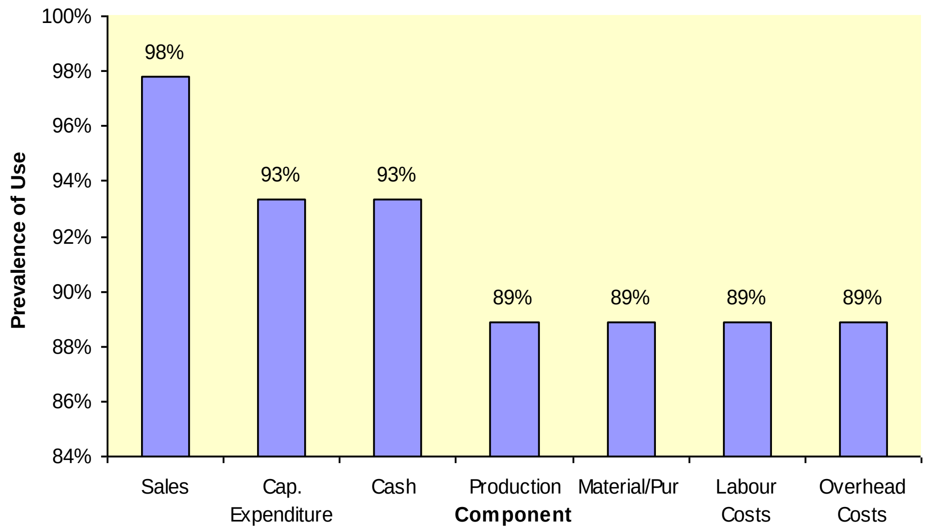
The response rate was sixty percent. Ninety-eight percent of the firms prepared budgets. Sixty five percent of the respondents have more than fifty employees and are large manufacturing firms. All the firms studied indicated that they were engaged in the conversion of materials into finished product (see table 1 below).The responses were distributed as follows:

Table 1 Distribution of respondents

Category	Responses
Food, Beverage and Tobacco	12
Chemical and Allied	5
Leather Products and Footwear	0
Metal and Allied	5
Motor vehicle assembly	1
Paper and Paperboard	4
Pharmaceutical and Medical Equipment	4
Plastics and Rubber	6
Textile and Apparels	6
Timber, Wood and Furniture	2
Total	**45**

Majority of the firms studied do prepare all the components of the operating budget, namely: production budgets, sales budgets, capital expenditure budgets and overhead cost budgets. Of all the components, sales budgets were the most widely prepared with ninety-eight percent of the firms preparing them. Figure 1 summarises the prevalence of the components of the operating budget.

Fig. 1 Components of the Operating Budget



When the respondents were asked about the budgeting methods, it is apparent that the majority, almost sixty percent, used prior year budgeting, The other forty percent use zero based budget, activity based costing budget or a combination of all the three. A majority of firms (76%) prepare budgets that cover between one and three years. The performance against budgets is reviewed on a monthly basis by seventy seven of all the firms while seventy three of the firms studied prepare periodic and departmental budgets.

Aspects of Budget Implementation

The responses around the specified aspects of budgeting, presented in Table 2, indicated that majority of the firms have faith in the budgeting process. They indicated that there is good information flow during budgeting and that budgets are widely accepted within the organisations. There is agreement that budgeting facilitates both leadership and effective coordination.

Table 2 Aspects of Budget Implementation

Aspects of Budget Implementation	Strongly Disagree	Disagree	Not Sure	Agree	Strongly Agree	Total
Good Information Flow	2	4	4	16	18	44
Budget Accepted with Reception	2	12	4	8	16	42
Effective Leadership Provided	8	8	2	10	16	44
Effective Coordination	6	2	2	18	16	44
Total Score	**18**	**26**	**12**	**52**	**66**	**174**
%	**10%**	**15%**	**7%**	**30%**	**38%**	**100%**

Criticisms of Budgeting

A majority of the firms do not identify with the criticisms of budgeting. When asked to rate their agreement or otherwise to the criticisms of budgeting and their support for “beyond budgeting," majority either disagreed or strongly disagreed with the criticism posed, such as budget is time wasting. The one criticism that the respondents somewhat agreed with was that budgeting stifles innovation. This mean that is barely above the median score of “not sure." All other factors were generally disagreed with and scored below the median.

There was the consensus among the respondents that budgets do add value and are focused on the overall strategy of the firm. The standard deviations for the two variables were 0.98 and 0.88 respectively, suggesting high level of agreement on this item among respondents. As regards whether budgets are focused on value in the eyes of the customer, there was high variability (standard deviation of 1.62) meaning lack of agreement among respondents (see table 3 below).

Table 3 Criticisms of Budgeting

	Variables						
	Time	**NVA**	**Focus**	**Strategy**	**Inflexible**	**Customer**	**Innovation**
Total Score	94	62	63	87	94	98	133
Mean	2.19	1.44	1.47	2.02	2.19	2.28	3.09
Standard Deviation	1.38	0.98	0.88	1.42	1.01	1.62	1.41

Beyond Budgeting appears to be a long way off in our emerging economy and that budgeting in its current state is widely accepted in the local manufacturing industry. Manufacturers do not agree with the criticisms that have been forwarded as a basis for the beyond the budgeting model.

Table 4 Criticism of Budgeting Ranking

	Disagree	Agree
Do not Add Value	86%	14%
No Focus on Shareholders' Value	82%	18%
Divorced From Strategy	82%	18%
Time Consuming/Expensive	77%	23%
No Focus on Customer Satisfaction	68%	32%
Rigid & Inflexible	64%	36%

The result in table 4 above, show that respondents are evenly divided as to whether traditional budgeting stifle innovation. They find budgets to be adding value, focused on creating wealth to shareholders and not time consuming. A substantial number of respondents (thirty-six percent) six percent) agree that budgets are rigid; some are not sure as to whether budget focus on customer satisfaction.

Challenges of Budgeting

The respondents were asked why the targets set during budgeting are sometimes not met. Fifty-five percent agreed that companies fail if they set unattainable goals. Seventy- three percent think that the uncertainty in the environment leads to non-achievement of goals (see table 5 below)

Table 5 Challenges of Budgeting

Challenges	Disagree	Agree	Not Sure
Departmental Inability	68%	32%	0%
Unattainable Standards	45%	55%	0%
Uncertainty	27%	73%	0%
Ineffective Planning	36%	50%	14%

Specific Use of budgets

The respondents were asked to indicate on a scale their agreement or otherwise the extents to which budgets are used for particular purposes in their organisations. The results indicated that budgets are put to various uses. The respondents rated profit maximization as the most important use to which budgets are put and motivation of employees as the least important use of budgets.

The most important use of budget is fund's allocation, with a mean score of 4.28. The next is profit maximization with a mean of 4.23. Calculating rewards and motivation staff were rated as the least important application of budgets with the mean scores (2.86 and 2.88 respectively) below the median score. Fund's allocation and profit maximization show the lowest distance (standard deviation range of 0.85 to 1.09) from the mean, suggesting concurrence among respondents. The highest variability is seen in use of budgets as means for reward calculation with a standard deviation of 1.63 implying lack of agreement among respondents (See table 6).

Table 6 : Specific Uses of Budgets

	FC	PM_1	Comm.	PM_2	Rew	Mot	Cont	FA	COGS	RR	CC	IA
Total Score	179	182	158	140	123	124	169	184	125	154	143	141
Mean	4.16	4.23	3.67	3.26	2.86	2.88	3.93	4.28	2.91	3.58	3.33	3.28
Std Dev	1.25	1.09	1.46	1.45	1.63	1.52	1.35	0.85	1.59	1.37	1.46	1.44

Key: Forecasting the future (FC), Profit maximization (PM_1), communicating the company's objectives (Comm.), Performance measurement (PM_2), means of calculating rewards (Rew), Motivation tool (Mot), control tool (cont), Funds allocation (FA), Calculating cost of goods (COGS), reduce risk of failure (RR) , reduce costs (CC) and Investment Appraisal (IA).

Factors Considered When Budgeting

In this section, the respondents were asked to rate the importance the factors that they consider when preparing budgets. The factors posed to them were; economic outlook, past behavior and emerging trends, government regulations and controls, consumer attitudes, tastes and preferences, competition, advertising efforts and political situation. In addition to the factors specified, firms indicated that they do consider their production capacity, availability of funds, new products and services as important to budgeting. Firms indicated that economic trends and outlook are the most important factor with a mean score of 4.58. The next was trends and behavior of past costs followed by competition with means of 4.44 and 4.30 respectively. The least important was the advertising and promotion efforts of the firm with a mean of 3.23. All the factors were rated above the median of 3. The greatest consensus is found in importance of economic outlook with a standard deviation of 0.85. The importance of consumer attitudes and preferences shows high variability with a standard deviation of 1.55 (see table 7).

Table 7 Factors Considered when Budgeting

Variables	Economic outlook	Past Trends	Govt Regulations	ADTP	Competition	A&P	Political Situation
Total Score	197	191	174	147	185	139	151
Mean	4.58	4.44	4.05	3.42	4.3	3.23	3.51
Std Deviation	0.85	1.05	1.36	1.55	1.04	1.56	1.3

A&P is advertising and promotion; ADTP is consumer attitudes, tastes and preferences

Summary of Findings

The results indicated that around ninety-three percent of the firms prepare budgets. Operating budget is widely used with ninety-eight percent of the firms preparing the sales budget, and eighty-nine percent preparing the production, material and purchase, labour costs and overhead cost budgets. Cash budget and Capital expenditure budget are prepared by ninety-three percent of the firms.

The most widely used method of budgeting is the prior year (incremental) method, and most firm compare actual results against the budgeted. Economic outlook, competition and trends of past costs are considered the most important factors while budgeting. Most firms do not agree with the criticisms of budgeting posed by the proponents of "beyond budgeting" as all variables posed scored a mean that was below the median. The criticism that budgets stifle innovation scored slightly above 3 at 3.09 indicating some agreement with this criticism. Profit maximization, forecasting the future and fund's allocation was rated the most important uses of budgeting with mean ratings of 4.23, 4.16 and 4.28 respectively.

Discussions and Conclusions

The data above tell us budgets are employed by manufacturing firms in Kenya. A clear majority use most of the components of the master budget. The operating budget is a widely used tool. Cash budgets and capital expenditure budgets are also common.

The most widely applied budgeting period is between one and three years, and most of the firms review performance against budget every month. Budgeting is used by the manufacturing firms as a management tool for evaluating performance of the firm. It is also clear that the companies' medium term strategic plans are operationalize in budgetary terms.

The most important use of budgets according to this research is maximization of shareholders value. This is achieved through planning for the most optimal use of resources as well as continuously evaluating performance and putting in timely corrective action. With most of the firms reviewing their performance against budget every month, deviation form planned performance will be realized and corrected in good time.

The most important factor to consider while budgeting is the overall economic outlook. With all factors getting a mean that is above the median of 3, we can conclude that all of them are considered important to the process. This is in line with the review of literature, which indicated that unknown costs can be estimated by use past past trends and industry averages. (Clarke and Toal, 1999). Past behavior and emerging trends, government regulations and controls, consumer attitudes, tastes and preferences, competition, advertising efforts and political situation are all rated as important. An organization that competes with other vendors to provide services, overestimating costs can lead to the loss of service requests for each department (Covaleski et al., 2003; Little et al., 2002) These are assumptions which if not well understood by the budgeting firm can render the budgets irrelevant.

In terms of ranking, the least important factor is advertising and promotion efforts, but there is no consensus on the importance of this factor. We can only speculate that the importance or otherwise may depend on other factors like the category of manufacturing that a firm belongs.

In as far as challenges that lead to the budgeted output not being achieved, uncertainty in the economic, political and technological environment was ranked the most important. This is hard to predict and when the actual turns out to be different from the assumptions, then the performance is likely to be very different from the budgeted performance.

With regard to the criticisms of budgeting which form the basis of the “Beyond Budgeting” most firms did not identify with the criticisms. They majority disagreed with all the criticisms of budgeting. All but one of the factors had a mean rating that was below the median. This indicates that budgeting in its current form is widely. Overall, they strongly felt that budgets do add value, and that they are aligned to strategy and value in the eyes of the shareholder. However, there is a strong feeling that budgets stifle innovation.

The Manufacturing industry should adopt more advanced methods of budgeting as the data show that majority of sampled firms use traditional prior year budgeting method. Although historical data cannot and should not be ignored while planning for the future, prior year budgeting has some significant shortcomings, which could compromise the value of the budgets prepared. The problem is that less thought goes into the process, and real change is not incorporated in the budget.

Zero based budgets (ZBB) better equip management to make decisions when comparing actual program performance to the budget because it gives a better estimate of income projections. ZBB create a model for spending by breaking the habit of budgeting nonessential costs simply because they were incurred the prior year. Activity-based budget focus on activities that add value and better placed to support the shareholder's wealth maximization goal of the firm.

Since Zero Based Budgets and Activity-Based Budgeting have their own shortcomings, firms may benefit more from using a hybrid of all the methods. Some costs may only be reasonably estimated using historical data, but budgets are futuristic. However, incremental (prior year) budgeting in its traditional form may lead to carrying forward of inefficiencies from previous years.

With regard to review of the budgets, a majority of the firms review performance against budgets. While these are good, ways should be devised of incorporating cross-functional teams that cut across all ranks to create a sense of ownership within the organizations. This way, implementation of the corrective actions will seem less of an imposition.

Although calculating rewards and measuring performance of employees were rated as the less important uses of budgets, an ambitious and exhaustive budget can be used as a means of calculating rewards. This way, the employee can see what is in it for him and works hard towards achievement of that budget.

With regard to criticisms posed by the proponents of beyond budgeting, there is wide disagreement with all the factors by a majority of the firms studied. Budgeting is widely accepted in its current form in the manufacturing industry in Kenya. However, there is a need to adopt more recent developments or at least borrow from them. These include “beyond budgeting” and "benchmarking." These recent approaches to budgeting focus on the entire performance management process and emphasize more flexible models useful enhancing performance, financial planning processes and aligning individual behavior to corporate strategy.

Budgets are useful as a management tool but need to be used with caution. Sometimes there is a temptation to be too prudent and set very lenient budgets. This ensures that performance is always exceeding targets, but the value for the shareholder remains less than optimal.

Suggestions for Further Research

Budgeting should be studied in another sectors of the economy like the agricultural sector. Agriculture is a main source of livelihood for many Kenyans; such that strategic planning in the sector could play a big role in the success of the sector. More recent developments like “beyond budgeting” need to be studied in the manufacturing sector to assess whether the criticisms of budgeting have been felt and addressed. Further research may be done to assess the relationship if any of the budgeting practices in the performance of the companies. For the factors that affect budgets, it will be worthwhile to study them in depth and establish the extent to which they affect the process. Such research would aim to study how the firms go about estimating these factors to enable them to make realistic assumptions.

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