

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 Introduction**

Budgeting is a branch of management control in organisations. Budgeting is the process of identifying financial and non-financial resources and allocating these resources for use in the future. It is a system where information flows and administrative processes and procedures are combined (Merchant, 1981). In the organisation context, budgeting deals with distribution of limited resources in an efficient manner so as to maximise the wealth of the organisation.

Budget plays an important role as a planning and control system of the organisation (Merchant, 1981), for coordination as well as for communication purposes (Kenis, 1979). Fisher et al. (2002) added that budget can also be used to motivate subordinate performance mainly when the budget provides a platform to evaluate employees' performance (Hopwood, 1972). In short, there are three decision making functions that budgets provide: planning, control and motivation (Ronen and Livingstone, 1975).

According to Merchant (1981), one of the functions of budgeting is to enlighten organisational units as to the targets or goals of other units and of the corporation to be achieved. Based on budgets prepared, limited resources can be allocated efficiently throughout organisations to be used effectively.

Budgets can be created in various forms, such as the top-down approach, the bottom-up approach or the participative approach. The approach adopted depends on the involvement and the degree of influence the subordinate and superior has over the process of setting-up the budget.

Participative budgeting is one of the budgeting practices that have been adopted by organisations. Participative budgeting is defined as a process in which the manager is involved and has control over the determination of the budget (Shields and Shields, 1998). It is also a process where participating individuals share information and knowledge. An adequate level of participation can maximise the performance of members of the organisation to achieve the organisational goals. Kenis (1979) also suggested that the performance of subordinates can be enhanced through participation in determining budget goals.

Research in participative budgeting began in the 1940s (Shields and Shields, 1998) and at present, it is still attracting the attention of management accounting researchers who examine how participation is effective using different variables, for example cost management knowledge (Agbejule and Saarikoski, 2006), hierarchy control systems (Jermias and Setiawan, 2008), job-relevant information (Chong and Chong, 2002; Chong and Johnson, 2007), reasons-to-budget (Hansen and Van der Stede, 2004) and fairness perceptions (Lau and Lim, 2002; Wentzel, 2002; Maiga and Jacobs, 2007).

Moreover, there is inconsistency in the findings of empirical research examining the relationship between budget participation and performance (Merchant, 1981; Nouri and Parker, 1998; Shields and Young, 1993). Some studies show a positive relationship (Brownell, 1982a; Brownell and McInnes, 1986; Merchant, 1981), whereas others noted a significant negative relationship (Bryan and Locke, 1967; Cherington and Cherington, 1973; Locke and Schweiger, 1979) while a few studies revealed unrelated associations (Kenis, 1979) regarding the influence of budget participation on performance. Milani (1975) found a significant positive relationship but the relationship is not strong. Hence, these mixed results motivated the researcher to investigate the possible moderating and mediating roles in the budget participation and employee performance relationship.

According to Shields and Shields (1998), the conflicting results may be due to the indirect relationship of budget participation and performance or the presence of intervening variables. Intervening variables that have been examined, amongst others, are attitude (Milani, 1975), motivation (Brownell and McInnes, 1986), budget adequacy and organisational commitment (Nouri and Parker, 1998), and procedural fairness and trust (Lau and Tan, 2006). Moreover, budget participation is also likely to interact with different contingent variables to affect performance (Murray, 1990), for instance locus of control (Brownell, 1981; Brownell, 1982a), functional area (Brownell, 1985), type of state information (Chalos and Haka, 1989), budget favourability (Magner et al., 1995) and cost management knowledge (Agbejule and Saarikoski, 2006).

This study employs the goal setting theory that works based on a principle that the goals set provide the objectives that direct the action and behaviour of employees (Locke, 1996; Locke and Latham, 1984; 1990; 2002). It also suggests the motivational role of the budget in that it can increase the performance of employees. When the budget is prepared through participation, specific and attainable goals can be assigned which provide a clear direction for employees thus increasing their motivation in performing their task. The assignment of clear and reachable goals leads to the increment of employees' motivation (Bryan and Locke, 1967; Kenis, 1979; Locke and Bryan, 1968; Locke and Latham, 1984; Merchant, 1981).

Goal setting theory also acknowledges the importance of fair and reasonable goals that increase the performance of employees (Latham and Locke, 1979; Locke and Latham, 1984). The fairness perceptions of employees are important as they can demotivate the employees if any unfairness conditions exist in budget creation (Libby, 2001). It also ensures that all members of the organisation can work together to achieve the organisation's goals (Lau and Lim, 2002; Wentzel, 2002). However, in a participative budgeting setting, only a few study has systematically evaluated the influence of fairness perceptions in increasing managerial performance (Wentzel, 2002). Thus, using the goal setting theory, this study attempts to extend the work of Wentzel (2002) by examining whether budget participation increases the perceptions of fairness, which in turn increases the performance of employees. It is argued that by participating in the budget setting process, a fair budget can be determined from a fair process employed, thus increasing the likelihood of improving individuals' performance.

Positive perceptions of organisational fairness may motivate individuals to achieve organisational goals, and, in turn, increase their performance. While the relationship between organisational fairness and motivation has not been directly addressed in prior research, this study proposes that through participation, the perception of fairness can be improved and subsequently increase individuals' motivation. The concept of fairness is also quite new in the budgeting literature; as such, this study extends previous studies by examining the two dimensions of organisational fairness: distributive fairness and the procedural fairness.

Further, the budgeting process is argued to be very much influenced by the organisational culture that exists within an organisation (Frucot and Shearon, 1991; Hofstede, 1980; Lau and Tan, 1998; O'Connor, 1995). As this study aims to investigate culture's influence in the budgeting system, Hofstede's (1980) cultural dimension is adopted. It is suggested that the effect of power distance may mitigate the effectiveness of participation in the budget setting process at the organisational level (Lau and Buckland, 2000; Lau and Tan, 1998; O'Connor, 1995). This study examines whether the effectiveness of budget participation is influenced by organisational cultural differences between local and foreign firms in Malaysia, which according to Hofstede (1980) have different power distance levels.

Thus, in this study, behavioural implications of budgets are assessed. Specifically, it examines the effect of budget participation on performance via the role of organisational fairness and motivation. It also investigates the direct influence of organisational fairness upon motivation and whether organisational culture has any influence in affecting the effectiveness of budget participation on managerial performance, organisational fairness as well as motivation.

## **1.2 Problem Statement**

Budgeting has attracted the attention of researchers in various domains of psychological, economic and social literature (Covaleski et al., 2003). Research in participative budgeting has also demonstrated the role of budget participation in enhancing favourable attitudes and performance of employees. While many studies have examined the impact of participative budgeting on performance, the issue of the processes by which participative budgeting best operate to boost employees' job performance remains unaddressed. Shields and Young (1993) concluded that there is no conclusive evidence with regards to the effect of budget participation and performance. Thus, Shields and Shields (1998) further suggested that a richer model should be developed by future researchers to better explain how participation is effective with a broader scope of investigation to include other variables in the examination of the effect of budget participation and performance. Thus, this study contributes to the existing literature by offering an insight into the joint consideration of organisational fairness perceptions, motivation and organisational culture.

Further, there is an increasing interest of management accounting researchers to evaluate the effect of fairness perceptions on behavioural variables. Fairness perceptions are argued to have greater influence on organisational outcome variables (Alexander and Ruderman, 1987), thus by maintaining fairness they can promote more favourable effects of employee reaction (Folger and Konovsky, 1989; Lau et al., 2008; Tang and Sarsfield-Baldwin, 1996). While there has been much research on the perceptions of fairness in legal, political and psychological settings (Lau and Lim, 2002), only a few studies in the management accounting literature have examined the role of both dimensions of fairness in the organisation (for example, Maiga and Jacobs, 2007; Wentzel, 2002). Thus, this study aims to extend the work of Wentzel (2002) and Maiga and Jacobs (2007) to examine the

relationship between budget participation and both dimensions of fairness perceptions, and their effects on managerial performance.

Moreover, Libby (1999) argued that fairness leads to increasing employee motivation, but no systematic evaluation has been conducted to investigate the effect of fairness perception on motivation. While participation may motivate individuals and lead to improved managerial performance, the question remains as to whether perception of organisational fairness can directly motivate individuals and, in turn, increase managerial performance. This study attempts to answer this question.

Further, even though many studies have examined the impact of participative budgeting on performance, the issue of whether organisational culture (operationalised as power distance) affects managerial function in making decisions remains unaddressed. The difference in power distance index between countries in the Asian region and Anglo-American countries is clearly evidenced (Hofstede, 1983). In particular, Malaysia scored at the highest end, with an index of 104, while the score of Anglo-American countries (United States, Australia and Great Britain) ranges from 35 to 40 (Hofstede, 1983; 2001). It signifies that Malaysia is a high power distance country, whereas Anglo-American societies are amongst the low to moderate power distance countries. While budget participation is effective in Anglo-American countries, it is arguable whether the same effect occurs in high power distance countries (Frucot and Shearon, 1991; Hofstede, 1980; Lau and Tan, 1998; O'Connor, 1995). Moreover, the issue arises as to whether these differences in the level of power distance reflect the effectiveness of budget participation practices at the organisational level. In other words, whether the effectiveness of budget participation is

influenced by the difference in power distance index between Malaysian local companies and foreign subsidiary companies situated in Malaysia.

Thus, this study aims to provide a more comprehensive model of budget participation in examining the role of organisational fairness perceptions, motivation and organisational culture in the organisation. It also aims to examine their influence on the performance of employees.

The main research questions for the study are as follows:

1. Does budget participation have a direct relationship with managerial performance, organisational fairness and motivation?
2. Does better perception on organisational fairness have a direct relationship with motivation and managerial performance?
3. Does motivation have a direct relationship with managerial performance?
4. Does organisational fairness mediate the relationship between: (i) budget participation and managerial performance, and (ii) budget participation and motivation?
5. Does motivation mediate the relationship between: (i) budget participation and managerial performance, and (ii) organisational fairness and managerial performance?
6. Does organisational culture moderate the relationship between: (i) budget participation and organisational fairness, (ii) budget participation and motivation, and (iii) budget participation and managerial performance?

### **1.3 Objectives of Study**

The purpose of this study is to test empirically the effects of participative budgeting on managerial performance through the role of organisational fairness and motivation as intervening variables. Moreover, this study also examines whether participation interacts with organisational culture in affecting fairness perception, motivation and managerial performance. It is suggested that by participating in the budget setting process, not only may individuals' perceptions of organisational fairness be improved, but also that employees' motivation may be enhanced, and in turn individuals' performance increased.

The research objectives associated with the research questions are stated as follows:

1. To examine whether budget participation has a direct relationship with managerial performance, organisational fairness and motivation.
2. To examine whether organisational fairness has a direct relationship with motivation and managerial performance.
3. To examine whether motivation has a direct relationship with managerial performance.
4. To examine whether organisational fairness mediates the relationship between: (i) budget participation and managerial performance, and (ii) budget participation and motivation.
5. To examine whether motivation mediates the relationship between: (i) budget participation and managerial performance, and (ii) organisational fairness and managerial performance.
6. To examine whether organisational culture moderates the relationship between: (i) budget participation and organisational fairness, (ii) budget participation and motivation, and (iii) budget participation and managerial performance.

#### **1.4 Contributions and Significance of Study**

Meta-analysis of the studies on budget participation reveals the inconsistency of the findings in the relationship between budget participation and performance of employees, which some shows significant, insignificant or unrelated associations. In view of these variances, Shields and Shields (1998) suggested that the relationship could be indirect rather than direct and that it might be possible that the relationship is affected by other intervening variables. This research attempts to extend the previous research by developing a more comprehensive model to provide better explanations related to budget participation behavioural consequences. This study aims to examine whether budget participation improves managerial performance in the presence of the perceptions of organisational fairness, motivation and organisational culture.

Further, in psychological, political and legal literatures (Lau and Lim, 2002), many studies have been conducted to investigate the role of fairness perception in affecting the attitudes and behaviour of employees. In the accounting literature, however, only a few studies have evaluated systematically both dimensions of organisation fairness – distributive fairness and procedural fairness – in the contexts of management control systems in organisations (Wentzel, 2002; Maiga and Jacobs, 2007).

Wentzel (2002) examined the combined mediating effect of fairness perceptions and goal commitment in the relationship between budget participation and performance, whilst Maiga and Jacobs (2007) provided a model in which fairness perception, trust and goal commitment mediate the relationship between budget participation and budgetary slack. This study aims to extend the research by Wentzel and Maiga and Jacobs by examining a model in which fairness perception and motivation mediate the relationship between budget

participation and managerial performance. In addition, it also examines the interaction of budget participation and organisational culture on organisational fairness, which has not previously been examined.

Moreover, with regards to the effect of fairness perceptions on managerial performance, Lau et al. (2008) acknowledge the importance of employee performance and they suggest that “future research ... investigates the processes by which procedural fairness affects employee performance” (p. 133). In this study, therefore, not only are the effects of procedural fairness on employee performance examined but also other dimensions of organisational fairness.

This study also empirically investigates whether fairness perception affects motivation. While most of the studies in fairness literature have discussed the motivational role of fairness perception (Libby, 1999; 2001), to date no empirical evidence in accounting literature has actually examined the relationship. Thus, this study attempts to fill this gap by investigating the influence of fairness perception on motivation.

This study also contributes to the existing literature by providing a recent power distance index in Malaysia. Power distance is related to the issue of inequality of distribution of power and authority among individuals in organisations. Societies with large power distance index normally indicate an autocratic style of leadership and that centralisation of power is practised in the organisation. On the other hand, societies with low power distance index practise a more participative style of leadership with more decentralisation of power.

Hofstede (1980; 1984a) has conducted a study to investigate power distance index in 40 countries and he subsequently extended the research to another ten countries and three regions, which made up a total of 53 countries and regions (Hofstede, 1983; 2001). He found that power distance index in Malaysia is 104, which constitutes a high power distance index. Since the study was conducted from 1967 to 1978, the index might have changed in the new millennium as most of the Asian countries are experiencing fast economic growth (Lau et al., 1995). This study attempts to provide an updated power distance index by employing Hofstede's (1980; 2001) power distance measurement. Further, this study also seeks to understand whether the differences in the index for local companies (expected high index) and Anglo-American subsidiaries companies (expected low index) operating in Malaysia (Hofstede, 1983) affect the effectiveness of budget participation practices in both ownership structures.

While the influence of organisational culture on participation has been studied in the previous budgeting literature (Lau and Buckland, 2000; Lau and Tan, 1998; O'Connor, 1995), to date the effectiveness of budget participation in enhancing fairness perceptions, individuals motivation as well as increasing the performance of employees has not been assessed systematically, in the presence of high power distance in Malaysian society (Hofstede, 1983). Thus, this study attempts to fill in this gap. It examines the impact of power distance on the effectiveness of participation in increasing those positive attitudes and behaviours of employees. Specifically, this study examines whether participation interacts with organisational culture in affecting fairness perception, motivation and managerial performance.

Further, the current study contributes to the literature by widening the scope of investigation of budget participation that may affect performance. It provides empirical evidence about the tendency of organisational fairness to influence motivation and performance among managers. From a practical perspective, this study is important in the sense that it may assist superiors to understand that good perception of organisational fairness may increase employee motivation, which in turn can improve subordinates' performance. In addition, this study provides further evidence to the organisation of the significance of maintaining fairness perception in the budgeting process, which may affect the performance of managers and subsequently influence organisational performance.

Finally, even though extensive studies have been carried out to understand the relationship between budget participation and managerial performance, the findings are inconclusive (Shields and Shields, 1998; Shields and Young, 1993). In view of the inconsistent findings and the lack of studies that have been conducted in Malaysia, this study provides evidence on the relationship between budget participation and managerial performance in Malaysia.

## **1.5 Organisation of the Thesis**

This thesis consists of the following chapters:

### **Chapter One: Introduction**

Chapter One reviews, in general, the role of budget as a planning and control device in the organisation. It also discusses budget participation issues, the problem statement and objectives of the study. In the last sections, the contributions and significance of the study are addressed.

## **Chapter Two: Literature Review**

Chapter Two reviews the literature and previous studies conducted by a large number of researchers related to the issue of budget participation and its variables under study. Altogether, there are five sections to accommodate the five variables: budget participation, organisational fairness, motivation, organisational culture and managerial performance.

## **Chapter Three: Theoretical Framework and Hypotheses Development**

Chapter Three contains a discussion of the theoretical framework that generally provides the foundations of this study. It is followed by the development of testable hypotheses.

## **Chapter Four: Research Methodology**

Chapter Four covers the research methods used, i.e. questionnaire survey and semi-structured interviews. It discusses the research and questionnaire design, the interview guide and the mode of data analysis for both types of data collection method.

## **Chapter Five: Research Findings**

Chapter Five presents the statistical results and discusses the findings of the analysis and their interpretation. It also discusses the findings of the semi-structured interview.

## **Chapter Six: Discussion and Conclusions**

Chapter Six summarises the findings and discusses the results. This chapter also provides the implications of the study. The limitations and directions for future research are also presented.