CAM-I

Beyond Budgeting Round Table

Beyond Budgeting
Questions and Answers

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October 2001

Introduction

> *"We seem to be a bit unusual. We have taken strides down the empowerment path. We have truly embraced customer service. And we even know a lot about customer profitability. Yet the planning and budgeting system is still at the core of performance management. And it causes us immense problems. For a start it fails to support our strategic objectives and it rewards the wrong behaviour. And at 475 pages and 3.5kgs in weight, our budgeting manual is a major cause of deforestation! There are thousands of budget centres and it takes nine months to put together soaking up around 20% of management time (we estimate the annual cost at around Euro 30-35 million). If we don't meet the budget contract the roof falls in. We lose bonuses of up to 40% of salary and get overlooked for promotion or new opportunities. Excuses are not tolerated. Even a sudden currency change, the collapse of a country's economy, social unrest, war, and natural disasters are no excuse. People will move heaven and earth to achieve their numbers. But you have to wonder whether they are real. In other words, how much has been 'borrowed' from future periods? It all amounts to a huge distortion of people's behaviour and a complete waste of everyone's time."*

This comment by a senior manager in a global company encapsulates the problems of the planning and budgeting process in many medium- to large-sized organizations today.

The CAM-I Beyond Budgeting Round Table (BBRT) was set up in response to growing dissatisfaction, indeed frustration, with traditional budgeting. Since its inception in January 1998, 55 (mostly large European) companies have participated in the BBRT. Though its origins are in the UK, it now has members from many countries including the UK, Belgium, Holland, France, Germany, Norway, Sweden, Switzerland, South Africa and the USA. All member companies joined because they recognized that the budgeting approach was increasingly causing dysfunctional behaviour as well as being out of kilter with their competitive environment. Despite these concerns, however, few were convinced at the outset that there was a viable solution. Our task was to provide this solution. We did this by first identifying those companies that had abandoned budgeting, visiting them, and then (through case reports and presentations) reporting back to BBRT members. By extracting best practices we gradually pieced together a coherent set of common principles and processes that have formed the framework of what has since become known as the beyond budgeting model. It has taken a few years for many BBRT members to move from being curious observers to committed implementers. They needed to be convinced by the evidence. We believe that our step-by-step approach to producing a set of principles, then a diagnostic, and finally an implementation guide, provided this evidence, and has given them the confidence to proceed.

The BBRT is now acknowledged to be a thought leader on the subject of devolved and adaptive organizations. In the course of the past four years we have been asked many questions about the concepts and practical implications of beyond budgeting. This paper addresses these questions. We have adopted a 'conversational' style to enable us to 'develop' some of the points and thus simulate a live question and answer session.

Jeremy Hope and Robin Fraser

Issues addressed

1. **Beyond budgeting -** *Tell me in a few words what "beyond budgeting" is about*.
2. **Performance contracts and budgets -** *What is the difference between a "performance contract" and a "budget"?*
3. **Six fallacies of the budget contract -** *What is wrong with the budget contract?*
4. **Hidden costs -** *You imply that budget contracts carry hidden costs. What are they?*
5. **Ineffective solutions -** *I thought many of the problems you allude to had been overcome?*
6. **Beyond budgeting cases -** *How many organizations have adopted "beyond budgeting" and what have been their experiences?*
7. **Beyond budgeting principles -** *What is different about beyond budgeting?*
8. **Replacing performance contracts -** *If we don't have fixed performance contracts with our managers, how can we set 'stretch' targets and thus produce acceptable profit forecasts, and how do they know what is expected of them?*
9. **Performance contracts and dealing with analysts and bankers** - *How do I know what to tell analysts?*
10. **Planning and control -** *How do you manage the business if you don't have annual plans and budgets? What do we get in place of budget-based controls?*
11. **Coordination -** *How do you coordinate actions without budgets?*
12. **Leadership principles and devolution -** *I see that devolving authority to front line teams is an important part of the change program. We have been trying to make this work for years, but without much success. What makes you think it will work this time?*
13. **Implementation – Getting started -** *Who should lead the beyond budgeting program?*
14. **Implementation – Phased approach –** *I'm not sure I can get our leaders to go the "whole way" immediately. Can beyond budgeting be implemented in "phases"?*
15. **Successful "budgeting" organizations -** *There are surely many organizations that are successful with traditional budgets. How do you explain this?*
16. **Shareholder value -** *My success is based on how much value I create for shareholders. How does beyond budgeting help me achieve this?*
17. **Different countries and cultures -** *I can see how this new model might work in Scandinavia, but we have operations in all parts of the world. Will it work elsewhere?*
18. **Different industries -** *Does the model apply in all industries? For example, I would have thought that capital-intensive industries would be more suited to the traditional budgeting approach?*
19. **The public and not-for-profit sectors -** *Do the public and not-for-profit sectors have anything to learn from beyond budgeting?*
20. **Governance -** *One of my roles is to ensure that our control systems are adequate, thus satisfying the governance obligations placed on us by shareholders. How will your proposals affect this?*
21. **Economic value added -** *Is beyond budgeting compatible with EVA?*
22. **Balanced Scorecard -** *We use the Balanced Scorecard in some of our business units. How does beyond budgeting work with the scorecard?*
23. **Activity-based management -** *Activity-based management is another tool we use. What's your view on this? How can it support beyond budgeting?*
24. **Rolling forecasts -** *We are thinking of using rolling forecasts. Is this another tool that can work well with beyond budgeting?*
25. **Information systems** *- You talk a lot about moving from the idea of "mechanical" systems to "webs of relationships". What are the implications for information systems?*

1. Beyond budgeting

Q: *Tell me in a few words what "beyond budgeting" is about.*

A: "Beyond budgeting" is about releasing capable people from the chains of the top-down performance contract and enabling them to use the knowledge resources of the organization to satisfy customers profitably and consistently beat the competition. With intellectual assets accounting for 80-90% of shareholder value today, people really are the organization's most valuable asset. But the way the annual budget contract works means that their energy and ingenuity is used more for negotiating the budget than for creating value for customers and shareholders. The budget contract is a relic from an earlier age. It is expensive, absorbs far too much time, adds little value, and should be replaced by a more appropriate performance management model.

2. Performance contracts and budgets

Q: *What is the difference between a "performance contract" and a "budget"*

A: There are two types of performance contract. One is between executive leaders and the market (the "earnings contract"), and the other is between leaders and operating managers (the "budget contract"). The purpose of the budget contract is to delegate the accountability for achieving agreed outcomes to divisional, functional, and departmental managers. The terms of these contracts and the assumptions underlying them, typically include:

- *Targets.* The assumption is that the budget negotiation process maximizes profit potential in both the short- and the long-term. Targets can be set top-down with no participation from front line managers, or they can be 'negotiated' between superiors and subordinates. They are normally fixed for a period of twelve months and based on financial numbers.
- *Rewards.* The assumption is that financial incentives build motivation and commitment and fairly reward performance achievement. They are usually fixed to the agreed target and cover a range of outcomes (e.g. from just below the target to just above the target). While rewards usually apply to managers, they are sometimes extended to team members. Recognition (e.g. promotion) can also be contingent on the achievement of targets.
- *Plans.* The assumption is that the annual planning and budgeting process is the best way to direct actions that maximize market opportunities and meet strategic objectives. This process can be top-down (prepared by leaders or central planning departments), or more likely bottom-up, with local teams preparing their plans and then negotiating and agreeing them with superiors.
- *Resources.* The assumption is that by evaluating the merits of each budget proposal, central planners and controllers can sensibly allocate resources to optimize the efficiency of the business. Once plans have been agreed, the 'master budget' can be prepared and resources allocated to the detailed budgets. Major projects will be part of the capital budgeting process.
- *Coordination.* The assumption is that central planners can coordinate budgets across the business and ensure that one part knows (and can deliver) its commitments to another part. For example, they need to ensure that production and sales are in tune, and marketing has the resources to support the sales target.
- *Reporting.* The assumption is that if managers and executive leaders are regularly informed

of progress they can take corrective action to ensure that performance remains “on track” with the agreed plan. Thus managers will need to explain any variances and provide updated forecasts as a basis of such action.

The budget contract takes, on average, between four and five months to complete.[1] Its terms and conditions can either be explicit (usually a written letter from a superior to a subordinate), or implicit (custom and practice tells the parties what the likely outcomes will be). In addition to the six elements identified above, the terms of such a contract are likely to include a time period within which targets must be achieved, the limits of authority, and the reporting intervals. This is much more than a simple budget – a term usually taken to mean a financial view of the future derived from someone’s best opinion of the ‘most likely outcome’ given the known information at the time. Such estimates are prepared all the time for managing cash flows. Indeed such a budget is an integral part of every management model. The purpose of a *budget contract*, however, is to *commit* a subordinate or team to achieving an agreed outcome and then enable a superior to *control* the results against that outcome (reserving the right to interfere and change the terms if necessary). The budget ‘contract’ is not of course legally binding. It is more of a promise or a commitment than a legal transaction. And its interpretation can be different across and within organizations. Indeed, budget contracts range from highly authoritative to highly participative.

3. Six fallacies of the budget contract

Q: *What is wrong with the budget contract?*

A: The budget contract is a relic from an age when head office people made the decisions and front line workers were told what to do. But such remote-control management no longer works in an age when decisions have to be made quickly at the front line to meet the exact (and exacting) needs of customers. To believe in the effectiveness of performance contracts you must, by and large, believe that setting or negotiating fixed financial targets is the best way to maximize profit potential; that financial incentives build motivation and commitment; that annual plans are the best way to direct actions that maximize market opportunities; that leaders are best placed to make resource allocation decisions that optimize efficiency; that leaders can effectively coordinate plans and actions to bring coherence; and that financial reports provide relevant information for effective decision-making. However, if we examine each of these beliefs underlying the budget contract, we can see that every one turns out to be a fallacy.

Fallacy #1: Fixed financial targets maximize profit potential

Setting a numerical target and controlling performance against it is the foundation stone of the budget contract in today’s organization. But, as a concept, it is fundamentally flawed. It is like telling a motor racing driver to achieve an exact time for each lap of the race before starting the race and without knowing many of the factors that will determine the outcome (such as the performance and behaviour of other drivers, reliability of the car, weather conditions, and so forth). In other words, it cannot predict and control extraneous factors, any one of which could render the target totally meaningless. Nor does it help to build the capability to respond quickly to new situations. But, above all, *it doesn’t teach people how to win*. Fixed financial targets are at the core of what is rotten about budget contracts and should be abandoned.

Fallacy #2: Financial incentives build motivation and commitment

The vast majority of organizations regularly experiment with different ways to tie pay to individual performance.[2] Clearly many leaders appear to believe that the performance 'holy grail' is finding the right mix of targets and incentives within the budget contract. But the link between incentives and profit performance is tenuous at best. In 1993, Alfie Kohn's article in the Harvard Business Review entitled "Why Incentive Plans Cannot Work" generated more comment than just about any other article in the history of this famous journal. When asked, "Do rewards work?" Kohn replied that the answer depends on what we mean by "work". Research suggests that, by and large, rewards succeed at securing one thing only: temporary compliance. When it comes to producing lasting change in attitudes and behaviour, however, rewards, like punishment, are strikingly ineffective. Once rewards run out, people revert to their old behaviours…They do not create an enduring commitment to any value or action. Rather incentives merely – and temporarily, change what we do". [3] There is deep dissatisfaction with incentive schemes. Surveys conducted by William M. Mercer, for example, led them to conclude that they absorb vast amounts of management time and resources, and they make everybody unhappy.[4] This is not to say that rewards aren't appropriate. They are. But they should be seen as a share of success (like a dividend on intellectual capital) rather than a "do this, get that" type of incentive linked to a target. They should also be based on the whole team and geared to competitive success, not on a few people meeting some negotiated number.

Fallacy #3: Annual plans direct actions that maximize market opportunities

In most firms, planning is seen as a hypothesis for getting from A to B. This involves managers in defining a medium-term objective and then planning to achieve that objective through a number of defined steps using the resources at their disposal. It is based on the premise of "predict and control". Thus the planning process is highly deterministic. But this also means that it is difficult to change, even when the fundamental assumptions on which it was based become untenable. Leaders responsible for developing strategies are often resistant to signs that they may not be working. Most survey evidence confirms this view. For example, 60% of firms fail to align their action plans with their strategy.[5] And 78% of companies do not change their budgets within the fiscal cycle[6]. Perhaps even more startling is another survey result that shows that 85% of management teams spend less than one hour per month discussing strategy.[7] This evidence suggests that front line managers still follow the plan, no matter what is changing around them.

Fallacy #4: Central resource allocation optimizes efficiency

One of the primary purposes of traditional budgeting is to enable senior managers to allocate resources to operating units so that the optimal resource usage is obtained across the company. This process enables them to exert control over the spending plans of all their operating units and cost centres. Thus the head office is often seen as the corporate "banker" either constraining or unleashing expansionary proposals. Central bankers are notoriously risk averse, seeing the business more as a portfolio of assets than a portfolio of business opportunities. Thus resources flow to existing products and businesses rather than to new ideas, they support vested interests rather than new opportunities, and they flow to departmental budgets rather than strategic initiatives.

Fallacy #5: Central coordination brings coherence

Leaders attempt to coordinate plans by linking one budget with another, but such relationships are only valid at one point in time. They are based on the concept of 'cause-and-effect'. This is another fundamental flaw in the concept of planning and budgeting, and stems from the 'organization-as-a-machine' assumption. While causality looks seductively simple on spreadsheets, in the real world of complex human relationships, it is dangerous. Cutting, say $1m from the payroll, for example, rarely, if ever, results in an extra $1m bottom line profit. There will likely be adverse effects on productivity, overtime, customer service, absenteeism of remaining staff, and other costs that are not so apparent on the profit and loss account.

Fallacy #6: Financial reports provide relevant information for strategic decision-making

Performance reports usually contain only lagging indicators (i.e. numerical variances connected with past events) that are primarily financial. But financial variances do not lend themselves easily to examining root causes. This should not surprise us when we remember that financial measures are a function of a belief system rooted in the mechanical organization. It assumes cause-and-effect. It assumes linear, one-to-one, relationships. Many computerized accounting systems reinforce rather than challenge this model. The only difference is that they provide deeper and faster 'drill-down' capabilities that enable senior executives to make enquiries at low levels of the accounting system. In other words, they can see minute parts in detail, but gain little knowledge of the patterns of change that affect the whole system.

4. Hidden costs

Q: *You imply that budget contracts carry hidden costs. What are they?*

A: According to a recent cover article in Fortune magazine, around 70% of companies are poor at executing strategy – a massive indictment on the performance management capabilities of budgets.[8] It turns out that most companies were characterized by incremental thinking, sclerotic planning and budgeting processes, centralized decision making, petty operating rules and procedures, and controllers that demand answers to the wrong questions. And despite a decade of flattening hierarchies and the advent of enterprise-wide accounting systems and balanced scorecards, performance management systems (with the budget contract at their core) remain the primary blockage. More specifically, the hidden costs of the performance contract can be seen from (1) a process perspective (the time it absorbs and costs) and (b) an organization perspective (the cost structure that it supports).

Hidden costs from a process perspective. A KPMG Consulting study showed that the planning and budgeting process absorbs up to 20 to 30% of senior executives' and financial managers' time.[9] One global carrier organization reckoned that its annual planning and budgeting process costs around $35 million. And a 1998 benchmarking study showed that the average company invested more than 25,000 person days per billion dollars of revenue in the planning and performance measurement processes; the average time taken for developing a financial plan was 4.5 months; and companies required an average of 21 days to complete a forecast.[10]

Hidden costs from an organization perspective. Swedish bank, Svenska Handelsbanken, has been operating without annual plans or performance contracts for around thirty years. Though relatively small in global terms ($2 billion income; 8,500 employees), it offers the full range of universal banking services and thus is a smaller scale model of most larger European and North American banks. Its cost-to-income ratio has consistently ranged between 40-50%. In 2000 it was 45%. The primary reasons for this low level of costs are a small head office function (half a head office person per branch as against five people for most other banks); a flat management structure with highly devolved decision-making; low bad debts; low transaction costs through extensive use of telephone and Internet banking; and a cost reduction philosophy created by the transfer of profit responsibility to branches and the eradication of the budgeting mentality. As a comparison, the average cost-to-income ratio of the twenty largest North American banks in 2000 was 63.9%[11] and the average for its Nordic rivals was 61%. Taking the cost advantage to be, say, 15% of income, this means that for every billion dollars of income, Handelsbanken has $150 million fewer costs than other banks.

5. Ineffective solutions

Q: *I thought many of the problems you allude to had been overcome?*

A: The weaknesses of the budget contract have been recognized for decades. Writers such as Mayo, McGregor, Maslow, and Herzberg have all argued in one form or another that superior performance is driven not by planning, controls and incentives, but by team working, self-esteem and personal development. And more recently, such writers as Senge, Wheatley, Johnson, Mintzberg, Schein, and Argyris have all argued that the budget contract seduces leaders into believing they can control the business through the numbers when, in reality, this is a dangerous illusion. But how much has actually changed in practice? Very little is the answer. Attempted solutions broadly fall into four categories: decentralization, process improvements, resource management improvements, and alternative strategic models.

Decentralization isn't effective

Decentralization, team working, and empowerment, have all been used to try to cut the costs of the corporate bureaucracy and increase the speed of decision making, but all have met with limited success. Most have been attempts to fine-tune rather than challenge the traditional model. One problem has been a lack of understanding of the changes required. In practice, decentralization often means no more than the delegation of control within a strict regime of coordination and accountability, with the performance contract as the primary weapon for policing this control. Delegation and coordination, however, do not make comfortable bedfellows. Indeed a constant battle is being waged in most large organizations between the forces of decentralized initiative (usually the losers) and the forces of centralized coordination (invariably the winners). It is the power of the group finance team to demand fixed plans and budgets and control performance against them that reinforces the centralized model and mind-set.

Better budgeting is not the answer

Many progressive companies today are introducing rolling forecasts, and more frequent, and much streamlined, planning and budgeting processes, in an attempt to address the demands of a business environment that is rapidly changing. But they do not provide long-term solutions because they do not address many of the fundamental weaknesses (e.g. poor strategic linkage) of the budgeting contract. In fact they often create more work (and cost) rather than less. As a Fortune Magazine article noted many years ago: “The value of an annualized budget depreciates fast. Simply revising it every few months may tighten the budgetary coils instead of releasing managers to act strategically”.[12]

Improving resource management only goes so far

There have been various attempts to overcome the resource management problems of budgeting, and with some success. For example, zero base budgeting (ZBB) is an approach to budgeting that starts with a blank sheet of paper in regard to discretionary expenditure. It became popular in the 1970s and 80s and proved to be a useful (usually one-off) exercise to review discretionary overheads. However, in practice, the process is so bureaucratic and time consuming that few companies use it more than once. Activity based budgeting (ABB) is another approach to improving resource management. It is, in effect, activity-based costing in reverse. In other words, it starts from estimating the demand for resources and works backwards to derive the activities and resources required to support that demand. ABB is undoubtedly a useful tool for helping managers identify and eliminate excess capacity. However, not unlike ZBB, it requires painstaking detail to apply it well and introduces undesirable rigidities around processes. While many companies have successfully used activity-based costing, few have extended the use of its principles into their budgeting processes.

Alternative strategic models support rather than replace the performance contract

Most so-called “strategic models” or “tools” are used by organizations to fix what leaders perceive to be mechanical breakdowns in their organizations. “Reengineering” business processes even uses the language of mechanical solutions. Reengineers, by and large, use information technology to design the most elegant solution, always trying to minimize the roles played by real human beings. It is because people are seen to cause the breakdowns that reengineers try to eliminate them as far as possible from the process. Likewise, organizations that use “customer relationship management” models tend to use technology to find customers for products or services rather than provide solutions for customers. Other “numbers-based” tools such as shareholder value models, rolling forecasts, and benchmarking, are all potentially helpful *if implemented in the right way.* The wrong way is to use them to support the performance contract. It is the conceptual framework that is the problem. Most models are aimed at making the top-down control system work more efficiently, rather than fundamentally changing the way that organizations interact with their customers.

6. Beyond budgeting cases

Q: *How many organizations have adopted “beyond budgeting” and what have been their experiences?*

A: While Dr Jan Wallander was transforming Handelsbanken into one of Europe’s most successful banks of recent decades, few companies took the trouble to find out what he had done, and more importantly, how to turn his philosophy into a set of guiding principles. It was only in the 1980s that a French businessman, Jean-Marie Descarpenties was to follow a similar approach, first at packaging company, CarnaudMetalBox, and then at computer company, Groupe Bull. At the same time Dennis Bakke and Roger Sant were establishing an electric utility company in America, known as the AES Corporation, and based on a core set of principles that both Wallander and Descarpentries would have approved. In the 1990s, as word got around, a number of other companies started to follow suit. Furniture manufacturer and retailer, IKEA, abandoned budgeting in 1994, car giant, Volvo Cars in 1995, and petrochemicals company, Borealis, also in 1995. Norwegian based, Fokus Bank, and Swedish plumbing and heating distributor, Ahlsell, soon followed. And more recently two UK-based organizations, cider-maker, Bulmers, and charity Sight Savers International, have started the process. Other companies including Siemens, UBS, and UDV-Guinness are just starting their “beyond budgeting” journeys.

Q: *Does beyond budgeting lead to better performance?*

A: The evidence from our own observations and from the surveys we have conducted suggests that it does, but it is much stronger in those organizations that have “gone all the way” (that is, changed the culture) than those that have had more limited objectives (that is, restricted changes to performance management processes). Consider the evidence from our cases.

Handelsbanken has outperformed its Nordic rivals on just about every measure you can think of including return-on-equity, total shareholder return, earnings-per-share, cost-to-income ratio, and customer satisfaction. And it is has done this year-in, year-out, for the past 30 years. It is the most cost efficient bank in Europe and has recently been voted one of Europe’s best Internet banks. CarnaudMetalBox was transformed from a debt-laden company worth only $19m in 1982 to a market value of $3bn in 1989 and described by Fortune Magazine as one of the best European corporate performances of the 1980s. Bull had a similar experience under the leadership of Descarpentries (though in both cases results went into decline when he departed and the management model reverted to the traditional budgeting contract). Volvo made significant progress and moved from number nineteen to number two in world profitability by 1997 (it has since been acquired by Ford). Borealis has met its ambitious return-on-capital targets and reduced costs by 30% over 5 years. Fokus Bank came from nowhere to be the most cost efficient bank in Norway and was then acquired by Danske Bank of Denmark. Ahlsell is now the sector’s most profitable company in heating and plumbing, and in electrical – a major turnaround from its position in the early 1990s. Bulmers is growing revenue and profitability at a much higher rate than the industry average and there have been significant cost savings. And AES has been one of America’s “wonder” stocks of the 1990s (total shareholder return was top of the Fortune rankings in the Utility sector for 1999).

7. Beyond budgeting principles

Q: *What is different about beyond budgeting?*

A: The root of the planning and budgeting problem lies in the pervasive view of organizations as machines for making money, as opposed to complex human organizations composed of webs of relationships that have a life of their own, that evolve over time, and that constantly adapt to the changes in the environment. Of course they must “make money” and satisfy their key constituents (such as shareholders), but they must also have a higher purpose or responsibility, usually connected to some social contribution to the local or world community. Beyond budgeting connects these ideas of the organization as a human network with different ways of managing performance.

Table 1 contrasts the traditional with the beyond budgeting processes and shows how they meet (or don’t meet in the case of traditional processes) the purposes of performance management.

Table 1 –Comparing traditional and beyond budgeting processes

Purposes of performance management	Traditional ‘budgeting’ processes	Beyond budgeting processes
• **Goals -** to balance the need to maximize short- and long-term profit potential.	• Fixed annual targets (performance contracts) drive short-term actions	• Relative and self-imposed KPI ‘aspirational’ goals drive sustained competitive success

• **Rewards -** to provide an effective basis for motivating and rewarding performance.	• Individual incentives build a "defend own turf" attitude, and "meet the target" drives irrational behaviour	• Team-based rewards build a 'one-team' attitude, and peer pressure drives continuous improvement
• **Plans -** to direct actions to maximize market opportunities.	• Annual plans support a 'make and sell' or 'company first' approach to strategic management	• Event-driven strategies support a 'sense-and-respond' or 'customer-first' approach to strategic management
• **Resources -** to ensure that resources are available to support agreed actions.	• Centrally allocated resources inhibit fast response and encourage waste	• On-demand resources enable fast response capabilities and reduce waste
• **Coordination -** to harmonize actions across the business.	• Centrally linked budgets provide slow, disjointed solutions that often fail to meet customer needs	• Dynamic linking of customer demands provide, fast, seamless solutions that meet customer needs
• **Controls -** to provide relevant information for strategic decision-making and controls.	• Financial variances that compare actuals with budget provide a poor basis for learning	• Multifaceted and multi-level information systems provide patterns of information that inform strategic decision-makers

We have developed a model that has twelve principles of which six relate to performance management processes and six relate to leadership actions (each leadership principle supports a process). Table 2 shows these principles, but will be better understood in the context of a new conceptual framework. Such a framework includes the following reference points:

- The primary objective is to satisfy customers profitably (this, in turn, leads to increases in shareholders' wealth). Thus organizations are best understood by looking at the whole value delivery system rather than its individual parts. The appropriate metaphor is a web of interdependent human relationships, not a machine with independent parts.
- The only measure of success that ultimately matters to shareholders is relative success. Investors that are willing to place their funds in a particular business sector want to back the right horse over the longer-term. So providing the best competitive returns is what matters most.
- Planning doesn't have to revolve around the calendar. The future is inherently unpredictable, therefore decisions should happen continuously and adapt to events as they happen.
- The quality of decision-making does not necessarily improve the higher in the organization it takes place. Indeed, given the same information at the same time, most competent people come to the same conclusion
- The real controls do not come from looking at the past. They come from seeing the present and an evolving future in terms of patterns and trends that paint a "big picture" of where performance is heading. Individual measures are never as "specific" as they seem. They are usually dependent on other factors and thus too easily distorted to be meaningful.

Table 2 – The 12 beyond budgeting principles

Key performance management principles	Key leadership principles
1. Beat the competition	7. Create a performance climate based on sustained competitive success
2. Reward team-based competitive success	8. Build the commitment of teams to a common purpose, clear values, and shared rewards
3. Make strategy a continuous and inclusive process	9. Devolve strategy to front line teams and provide the freedom and capability to act
4. Draw resources when needed	10. Champion frugality and challenge the value-added contribution of all resources
5. Coordinate cross-company interactions through "market-like" forces	11. Organize around a network of teams that dynamically connect their capabilities to serve the external customer
6. Provide fast, open information for multi-level control	12. Support transparent and open information systems

8. Replacing performance contracts

Q: *If we don't have fixed performance contracts with our managers, how can we set 'stretch' targets and thus produce acceptable profit forecasts, and how do they know what is expected of them?*

A: Let's think about this for a moment. What exactly does setting a financial target achieve? It is just a number. It doesn't stretch performance, build commitment, or make anyone think. It is all too easy for managers to agree to a number knowing from experience that they can meet it, and even if they can't, they will have enough plausible excuses to maintain their jobs. Moreover, how does anyone know if the numbers are too high or too low? Negotiated financial targets are notorious for leading to incremental thinking and safety-first strategies. If that's what you want, then it's fine. But if you really want people to do their best and stretch their performance, then you have to put something different in place. Most organizations that have gone down this path use relative measures. This means that everyone is always trying to beat the competition and climb their way to the top of the performance league table. Business to business, plant to plant, branch to branch – there are many ways to compare performance both inside and outside the organization. In some cases, where there is a lot of catching-up to be done, business leaders will set themselves benchmarks as 'aspirational' targets. These are fine provided they are not seen as commitments. Getting most of the way is normally sufficient to make significant improvements.

Q: *I can see the sense in that, but it still doesn't tell me the profit forecast for the year.*

A: There are ways of working this out from the level of improvement expected and, in most cases, from rolling forecasts. These forecasts are usually updated every quarter and provide an unbiased view of what the likely profit and cash flow outcomes will be. But it is crucially important that they are not trying to reach some specified number.

Q: *We have always used stretch targets and spent considerable time adjusting budgets to achieve the profit forecast we want. How do we know that we are going to achieve the result that we want if we don't do this?*

A: The implicit assumption in your question is that budgets do, in fact, provide this control. But this perception is, in our view, an illusion. In large complex human organizations the very idea that you can plan, coordinate and control a set of numbers doesn't make much sense. Things are bound to go wrong, and as soon as that happens all the intricate interlocking numbers that connect one budget to the next become invalid. This means that managers must improvise. So why not assume this is the 'norm' and give them the necessary tools and training to enable them to respond to changing events as they happen? Organizations that have devolved decisions to front line teams have found that their results improve, and there is far less disruption to work processes. The result is more consistent performance. This is the real answer to the fears of analysts. What destroys confidence are nasty surprises and profit warnings.

Q: *But how do we get people to stretch their performance?*

A: Investors want to place their money in firms that will be at the top of their sector league table. So gearing every business unit and team to beating the competition is the best way to achieve this. People should always be striving to improve their position in the league table. This is what stretches performance.

Q: *But what about incentives? How do we motivate people?*

A: The beyond budgeting view is that while "incentives" (or a "do this, get that" approach) don't work, the recognition of team-based success is important. This can be done in a variety of ways. One is a profit share based on the "winning margin". Another is a judgemental evaluation of how well the team did in the context of competitive conditions. And another is to compare teams with internal or external competitors or benchmarks. It is crucial, however, to recognize that teams should be the focus of rewards. In modern organizations it is well nigh impossible to relate extra revenue or profit to a marginal activity or piece of work. The scope of the 'team' should equate with the level of direct dependencies. Anything less than this is, to some degree or other, likely to be divisive. Such an approach will provide an effective basis for motivating, evaluating and rewarding performance achievement for the following reasons:

- *It supports the 'one-team' view of the organization as a 'community'.* Sharing in the profits of the business unit or firm as a whole is not intended to manipulate behaviour, but to demonstrate that everyone is in the same rowing boat, all pulling in the same direction.
- *It supports knowledge sharing.* By breaking down the budgeting barriers that prevent the sharing of resources and knowledge, team-based rewards encourage people to be more open with each other.
- *It supports the commitment to a common purpose and values.* Individual financial incentives, by and large, are manipulative. The assumption has to be that executives want to make people act in a way that they otherwise would not do. If this is not the case, what is their purpose? So by removing such incentives, people are more likely to take notice of value statements, and elevate the purpose of work above and beyond making short-term profits.

9. Performance contracts and dealing with analysts and bankers

Q: *How do I know what to tell analysts?*

A: Do you really need to tell them anything? Take a leaf out of the UBS book. Instead of promising an earnings number, why not share with them details of the business strategy and key performance indicators and let them work out what they think is the value of the business? This frees you from the burden of making some specific number and encourages them to build their confidence in the future of the business and the strength of its management. It also enables you to manage their expectations more effectively. There will be fewer surprises, so the share price should have a smoother ride. Let them judge you on your performance, not your promises!

Q: *But won't analysts be uncomfortable when they hear we have dismantled the budgeting system? Will they not perceive a weakening of controls?*

A: Though the budget reports have gone, there are many other information streams that provide a better view of what's happening to performance. In fact, in all our case visits, senior managers felt they had better control than before because they got fast and untreated information on what was happening at the front line. If you explained to investors that the new information system enables you to make good decisions and better anticipate future events, they should be delighted. Moreover, you would be starting to build real strategic capability throughout the organization, and it is this that builds shareholder value. Remember that shareholders are betting on the future not the present and what you need are management processes that build future value not just fix short-term problems.

Q: *How does beyond budgeting affect small businesses or "start-ups" that have to deal more with bankers than analysts?*

A: One would normally expect owner-managers to be more in touch with performance issues than managers in a large organization. But they can equally become locked into a performance contract as they promise bankers or venture capitalists results that they soon realize they can't deliver. In these situations, it makes sense to take fast decisions to change course rather than stick to a plan that's not working just because that's what was agreed at the outset. By and large, owner-managers find that honesty is the best approach. If bankers trust your judgement and are confident that you're always honest and open with them, then they will repay this openness with maximum support. Conversely, fudging the numbers to meet an agreed target will likely end in tears.

10. Planning and control

Q: *How do you manage the business if you don't have annual plans and budgets?*

A: Most leaders are obsessed with planning and control. They have earned the right to be in charge. Launching a new "plan" or "campaign" is how they learn to drive people forward to the next profit milestone. Though this annual planning process absorbs large amounts of time and effort, it tells everyone what they must do for the period ahead. Its self-fulfilling purpose is to eliminate any surprises. But this approach is myopic. Surprises occur all the time. If they are seen as opportunities to be grasped rather than problems to be avoided, then organizational life will be more interesting and rewarding. But only by devolving strategic decision-making to front line people will the speed of response be sufficient to enable such opportunities to be taken. They need information and they need clarity of vision and purpose. This is much more than a destination. As Wheatley suggests, "we should start by recognizing that in creating a vision, we are creating a *power*, not a place, an *influence*, not a destination [italics added][13] Such an approach to strategy development will build greater capability for responding to events as they happen for the following reasons:

- *Customers are at the centre of strategy.* Moving from fixed annual plans to market-responsive strategies places the customer at the centre of strategic management. Knowing their needs and satisfying them profitably is the new focus of attention unbridled by rigid plans agreed months earlier.
- *Everyone is potentially involved.* Executive leaders do not have a monopoly of wisdom. Opening up strategy to a wide range of people who have different ideas can only enrich the process.
- *Strategic capabilities are extended.* Devolving strategy to teams closer to the customer will enhance the strategic capability of the whole organization.

Q: *What do we get in place of budget-based controls?*

A: You will have more controls than ever before. For a start you will see a huge improvement in the accuracy of forecasts. Because no one is fiddling with forecasts and trying to paint a rosier picture than the real numbers suggest, the distortions will largely disappear. You will also see more trends, moving averages, and leading indicators. It means that you will focus more on managing the future than the past, and this provides much earlier warning signals that tell you if performance is about to run off course, giving you more time to review strategy and make the right decisions. Moreover, fast information reaches different organization levels at the same time thus providing an interlocking set of controls that was never there in the line management system. There really is no place to hide in this organization. People are exposed and fully accountable for results.

11. Coordination

Q: *How do you coordinate actions without budgets?*

A: Most organizations declare that their aim is to be “customer focused” or “market responsive”. But implementing a market-responsive strategy and then trying to coordinate plans centrally makes no sense at all. Business units need to coordinate their plans dynamically, as the market dictates. They need to see themselves (and other teams) as suppliers of products or services to either internal or external customers, as elements in a coherent value delivery system. In other words, instead of being directed to supply a particular product or service to another unit, business units are tied together with ad hoc agreements that are made according to the prevailing demand in the (internal and external) market. Of course some agreements need to cover, say, a quarterly or even an annual period, because central service facilities need time to increase or decrease their capacity. But the fundamental change is from central planning to dynamic supplier-customer relationships. This means that teams are accountable for satisfying customer requirements. It is a responsibility model based on outcomes. This is very different from the hierarchical world of line management in which people are accountable to bosses. Such an approach has a number of benefits:

- *The organization is seen as a whole system rather than a number of parts.* The emphasis is on providing the external (paying) customer with an excellent service, not pleasing the next boss up the line.
- *There is less waste.* Most traditional organizations de-couple their business processes and manage each part to optimum efficiency. However, this usually means that they produce for

stock rather than customers causing less quality and more waste in the system as a whole.

- *It recognizes the importance of teams.* If organizations are a complex web of human relationships rather than a machine, then recognizing the mutual responsibilities of teams is crucially important.

12. Leadership principles and devolution

Q: *I noticed from the Table you showed earlier that devolving authority to front line teams is an important part of the change program. We have been trying to make this work for years, but without much success. What makes you think it will work this time?*

A: Devolution, or empowerment as it's often known, has got a bad name because many firms "empower" people without giving them both the freedom and capability to make decisions. The trouble is that the budgets and control systems are never far away. It is like telling people they can make decisions but always being on their backs to ensure they are making the right ones! In the beyond budgeting world, these micro-controls disappear. People know the boundaries and values within which they can act and they gradually build up the confidence to take decisions. Firms that have done this successfully find that their response to threats and opportunities is much faster.

Q: *I can already see problems. For example, don't we need much higher levels of competence than we have now? Our people have been used to being told what to do. They haven't developed strategic decision-making skills.*

A: You're right. It doesn't happen over night. People need a lot of help. They need training, tools, and, most important of all, access to information.

Q: *But doesn't it also require people with the right attitudes?*

A: Yes it does. You will only build a high trust organization in the longer-term if you get people that fit in with your new culture of responsibility and sharing. You also want people who care about the company. If they are here just for the money then you shouldn't be surprised if they leave at a moment's notice when they receive a better offer. So there needs to be a clear purpose that everyone can understand. What we mean is some social purpose such as improving human health or providing the world with essential (and affordable) products and solutions. People also want to share in the results of their efforts. In the same way that shareholders receive a dividend on their financial capital if the firm does well, employees want a return on their intellectual capital. It's fairness rather than incentives that matters to people. They want to work within a climate of mutual trust. Let me put it this way. Instead of thinking about employment contracts you should be thinking about "moral contracts". If the company provides the climate and the education necessary for personal development, then employees will repay that investment with total commitment. Instead, what happens now? You pay people a lot of money but use very little of their real knowledge and capability.

Q: *What are the main problems we will encounter?*

A: Two issues usually come up. One is stopping senior managers interfering with lower level decisions. And the other is getting the message across to people that empowerment isn't a free ride. On the first point, leaders need to really believe in devolution, and be incredibly disciplined not to interfere even when they can see mistakes being made. Hammering out an agreed set of principles and values is also a crucial step. This establishes the framework that everyone operates within and ensures that they can take decisions with confidence. On the second point, perhaps the most difficult problem is how different people interpret their new freedom. For example, some people think that empowerment means that leaders have no right to make decisions that affect their work. In other words, they see empowerment as a charter for free riders. You have to recognize that despite trying hard to bring everyone up to par in terms of strategy and decision-making, there will always be people who can't make it. Either they don't have the right attitudes or other traits essential to working in this new environment. Team leaders still have to make hard decisions and this sometimes means weeding out their weakest members. These people can either be transferred to other roles where their strengths can be better utilized, or they will have to leave the organization altogether. People must have trust and confidence in each other. If this doesn't exist because of a few people, they must be dealt with. This is a critical message to get across.

13. Implementation – Getting started

Q: *Who should lead the beyond budgeting program?*

A: There are, by and large, three drivers of the change program. The first is the *visionary leader* who either joins the organization with a philosophy and mandate for change or who is persuaded by the evidence that beyond budgeting is necessary to bring about their vision of the organization. Visionary leaders make powerful 'sponsors'. The second is *the 'high-level' sponsor* who is persuaded by the argument, but sees the project as a more effective way to manage the organization in the information age. Sponsors are people with the legitimacy to sell the change program and mobilize the people and resources necessary to make it happen. They are usually the CEO or the CFO-CEO partnership (with the CFO leading the program). The third is the *'change advocate'* who must first sell their ideas to potential sponsors before they can mobilize people to accept change. They see beyond budgeting as a way to break free from the overpowering constraints of the performance contract. Change advocates need to persuade high-level sponsors and gain the legitimacy needed to drive the project forward. Each driver of the change program will make little progress unless they convince *key influencers* that the case for change is strong and the change program is necessary. These are the people that are most affected by the beyond budgeting program. They typically include functional directors (e.g. finance, sales, marketing, operations, I.T. and human resources) and business unit teams. Experience has shown that these people are not hard to convince (budgeting is seen as a drain on their time with few obvious benefits).

14. Implementation – Phased approach

Q: I'm not sure I can get our leaders to go the "whole way" immediately. Can beyond budgeting be implemented in "phases"?

A: There is little point in changing performance management processes to support a more adaptive, devolved model, if your leaders continue to insist on retaining tight central control with performance contracts based on short term predictions. The best way forward is to proceed with a "three phase" approach to beyond budgeting. Phase 1 sets out the Vision, Phase 2 is to design and implement the new systems, and Phase 3 is progressive devolution and roll-out.

Before attempting to start on the Vision phase, you should prepare a case for change. Getting approval to this will ensure that sufficient resources can be deployed to Phase 1 for it to be successful. Creating and agreeing a vision for the new management model includes the aims and principles on which the model will be designed, and the first level of detail behind the 12 principles. It then needs to come together into a document and be discussed and approved by top management, and the Board, and be widely sold to 'key influencers' inside the organization. It will also include the plans and resources needed to make it happen. The main resource is training. Preparing templates for how to engage in the strategy and action planning processes, for example, will be a valuable investment. However, *it should not be sold as yet another major "change program".*

If the CEO or CFO doesn't sign up to the Vision, then think long and hard before proceeding. Beyond Budgeting cannot be implemented by stealth. It needs reinforcement from the top. Phase 2 is about designing and implementing the new systems and taking out the old ones, including budget contracts. This phase would normally be led by the CFO. Phase 3 (intensive at the beginning but it never ends) is progressive devolution, using the new system to show which teams are performing well compared with their peers or external competitors. This leads on to capacity building through training and if necessary switching people. Some large companies will want to do a pilot and roll-out. Others will want to just take out the budget and hope that the training provided will be sufficient for all business units to cope with the new approach. Each will follow these 3 Phases, but the roll-out will be much quicker (typically a year) because the new systems will already exist.

15. Successful "budgeting" organizations

Q: *There are surely many organizations that are successful with traditional budgets. How do you explain this?*

A: Performance contracts and budgets are less obviously harmful when conditions are stable and companies are operating in a growth market. As soon as the market turns down, however, many of them are found out. Look at how many "successful" companies were suddenly writing off huge sums and downsizing their operations as soon as they had the excuse of a serious business downturn in 2001. The other point is that because so few companies have so far adopted beyond budgeting principles, most business sector performance league tables only include traditional budgeting companies. It is only when you have a beyond budgeting company operating in a business sector that a real comparison can be made. And whenever this happens, they shine through.

16. Shareholder value

Q: *My success is based on how much value I create for shareholders. How does beyond budgeting help me achieve this?*

A: There are few companies in the world over the past twenty years that have created more shareholder value than General Electric, Toyota, and Svenska Handelsbanken. While GE and Toyota exhibit many of the features of beyond budgeting (Toyota, for example, never uses fixed targets or performance contracts to drive results), Handelsbanken exhibits all of them. For other evidence, we can point to some recent surveys that indicate a strong link between devolution and shareholder value. For example, Watson Wyatt, have constructed a 'Human

Capital Index' that shows a clear relationship between the effectiveness of a company's human capital and the creation of superior shareholder returns[14]. They surveyed more than 400 US and Canadian publicly traded companies with at least three years of shareholder returns and a minimum of $100 million in revenues or market value. The conclusion was that 30 key human resource practices (under four broad headings) make a difference of around 30% to shareholder value. They include finding and keeping the right people (10.1%), clear rewards and accountability (9.2%), collegial, flexible workplace with flat structures (7.8%), and communications integrity with a policy of sharing information (4.0%). In another survey, McKinsey found that companies scoring in the top quintile of talent-management practices outperform their industry's mean return to shareholders by a remarkable 22 percentage points.[15]

17. Different countries and cultures

Q: *I can see how this new model might work in Scandinavia, but we have operations in all parts of the world. Will it work elsewhere?*

A: Let us address the 'Scandinavia' point first. We can only speculate, but there are four reasons why Scandinavian organizations adapt readily to a more market-responsive and devolved style of management. First, it's a closely-knit business community where imaginative ideas travel quickly. Secondly, Scandinavia has a high proportion of global companies relative to its size, and thus they have plenty of experience of uncertainty. Thirdly, financial budgeting conflicts with the notion of intellectual capital – an idea that also had its genesis in Scandinavia. And fourthly, Scandinavian companies are fortunate in having a predominance of well-educated people with the self-confidence to accept the high-levels of responsibility demanded by the new model. Whatever the answer, I am sure it is not some peculiar cultural phenomenon. Much the same questions were asked about Japanese quality in the early 1980s and Scandinavian knowledge management in the early 1990s. When asked this question at a recent conference, Thomas Boesen, of Borealis, replied that Scandinavians (particularly Swedes) are quick to ask "Why?" They are not afraid to ask senior executives why they want plans and information if they can't see the value in it themselves.

Q: *What about the question of different countries and cultures?*

A: As earlier movements such as quality and knowledge management have demonstrated, it is the consulting community that propagates the message and supports the change programs essential to success. They have an excellent record of adapting ideas to local cultures. The idea of breaking free from the performance contract has already permeated many organizations in a number of countries. Here are some examples.

In the UK, organizations such as Bulmers, Sight Savers International, and Leyland Trucks, have adopted the ideas in a serious way. And large organizations such as BP-Amoco and UDV-Guinness have taken tentative steps. In Scandinavia, a number of large companies have adopted the principles of beyond budgeting. These include Handelsbanken, Ahlsell, Volvo Cars, Borealis, IKEA, Fokus Bank, Scania, and SKF. In continental Europe, Rhodia (France) and Philips (Holland) have embraced the ideas. And UBS (Switzerland) and Siemens (Germany) are on their way. In North America, AES is a supreme exemplar, CIBA Vision has made real progress, and GE has many of the hallmarks of adopting the principles. And in Japan, Toyota has operated without performance contracts for decades.

The AES experience is particularly interesting. AES is a global electricity supplier with operations in every continent and many third world countries. Perhaps the greatest challenge was in the old Soviet bloc. But when asked about this they replied that their employees in the Hungarian plant just took longer to grasp the issues and change behaviours. It took about three to four years instead of the usual one to two. But eventually all employees in all countries become comfortable with the responsibility culture.

18. Different industries

Q: *Does the model apply in all industries? For example, I would have thought that capital-intensive industries would be more suited to the traditional budgeting approach?*

A: In broad terms we think you're probably right. Indeed budgetary controls were designed to fit large manufacturing firms in the 1920s. But remember that these firms were investing huge sums in productive capacity often to supply an insatiable demand for new products, especially in the decades after the second world war when consumer expectations were rising. Their problems were concerned with production planning, scheduling, and distribution – all processes well-suited to the capabilities of the budgeting model. Now it is very different. Consumers have almost too much choice. They can change their minds at the click of a mouse. And new competitors with different business models can spring from anywhere often making your costs appear too high or your technology look too outdated. The result is that your customers are at risk. Besides, manufacturers today often make as much, if not more, profit out of services than products. Thus for many reasons, manufacturers have as many reasons to challenge the budget contract as service and hi-tech organizations.

Q: *But many businesses pursue 'operational excellence' strategies. These firms typically do many repetitive tasks, have a preponderance of low skilled workers engaged in high-volume activities, and succeed by constantly improving efficiency. Aren't they candidates for the traditional budget contract?*

A: While many 'make-and-sell' organizations still exist, their ability to compete in the information age with 'operational excellence' (or lowest cost producer) strategies has been challenged by no lesser authorities than two of the world's best known strategy experts. Both Michael Porter and Gary Hamel agree that it is becoming harder and harder to forge competitive advantage from operational excellence[16]. Rather like quality, being operationally excellent is becoming a prerequisite rather than a differentiator. This confuses many companies that believe that smart and rapid use of the Internet allows them to steal a march on their competitors. Most of the productivity gains are passed on to customers in the form of lower prices, thus reducing margins across the whole industry. There is little doubt that innovation and customer intimacy are now the only two sustainable sources of competitive advantage and both depend (much more than operational excellence) on decentralization and the right climate for attracting good people.

19. The public and not-for-profit sectors

Q: *Do the public and not-for-profit sectors have anything to learn from beyond budgeting?*

A: The first part of our answer is that accountability in the public sector comes through the political process, not through profit or even "targets" (which might include benchmarks). Numerical targets can never capture the quality of a good public service. Elected politicians need to set broad goals and trust in their managers to "get on with it". Having said that, there are improvements that can be made in areas such as resource utilization. This is one of the biggest problems confronting both public and non-profit sectors. How do they best utilize their *limited* resources to meet the *unlimited* public need? In this respect, both sectors are dominated by budgets. The problem is that the budgeting process is all about justifying existing resources ("use them or lose them") and acquiring as many new resources as possible. Decisions about priorities are based on budget submissions and taken by people far removed from the action. Resources are then allocated and fixed for the year ahead.

While applying market principles to public organizations is not always a wise approach, there is much to learn from the internal market system that operates within some beyond budgeting organizations. If resource "buckets" were allocated to users and they had the scope to spend that money in the way they thought best to maximize their performance *and they had the cost information to understand their inputs and the flexibility to buy in their resources from an internal (and external) market*, then they might have the incentive to take a harder look at their costs. Kaplan provides an interesting example from the City of Indianapolis in the USA. After many years of budget overruns the new mayor decided to put a number of contracts out to tender. One included the paving of roads, filling potholes, sweeping streets, and collecting garbage. He first asked for current costs. No one had a clue. He then commissioned an activity-based costing study. This showed a different view of costs. He then shared the information with departmental workers who decided to bid for the contract. Armed with the new information, the workers' bid was by far the lowest cost ($286 per ton against the previous cost of $640). Cost savings came from fewer supervisors, reduced work crews (labourers, vehicle drivers, and equipment operators) and more efficient use of vehicles. The lessons were that once the full information was shared with the workers (they had no idea about the central service costs), and once they had the freedom to act, they were in the best position to make improvements.[17]

20. Governance

Q: *One of my roles is to ensure that our control systems are adequate, thus satisfying the governance obligations placed on us by shareholders. How will your proposals affect this?*

A: There has been a lot of talk about governance recently. Though governance statements usually mention that "budgets and controls" should be adequate, I don't think they were thinking about the side effects in terms of dysfunctional behaviour. So instead of budgets reinforcing good governance, they often undermine it. In fact, many blue chip organizations have been caught falsifying accounts and engaging in other shady practices in desperate attempts to meet their performance contracts. In our view, only by eliminating these contracts will these practices change. So replacing the performance contract will benefit governance rather than jeopordize it. This does not mean that internal controls are diluted. Far from it. Firms that have implemented beyond budgeting have kept strong internal audit departments. But they are focused on strategic issues as well as risk management.

21. Economic value added

Q: *Is beyond budgeting compatible with EVA?*

A: EVA is rooted in the Newtonian concept of the "organization-as-a-machine". It uses numbers to make decisions. But not everything can be reduced to a series of future cash flows. These are based on long-term forecasts that can be highly unreliable. Front line managers need to use their intuition to make quick decisions and they must have the freedom to act. If EVA models enable them to do this more effectively, then that is supportive. But if they are used as a way of forcing managers to reduce every decision to a detailed shareholder value-based proposal that requires higher-level approval, then that would be unsupportive. But, worst of all, if they are used as the basis for performance contracts, then they can be potentially disastrous as there are so many uncertainties inherent in the numbers. The devil is in the detail of implementation.

22. Balanced Scorecard

Q: *We use the Balanced Scorecard in some of our business units. How does beyond budgeting work with the Scorecard?*

A: It all depends on how the Scorecard is used. If it is used to build a picture of strategy that can then be described and communicated to a number of teams, then the scorecard has a strong contribution to make. And if it is used to provide managers with a strategic measurement framework that shows a moving picture of change from their perspective, then, again, it has a valuable role to play. It is the ability to focus on continuous feedback and learning that it perhaps its greatest strength. But it is when the scorecard is used to set targets, and place numbers on cause-and-effect linkages that dictate actions to managers, that the Scorecard starts to run into difficulties (both conceptual and practical).

How targets are set using the Balanced Scorecard is a good test of how to ‘get it right or wrong’. The wrong way is to link targets to rewards in a performance contract. If the scorecard appears as ‘just another budget’ with annual negotiations of targets and resources, then it is not surprising that local managers will fail to embrace its real strengths. In such a situation, the message will be a familiar command and control one, thus undermining any notion of empowerment and trust. It simply appears as a better tool for financial control.

The scorecard is an excellent tool for educating and engaging people in the strategy process. For example, identifying whether customer intimacy or product leadership is your core value proposition and which business processes are critical to supporting it, enables managers to determine the key performance indicators that should be monitored. It is the feedback loops that tell managers what to do next rather than remain stuck with predetermined plans. Surprises should be taken in their stride and not ignored if they don’t fit the anticipated result.

23. Activity-based management

Q: *Activity-based management is another tool we use. What’s your view on this? How can it support beyond budgeting?*

A: Activity-based management (ABM) can be helpful to the beyond budgeting manager in four ways. First, activity-based budgeting (ABB) can help managers to estimate the need for capacity. By using current forecasts and prevailing trends, managers can quickly work backwards from the level of customer demand to the resources that are required to sustain it. ABB is not easy to implement but, if done correctly, it can help managers identify excess capacity and thus reduce costs or, perhaps more realistically in the short-term, redeploy that capacity elsewhere in the business. Secondly, ABM is useful for computing the full costs of transactions, especially of those subject to significant customization. Many firms adopt customized solutions without having the information systems in place to calculate whether these solutions are really profitable. Only when the full costs of serving and supporting a customized transaction are taken into account can the real profit or loss be revealed. Thirdly, ABM can help managers avoid those costs that should not be incurred at all. This applies not only to process improvement but also to whether the whole process is worth doing. And finally, ABM support a horizontal process view of the organization and thus supports the concepts of the organization as a web of supplier-customer relationships.

24. Rolling forecasts

Q: *We also thinking of using rolling forecasts. Is this another tool that can work well with beyond budgeting?*

A: Most certainly. Rolling forecasts in the traditional company are aimed at helping managers to focus on meeting the current year's budget. They have no other strategic purpose. They are, more often than not, no more than a recompilation of the budget and lead to managers taking appropriate actions that enable them to meet their agreed targets. In beyond budgeting companies, rolling forecasts have a different purpose. They principally help managers to break away from the annual budgeting cycle and take decisions based on a moving picture of information concerning the likely outcome of existing trends. This supports the devolved management process by placing front line people more in control of their actions than would otherwise be the case.

The important issue is that forecasts are separated from the line management system. Borealis achieves this by looking at forecasts from the perspective of legal entities within the group rather than from the perspective of business divisions. While the line management runs through the division, the legal entity view does not have anyone at its head with line responsibility. So local managers use forecasts for local purposes and senior executives use forecasts for cash flow and tax planning. The two purposes are different and do not overlap.

There is, however, one major caveat with rolling forecasts. They will be of little or no value if they are seen by senior managers as a tool for questioning or reassessing performance targets. Nor must they be used to demand changes or improvements. If forecasts are used by senior executives to micro-manage or demand immediate action, then trust and confidence will rapidly evaporate. The only time such questions can fairly be asked is if forecasts show a significant change and such a change has not been explained beforehand. Managers should be responsible for dealing with problems and reflecting any corrective actions they have taken in their revised forecasts.

25. Information systems

Q: *You talk a lot about moving from the idea of "mechanical" systems to "webs of relationships". What are the implications for information systems?*

A: Most information systems mirror the organizational structure and, for most firms, this means improving the plumbing and wiring of the hierarchy. Early enterprise-wide systems offered the prospect of cross-functional integration by enabling firms to 'set switches' to turn integration capabilities on-and-off. But its very rigidity forced firms to make compromises and fit into the system template rather than design their own requirements into the system. And, we have to say, even recent systems we have seen shows no signs of breaking this trend. Talk of "information cockpits", for example, suggests a highly centralized view of information management. And the power of "drill down" facilities shows no understanding of what devolution is all about. Information systems designers often assume that it is the speed and power of data analysis that users value. Hence the notion of the information cockpit with a few senior executive pulling levers and pressing keys to make decisions that are, more often than not, far better done by front line managers. The problem is that such systems appear to offer better controls, but this is a fallacy.

Q: *So, what do you suggest is the right approach?*

A: We think Bill Gates' idea of a "digital nervous system" comes pretty close. It is much more in tune with the idea of an organization as a web or relationships rather than a machine with multiple parts. He starts by explaining that the biological nervous system triggers your reflexes so that you can react quickly to danger or need. It gives you the information you need as you ponder issues and make choices. You're alert to the most important things, and your nervous system blocks out information that isn't important. He then goes on to explain why companies need to have that same kind of nervous system: the ability to run smoothly and efficiently; to respond quickly to emergencies and opportunities; to quickly get valuable information to the people in the company that need it; the ability to make decisions quickly and interact with customers... A digital nervous system consists of the digital processes that enable a company to perceive and react to its environment, to sense competitor challenges and customer needs and to organize timely responses. A digital nervous system requires a combination of hardware and software. It's distinguished from a mere network of computers by the accuracy, immediacy and richness of the information it brings to knowledge workers and the insight and collaboration made possible by the information.

Q: *What you suggest sounds like unstructured, unbounded information roaming around the organization. I'm not sure that senior executives would allow that.*

A: We agree that this is a major challenge. But, when you think about it, the whole idea of "controlling" and "restricting" information is a bit ridiculous. As James Gleick put it, information is the solar energy of organization.[18] If we really want to foster insight and collaboration, then we must open up the information system (IS) to all those that can gain from it. The notion that only people at the centre can use it wisely is just plain wrong-headed. People need to see what's happening right now. They need to be constantly exposed to "breaking news" in media terminology. The IS should be designed to scan and probe for patterns of change in the marketplace. All points of contact with customers and the market in general should be tuned to feeding back data into the IS. This enables use of data warehousing capabilities and tools to search for patterns of change that are not readily observable in any other way. The IS should also support anticipatory management by bridging the time elapsed between lagging and leading indicators. For example, customer acquisitions and defections can be monitored as they happen (at least in industries with regular ordering patterns); strategic initiatives can be monitored as they unfold; and trends come alive as they appear instantly on the screen. Data warehouses are now commonly used to see patterns within large volumes of information that cannot be readily observed with the human eye.

Popular aphorisms such as "what you measure is what you get" need to be reconsidered. Most of the "cultural" factors that create winning organizations cannot be measured. Indeed, financial accounting numbers are given too much visibility. They are not the "hard stuff" that macho managers believe. The rule of thumb should be that the fewer the measures, the less opportunity there is for misinterpretation and dysfunctional behaviour. When used to evaluate outcomes they have many imperfections, but they remain the only option. But when used to set targets they are positively dangerous. Opening up the data flows to many more people and many new interpretations is the way to enrich understanding.

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CAM-I Beyond Budgeting Round Table (BBRT)

CAM-I Inc is a not-for-profit international research consortium that undertakes management and technical research into issues of common interest to a number of companies that pool their resources to find practical solutions. In the late 1980s for example CAM-I led the development of Activity Based Costing (ABC) and is today the leading forum for cost management in the USA.

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- *Van den Burgh Foods (Unilever)*
- *West Bromwich Building Soc.*
- *Whitbread*

The research leaders are Jeremy Hope, co-author of *Competing in the Third Wave* and *Transforming the Bottom Line,* and Robin Fraser, management consultant, formerly a partner with Coopers & Lybrand, now PricewaterhouseCoopers. The academic advisers to the project are Professor Michael Bromwich (London School of Economics), Professor Michel Lebas (Groupe HEC, France), and Professor David Otley, Lancaster Business School.

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