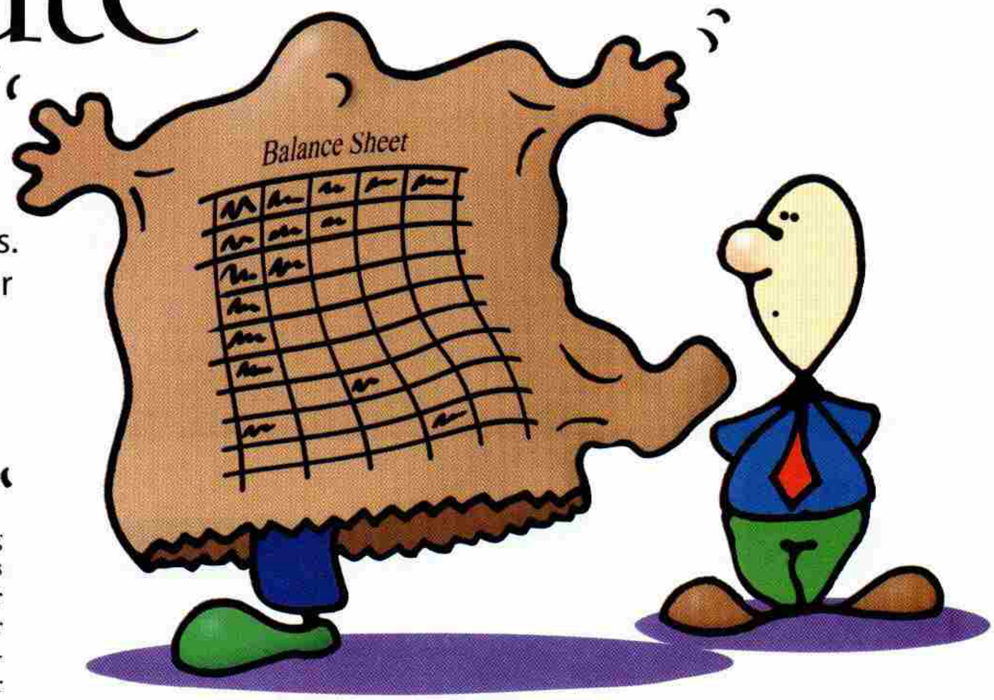
Figures of hate

Traditional budgets hold companies back, restrict staff creativity and prevent them from responding to customers. Jeremy Hope and Robin Fraser suggest a better way forward



John Paul Early

Independent research into the need to tackle Beyond Budgeting has been mounting ever since we raised the issue in our previous articles (*Management Accounting*, December 1997 and January 1999). For example, fewer firms are satisfied with their budgeting processes: in a 1998 *CFO Europe* survey, 88 per cent of respondents said they were dissatisfied with the budgeting model[1].

Many companies are spending more time on budgeting and less on strategy. Research has shown that 78 per cent do not change their budgets in the fiscal cycle[2]; 60 per cent don't link strategy and budgeting[3]; and 85 per cent of management teams spend less than one hour a month discussing strategy[4].

And the value of budgeting is even less than expected. A recent report noted that its value had diminished because[5]:

- the mechanics of the budgeting process are inefficient;
- budgets are prepared in isolation from, and not aligned to, company strategy and goals;
- the focus is on financial outputs and excludes other performance measures;
- the budgeting time horizon is not linked to the "rhythm" of the business – long horizons in rapidly moving sectors and short horizons in relatively stable sectors;
- information on current performance is not easily accessible;
- managers tend to play games with, and manage around, plans;
- employee goals and the appraisal process are not linked to business objectives.

At the same time, budgeting has become even more expensive, yet adds less value than expected. A 1998 benchmarking study showed the costs of operating with the budgeting model: the average company invests more than 25,000 person days per billion dollars of revenue in the planning and performance measurement processes; the average time taken to develop a financial plan is four and a half months; and companies need an average of 21 days to complete a forecast[6].

A KPMG study showed that inefficient budgeting eats up 20 to 30 per cent of senior executives' and financial managers' time. This is confirmed by two large European companies, Volvo Cars and Borealis, which have calculated that over 20 per cent of management time is taken up by budget and reporting processes. John Fanning of KPMG believes that companies could save, on average, £4 million a year, if they replaced their budgeting systems[7].

The early work of the Beyond Budgeting Round Table (BBRT) focused on new steering mechanisms to replace budgeting, but we are now focusing on the organisational and behavioural changes needed to support these new mechanisms. This is reflected in the latest set of 12 Beyond Budgeting principles:

1. *Governance* – use clear values and boundaries as a basis for action, not mission statements and plans.
2. *Performance responsibility* – make managers responsible for competitive results, not for meeting the budget.
3. *Delegation* – give people the freedom and ability to act, don't control and constrain them.
4. *Structure* – organise around the networks and processes, not functions and departments.
5. *Co-ordination* – co-ordinate cross-company interactions through process design and fast information systems, not detailed actions through budgets.
6. *Leadership* – challenge and coach people, don't command and control them.
7. *Goal setting* – beat competitors, not budgets.
8. *Strategy process* – make the strategy process a continuous and inclusive process, not a top-down annual event.

9. *Anticipatory management* – use anticipatory systems for managing strategy, not for making short-term corrections.
10. *Resource management* – make resources available to operations when required at a fair cost, don't allocate them from the centre.
11. *Measurement and control* – use a few key indicators to control the business, not a mass of detailed reports.
12. *Motivation and rewards* – base rewards on a company and unit-level competitive performance, not predetermined targets.

Principles 1 to 6 concern effective organisation and behaviour, and principles 7 to 12 concern effective performance management.

In essence, Beyond Budgeting entails a shift from a performance emphasis on numbers to one based on people. It assumes that performance improvement is more likely to come from giving capable people control over decisions (and making them accountable for results), than from simply adopting different measures and incentives.

This is not a comfortable message for a measurement industry that believes that implementing Economic Value Added or Balanced Scorecard are enough on their own to change performance. It is the combination of effective organisation and behaviour and effective performance management that leads to success (see figure 1). And, just like any mathematical equation with multiplicative variables, if any of the variables is zero, the net result will be zero. The failure to recognise this has wrecked many attempts at performance improvement.

A recent *Business Week* feature on organisations in the 21st century warned managers: "If you've worked as a manager for at least a decade, you can forget much of what you've learnt so far. Prepare to toss out your business-school case studies and set aside many of the time-honoured principles that have guided generations of managers. The vast changes reshaping the world's business terrain are that far-reaching, that fundamental, that profound."[8] And according to Gary Hamel : "It is universally apparent that we are living in a world so complex and so uncertain that authoritarian, control-orientated companies are bound to fail."[9]

The concept of how a successful company operates in the information age is shifting from "make-and-sell" to "sense-and-respond"[10]. Make-and-sell is an industrial-age model based on transactions, capital assets, mass production, economies of scale and product margins. Sense-and-respond is an information- and service-age model, which emphasises client relationships, intellectual assets, mass customisation, economies of scope and value creation.

To compete successfully in the information

Figure 1

age, managers must be exceptionally good at six key issues. They must create a climate for fast response, engage the best people, generate new business concepts, operate with low costs, find and keep the right customers and keep shareholders satisfied.

Table 1 sets out these concepts of success and shows how budgets can block their achievement. And Beyond Budgeting principles underpin these key success factors.

For a start, Beyond Budgeting enables firms to respond faster and, therefore, cope better with uncertainty. In days when competitor actions were largely predictable and suppliers held sway over customers, firms could plan, make and schedule activities to optimise the efficiency of their internal processes. But increasing uncertainty makes such practices ineffective – firms cannot predict new competitors or what business concepts they will use. Such change wreaks havoc with traditional planning and budgeting.

Fast response means making strategy an adaptive process. Managers must be put in charge of strategy and be able to monitor it continuously, rather than once a year. And if new initiatives are needed, managers must have fast access to resources. They need, for example, the authority to acquire key people when they are available (not when there is room in the budget); to react to competitive threats and opportunities as they arise (not as predicted in an outdated plan); and to acquire and deploy resources when necessary (not as allocated by head office).

The attitude to change is also important. Beyond Budgeting companies see change as an opportunity, not a threat. They probe constantly for signs of impending change and preempt competitors' actions and customers' needs. They prepare rolling forecasts that support strategy reviews and investment decisions (being careful not to distort the forecasting process by allowing senior managers to influence the outcome). And they have up-to-the-minute information about customers, costs, profits, market changes and anything else essential for rapid response and good decisions.

Beyond Budgeting also helps firms to find and keep the best people. A 1998 McKinsey report, *The War for Talent,* pointed out that big companies are finding it difficult to attract and retain good people[11]. The top three reasons why managers chose one firm over another were "values and culture" (58 per cent), "freedom and autonomy" (56 per cent) and "exciting challenge" (51 per cent)[12].

Offering a challenging environment is crucial to engaging and keeping the right people, but the budgeting model with its overarching bureaucracy, head-office memos and directives, and detailed rules and procedures, undermines such an environment. At one time this didn't matter. Competitive salaries and good career prospects meant large firms could usually attract the people they needed, but talented managers today are much more demanding about their future employers.

In addition, Beyond Budgeting supports the new generation of business concepts. Product and strategy lifecycles are shrinking rapidly as new product ideas are copied and firms cannibalise existing products so they can be first to market new ones.

It is increasingly clear that businesses cannot plan and control their way to the future in incremental steps. They must innovate and they must think differently. This means using the creativity of their people to develop imaginative strategies, new business models, and more relevant management practices.

Bloated bureaucracies and budgetary controls are the enemies of insight and innovation. They stifle creativity with a rigid system of budgetary controls that reward good housekeeping, but fail to acknowledge creativity or innovation. And they fail to provide a management climate that encourages creative people to thrive.

Managers in Beyond Budgeting companies foster insight and innovation by sharing knowledge across networks. They encourage new ideas by breaking free from incremental thinking. And their leaders act more like venture capitalists who oversee a portfolio of businesses with a diverse range of risks and

Table 1 - Concepts of success in the information age

Change in environment	New success concepts	Key success factors	Barriers
Rising uncertainty Environment is now unstable and unpredictable; competitors can come from anywhere at any time	1. *Coping with rising uncertainty* – adapt quickly to competitive changes and customer needs, don't rely on improving forecasting and scheduling processes	*Radical devolution* – devolve authority for fast action, don't centralise and delay decisions	Rules and procedures and budgetary control undermine empowerment
		Adaptive strategies – make strategy an adaptive process, don't make strategy a fixed and deterministic plan	Fixed strategy and budgeting cycles are built into the traditional model and difficult to change
		Fast information – provide fast and open information systems. Don't restrict information to those who need to know	Knowledge is assumed to be accumulated at the centre leading to restricted flows of information
Intellectual capital is increasing in importance Talented people are hard to find and even harder to attract	2. *Finding and keeping talented people* – provide a challenging work environment that enables personal development. Don't assume that people will be attracted by pay or perks	*Right people* – recruit and develop the right people . Don't simply fill vacancies	Budgets don't connect people with value creation
		Scope to perform – provide multiple responsibility centres. Don't consolidate the structure into larger units	Traditional cost-cutting mentality leads to larger units to gain economies of scale
		Inspirational leadership – don't adopt the carrot and stick approach	Budget-based performance contract creates a climate of management by fear
		Share in wealth – use a fair reward system, not one that benefits a few people	Incentives usually linked to budgets
Increasing pace of innovation To compete, firms must constantly refresh their products and strategies, and generate new business concepts	3. *Generating new business concepts* – create a climate for self-questioning and innovation, not one of subordination and controls	*Venture capital model* – view the business as a portfolio of investments, not as sub-sets of the budget	Central planning approach sees only short-term impact of risky investment proposals
		Stretch climate – create a climate of challenge and stretch, not caution and control	Bureaucracy and controls stifle challenge and creativity
		Learning and sharing – share knowledge, don't keep it to yourself	Budget cells encourage 'defend own turf' attitude
Falling prices and costs Prices are falling and costs must be reduced; cost increases can no longer be passed on to customers	4. *Operating with low costs* – challenge and reduce costs. Don't protect and increase them	*Low cost network* – adopt a low-cost network structure, not an expensive and complex hierarchy	Hierarchy means that high costs are 'hard wired' into the system
		Strategic alignment – align resource usage and costs with strategy, not with departmental budgets	Budget view fails to support strategic cost alignment
		Challenge costs – don't allow them to become budget entitlements	Budget process prevents cost-reduction issues being addressed
Declining customer loyalty Customers now have extensive choice and will switch loyalties if not totally satisfied	5. *Finding and keeping the right customers* – focus strategy and behaviour on serving customers, not selling products	*Customer relationships* – satisfy customer needs quickly and profitably. Don't just see customers as buyers of products	Sales targets and incentives run counter to meeting customer needs
		Customer focus – focus strategy on customers, not products	Product focus is difficult to shift
More demanding shareholders Shareholders now demand better returns than competitors and consistent results	6. *Creating consistent value for shareholders* – align targets, measures and rewards with long-term value, not with short-term profits	*Alignment with value creation* – align key decisions with long-term value creation, not short-term profits	Budget contract drives short-term decisions
		Range of controls – base controls on a range of future indicators and relative performance, not on financial budgets	'Rear-view mirror' controls based on budgets fail to give managers a future view

Swedish bank gets a handle on costs

According to Sven Grevelius, EVP finance at Swedish bank Handelsbanken, challenging costs is fundamental to the Handelsbanken philosophy. "Why do we have lower costs than other banks? It's not easy to be specific, but there are a number of issues that spring to mind," he says.

"First, we have few people at head office controlling the business. Second, and related to the first point, people in the regions and branches are self-sufficient. They run their own part of the business without much help from above and, because they are measured on their competitive results instead of a negotiated budget, they are much more concerned about costs. Even branch secretaries can query expenses if they look out of line. The group profit-sharing scheme has much to do with this attitude of weeding out unwarranted expenses and improving profits.

"Third, we have lower credit losses. This is related to the second point. Because we give responsibility to many frontline people, they feel that they own their decisions and are more concerned that these are based on good information.

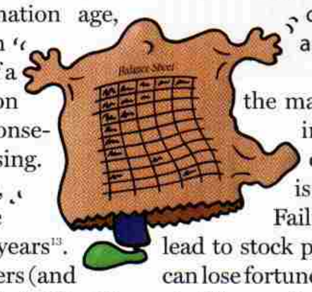
"Fourth, we don't simply allocate central costs to regions and branches. We expose these services to the pressure of negotiation. If branches don't want certain services or feel that they are paying too much, they will make their feelings known. Last, we use technology to reduce costs. Our internet banking services have been very successful, but we are careful to ensure that all internet transactions end up at the customer's own branch. This ensures that branch performance benefits from the low cost of internet transactions, which further encourages their use.

"Devolving responsibility for results, turning cost centres into profit centres, squeezing central costs, using technology, and eradicating the budgeting 'cost entitlement' mentality, are some of the actions we have taken to place costs under constant pressure."

rewards, than like central bankers who are interested only in low-risk projects. They know that people will perform better only if they are emotionally committed and this means working for more than money.

And Beyond Budgeting leads to lower costs. For decades, firms have passed internal cost increases on to their customers. But enterprising firms are now using technology and global markets to offer radically different (and often cheaper) ways to deliver customer value. The downward pressure on prices and margins has never been so intense and enduring. But, often, company hierarchy is not wired for low cost or speed; it is wired for control, and budgeting systems are its traffic lights.

So Beyond Budgeting companies operate with lower costs. They align products, processes, projects and cost structures with their strategy. They also avoid fixing their capacity too far in advance. Beyond Budgeting also leads to finding and keeping the right customers. As we travel further into the information age, customers are presented with more choices (often at the click of a mouse) and more information on which to base these decisions. Consequently, customer churn is increasing.



Frederick Reichheld notes that, on average, US corporations lose half their customers every five years[13]. Firms need to know their customers (and non-customers) and must be able to identify and target the "right" ones. They need to know how to satisfy them (their value needs) and how to maximise profits from them. But finding the "right" customers is rarely on the agenda of sales planning meetings. Most sales budgets are constructed and monitored on the basis that customers are segmented by product group, size, lifestyle, or some other grouping. They don't segment customers by their value needs.

Beyond Budgeting companies, however, place customer value needs at the centre of strategy. They distinguish between customers who want transactional sales (they want to buy the cheapest products and services, perhaps on the internet); those who want additional service (they are prepared to pay for advice about the most appropriate solution); and those who require customisation (they need their exact requirements to be addressed and satisfied). Clarifying customer ownership is crucial to maintaining a strong relationship.

And Beyond Budgeting leads to consistent shareholder value creation. As fund managers fight to head the performance league tables for economic value and shareholder returns, and increasing numbers of "day-traders" play the market, there is little doubt that investors are becoming more demanding, while their loyalty is weakening.

Failure to meet profit promises can lead to stock price falls and senior executives can lose fortunes as their stock options depreciate. The reaction of many companies using the budgeting model is to cut costs to support quarterly profits, but this results in fewer good people doing more work and working longer hours.

And tougher targets are intensifying pressure. Downsizing, layoffs, short-term contracts and higher productivity demands are pushing workers to the verge of nervous breakdowns. It is small wonder that a recent ILO report, *Mental Health in the Workplace*, concluded: "Workers worldwide confront, as never before, an array of new organisational structures and processes which can affect their mental health. These trends represent a wake-up call for business. For employers, the costs are felt in terms of low productivity, reduced profits, high rates of staff turnover and increased costs of recruiting and training replacement staff."[14]

Beyond Budgeting companies aim to create consistent value streams. Giving managers control of their actions and using simple measures based on key value drivers and geared to beating competition is all that most cases require. Leading and lagging indicators help to monitor value creation and provides an early warning system against a financial downturn.

Companies interested in participating in a global benchmarking project on the Beyond Budgeting model should visit the survey website at www.beyondbudgeting.org Participation will help you to relate the concepts in this article to your unique circumstances. It's the first step to breaking out of the industrial age strait-jacket and moving towards a management model that really supports strategy.

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These issues will be examined in the CIMA Mastercourse Beyond Budgeting on 22 February in Dublin, 22 May in London, 27 September in Edinburgh and 13 November in London. Tel: 020 7917 9244.

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