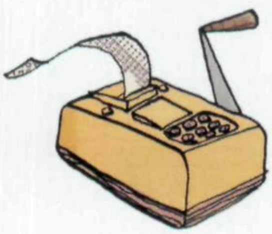
Modern companies reject centralization, inflexible planning, and command and control. So why do they cling to a process that reinforces those things?

Who Needs Budgets?

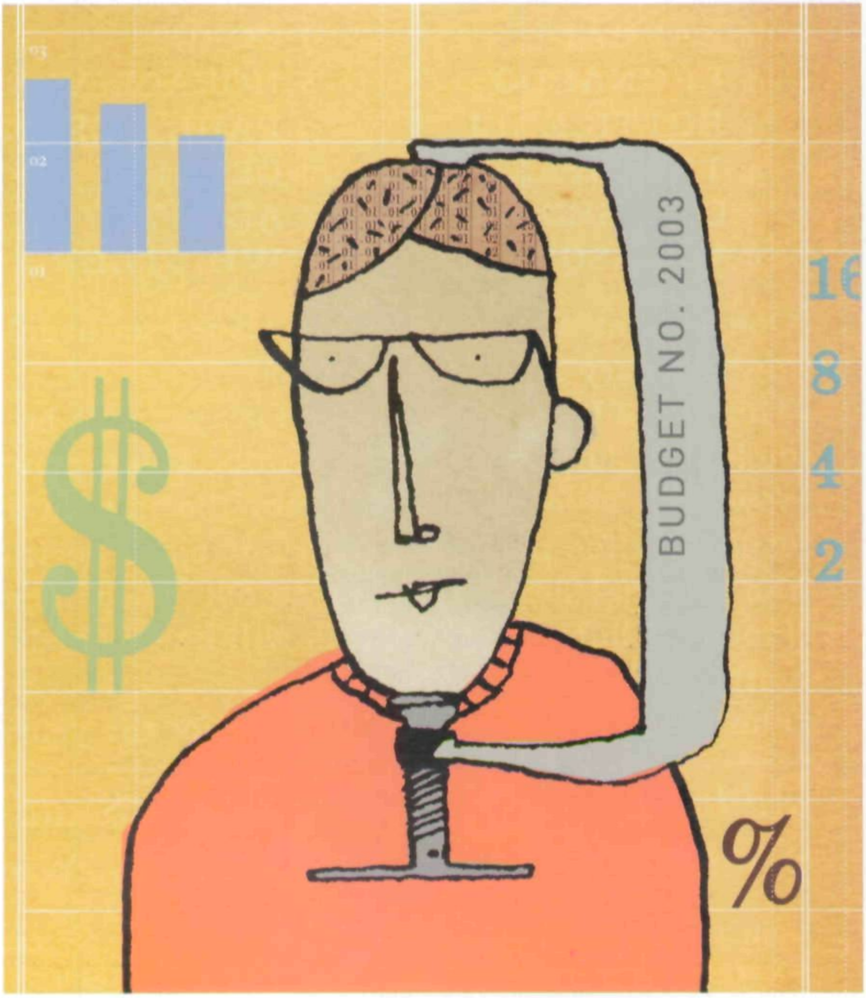


by Jeremy Hope and Robin Fraser

BUDGETING, as most corporations practice it, should be abolished. That may sound like a radical proposition, but it would be merely the culmination of long-running efforts to transform organizations from centralized hierarchies into devolved networks that allow for nimble adjustments to market conditions. Most of the other building blocks are in place. Companies have invested huge sums in IT networks, process reengineering, and a range of management tools including EVA (Economic Value Added), balanced scorecards, and activity accounting. But they have been unable to establish a new order because the budget and the command and control culture that it supports remain predominant.

Senior executives have been heard to proclaim that their people have all the authority of the chairman. In practice, they marshal the power of computer systems to uncover mind-numbing levels of detail and, using the budget as a benchmark, demand to know why a sales team has rung up higher-than-normal telephone charges, for instance, or why it has underspent the quarter's entertainment allowance. And where is "all the authority of the chairman" when the team finds it can't meet the budget's sales targets? Fearing the consequences, the team will lean on customers to order goods they have every intention of returning. And if by some chance the team thinks it will exceed its targets, it will press customers to accept delivery in the next fiscal period, delaying valuable cash flows.

In extreme cases, use of the budget to force performance improvements may lead to a breakdown in corporate ethics. People who worked at WorldCom, now



JON CANNELL

bankrupt and under criminal investigation, said CEO Bernard Ebbers's rigid demands were an overwhelming fact of life there. "You would have a budget, and he would mandate that you had to be 2% under budget," said a person who worked at WorldCom, according to an article in *Financial Times* last year. "Nothing else was acceptable." WorldCom, Enron, Barings Bank, and other failed companies had tight budgetary control processes that funneled information only to those with a "need to know."

In short, the same companies that vow to stay close to the customer, so that they can respond quickly to precious intelligence about market shifts, cling tenaciously to budgeting – a process that disempowers the front line, discourages information sharing, and slows the response to market developments until it's too late.

A number of companies have recognized the full extent of the damage done by budgeting. They have rejected the reliance on obsolete data and the protracted, self-interested wrangling over what the data indicate about the future. And they have rejected the foregone conclusions embedded in traditional budgets–conclusions that render pointless the interpretation and circulation of current market information, the stock-in-trade of the knowledge-based, networked company.

In the absence of budgets, alternative goals and measures – some financial, such as cost-to-income ratios, and some nonfinancial, such as time to market – move to the foreground. And business units and personnel, now responsible for producing results, are no longer expected to meet predetermined, internally selected financial targets. Rather, every part of the company is judged on how well its performance compares with its peers' and against world-class benchmarks.

In companies using these standards of performance, business units become smaller, more numerous, and more entrepreneurial. Strategy becomes a grassroots endeavor. The aggregate result of many small teams exploiting local opportunities is a much more adaptive organization.

But that's not to say these companies abandon their high expectations. They don't naively assume that everyone who is given more autonomy will improve his or her performance. In fact, they require employees to do something much tougher than meet a fixed target. They ask them to chase a will-o'-the-wisp, to measure themselves against how well comparable groups inside and outside the company will turn out to have done in the same period, given the economic conditions prevailing at the time. Because employees won't know whether they've succeeded or by how much until the period is over, they must use every ounce of their energy and ingenuity to ensure that their performance is better than that of their peers. Business units, plants, branches, and other groupings can measure their progress against comparable units within the company through the use of a few key financial measures. In order to measure themselves against external peers, they can use operational benchmarks based on industrywide best practices. (In some cases, companies that have rejected budgets rely on benchmarks collected and prepared by specialist firms that understand the particular industry.) As in sports, the objective is to keep improving your position until you become the league leader.

Abandoning budget targets – those solemn but ultimately hollow promises to investors – frees a business to give a wide variety of emerging information its due. Sharing that information can form the basis of a new kind of relationship with the capital markets. UBS, the Swiss financial services company, hasn't discarded budgets, but it has changed how it communicates. "We provide very few financial-performance commitments," says Mark Branson, the company's chief communications officer. "Our experience shows they are counterproductive, building pressure for short-term action to save the credibility of forecasts. In effect, we show analysts and investors how the business works. This shifts the emphasis from meeting short-term promises to improving our competitive position year after year. The result is much more accurate interpretation of our results and news flow, meaning less volatility in our shares. Analysts like and respect our approach. They no longer ask for numbers-based forecasts." The willingness of the company's investors to live without such promises has inspired UBS to shift its focus from detailed plans to trend analyses and rolling forecasts.

Breaking Free from the Budget Vise

Though the first companies to reject budgets were located in Northern Europe, organizations that have gone beyond budgeting can be found today in a range of countries, industries, and cultures. They include two banks, a petrochemicals company, a distributor, a car manufacturer, a brewer, a furniture retailer, a truck manufacturer, an eye-care company, a computer manufacturer, a telecommunications company, a ball-bearings manufacturer, a food producer, and a specialty chemicals company. They range from small – a 250-employee charity dedicated to preventing and curing blindness – to huge and complex, as in the case of one global industrial organization with thousands of products.

At these companies, an annual fixed-performance contract no longer defines what subordinates must deliver to superiors in the year ahead. Budgets no longer determine how resources are allocated or what business units make and sell or how the performance of those units and their people will be evaluated and rewarded. Some project leaders estimate that they have saved 95% of the time that used to be spent on budgeting and forecasting.

Instead of adopting fixed annual targets, business units set longer-term goals based on benchmarks such as return on capital. The elements or factors measured are key performance indicators – KPIs – such as profits, cash flows, cost ratios, customer satisfaction, and quality. The criteria of measurement are the performance of internal or external peer groups and the results in prior periods. Two of the important corporate goals at Borealis, a Danish petrochemicals company, have been the reduction of fixed costs by 30% over five years and a decrease in time lost to accidents in its plants. However, the company's business units and personnel are measured and rewarded on the basis of how well they reduced fixed costs and improved uptime in comparison to best-in-class industry benchmarks.

In an empowered organization, people are free to make mistakes and equally free to fix them. Managers have wide discretion in making decisions; as a result, they can obtain resources more quickly than in traditional companies and without having to document need quite so elaborately, partly because they are accountable for the profitability of their units and can therefore be expected to shed any excess in the event that demand falls. In such a system, the "spend it or lose it" philosophy that's at work in traditional organizations has no meaning. And employees, because they don't require much supervision, don't need the extensive central services that most organizations provide. Eliminating those services has a dramatic effect on a company's cost structure.

Key performance indicators – which tend to be financial at the top of an organization and more operational the nearer a unit is to the front line – fulfill the self-regulatory functions of budgets. But KPIs don't need to be so precise. UK charity Sight Savers International, for example, has begun to develop target ranges for its KPIs. While managers are

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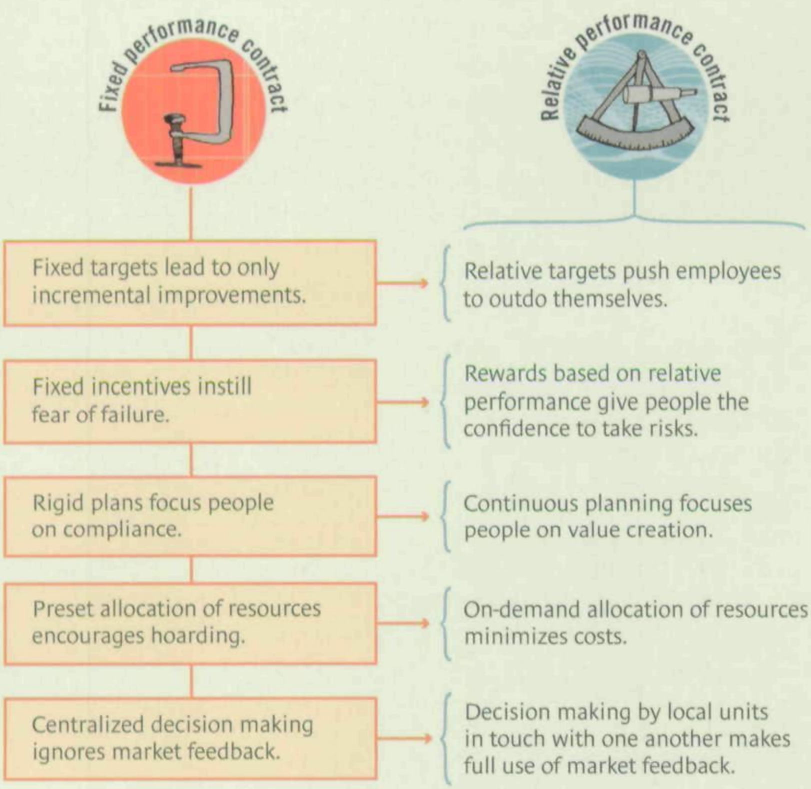
The New Performance Contra

Companies that move beyond budgeting shift decision-making from the core to the periphery. Instead of negotiating, in advance, the targets managers must reach, the resources they will have, and their reward for simply doing what's expected, these companies trust their managers to claim the resources they need to seize the opportunities they see. In short, an ever-changing market, not a dated plan, dictates behavior. And it's beating the competition that brings rewards.



free to devise ways of achieving results within these ranges, senior executives look at the risks and test the assumptions of strategic initiatives that require very substantial resources.

At many such companies, rolling forecasts that look five to eight quarters into the future play an important role in the strategic process. The forecasts, typically generated each quarter, help managers to continually reassess current action plans as market and economic conditions change. (For more information on how rolling forecasts work, see the sidebar "An Ever-Changing View of the Future.")

Without budget expectations to worry about, staff members can do something with the nonconforming customer and market information they collect–other than hide it. The reporting of unusual patterns and trends as they unfold helps the business avoid shortages or overages and formulate changes in direction. Instead of being imposed from above, strategy seeps up from below.

How the Budget Problem Grew

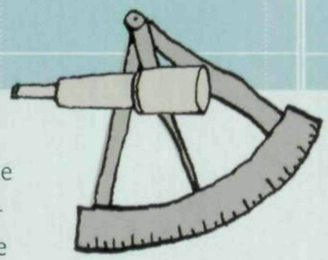
For most participants, the traditional budgeting process starts at least four months before the beginning of the fiscal year. Operating divisions, business units, and departments receive "budget packs" that include forms asking for forecasts of sales, profits, and capital expenditures. The forecasts are reviewed at a high level, and after several rounds of give-and-take, the budget document is finalized.

The budget is a vast compendium of details. It lists the capital and operational resources that the corporate center is to make available to operating units, the obligations made by each unit for the coming year, and the commitments that business or operating units have made to one another, such as a production unit's pledge to meet the sales plan. It also states what will happen to individuals' compensation if targets are missed or surpassed. Over the course of the fiscal year, each unit is expected to file regular reports on its progress toward meeting the targets.

Despite the number-crunching abilities of powerful computers, budgeting remains a protracted and expensive process, absorbing up to 30% of management's time. A 1998 study of global companies showed that on average they invested more than 25,000 person-days per $1 billion of revenue in the planning and performance-measurement processes. Ford Motor Company is reported to have figured that its total cost amounted to $1.2 billion per year. For companies involved in mergers, acquisitions, spin-offs, and other reorganizations, the budgeting workload can be overwhelming.

Increasingly, even finance people question the value of budgeting. One published report says nine out of ten think it is cumbersome and unreliable. Among their complaints: It takes time away from activities that add greater value, such as supplying managers with the information they need to make decisions. A 1999 global best-practices study concluded that finance personnel spent only 21% of their time analyzing and interpreting the numbers; they spent the rest doing "lower-value-added activities" such as gathering and processing data, often for budget-related discussions.

An Ever-Changing View of the Future



Many of the companies that have gone beyond budgeting enrich and accelerate their information flow through the use of rolling forecasts, which are created every three months or so and always cover the same period – typically, five to eight quarters. Because these forecasts are regularly revised, they support managers' ability to fashion strategies that continuously adapt to market conditions.

Rolling forecasts differ from budgets in several ways. They don't envision a fixed "finish line" at the end of the fiscal year when income, costs, and other elements are measured against the budget's (by now) stale targets. They include only a few key variables, such as orders, sales, costs, and capital expenditures, which means they can be compiled relatively easily and quickly, sometimes by a single person in a single day. (Budgets and even conventional budget "updates," by contrast, involve detailed recompilations of data and require several layers of approval.)

Most important, rolling forecasts are more accurate, for two reasons. First, they are constantly refreshed by the latest estimates of economic trends and customer demand and by emerging data from the most recent quarter. Second, no one has a reason to manipulate or spin the numbers, because there are no fixed profit targets – or penalties for missing them. Anyone who tried would probably fail: Organizations that use rolling forecasts rely on information and control systems that allow everyone in the company to see the same information at the same time.

Here's how rolling forecasts usually work. Let's say that in the middle of March 2003, a company creates a five-quarter forecast that covers the period from the beginning of April 2003 through the end of June 2004. From the moment it is completed, new data start coming in. Once three months' worth is in hand, the process begins again. A new five-quarter forecast updates the projections for the period covered by the previous forecast and creates a brand-new projection for the quarter farthest in the future, July–September 2004.

Volvo relies on several types of rolling forecasts. Every month, it orders up a "flash" forecast that looks three months ahead, informing managers about current demand and helping them determine whether, for example, price promotions should be introduced or curtailed. Every quarter, a 12-month forecast updates the managers' working assumptions about customer behavior and economic trends. And every year, two additional forecasts – one looking four years ahead, one looking ten years ahead – help managers assess the company's market positioning and determine schedules for phasing out old models and phasing in new ones.

Unlike budget updates, whose forecast period becomes shorter and shorter as the end of the fiscal year approaches, rolling forecasts always look the same distance into the future, allowing the company to see whether performance is on a trajectory to meet goals that are a year or more away. Rolling forecasts enable finance people to collect and manage the cash needed for tax payments and capital expenditures, and they help operational managers estimate capacity and thus plan for expansions or contractions in demand. As managers become more adept at preparing and interpreting rolling forecasts, the CEO is able to anticipate performance changes sooner, thereby improving his or her ability to establish, well ahead of time, realistic expectations in the investment community.

Used in a responsible way, budgets provide the basis for clear understanding between organizational levels and can help senior executives maintain control over multiple divisions and business units. In the wrong hands, however, budgets can result in "earnings management" or even outright fraud. Such problems are more apt to occur as the pressure to improve performance increases, especially when economic conditions are deteriorating. Few CEOs want to miss their earnings targets and risk ridicule by investors and the media. And few operating managers are willing to be up-front about bad news if it means incurring the wrath of superiors and forfeiting bonuses.

The budgeting process emerged in the 1920s as a tool for managing costs and cash flows in large industrial organizations such as DuPont, General Motors, and Siemens. It wasn't until the 1960s that it mutated into a fixed performance contract. It was at this time, according to Tom Johnson, coauthor of *Relevance Lost: The Rise and Fall of Management Accounting,* that companies used accounting results not just to keep score but also to dictate the actions of people at all levels of the company. By the early 1970s, a new generation of leaders schooled in the finer arts of financial planning had begun to rely on financial targets and incentives–in lieu of such benchmarks as productivity and marketing effectiveness – to drive performance improvement.

But rigid adherence to annual fixed plans and budgets stifled innovation, hindering the corporate response to the earnings and cost pressures that arose in the 1980s and 1990s from the demands of institutional shareholders, foreign manufacturers' entry into domestic markets, and the ratcheting up of competition. Business units became preoccupied with meeting sales targets rather than satisfying customers. Salespeople eager to try new tactics were thwarted by rules requiring multiple signatures authorizing any change in plan.

Eventually, a few companies realized that budgeting played a powerful role in defining and enforcing cultural norms that discourage frontline people from taking responsibility for performance. These companies decided to take the plunge and dispense with the traditional budgeting process. Two of the most enthusiastic adopters of the new approach are described below.

Svenska Handelsbanken

Though not large by international banking standards – it has 550 branches in the four Scandinavian countries and the UK and 20 offices in major cities around the world–this Swedish company offers corporate finance, home and consumer financing, life insurance, mutual funds, and banking by telephone and the Internet. Since it abandoned budgeting in the early 1970s, the bank has outperformed its Scandinavian rivals on just about every measure, including return on equity, total shareholder return, earnings per share, cost-to-income ratio (or cost-to-revenue ratio, in the terminology of other industries), and customer satisfaction. It produced an annual total shareholder return of 24% between 1979 and 2001 – a rate 33% higher than its nearest rival. Annual earnings per share grew at a rate of 10.9% from 1990 to 2000. Handelsbanken is also one of the world's most cost-efficient banks, achieving a cost-to-income ratio of 45% in 2001; at most international banks, the ratio is over 60%. Few of its loans go bad, largely because the bank has a policy of giving frontline people responsibility for authorizing loans.

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In the late 1960s, it was a different story. The bank was losing customers, especially to a smaller rival run by Jan Wallander. So Handelsbanken invited him to become its CEO. He accepted on the condition that the bank agree to drastically decentralize operations. His years as an economist and nonexecutive director of Ericsson, the Swedish electronics company, taught him that few forecasts are worth the paper they are written on. His conclusion was that "either a budget will prove roughly right and then it will be trite, or it will be disastrously wrong and in that case will be dangerous." Here is what Handelsbanken looks like today.

Organization. The bank has only three layers–branch managers, regional managers, and the chief executive–and no organization chart. The spans of control are therefore very wide, precluding micromanagement. The few decisions that require high-level approval are kicked upstairs almost immediately. An answer usually arrives within 24 hours.

To promote a sense of ownership and accountability among as many people as possible, the bank has created some 600 profit centers, including regions and branches. Though each branch is free to set prices and discounts and decide which products to sell, it knows that costs must be around 40% of income and that this requires every staff person to contribute to profitability.

In contrast to the approach at many other financial services companies, Handelsbanken dispenses with a central marketing function (except in the case of product launches) and sales targets. Instead, the individual branches are given responsibility for reducing costs, satisfying customer needs, and boosting income. Because half of Handelsbanken's staff has lending authority, customers receive answers quickly.

Performance. Regions and branches, in effect, set their own targets on the basis of the improvements they want to make. The company's 11 regions, competing like teams in a league, try to top one another on return on equity, a measure the markets use to judge the bank and its rivals. Branches compete with one another on their cost-to-income ratio as well as on profit per employee and total profit. Standings are prominently displayed in what the company refers to as league tables.

According to Wallander, now the honorary chairman, "We just communicate to people the average and a ranking that shows which branches are above and which are below. The system works on its own. Managers know what is 'acceptable' performance–you can't linger in the depths of the league table for long. Peer pressure plays an important part in this process. No branch manager wants to let down the regional team."

The head office monitors transaction volumes, fluctuations in numbers of customers, customer profitability, branch profits, cost patterns, productivity, and much more. If it notices that a branch is underperforming, someone will make sure the region's controller knows about it. It is then up to the branch to take action–or not.

In a traditional company, teams that are fighting one another for customers and resources are unlikely to share data, leads, or insights. Two policies at Handelsbanken keep competition and cooperation in balance. One requires every customer to be attached to a particular branch; this avoids disputes over who gets the benefit of a customer order that has been handled by two branches. The other puts a portion of the company's profits in a companywide pool from which every employee derives an equal share, irrespective of seniority or individual performance. Thus, apart from securities traders, no one at the bank is rewarded for reaching a predetermined target–nor are branches even rewarded for doing well in a performance-league table. Individual and unit rewards consist of peer recognition and praise. Consequently, branches feel safe sharing information about customers.

Some might argue that such a reward structure gives a free ride to managers who produce little in the way of results. On the contrary, a team-based and open organization like Handelsbanken that is governed by peer pressure exposes free riders very quickly.

Resources. Each branch manager decides what resources the unit needs. Managers have had the authority to determine staffing levels since the early 1990s, and now they can set staff salaries and negotiate property leases as well. If demand falls or new IT systems take over functions formerly performed by the staff, it is the local manager who is best positioned to decide whether to redeploy employees or let them go. Experienced managers at the company expected an increase in the number of workers when unit heads were given staffing authority, but the opposite happened.

In a traditional budgeting system, inflexible cost targets can have the perverse effect of limiting the amount of business a unit takes on. At Handelsbanken, branches have the authority to decide whether the income generated by, say, opening many new accounts is worth the higher costs those accounts will entail.

Information. Of course, a company without a budget requires a fast and effective information system capable of monitoring tens of thousands of transactions. Handelsbanken has the ability to monitor region and branch profitability on-line and to analyze patterns of excessive discounts, defecting customers, and unusual transaction volumes. Rolling cash forecasts, prepared every quarter, signal whether cash flow is improving or declining; if a problem looms, they make clear that steps need to be taken to ensure adequate liquidity. The cash forecasts are prepared by the finance department and seen by the vice president of finance and the CEO only. "Other banks have access to the same technology, so the difference must be down to how we work," says Arne Mårtensson, the bank's chairman. "We are quick to spot any changes in trends within regions and branches, and this leads to searching questions being asked on the telephone. Problems are transparent; they are not hidden within the nooks and crannies of management layers and allowed to fester."

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Ahlsell

Since this Swedish wholesaler abandoned budgeting in 1995, its main lines of business – electrical products and heating and plumbing–have overtaken their Swedish counterparts in profitability. After suffering through a severe business slowdown in the early 1990s, the company realized it could achieve substantial savings and operational improvements by centralizing warehousing, administration, and logistical support while devolving responsibility to large numbers of profit centers. At one time, there were only 14 such centers; now, after a series of acquisitions, there are more than 200. Business-area teams (such as heating and plumbing) within each local unit are now separate profit centers, and they're fiercely competitive with one another.

Detailed sales plans are no longer made centrally; headquarters communicates only general aims, such as becoming number one in electrical products within two years. The local units have been freed to develop their own approaches in response to local conditions and customer demands. The new organization recognizes that customer relationships are forged by frontline units, which can now set salary levels and customer discounts and even decide to obtain supplies from outside vendors if that is expected to save money.

Because unit managers also have the authority to adjust resource levels in response to changing demand, they now recruit staff or order layoffs as required, rather than according to the timing and constraints of the annual budget cycle. (Staff turnover is less than 5% per year–the lowest in the industry.) The function of the regional leadership, meanwhile, has changed from providing detailed planning and control to coaching and supporting the frontline units. To help the local units manage themselves more effectively, the finance staff teaches everyone how to interpret a profit and loss statement.

Key performance indicators are now used to set goals and impose controls. In the central warehouse, for example, the KPIs are cost per line item, costs as a percentage of stock turnover, stock availability, level of service, and turnover rate. The key indicators for the sales units are profit growth, return on sales, efficiency (determined by dividing gross profit by total salary cost), and market share.

In the days when Ahlsell kept budgets, it didn't monitor how profitable individual customer accounts were or what it cost to replace them. Selling was treated as an end in itself, and the company simply paid its salespeople for selling products. Since the abolition of budgets, the accounting system has been producing information on customer profitability. According to finance director Gunnar Haglund, the architect of Ahlsell's management model, "Salespeople now have a different approach. They know how every customer wants to deal with us – whether [they're seeking the] lowest-cost transactions, value-added services, or a closer, more strategic relationship – and which customers offer the best profit-making opportunities. This is gradually improving our customer portfolio."

Rolling forecasts are now prepared quarterly by staff members at the head office, who make phone calls to a few key people over the course of a few days each quarter. Results from the previous quarter are available with little delay, and employees at every level in the company see them simultaneously. At the end of each year, unit managers – there are now many of them – receive bonuses based on how the year's return on sales compares with the previous year's.

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So long as the budget process dominates business planning, a self-motivated and adaptable workforce is a fantasy, however many cutting-edge tools and techniques a company embraces. That's because all of the principles and practices of budgeting assume, and perpetuate, central control. People at the front line of a top-down operation are hardly likely to report bad news if the inevitable result is a verbal beating – or to report good news, for that matter, if their reward is more ambitious targets.

In contrast, companies that dispense with budgets can unleash the full power of modern information systems and tools. Corporate planning ceases to be a series of breathless sprints and instead becomes an endless conversation. Knowledge flows from frontline people to headquarters and back again, permitting the full potential of a radically decentralized organization to be realized.

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