Beyond Budgeting Institute

White Paper

The Case for Moving Beyond Traditional Budgeting

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About Beyond Budgeting Institute and BBRT

The Beyond Budgeting Institute is at the heart of a movement that is searching for ways to build lean, adaptive and ethical enterprises that can sustain superior competitive performance. We promote a set of principles that lead to more dynamic processes and front-line accountability. Organizations that follow this approach transform their management model in line with these principles.

Our ideas are spread through the Beyond Budgeting Round Table (BBRT); a shared learning network of member organizations with a common interest in transforming their performance management models to enable sustained, superior performance. We help organizations learn from worldwide best practice studies and encourage them to share information and experiences to move beyond command and control.

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The Case for Moving Beyond Traditional Budgeting

The budgeting process can be laborious and it may also fail to give you the results you need. In this paper Anders Olesen explains how you can move beyond budgeting – and provides case studies.

The budget is generally regarded as an indispensable management tool. The process typically provides a detailed plan for the first year in the company's strategic plan. The budget produces targets for the coming year, a financial forecast, and an allocation of resources. The thorough process ensures coordination throughout the entire company. The budget provides management with a "stick in the ground" and a sense of control.

In this paper, I would like to demonstrate that it is possible to achieve all of the above with fewer resources and with higher quality than is possible in a traditional budget process. One of the tricks is to separate the all-inclusive budget process into several separate sub-processes.

When combining such new processes with appropriate leadership principles to form a coherent management model, it is possible to unlock the organization's full performance potential. This is what we call Beyond Budgeting.

Conflicting purposes

When asking companies about the reasons for budgeting, they almost invariably mention the following purposes of the budget:

Target setting

- The budget sets targets in line with the corporate strategy.
- Targets are broken down by division, BU, region, team, etc.; thus enabling everyone to see how they contribute to the corporate strategy.
- Targets are used for the annual bonus plan.

Forecasting

- The budget provides a financial plan for the coming year.
- Such financial plan – including P&L, balance sheet and cash flow - is often required by shareholders and lenders.

Resource allocation

- The budget provides managers with the allowed maximum spending; in monetary terms and often also in terms of headcount.

Definition

In this article, the word "budget" refers to the corporate budget that is prepared through an annual corporate-wide process, not the personal budget or a project budget or any other variety of that which generally refers to planned income and expenses.

The budget is thus supposed to do many important things for us. Most will agree that the above mentioned purposes must be addressed in order to manage a company and stay in control.

A key problem with the budget process, however, lies exactly in these purposes: they are all important, but they are different and even conflicting in nature.

There is for example an inherent conflict between target setting and forecasting:

- A target is what you want to happen.
- A forecast is what you think will happen.

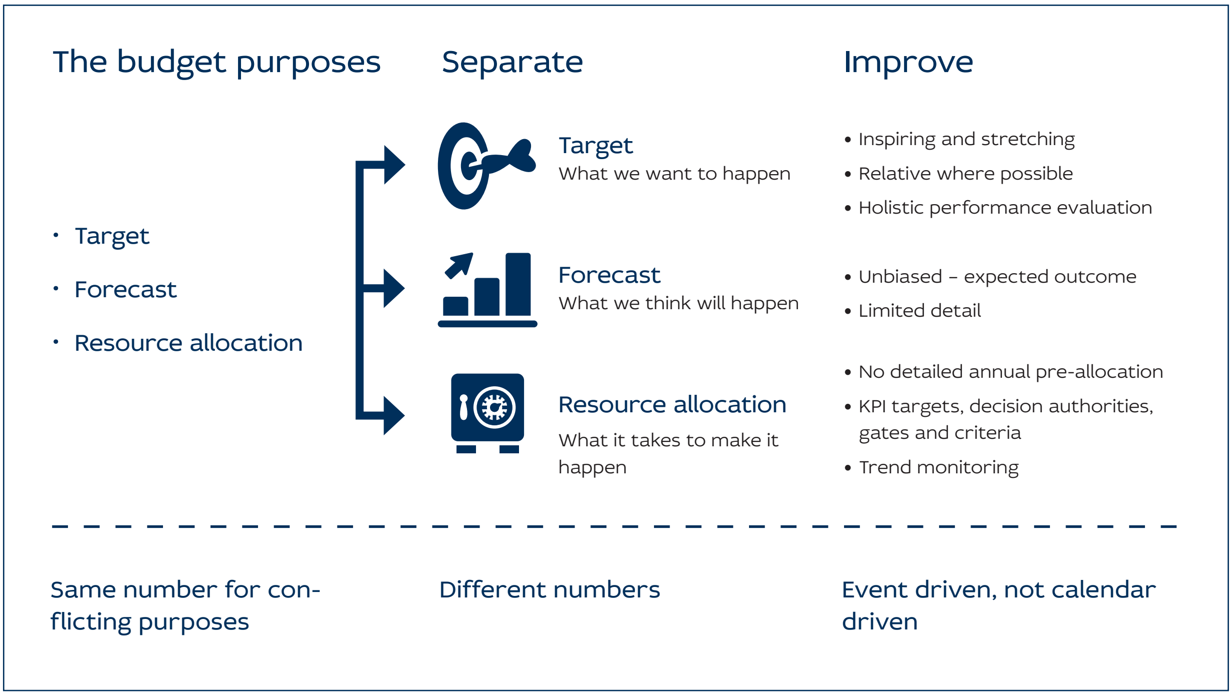
A target should be ambitious; it should provide direction and inspiration for the organization to reach the desired outcome.

On the other hand, a forecast should show the expected outcome. It should provide decision makers with information about where the company is heading, whether they like what they see or not. To enhance the quality of decisions, such information must be unbiased and sufficient (without drowning in details).

When combining conflicting purposes in ONE process, it is impossible to solve all of the purposes equally good. Accordingly, the traditional budget process is by default flawed.

This insight leads to the natural conclusion that the budget process should be separated into different sub-processes that are directed at each of the important purposes, as illustrated below:

Solving the budget conflict



There are more problems with budgeting than the inherent conflict between target setting and forecasting; some of these are reviewed in the following.

Fortunately, experience shows that when companies separate their budget process into sub-processes this also makes it easier to address the other budget problems.

Problems with traditional budgeting

Most leaders know that the budget process has its problems; I have yet to meet anyone who claims the opposite.

Multiple studies show, for example, that the validity of the budget is relatively short. Typically, some 20-30 % of the companies interviewed will answer that the budget is obsolete even before the budget year begins. And very often, some 60-70 % will answer that this happens during the first half of the year.

The level of waste as expressed by these figures is horrifying; where else is such waste accepted year after year?

Some of the typical problems with budgets are that:

- the link to strategy is often weak;
- they are very time-consuming
- decisions are made too early and at too senior a level;
- assumptions are quickly outdated;
- they can prevent value-adding activities;
- they create an 'accordion' forecasting horizon; and
- they are often a bad yardstick for evaluating performance.

Often weak link to strategy

The budget is supposed to be the detailed plan for year one in the strategy period. However, experience shows that very little of the budget work has anything to do with strategy. Very quickly, the budget process is reduced to a fight for less ambitious targets and more resources. This has much to do with the relatively short (one year) budget horizon and is often due to the link to bonuses.

Decisions made too early and at too senior a level

Many decisions are made during the budget process: prioritization of resources, for example. Due to the nature of the traditional budget process, we very often find that people high up in the hierarchy and far away from the situation settle disputes over resources. This can affect the quality of decisions negatively.

This means that companies - simply because of an internal process - force themselves to take decisions much earlier than necessary. And since the best decisions are made with the latest information at hand (i.e. as late as possible) this too means that the quality of decisions will suffer.

Prevents value adding activities

When considering an expense or investment, this question is too often asked in budget environments: "Is it included in the budget?" If so: go ahead. If not: no go - wait for next year's budget.

During the year, new and unexpected threats and opportunities will appear; things that were not - and could not – be foreseen when preparing the budget.

Despite all good intentions in the budget process, sticking to the budget will inevitably lead to a less than optimal use of resources simply because it is impossible to foresee what will happen.

"Accordion" forecasting horizon

Logically, one should think that a company's forecasting (or planning) horizon was determined by the nature of the company's industry and that it, accordingly, would be relatively stable over time.

However, in a normal budget environment, the forecasting horizon lasts to the end of the budget year. This means that the forecasting horizon - and hence, the focus of the organization - will vary significantly during the year: from roughly 3 to 15 months. This is purely driven by the financial year-end focus and has nothing to do with the underlying business needs.

A bad yardstick for evaluating performance

In a budget environment, you are a success if you reach your budget, and this often comes with a bonus. On the face of it, this sounds fine, but it has several negative side effects:

- rational managers will fight for relatively unambitious targets; thus increasing their chances for personal success;
- since conditions (and budget assumptions) always change during the year (currencies, oil prices, interest rates, etc.), it can be impossible to determine what success will look like beforehand;
- even if the cost budget is met, this is no guarantee for the most optimal use of resources. Some parts of the organization could probably have managed with less, and others may have underspent and missed opportunities;
- even if the revenue budget is met, this is no proof of success; maybe the competitors did even better and the market share came down.

Why most companies still budget

Very few disagree that the budget has the above-mentioned problems, yet most companies continue to prepare annual budgets. Why is this? Well, we can only find two explanations; either:

- Managers do not know what to do instead - what is the alternative?, or
- Managers consider the problems too small to justify a change

In the former case, the good news is that an alternative exists - as explained in this paper.

Concerning the latter, we disagree that the problems are too small to justify change. The budget is meant to support and enhance performance but is actually doing the opposite, and when the budget is more of a barrier than a support for good performance then the problem is indeed very serious and worth changing.

Will performance suffer without the traditional budget?

No - quite the contrary. It is our experience that the separation of the budget process into sub-processes has a positive impact on an organization's performance. Simply by changing the process, you will achieve better and more meaningful targets, more relevant and timely financial forecasts and an improved use of resources… with less effort.

The largest Norwegian business school recently conducted a research project within the Norwegian banking industry. The purpose was to identify relationships (if any) between financial performance and management tools applied by Norwegian banks. For most of the analysed tools, the researchers could not prove a significant link between tool and performance. However, concerning the budget, the study had a remarkable result: the financial performance (measured over a long period) of the banks without traditional budgets was significantly better than that of the other banks.

The Beyond Budgeting principles

One of the great advantages of separating the budget process into sub-processes for target-setting, forecasting, and resource allocation is that this opens up for significant process improvements; improvements that are impossible to achieve with one common budget process.

When you address the target-setting process, for example, and start thinking about how to design the optimal process, new and interesting ideas - that were unthinkable in the one-process-environment - will appear: What is actually the purpose of the target? How is this best achieved? What kind of targets should we have? How about non-financial and relative targets? Must there be a date linked to every target? Who sets the targets? How often?

Another significant advantage is that the new processes invite to and can facilitate the implementation of leadership practices that can further enhance performance improvement. Accordingly, and

LEADERSHIP PRINCIPLES

Governance and Transparency

1. Values – Bind people to a common cause; not a central plan
2. Governance – Govern through shared values and sound judgement; not detailed rules and regulations
3. Transparency – Make information open and transparent; don't restrict and control it

Accountable Teams

4. Teams – Organise around a network of accountable teams; not centralised functions
5. Trust – Trust teams to regulate and improve their performance; don't micro-manage them
6. Accountability – Base accountability on holistic criteria and peer reviews; not on hierarchical relationships

MANAGEMENT PROCESSES

Goals and Rewards

7. Goals – Set ambitious medium-term goals; not short-term negotiated targets
8. Rewards – Base rewards on relative per formance; not fixed targets

Planning and Controls

9. Planning – Make planning a continuous and inclusive process; not a top-down annual event
10. Coordination – Coordinate interactions dynamically; not through annual budgets
11. 11Resources – Make resources available just-in-time; not just-in-case
12. Controls – Base controls on fast, frequent feedback; not on budget variances

based on the practical findings of our network, we have developed the Beyond Budgeting Principles - see box - that address both the processes and the leadership aspect.

The focus of this paper is on the process side. However, organizations must address the leadership aspects as well. For employee motivation as well as management credibility, it is crucial that management processes and leadership principles are aligned.

Some practical examples

To illustrate how the separation of budget processes can work in practice, you will find some examples in the following. The examples are from successful - but very different - companies that have combined their management processes with strong leadership principles to form coherent management models.

As you will see, the specific solutions and processes adopted vary between the companies. There are, however, also several similarities:

- The companies place great emphasis on values and purpose (ref. principle 1 and 2) and transparency (principle 3).
- Some of the companies are organized as decentralised teams (principle 4 and 5); and others have implemented the new processes as part of an effort to increase the responsibility and accountability BU's.
- Several of the mentioned companies have introduced profit sharing schemes instead of individual targets and bonuses (principle 7 and 8).

CASE STUDY – Handelsbanken

Handelsbanken is a full-service bank with nationwide branch networks in Sweden, the UK, Denmark, Finland, Norway, and the Netherlands. Listed on the Stockholm stock exchange, Handelsbanken has more than 11,000 employees in 25 countries.

Handelsbanken has one financial target: to achieve a shareholder return that is above the average of its peers. This target has remained unchanged for 42 years; i.e. the bank spends no time on target setting. The bank has reached this target every year since it was established.

In the same 42-year period, the bank has not prepared annual budgets and it does not even prepare financial forecasts. Yet it remains in full control and it is the most cost-effective listed full-service bank in Europe. Based on five different financial measures, including financial strength, the ability to manage risk and cost efficiency, Bloomberg recently ranked Handelsbanken as the strongest bank in Europe. During the recent financial crisis, the bank did not need help from governments or shareholders; contrary to almost all other banks in Europe.

Handelsbanken is a prime example of a company that has also addressed the leadership principles. A key component of the bank's successful and coherent management model is a highly decentralised organizational structure and a high level of transparency; the latter also enables fast and frequent feedback (principle 12).

CASE STUDY – The Maersk Group

The Maersk Group is a worldwide conglomerate and operates in some 130 countries with a workforce of more than 89,000 employees. The annual revenue is approx. USD 48 billion (2014).

With the objective of creating a stronger link between strategy and action, Maersk has implemented a new management model based on the following design criteria: visibility, agility, control, and simplicity. A key element of the new management process is the separation of processes for target setting, forecasting, and resource allocation (principle 7, 9, 10 and 11). This has resulted in significantly improved sub-processes for each of these very important planning elements.

They also now have a more holistic view on value creation (principle 6) which is now evaluated against internal as well as external benchmarks.

Rolling forecasts combined with a new performance review process have improved Maersk's ability to react to rapidly changing market conditions.

CASE STUDY – Coloplast

Coloplast develops products and services that make life easier for people with very personal and private medical conditions. Their business includes ostomy care, urology and continence care, and wound and skin care. Coloplast operates globally, employing more than 9,000 people.

In 2009, following a year with four downward adjustments to the stock market, management realized that changes were needed. Coloplast wanted a new process to support its very ambitious performance improvements. This meant a farewell to the traditional budget and the introduction of new sub-processes: target setting, rolling forecasts, and a flexible resource allocation.

The new processes have helped Coloplast reach more ambitious targets, and provided the company with more agility. The absence of cost budgets has actually helped increase cost consciousness (principle 11). Financially Coloplast is now outperforming its peers. The EBIT margin, which stood at 12 % in 2008, was five years later at 32 %; far ahead of its peers.

CASE STUDY – Timpson

Timpson is a retail service business with more than 1,300 outlets in UK and Ireland. Timpson offers shoe repairs, key cutting, engraving, watch repairs, dry cleaning and mobile phone repairs – its biggest service is photo processing.

Timpson applies a unique management model where the people who front the customers are the ones that run the business - everyone else (without exception) is there to help them do their job. This is what Timpson calls Upside Down Management.

There is no headquarter; a small team supporting their colleagues in the shops provides central services.

Timpson "does not waste time trying to predict the future", as John Timpson (the company's chairman) writes on his blog; i.e. the company is not managed through budgets; they actually don't even prepare targets or forecasts - and they manage very well.

Timpson often features on the Best Workplace lists in the UK and across Europe, which has very much to do with its leadership (principle 1-6).

CASE STUDY – Statoil

Statoil is an international energy company with approximately 23,000 employees worldwide and operations in 36 countries. Headquartered in Norway, Statoil is listed on the New York and Oslo stock exchanges.

Ten years ago, Statoil decided to go beyond budgeting and they have since then developed its coherent management model also referred to as "Ambition to Action".

Each division/BU/team has its own "Ambition to Action"; Statoil's version of a balanced scorecard. All of these are transparent to everyone in the company, and teams can anytime during the year change their own targets, KPI's, priorities, etc. (principle 3-6 and 9-10).

Like Handelsbanken, Statoil measures its success relative to its peers. Accordingly, they have two corporate financial targets: above average on Total Shareholder Return, and first quartile Return on Capital (principle 6-7).

Statoil has developed a dynamic forecasting model, which asks units to update their forecasts when something significant has changed (principle 9-10).

The company practices a dynamic resource allocation process (principle 11), whereby new projects can be proposed at any time, and are approved or rejected dynamically based on project quality and on financial capacity available from the dynamic forecasting.

Another key principle in Statoil's model is a holistic performance evaluation (principle 6 and 8), which includes "pressure-testing" of measured KPI performance before any conclusions are drawn, as they see KPI's as "Indicators" only. This involves applying hindsight insights, and using information not picked up through measurement. Values and how results are achieved are also emphasized, and counts 50 % in the final evaluation.

CASE STUDY – Mainfreight

Mainfreight is a global supply chain business headquartered in Auckland, New Zealand and it is listed on the New Zealand stock exchange. The company currently has more than 240 branches around the world. In 2014, it generated NZD 1.9 billion in revenues and it employs almost 6,000 team members.

Mainfreight's success is underpinned by its unique performance management system. This supports a strong can-do attitude (principle 1 and 2) and excludes traditional budgets. As Mainfreight expands, it removes budgets from the companies it acquires and introduces its own performance management system.

One of its key principles is to avoid centralized control processes, budgets, and bureaucracy (principle 3-6). These are regarded as ineffective and time-consuming and take managers' attention away from the business. To illustrate this, here is a quote from Mainfreight's latest Annual Report: "As we grow our global business we continue to resist bureaucracy and corporate bull$#@t! It is a credit to our team of 5,771 people that we still think and act like a startup."

CASE STUDY – Alfa Laval

Alfa Laval is listed on the Stockholm Stock Exchange and is a leading global supplier of products and solutions for heat transfer, separation, and fluid handling. 2014 revenues stood at approx. GBP 2.6 billion. The company has about 18,000 employees and activities in 100 countries.

In 1998, Alfa Laval abandoned traditional budgets and introduced a new system of financial management whereby each of the budget purposes are handled in separate sub-processes.

The reasons for the change was very similar to that of other companies: conflicting purposes inherent in the traditional budget process, budget outdated early in the year due to inevitable changes in budget assumptions, too much time and energy spent on irrelevant details, weak link between planning horizon and the business cycle, etc.

In addition, the old budget process delayed the decision and implementation of important business initiatives as many of these were not foreseen when preparing the budget (principle 9-11).

Over the latest ten years (i.e. including the recent financial crises), Alfa Laval's EBITDA-margin has been in the 15-22 % range; which is extremely good for its industry. One of the key elements behind this strong performance is a drive for continuous improvement (principle 2 and 6).

Getting started / next step

I hope that this paper has demonstrated the benefits of separating the traditional budget process into sub-processes. Hereby, the quality of the company's planning efforts can be significantly improved with the same or even with fewer resources.

To achieve the full performance potential of the organization, it must also address its leadership processes. The true strength lies in the combination of the two, thus forming a coherent management model.

For established organizations to get started on a Beyond Budgeting journey, we generally recommend to start with a separation of the budget process, and to address the leadership principles subsequently.

For more information or help to get started, please feel free to contact the Beyond Budgeting Institute.