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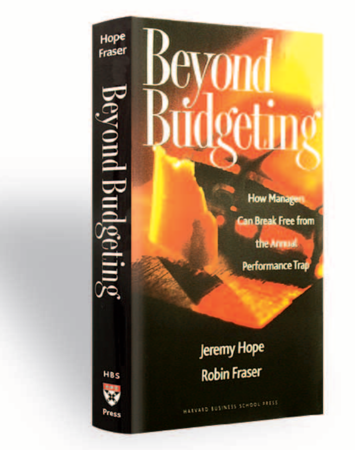

By Jeremy Hope and Robin Fraser

How Managers Can Break Free From The Annual Performance Trap

BEYOND BUDGETING

THE SUMMARY IN BRIEF

It's no secret that annual budgeting processes are time-consuming, add little value and prevent managers from responding quickly to changes in today's business environment. Traditional budgeting's focus on fixed targets and performance incentives often leads to dysfunctional, even unethical, management behavior. But organizations can break free from the annual budget trap once and for all.

Beyond Budgeting *presents an alternative, coherent management model that enables companies to manage performance through processes specifically tailored to today's volatile marketplace. Based on the decision-making needs of front-line managers, this model lets you take advantage of two major opportunities. Your company can create a set of adaptive management processes that replace centrally controlled, predetermined goals with self-regulating, relative competitive benchmarks and transfer the power and decision-making authority from the center of the organization to the front line.*

What You'll Learn In This Summary

✓ **Why the annual budget and performance contract is a trap and how you can break free from it.** Do away with budgets and you will save time and money while you create a more ethical and profitable company.

✓ **How creating an adaptive process lets managers focus on continuous value creation instead of meeting budget goals.** No longer will managers meet artificial, internally set goals. Instead they will measure their performance against others in the industry as managers set stretch goals.

✓ **How and why to create a radically decentralized organization to become a high performance organization.** By decentralizing, you create a vital, responsive organization.

✓ **What you need to do to realize the full potential of management models like customer relations management, benchmarking, Balanced Scorecards, activity-based management and rolling forecasts.**

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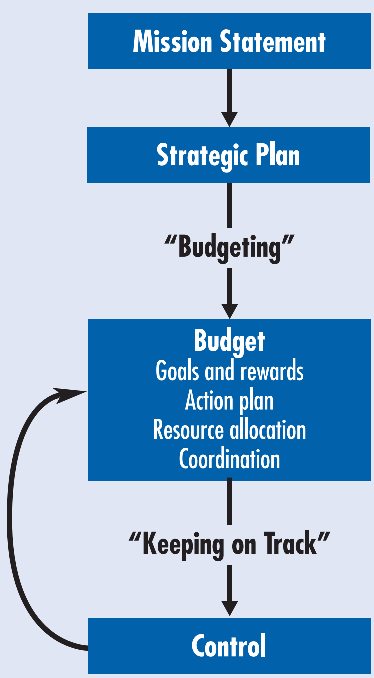
The Annual Performance Trap

Like them or loathe them, everyone has a view about budgets. CEOs like the warm feeling they get when they see the year-end profit forecasts. But they might be anxious about the reliability of the assumptions and the firm's ability to respond to change. CFOs like the way they are able to tie operating managers to fixed performance contracts (fixed targets reinforced by incentives). But they also know that the process takes too long and adds little value. Operating managers like "knowing where they stand." But they are also concerned about the time wasted and that fixed performance contracts lead to decision paralysis and cosmetic accounting rather than decisive action and ethical reporting.

The consensus in American business circles is that the budgeting process isn't all it could be. Dissatisfaction is rampant. There are three main reasons for this:

- Budgeting is cumbersome and too expensive;
- Budgeting is out of kilter with the competitive environment and no longer meets the needs of either executives or operating mangers; and
- "Gaming the numbers" has risen to an unacceptable level.

The Traditional Budgeting Process



Budgeting is Cumbersome and Too Expensive

The budgeting process is a deeply embedded annual ritual. It absorbs huge amounts of time for an uncertain benefit. Typically, it starts with a mission statement that sets out the aims of the business followed by a group strategic plan that sets the direction and high-level goals of the firm. These form the framework for a budgeting process that grinds its way through countless meetings.

The average time consumed by the budgeting process is between four and five months, absorbing 20 to 30 percent of senior executives' and financial managers' time. A 1998 benchmarking study showed that the average company invested more than 25,000 person-days per billion dollars in revenue in the planning and performance measurement processes.

For any firms involved in mergers, acquisitions, disposals and other reorganizations, the budgeting workload can be overwhelming. The result is a finance team under constant pressure to reconfigure the numbers rather than support hard-pressed managers with the information they need to make decisions.

Budgeting Is Out of Kilter With the Competitive Environment

The pressure on corporate performance has become intense. Shareholders demand that firms be at or near the top of their industry peer group. Intellectual capital, such as brands, loyal customers and proven manage-

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The Annual Performance Trap

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ment teams, drives shareholder value. Product and strategy cycles have shortened. Prices and margins are under pressure and customers are becoming fickle. The old command-and-control management style is out of tune with the new need for agile and adaptive leadership and the need to transfer more power and authority to people closer to the customer.

Few of the innovative management tools of the past decade have been used to fundamentally transform the performance management process. At best they have made marginal improvements to a broken system. Few have achieved their potential.

'Gaming the Numbers' Is at Unacceptable Levels

Budgets started life in the 1920s as tools for managing costs and cash flows in large organizations. By the 1960s they had mutated into fixed performance contracts. By then companies were using accounting results such as costs, net income and return-on-investment (ROI) to do more than keep score but also to motivate operations personnel at all levels. By the 1970s, financial indicators were being used to manage the business.

This lead to the increased use of the fixed performance contract as the basis for setting fixed targets against which performance was evaluated and rewarded. The fixed performance contract begins with an "earnings" contract between senior executives and external parties, such as investors or bankers, and then cascades down the organization in the form of "budget" contracts between senior executives and operating managers.

The typical budget contract provides:

- **A fixed target, such as sales, profits, costs and return on capital.**
- **An incentive for meeting or exceeding targets.**
- **An agreed-upon strategic and financial plan.**
- **A statement of resources available.**
- **A commitment to cross-company actions such as a promise by production to meet a sales plan target.**
- **A reporting schedule so that progress can be monitored.**

One problem with this management method is that it may lead to fraud. Fear of failure (to meet the goals specified from above) is often the underlying cause. This was evident at both Enron and WorldCom. When senior executives and operating managers commit to overly aggressive targets, they may fudge the numbers to meet them. The fixed performance contract is a deadly virus. It can lay dormant for years until an aggressive "management by the numbers" leader comes along and activates it. It is a dismal way to manage a business. ■

Breaking Free

There are organizations that have found a better way. They have eliminated the annual cycle of preparing, submitting, negotiating, and agreeing upon a budget by department, function, business unit, division or even the whole organization. The result has been to save months of work. The budget no longer represents an annual fixed performance contract that defines what subordinates must deliver or how resources are allocated or what business units must make and sell. The budget no longer determines how the performance of those units and their people will be evaluated and rewarded.

Who are these organizations? They vary in size from a small charity to a huge global firm. They have gone beyond budgeting, enabling more adaptive management processing and a radically decentralized organization.

The Adaptive Process Opportunity

Rhodia is a large specialty chemical company with sales of $7.2 billion operating in many global consumer markets. The annual budgeting process took six months and was slowing down its ability to respond to the market. In 1999, the company replaced it with two performance management cycles. One takes a strategic view and continually looks two to five years ahead, with an annual review. The other takes an operational view and looks five to eight quarters ahead, with a quarterly review. Managers now focus on medium-term strategy rather than short-term fixed targets.

The contrast between the old and new way of doing things is dramatic. It looks like this:

Targets: Instead of setting a fixed sales/profit target, the organization trusts everyone to maximize profit potential by continuously improving against an agreed-upon benchmark and remaining in the top of the industry peer group.

Rewards: Instead of a fixed reward, managers are rewarded by a peer review panel based on performance and with "hindsight" at the end of each year.

Plans: Instead of an agreed action plan, the organization trusts everyone to take whatever action is needed to meet medium-term goals.

Resources: Instead of a fixed budget amount, managers trust the organization to provide the resources needed to meet goals, and management trusts everyone will keep resources within agreed-upon key performance indicators.

Coordination: Instead of an imposed-from-above coordination of activities, the organization trusts that everyone will work together according to periodic agreements and customer requirements.

Controls: Instead of monthly performance monitor-

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Breaking Free

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ing, the organization trusts everyone will provide an accurate forecast based on the most likely outcome. The organization will only interfere when the indicators move out of bounds.

The principles of *Beyond Budgeting* offer a new coherent management model. It assumes that front-line managers are able to regulate their own performance. Senior executives provide a supportive role. They challenge and coach, but decisions are taken locally within a clear governance framework based on principles, values and boundaries. In the new coherence, relative improvement contracts, strategic models, rolling forecasts and service-level agreements make sense.

Radical Decentralization

There must also be a wider coherence among the organization's success factors, its strategy, its management processes, and its leadership styles and culture. The process is about lifting the burden of bureaucracy from the shoulders of front-line people, eradicating the dependency culture and enabling people to accept even more responsibility for their own performance.

The delegation of decision-making and spending authority has always been one of the key functions of budgeting. However, this delegation usually occurs within a regime of compliance and control. When that power is transferred from the center to operating managers and their teams, vesting them with the authority to use their judgment and initiative to achieve results without being constrained by some specific plan or agreement, the organization creates an empowered work force. That in turn drives superior performance.

Radical decentralization requires that leaders share six common principles. These are:

1. Build a governance framework based on clear principles and boundaries.

2. Create a high-performance climate based on the visibility of relative success at every level.

3. Provide front-line teams with the freedom to make decisions that are consistent with governance principles and strategic goals.

4. Place the responsibility for value-creating decisions on teams.

5. Focus teams on customer outcomes.

6. Support open and ethical information systems.

Going beyond budgeting provides benefits for shareholders, too. It addresses two primary issues investors face. The first is whether they believe an organization will produce sustainable growth in shareholder wealth. The second is whether they trust the management team. ■

Svenska Handelsbanken Decentralizes

Swedish bank Svenska Handelsbanken was struggling and losing customers, especially to a smaller rival run by Dr. Jan Wallander. So the bank invited him to join it as its new CEO. He accepted with the proviso that the bank would have to radically decentralize operations and abandon its budgeting process.

Convincing others that the organization should not be coordinated and controlled from the center was a tough challenge. Wallander was resolute. He believed that what holds an organization together is a commitment to a clear purpose, principles and values. Above all, Wallander believed in setting people free — free from stifling bureaucracies, predetermined plans, fear of failing to meet fixed targets, and forced cross-company actions designed by central planners. He opened up the information system so that everyone could see the same information at the same time. Sharing and cooperating were no longer choices: They happened automatically.

Since abandoning the budgeting model in the 1970s, the bank has produced outstanding return for shareholders, consistently beating all its European rivals on the key ratios of cost-to-income and costs-to-total assets. The CEO credits its decentralized management model as a major source of competitive advantage.

How Adaptive Process Opportunity Lets Managers Focus on Value Creation

Breaking free from the fixed performance contract is key to unlocking stretch targets, implementing adaptive processes and eradicating most of the undesirable game-playing that pervades the budgeting process. Break free by:

- **Setting stretch goals aimed at relative improvement.** You do this by telling the team that they should set their goals based on their highest aspirations. Just make certain that the stretch goal isn't seen as a fixed target against which performance will be evaluated. Also make sure that goals are set relative to external benchmarks. Benchmark goals are based on industry best-in-class performance measures, and teams are given an extended period of time to reach them. Most companies set the goal as being in the top quartile of their peer group. You can also set goals relative to internal peers as a way to boost continual improvement.

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How Adaptive Process Opportunity Lets Managers Focus on Value Creation

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● **Base evaluation and rewards on relative improvement contracts with hindsight.** Do not link rewards to fixed targets agreed upon in advance. Set bonuses based on a relative improvement contract that involves a whole team setting and meeting a range of performance benchmarks over a period of time. Use a peer review group to evaluate their performance with the benefit of hindsight. The peer panel must ask, "Did they do as well as they could have done given what we know about the profit-making opportunities during the period and what the competition has achieved?"

● **Make action planning a continuous and inclusive process.** The calendar or fiscal year may be an appropriate time period for reporting results to investors but it is unlikely to be for managing the business. Focus instead on continuous value creation.

● **Make needed resources available.** Managers need fast access to resources. Although you may provide parameters within which resources can be committed, within these limits managers should have wide discretion over how they utilize resources. Provide fast-track approval for major projects outside the budgeting process. Major projects should be approved as needed, not because it is the right time of the year. Managers should have the power to implement small projects.

● **Coordinate cross-company actions according to prevailing customer demand.** Let the pace of market demand set commitments. Whenever possible respond to unanticipated customer requests. Give those who are making the front-line decisions access to customer profitability information or they risk creating losses as the costs of customizing affect customer profitability.

● **Base controls on effective governance and on a range of relative performance indicators.** Decentralizing means making the switch from central control to multilevel controls. Multilevel controls means knowing what is going on and interfering only when necessary. Ensure that there is effective governance from the center which supports local decision-making.

Applying these principles results in aspirational goals, reduced gaming, ambitious strategies, fast response, reduced waste, improved customer service, and an atmosphere that promotes learning and ethical behavior.

Insights into Implementation

Little uniformity exists in how firms have approached the implementation of beyond budgeting. Though some have used consultants to help with the process design, few have used them to aid with the abandonment of the budgeting process and the implementation of its replacement. After surveying successful companies that have gone through the process, the following guidelines help shed light on how they managed the change-over:

● **Define the case for change and an outline vision.** Implementing beyond budgeting, even incrementally, is a significant change and needs to be handled accordingly. Going beyond budgeting is about changing a mind set. You won't be able to build support from the top and a groundswell below unless you make a convincing case for change that includes a vision of how things will be. The case for change should be both a clear statement of the "current pain" experienced with the budget-based model and the benefits to be gained by replacing it with something different.

● **Convince the board.** One of the key roles for the project team will be to convince the board that managing without budgets will bring significant benefits without too many down sides. The board will question whether the firm can maintain effective corporate governance and internal controls and whether changes will affect the firm's ability to forecast future earnings and

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How the Board at Borealis Was Convinced

Borealis is one of the largest petrochemical companies in the world. Output from its products can be found in thousands of everyday products from diapers to housewares to power cables. It was formed in Denmark in 1994 as a joint venture between two Nordic oil companies (Statoil of Norway and Neste of Finland). It inherited most of its processes, systems and people from the parents. Heading up the team that would create a Borealis unencumbered by the burdens of budgeting was Bjarte Bognses. His team's first job was to convince the board that doing away with the budgeting process was a good idea.

The team was confronted by board members who asked, "How do we control the business without budgets?" "and "Why take the risk?" Through a series of meetings, the team won the board over. They discussed two primary risks: that costs would explode because of fewer controls and that decision making would be paralyzed. Bognses addressed these concerns like this:

"We have good, capable people who take their jobs seriously. They know what to do. The likelihood of chaos is minimal. We should also consider the risks of not doing it. What would happen? We would carry on as normal with no one challenging costs and everyone demanding more resources than the company can afford." He won the board over and the company has become a powerhouse.

How Adaptive Process Opportunity Lets Managers Focus on Value Creation

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avoid upsetting the market with unpleasant surprises.

- **Get started.** Remind people that the change will actually mean less work, not more. A great approach is to eliminate the next budgeting process right away and immediately replace it with the new process.
- **Design the model and implement the process.** The annual budgeting process connects every part of an organization and influences how people think and behave at every level. Any changes must therefore take into account these effects. Realign recognition and rewards, and reestablish coherence in the whole process.
- **Train and educate people.** Combine a well-designed system and a rollout program with excellent training materials. Make sure everyone becomes familiar with the new processes as soon as possible.
- **Rethink the role of finance.** The success of managing without a budget will be fleeting unless the role played by the finance team is realigned with the new processes. This is a time of maximum uncertainty for the finance team. They need to know where they stand. Ensure they have the training to meet future challenges.
- **Change behavior.** Change will be driven by the new processes, not by management decree. Behavior change follows process change. With no detailed budget to define their targets and dictate their actions, managers must accept greater responsibility for their actions and more accountability for their results.
- **Evaluate the benefits.** Demonstrating short-term wins is important to keep resistors at bay. Show them hard evidence of success. Short-term wins should have three characteristics: They should be visible, unambiguous and clearly related to the changes. ■

Principles of Radical Decentralization

Effective empowerment is the product of freedom multiplied by capability. As with any mathematical equation, if one of the variables is zero, the result will also be zero. This explains why so many attempts at empowerment fail. Few leaders seem capable of supporting both variables at the same time. To make it work, you need to understand seven leadership principles. They are:

1. Provide a governance framework based on clear principles and boundaries. People at all levels of a firm need clear guidelines so they know what they can and cannot do. In control-oriented organizations, these were based on mission statements, plans and budgets. In empowered organizations, they are based on clear principles, values and boundaries. Essential boundaries include the strategic domain; codes of conduct; ethical and environmental considerations within which managers can operate; time between reporting intervals; and the area between what managers must do and what they might do.

2. Create a high-performance climate based on relative success. When senior executives fixate on meeting numbers every quarter and year-end, their obsession drives dysfunctional and disruptive behavior at every level. Managing without fixed targets and incentives leads to strong and consistent levels of performance when leaders champion relative performance, challenge ambition, and balance competition and cooperation.

Break Free From Fixed Performance Contracts

3. Fixed performance contracts tie operations managers to specific agreements and reduce their flexibility. Breaking free from these contracts is the single most important step that leaders can take to create an empowerment culture where beating the competition is what's important, not meeting some arbitrary internal goal.

4. Give people freedom to make local decisions that are consistent with governance principles and the organization's goals. Teams at every level need strategic direction. To instill a culture of responsibility rather than dependency, leaders should challenge assumptions and risks, involve everyone in strategy, and empower teams to make decisions.

5. Place responsibility for value-creating decisions on front-line teams. Decentralizing allows teams to respond to local opportunities in ways that create a more adaptive organization. Changing functional mind-sets to team-based mind-sets is a major cultural challenge. To embed the philosophy of teamwork and personal responsibility, leaders must create a network of small, customer-oriented teams, and base recruitment on a potential employee's fit with the team.

6. Make people accountable for customer outcomes. As you move beyond budgeting, your structure should become more networked, using independent units with distributed capabilities and expertise. You will be able to locate and combine expertise across the network and seamlessly bring collective expertise together to provide customer solutions. That way, teams can share knowledge across the business as they respond to customer demands.

7. Support open and ethical information systems providing "one truth" throughout the organization. Resist the temptation to hide facts from the organization. Good and bad news must be shared so potential problems can be solved before they become crises. ■

Insights Into Changing Centralized Mind-Sets

Changing the centralized mind-set is extremely difficult and depends on rooting out the budgeting and dependency culture. The problem is a lack of understanding of what leaders must do to make empowerment work effectively. To make it work, they must abandon:

- **fixed performance contracts**
- **command-and-control management**
- **the dependency culture**
- **central resource allocation**
- **multilayered functional hierarchies**
- **closed information systems**

To make the leap, the organization and everyone in it must see real benefits. The main benefits of empowerment are unlikely to be realized until the budget contract has been abandoned and alternative processes have been put into place. It is the new processes that change actions and behavior.

'We Really Mean It'

Abandoning the budget is one of the most positive actions leaders can take that say to people "we really mean it." Managers are immediately aware that there is no detailed plan that dictates their actions. They must think for themselves and take responsibility. The learning process is both fast and steep. Managers suddenly have to understand strategy at both corporate and local levels and know the principles and boundaries within which they are to operate. They have to understand that if they make mistakes, they won't be punished.

For many managers steeped in the command-and-control culture, devolving responsibility is airy-fairy stuff. Their job as they see it is to ensure that leaders have control, and that can only be done with hard numbers. These managers exist in every organization and are usually a difficult and vocal minority. The answer isn't to cater to them but to maximize attention to the top 90 percent or so who do get it — who understand the benefits of decentralization. Promote the people who embrace the new values and it will take root.

Some companies have found that the turning point in their switch to a culture of responsibility was when they changed how people were recognized and rewarded.

The Roles of Systems and Tools

Six tools are especially helpful in going beyond budgeting. These are:

1. Shareholder value models that align decisions of internal managers with the expectations and interests of external shareholders.

2. Benchmarking models align targets with external or internal best practices and display the results in terms of rankings lists.

3. Balanced Scorecards provide a strategic framework for local decisions and provide leading indicators that tell managers if strategic goals are met.

4. Activity-based management informs managers about the causes of costs and better equips them to understand the net profit contributions of products, channels and customers.

5. Customer relationship management tools focus managerial actions on knowing and satisfying customer needs profitably.

6. Enterprise information systems and rolling forecasts join up the disparate functions of the organization and enable managers to relate work and cost inputs to customer outputs across the business.

Advocates of tools and information systems claim potentially powerful results if they are implemented in the right way. Tools and systems will work if the organization's culture is supportive, its leaders are committed, and decision makers have the freedom to act on the information the tools provide. These are big "ifs." The reality is that few tools achieve their objectives. The problem is that although all these tools have been implemented to overcome the systemic failures of the traditional model, the processes that underpinned those failures have been left in place. They have, in effect, been neutralized by the powerful antibodies of the budgeting immune system.

Budgets are barriers to the full implementation of the listed models. Removing the barriers is key to successful implementation of the models. For each model, the approach differs slightly. Here is the breakdown:

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How IKEA Shares Information

IKEA's chairman Ingvar Kamprad believes his company's open information systems based on sharing of best practices give the international retailer a powerful competitive advantage. The company assigns "IKEA ambassadors" who are trained by the chairman himself in the company's values and culture to key positions in every unit. They socialize newcomers into the IKEA philosophy and facilitate the transfer of ideas and best practices across the company's operating units. As a result, newly set-up stores look at other stores and try their hardest to improve on them. Some of the distinguishing characteristics of the typical IKEA store have emerged out of this institutional entrepreneurship. These characteristics include cafeterias serving inexpensive exotic meals, such as Swedish meatballs; supervised play areas for children; and fully equipped baby-changing facilities.

Insights Into Changing Centralized Mind-Sets

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Shareholder value models let managers make decisions based on creating value greater than the cost of capital. By looking at every business as a portfolio of assets, products and customer segments, you can apply or reduce resources to them on the basis of their value-creating opportunities. This is hard to do in the traditional budgeting environment, where goals and resources are allocated for the year with little relationship to the allocations's impact on segments of the business. Some get more than they need in relation to their value-creation while others don't get enough. Instead, give front-line managers access to the information they need to see what creates the most value.

Measure Relative Success

Benchmark modeling is the philosophy of continuous improvement against a world-class standard. Well-chosen benchmarks ensure that firms are measuring performance against best industry standards rather than internally negotiated targets. Budgets are barriers to benchmarking because budget figures rarely are tied to external factors, but reflect realistic goals set internally. That can prevent moving ahead within the industry even as internally selected goals are met. It's the company's performance relative to the competition that counts, and that's what benchmarking measures. Using benchmarking also allows fair evaluation of efforts during turbulent times as it measures relative success.

The Balanced Scorecard was developed in the early 1990s as a response to the inadequate performance measurement systems that were primarily geared at reporting financial results against the budget. Scorecards are business units' strategy map. They set goals and provide an action plan for meeting those goals. Scorecards let front-line teams manage strategy by making sure goals and actions are aligned.

Understanding How Activities Add Value

Activity-based management models enable managers to better understand how activities add value to products and customers. An activity-based model can measure the cost of activities that are not readily accounted for in a budget that only shows the costs of functions and departments. By giving front-line employees access to activity-based information, they can make better decisions about their activities, and set priorities that lead to greater profitability.

Customer relationship management models identify what people must do to satisfy customers and build their loyalty and profitability now and in the future. Front-line workers must be freed from budget goals that restrict their ability to build relationships.

Enterprise information systems and rolling forecasts should be used to monitor business changes and have the capability to do so almost in real time. ■

A Management Model For the 21st Century

The essence of the adaptive and decentralized management model is that by giving capable and committed people the authority to make fast decisions in their local markets, they will act responsibly; respond appropriately to the threats and opportunities confronting them; and with an eye on competitive performance, deliver consistent results. The focus of the model has moved from central to local control. This means that it is the local team that engages in planning and execution. They are the ones in touch with customer needs and the ones who have the freedom and capability to act.

Leaders also benefit. They have more time to challenge and support front-line people and reinforce principles and boundaries. Fast, transparent information ensures that there are many checks and balances that provide strong controls.

Lower Cost

Low cost is also a feature of the beyond budgeting company — an important feature in difficult times. By removing the cost of the budgeting process and eliminating the entitlement mentality that traditional budgets create, front-line managers can spend less when they need less while safe in the knowledge that they will be provided greater resources should they need them.

A decentralized company also encourages an environment of good governance and ethical behavior. People want to work in a more virtuous organization where they can trust people and be part of a team. They want to know what the company stands for and where it is headed. And, most important of all, they want more meaning in their working lives.

The adaptive and decentralized model is the answer. It is based on releasing the enterprise, energy and capabilities of people supported by adaptive processes, appropriate tools and clear leadership principles. There is no place for fixed performance contracts and remote-control management. Leaders need to place more faith, responsibility and trust in their operating people. The result will be a management model that offers a unique source of competitive advantage. ■