The Principles of Beyond Budgeting

White Paper - June 2005

About BBRT

BBRT is a supported network of member companies with a common interest in improving planning and budgeting – sharing information, past successes and implementation experiences, with guidance from the research team and associates. Our purpose is to help organizations introduce ways to achieve more adaptive control and continuous planning.

This white paper outlines the founding principles and case examples of companies moving Beyond Budgeting. For more information on our research or membership, please contact:

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1. The “idea” and the “community”

The Beyond Budgeting Round Table (BBRT) is both an idea (“BB”) and a community (the “RT”). The BBRT is at the centre of a new movement that is searching for ways to build lean and adaptive organizations that can *sustain* superior competitive performance. Our aim is to develop and spread the idea through a vibrant growing community.

What is the idea?

Many organizations are now moving to what we call a beyond budgeting model. This model, derived from the ‘best of best practices’ of leading-edge organizations, consists of two sets of six principles that redefine performance management. The first six “process” principles support a more adaptive set of performance management systems that enable front line teams to be more responsive to the competitive environment and to customer needs. The second six “leadership” principles provide a framework for the devolution of responsibility to front line teams thus enabling them to respond quickly to emerging events and making them accountable for continuously improving (internal and external) customer outcomes and relative performance.

	Beyond Budgeting Process Principles
1. Targets	**Set aspirational goals based on continuous relative improvement** not fixed targets
2. Rewards	**Base rewards on relative performance with hindsight** not on meeting fixed targets
3. Planning	**Make planning an inclusive and continuous process** not an annual event
4. Resources	**Make resources available on demand** not through annual budget allocations
5. Coordination	**Coordinate cross company actions dynamically** not though annual plans and budgets
6. Controls	**Base controls on KPIs, trends and relative indicators** not variances against plan

	Beyond Budgeting Leadership Principles
1. Governance	**Base governance on clear values and boundaries** not on detailed rules and budgets
2. Performance	**Build a high performance culture based on relative success** not on meeting targets
3. Freedom to act	**Devolve decision making authority to frontline teams** don’t micro-manage them
4. Accountability	**Create a network of small units accountable for results** not centralized hierarchies
5. Customer focus	**Focus everyone on improving customer outcomes** not on meeting internal targets
6. Information	**Promote open and shared information** don’t restrict it to those who ‘need to know’

What problems does the idea address?

Many organizations today recognize that they are too rigid, unresponsive, bureaucratic and complex. Our belief is that this is caused by performance management systems that are fixed, annual and based on negotiation resulting in multiple fixed performance contracts at every level of the organization that constrain actions and stifle initiative.

Why should you adopt the idea?

1. To make the organization more agile and adaptive to change
2. To eliminate a process that is too protracted, expensive and adds too little value
3. To focus everyone on maximizing value for customers and shareholders
4. To effect a permanent (and significant) reduction in bureaucracy and costs
5. To eliminate gaming and other dysfunctional behaviour leading to better governance
6. To release the energy and enterprise of all your people

Why NOW?

The performance management process determines how people think and behave. Changing this behaviour from managing numbers to responding to change and improving customer and shareholder value will potentially have a greater impact on the bottom line (both short- and long-term) than almost any other improvement initiative.

What is the community?

The BBRT community is an independent research and knowledge sharing collaborative. We share our knowledge across our global membership network and we teach our knowledge through our conferences and workshops. The BBRT welcomes all individuals and organizations that want to learn and improve their performance management models or help others to do so. All members are 'general' members. This gives you access to the accumulated knowledge and to the network. Further learning can be accommodated through special interest groups. These enable members to learn more about applying the model in some particular way (e.g., to different industry types). The BBRT also welcomes management consultants and IT companies that want to develop client-based solutions from our ideas and principles. The BBRT is funded from membership fees and 'pay-as-you-go' fees for specific services to members.

2. Why some organizations move 'beyond' budgeting

Firms have been trying to come to terms with these problems for decades. In the 1970s and 80s, for example, zero base budgeting (ZBB) became a popular approach. ZBB starts with a blank sheet of paper in regard to discretionary expenditure. It proved to be a useful (though usually one-off) exercise to review discretionary overheads. In recent years, some firms have introduced more frequent and much streamlined planning and budgeting processes. These include budgets done half-yearly or quarterly instead of annually, and 'rolling budgets' that tend to have a twelve-month horizon (updated every quarter). Though these approaches offer more current (and thus more relevant) numbers for managers to follow, they suffer from an increased workload (even if done with fewer 'line items') and thus, more often than not, even higher cost.

Implementing strategic management models such as the Balanced Scorecard is another approach taken by an increasing number of firms that are trying to shift their emphasis from being 'budget-focused' to being 'strategy focused' organizations. But the full power of the Balanced Scorecard is constrained by the short-term performance drivers of the annual budget. These, by and large, remain focused on 'managing' the next year-end rather than supporting medium-term strategy.

Most of these 'improvements' have been aimed at reducing the costs and increasing the relevance of budgeting. But few have attempted to break free from the fixed performance contract and the annual trap that it creates. Indeed the evidence from Scorecard users is that the performance indicators used are predominantly financial (62 percent) and lagging (76 percent).[1] Our conclusion is that despite many attempts to change the budgeting process and the mindset it encourages, it remains the predominant feature of performance management in most organizations today.

3. The Beyond Budgeting process principles

Borealis A/S is at the leading edge of polymer research and development and is now the world's fourth largest producer with annual sales of $4bn. The problem it faced was that the budgeting process provided the illusion of control when, in reality, its core assumptions were based on volatile oil prices and a highly unpredictable business cycle. So it replaced the target setting, planning, measurement and control functions of the budgeting process by integrating them within a Balanced Scorecard that (freed from the constraining influence of short-term budgets) directed managerial attention toward a number of strategic themes that underpin medium-term goals (such as reducing fixed costs by 30% over 5 years).

Targets are now set by reference to industry benchmarks and the annual review process takes only a few weeks compared with five months spent previously on the budget. Rolling forecasts support quarterly performance reviews and costs are managed through KPI boundaries and trend analysis. Performance is now reviewed quarterly and Scorecard measures are a feature of web pages and bulletin boards that inform everyone about strategic performance. Project leaders reckon they have saved 95% of the time that used to be spent on budgeting and forecasting. Another (unexpected) benefit was the enhanced status of the finance people who are no longer seen as bean counters but as people who really help front line managers with operational decisions. Moreover, the finance people are pleased with the results, as project leader, Bjarte Bogsnes, explains: *"We now achieve what the planning and budgeting process did in a simpler, more direct way. In fact I would go further. The new system is not just simpler – it gives us far more information and control than the traditional budget ever did."*

The next section briefly describes what organizations such as Borealis used to do with their budgeting processes and what they now do without them.

3.1 How have organizations *set targets* without budgeting?

What they used to do: They set targets on the basis of financial and, more often than not, 'negotiated' numbers between superiors and subordinates before the start of the year. They were fixed for the year ahead. They represented the key component of the annual fixed performance contract. All actions were then focused on meeting the numbers.

What they do now: Each team sets its own aspirational goals (typically 3-5 years ahead) but these are not treated as commitments or contracts. They are informed by higher-level expectations set by senior executives. These goals are then used to set a framework for strategy. The benefits are that the process is fast and, because the benchmarking bar is always being raised, it is more likely to maximize profit potential.

3.2 How have organizations *rewarded* people without budgeting?

What they used to do: They assumed that managers would be motivated and fairly rewarded if the right mix of targets and incentives was put in place. Thus rewards were linked to a fixed outcome agreed in advance. The benefits were that managers "knew where they stood and what they had to meet". It was then up to them to achieve the target and bonus. They knew (and thus accepted) that this element of the budget contract led to 'gaming'. In one study of 402 US firms, almost all respondents stated that they engaged in one or more budget games...Managers either did not accept the budgetary targets and opted to beat the system, or they felt pressured to achieve budgetary targets at any cost".[2]

What they do now: Most evaluate and reward performance on the progress that both teams and the firm as a whole make toward achieving medium-term goals (using a range of metrics). Performance evaluation is made "with hindsight" in the light of how a unit performed over the period against benchmarks and peers. One firm has dispensed with local rewards altogether and for the past 30 years has been using one group wide profit sharing scheme based on a formula related to the competitive performance of the firm. One benefit is that all cases have seen a reduction in 'gaming' behaviour (with no fixed contract, there is little point in gaming).

3.3 How have organizations managed *action planning* without budgeting?

What they used to do: The planning process used to be either top-down (prepared by leaders or central planning departments), or sometimes bottom-up, with local teams preparing their plans and then negotiating and agreeing them with superiors. Moreover, many were based on departmental improvements that were not necessarily in accord with strategic objectives. After many months of discussion, the resulting plan provided clear guidelines that told people what they had to do in the year ahead. However, such a predetermined plan can be a liability when the business environment has become as unpredictable as it is today. But the evidence suggests that such problems are ignored. For example, only 20 percent of firms change their budgets within the fiscal cycle.[3]

What they do now: They review the medium-term outlook (usually a 2-5 year horizon) every year and the short-term outlook (typically, 5-8 quarters ahead) every quarter. Both cycles are aimed at continuous improvement and improving performance against peers and prior years. Responsibility for these reviews is, by and large, devolved to business unit teams and, in some cases, front line teams. The role of group executives is to set strategic objectives and medium-term goals and then challenge the plans and initiatives that managers propose to ensure their core assumptions and risks are reasonable and represent the best options available. Both cycles are 'light touch' processes taking no more than a few weeks for the annual cycle and a few days for the quarterly cycle. Useful tools such as rolling forecasts, the Balanced Scorecard, and activity accounting support these performance reviews. Action plans are derived from them. The primary benefits of these various approaches are faster response and a sharper focus on achieving strategic goals and satisfying customers' needs.

3.4 How have organizations *managed resources* without budgeting?

What they used to do: They allocated resources on the basis of budget contracts negotiated *in advance* together with a share of 'central costs' that (in theory, if not in practice) were needed to support them. The benefit was that at one point in time all resources were allocated to one unit or another. No further management attention was then needed until the following year's budget review. However, senior executives too often acted like central committees approving or disapproving investment proposals based on annual plans. It is little wonder that strategy expert, Gary Hamel, described this approach as *the last bastion of Soviet-style central planning and can be found in Fortune 500 companies*.[4]

What they do now: They make resources available and accessible to front line teams as and when required through 'fast-track' approvals and easier access to operational resources. They also have a high-level team that manages the resource portfolio (with quarterly reviews). They manage operational resources by setting guidelines based on ratios (such as a cost-to-income) within which managers can operate. They are held accountable *after the event* for the deployment of these resources. Some have developed an 'internal market' whereby resources can be acquired by operating units from central services providers at an agreed price. This approach overcomes much of the game playing associated with resource allocation. Devolving more resource decisions to front line teams has the effect of making them more accountable for resource decisions. This, in turn, builds greater ownership and leads to less waste.

3.5 How have organizations *coordinated actions* without budgeting?

What they used to do: They linked their plans through the central coordination of departmental and business unit budgets. For example, they ensured that production and sales were in tune, and marketing had the resources to support the sales plan. At that point in time each unit plan linked with another leading to a coherent plan for the whole firm. But while the plans of individual departments might have been coordinated with each other, it was doubtful whether this amounted to a coherent *strategy* for the firm as a whole. Departmental managers are often too keen to improve their own department without considering how this may fit with broader strategic goals (one study concluded that 60 percent of firms fail to align their action plans with their strategy).[5]

What they do now: They coordinate their plans and actions across the business not through a central plan, but through a process of managing customer demand. This can vary from dealing with customized requests to managing through agreed customer order cycles. Inside the firm, these arrangements take the form of "service-level agreements" that, in effect, are commitments from one process to another. These are fixed for a period appropriate to the demand cycle, but the key change is that operating units act as both suppliers and customers of products and services with needs that must be satisfied. With such an approach, the organization is more likely to act as an integrated system pursuing a common strategy rather than a number of disparate parts. It also encourages sharing and cooperation and focuses on providing the external (paying) customer with an excellent service.

3.6 How have organizations *measured and controlled performance* without budgeting?

What they used to do: They controlled performance against predetermined budgets and then took corrective action to ensure that performance remained "on track". Thus local managers would need to explain any variances and provide updated budgets or forecasts as a basis of further action. They would rarely look beyond the next fiscal year-end (in 77 percent of the 2000 global companies surveyed by the Hackett Group in 2002, the focus of the forecast process was solely on the current fiscal year).

What they do now: They find that with no budget to compare performance against, managers are not flying blind. On the contrary, they are more aware of where they are going than ever before as they have more relevant indicators to guide them. They use measures and controls to focus managerial attention on anticipating the future rather than explaining what went wrong in the past. Main features include comparisons with external benchmarks, performance league tables, leading indicators, and rolling forecasts. These are also combined with actual financial results, comparisons against prior years, and trend analysis, to provide a rich (and constantly moving) performance picture.

4. The ‘Beyond Budgeting’ leadership principles

It is clear that from the best exemplars of *Beyond Budgeting* that replacing the budgeting model is as much about enabling local planning and decision-making as it is about implementing better systems. But to achieve this transfer of performance accountability from the centre to teams closer to the customer requires actions from leaders at all levels of the organization. To achieve this organizations have (1) built a clear governance framework (2) created *a* high performance culture (3) devolved decision making authority to frontline teams (4) created a network of small units accountable for results (5) focused everyone on improving customer outcomes and (6) promoted open and shared information**.**

4.1 How have leaders built a *clear governance framework*?

What they have abandoned: They have abandoned the notion that employees base their commitment on mission statements and detailed plans prepared by someone else. They have abandoned the command, compliance and control approach that assumes that strategy formulation and execution take place in separate compartments. And they have abandoned the assumption that front line managers cannot be trusted with the responsibility to think and act on the latest information in the best interests of the firm as a whole.

What they have promoted: They have recognized that a high performance culture needs a governance framework that provides clear principles and boundaries that support empowered decisions. They believe that it is the challenge, responsibility, clear values, and fairness of shared rewards that drive people to achieve extraordinary results. They have adopted a ‘coach and support’ management style that places performance responsibility with front line people. It is this continuous involvement in planning and execution that builds motivation and commitments and leads to ambitious strategies and continuous improvement.

4.2 How have leaders created *a high performance climate*?

What they have abandoned: They have abandoned the use of the previous year’s performance as the basis of the current year’s targets – a process that leads to incremental changes. They have abandoned an internal focus on negotiating financial numbers that fails to provide a ‘reality check’ on performance. And they have abandoned the focus on agreeing annual targets for each individual unit and subunit that fails to see them in the context of an integrated value delivery system.

What they have promoted: They have elevated peer-based performance reviews to a whole performance culture based on relative success. They have set high performance standards based on world-class benchmarks. They have recognized the need to balance internal competition and corporation by clarifying who owns which customer. The result is a virtuous circle of high standards followed by improved performance.

4.3 How have leaders *devolved decision-making to front line teams*?

What they have abandoned: They have abandoned the culture of dependency whereby local managers would always have to ‘go up the line’ before a decision could be taken. They have abandoned the cautious ‘safety-first’ approach to strategy that leads to low expectations. And they have abandoned the exclusion of people from the strategy process on the assumption that only people at the centre have the experience and wisdom to make good decisions.

What they have promoted: They have set high standards, expectations, and benchmarks to stretch ambition and performance. They have challenged local strategies and action plans to ensure they are sufficiently ambitious but at the same time that they are robust and that risks are appropriate. And they have opened up the strategy process to anyone who can make a contribution. The benefits are that local people are more likely to produce imaginative strategies and are more committed to their successful execution.

4.4 How have leaders *created a network of small units accountable for results*?

What they have abandoned. They have abandoned the parochial behavior that is encouraged by local budget-like targets and incentive bonuses, and focused people's attention on customer outcomes and competitive results. They have abandoned the 'not invented here' syndrome that prevents units sharing knowledge. And they have abandoned the belief that central coordination and planning can bring success in a changing world.

What they have promoted: They have all created a team-based accountability culture by organizing around many small units and thus giving a large number of people a heightened sense of personal responsibility, and many people profit and customer responsibility. Moreover, most of these teams are all in league tables and are competing to perform better than their peers and competitors. They are accountable for their results, but these are measured in a way that takes into account, not just their local costs, but the total costs across the organization in serving their customers. This reinforces what everyone should know - that they are an integral part of the customer value delivery process and they must cooperate with others, particularly in sharing knowledge and reducing costs. The additional benefits are a stronger focus on profitability across the value chain and a greater willingness to share knowledge and resources. Leaders support the 'one team' spirit and champion customer value

4.5 How have leaders *focused people on customer outcomes*?

What they have abandoned: They have abandoned the functional hierarchy with its tendency to produce increasingly large business units on the basis of cost savings. They have abandoned the 'plan-make-and–sell' business model with central quotas and fixed sales targets that assumes that customers can be persuaded to buy what the firm decides to make. And they have abandoned the 'not invented here' syndrome that prevents units sharing knowledge.

What they have promoted: They have taken decentralization beyond major business units and down to the front line enabling a network of small local teams to work within a clear framework of values and boundaries. They have encouraged a "can do" and "no blame" culture. Managers can do what needs to be done, and fix what needs to be fixed, knowing that there will be *someone to support them if it doesn't work out.* And they have focused teams serving and satisfying customers' needs. The result is greater accountability for outcomes and more satisfied and profitable customers.

4.6 How have leaders *supported open and ethical information systems?*

What they have abandoned: They have abandoned the notion that information can be 'controlled' when networks and e-mail enable it to flow round the globe in nanoseconds. They have abandoned the belief that the primary beneficiaries of information are people at the centre. And they have abandoned the culture of 'treating and spinning' information to make it represent a misleading outcome.

What they have promoted: They have promoted information flows to new levels of openness and transparency. They have given their people access to the sort of strategic, competitive, and market-based information that was once the preserve of senior executives. And they have understood that all the numbers within the organization should stick to "one truth" and be transparent. They should be seen by everyone in their raw state without people 'treating' them or painting pictures that are designed to mislead. This gives everyone confidence in the numbers and supports decision-making. The outcome is more transparent and reliable information and more ethical reporting.

5. Case examples

The performance management system is typically annual, fixed and negotiated instead of continuous, flexible and self-regulated. It is based on a "fixed performance contract It is this contract that binds people to a culture of agreeing incremental targets, meeting those targets at all costs, following the plan without question, spending what's in the budget, failing to respond to customer needs, and always excusing adverse variances. Some firms have now moved toward a new performance contract based on relative improvement. With no short-term binding contract to worry about, they have the confidence to opt for stretch goals, take measured risks, focus on value creation, reduce costs, respond rapidly to customer needs, and look for continuous improvement. It is based on changing six processes. Each one involves a new contractual arrangement between parents and divisions, business units and departments.

Let's now look at three organizations that have adopted different performance management systems and examine briefly how they have broken free from the coils of the fixed contract and enabled their people to continuously improve the business. What is perhaps surprising about the three organizations I have identified as having world class performance management models is that not only are they in three different industries, but their headquarters (and thus corporate cultures) are based on three different continents (Asia, Europe and North America). They are Japanese car manufacturer, *Toyota*; Swedish bank, *Svenska Handelsbanken*; and U.S. airline, *Southwest Airlines*. Not only are they nimble and simple organizations but their performance management models are strikingly similar. And their performance records have been outstanding not just last year, or the year before, but for *over thirty years.*

5.1 Toyota – A World Class manufacturing model

Unlike any of its main rivals, Toyota has been consistently profitable for over 30 years. It is consistently top of JD Power customer satisfaction ratings. It is the original model of lean manufacturing and in recent years it has risen to be number 3 (and shortly number 2) carmaker in world (its goal is 15% of global sales by 2010). Its net margins of 8% dwarf its big three rivals. Its market capitalization is more than GM, Ford and Daimler-Chrysler combined and it has over $30 billion in cash. It is a truly awesome company.

There are no barriers to performance improvement at Toyota:

Goal setting: Three-year stretch goals are set at every level (e.g. reduce inventory by 50%; cut packaging costs by 30%; cut defects by 75%). All goals are operational (time, quality, innovation, and cost)

Planning and forecasting: Planning takes place at the plant/team level. Planning is monthly within a clear strategic framework. 12 month rolling forecasts support capacity planning

Measurement and reporting: Knowledge about current performance is visual and immediate (e.g. throughput, downtime, inventory levels). Reporting system is unified. Focus is on a few key operational metrics

Resource management: Resources are made available on the basis of monthly rolling forecasts that support capacity plans. Capital projects take 10 months to plan and two months to implement (right first time) compared with the opposite approach used by most other companies (two months to plan and ten months to implement (wrong first, second and third time).

Behavior: The management focus is on continuously improving systems and meeting internal and external customers' needs. Everyone has a voice and is expected to contribute to the continuous improvement of their work.

5.2 Handelsbanken – A World Class financial services model

Like Toyota, Handelsbanken has been consistently profitable for over 30 years. It is also consistently top of independent customer satisfaction ratings in Sweden and has the lowest number of customer complaints. It is consistently one of the most cost efficient banks in the world with a cost-to-income ratio of around 45% (compared with 60-80% for rivals). It has the highest shareholder returns of peer group; the highest credit rating of peer group; and has the highest value-added worth of any bank in Europe. Its performance is stunning compared to its rivals quarter-by-quarter and year-by-year.

There are no barriers to performance improvement at Handelsbanken:

Goal setting: Goals are self-imposed by branch teams and set at variable intervals. But these are not communicated to a higher authority - they are not a contract. There are no top-down targets.

Planning and forecasting: Planning takes place at the branch level, usually at six-twelve week intervals according to the needs of the branch. There are few forecasts.

Measurement and reporting: The whole banks and its 11 regions and 566 branches are measured on only 3 metrics (ROE, Cost/Income ratio and Profit/employee ratio). Information is fast and open. League tables are used to spur improvement

Resource management: Resources are made available through an internal market that enables branches to access, for example, people and IT resources when required rather than have them allocated months in advance. This approach drastically reduces waste and costs.

Behavior: The focus is on continuously improving performance and meeting customers' needs. There is no performance contract to worry about. The pressure comes from not letting down the team you are in or the regional group you are part of. Branches are profit centers and have considerable decision-making authority.

5.3 Southwest Airlines – A World Class airline model

Southwest is an icon of Corporate America. It has been consistently profitable for over 30 years and is regularly top of independent customer satisfaction ratings in many countries. It is also the most cost efficient airline and has the highest shareholder returns of its peer group. It has been voted one of best "corporate citizens" in America. Finally, it is the company that graduates most want to work for (over 200,000 resumes received in 2003 but only 908 new hires).

There are no barriers to performance improvement at Southwest Airlines:

Goal setting: Targets are set by each business unit within broad-based parameters and expectations. This enables innovative thinking and builds ownership and commitment at the local level. Benchmarks (such as cost components per available seat mile) and other key elements of business intelligence are widely shared

Planning and forecasting: Planning takes place at the front line. It is continuous process based on 12-month rolling forecasts and quarterly plans within a clear strategic framework; forecasts are based on 8 key drivers

Measurement and reporting: Managers have fast, relevant information within one unified reporting and open information system. A few KPIs at every level provide early warning signals

Resource management: Resources are made available monthly and quarterly based on rolling forecasts. Action plans can be approved at any time through the year and implemented immediately.

Behavior: The focus is on continuously improving performance and meeting customers' needs. Service is a "way of like" rather than a technique.

Conclusions

Transforming the performance potential of the organization by breaking free from the annual performance trap and releasing the full capabilities of front line people is the ultimate vision of 'beyond budgeting'. Implementing more adaptive management processes does not mean that project managers need to stray too far from their comfort zones. Devolving performance responsibility to front line people, however, is more radical and needs strong and determined leadership from the top of the organization. But the potential benefits are far greater and more enduring.

No one is promising an easy ride. Like all major change programs, the implementation process needs careful planning together with strong and consistent leadership. It also needs the careful selection of the right tools and techniques to underpin a well-designed management model that supports a clear business purpose and strategy. How information is used is crucial. If it is seen as a weapon of control then the transformation process will be still born. If it is seen as a liberating tool for front line managers to use their knowledge and judgment to respond responsibly and quickly, then a new opportunity beckons. This is the approach taken by those organizations that have gone 'beyond budgeting'

Endnotes

[1] Press release by Answerthink, March 20, 2002

[2] Robert Simons: *Levers of Control* (Boston: Harvard Business School Press, 1995), 83

[3] "Corporate Strategic Planning Suffers from Inefficiencies" Hackett Benchmarking PR Newswire, 25 October 1999

[4] Gary Hamel *Bringing Silicon Valley Inside* Harvard Business Review September-October 1999, p76

[5] Robert S. Kaplan and David P. Norton *The Strategy Focused Organization* Harvard Business School Press, 2001, p274