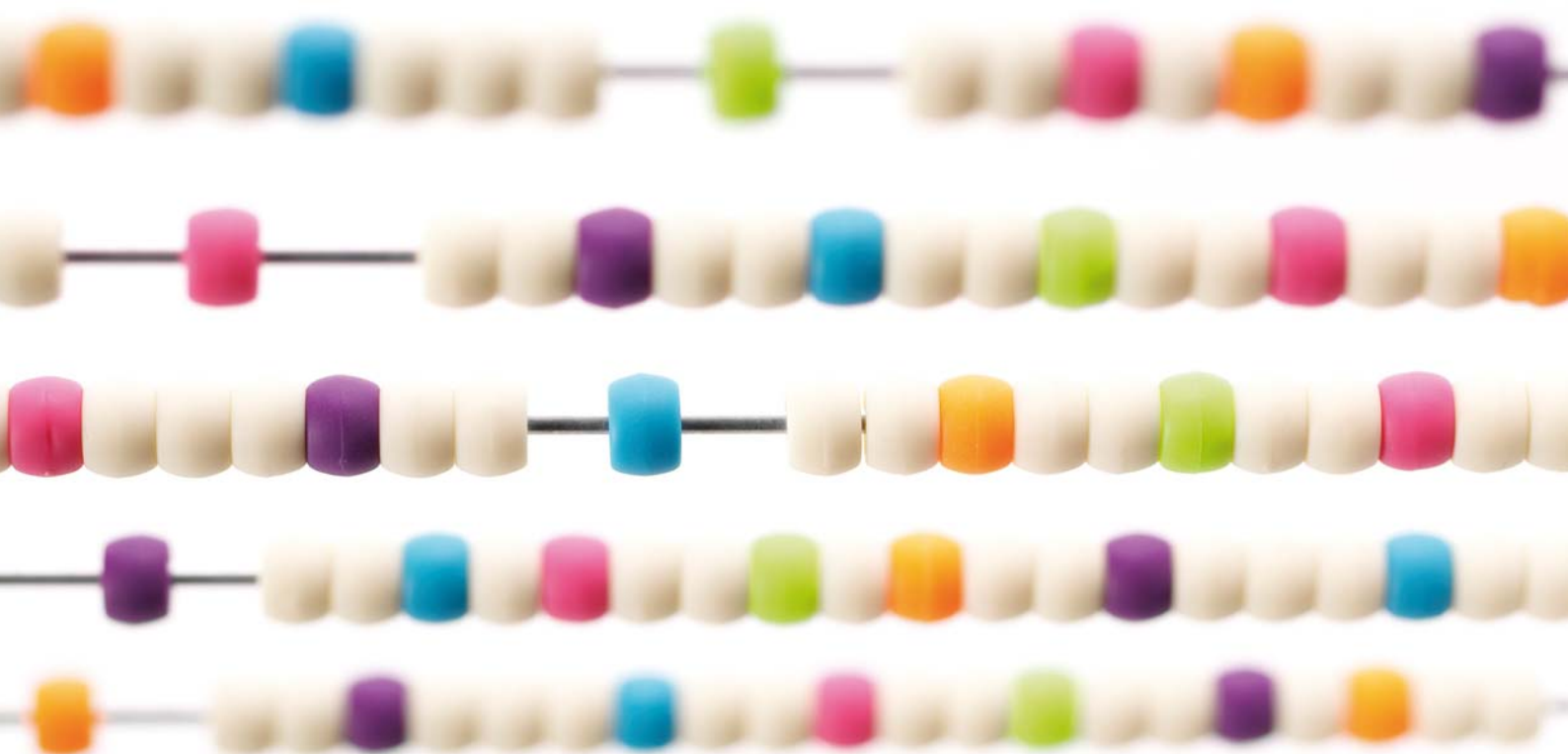


Beyond Budgeting

Topic Gateway Series No. 35



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Beyond budgeting

Definition and concept

Beyond budgeting is:

'An idea that companies need to move beyond budgeting because of the inherent flaws in budgeting especially when used to set contracts. It is argued that a range of techniques, such as rolling forecasts and market related targets, can take the place of traditional budgeting.'

CIMA Official Terminology, 2005

'A set of guiding principles that, if followed, will enable an organisation to manage its performance and decentralise its decision making process without the need for traditional budgets. Its purpose is to enable the organisation to meet the success factors of the information economy (e.g. being adaptive in unpredictable conditions).'

Beyond Budgeting, p. 212

Beyond budgeting (BB) is a specific idea which regards the abolition of the traditional budget process as the trigger for improving management control within organisations by a fundamental re-examination of how they might be managed better. The BBRT solution is radical and believes that the shortcomings of the budgeting process can only be overcome by abandoning budgeting altogether.

The BBRT combines the new concept of beyond budgeting with the status of a community round table. It shares its knowledge worldwide through conferences and workshops.

The source of all BB ideas is the Beyond Budgeting Round Table (BBRT) an independent industry led research consortium. The BBRT was established in the UK in 1998, but now has members in mainland Europe, the US and Australia. Much of the following information is derived from the BBRT website and from Hope and Fraser (2003) *Beyond budgeting: how managers can break free from the annual performance trap*.

BB identifies its two main advantages.

- It is a more adaptive process than traditional budgeting.
- It is a decentralised process, unlike traditional budgeting where leaders plan and control organisations centrally. When BBRT use the term budget, they mean the entire performance management process.

Background

It could be argued that budgets began in the 1920s as tools for managing costs and cash flows. By the 1960s, they had become fixed performance contracts between company superiors and subordinates. They were primarily concerned with estimating future income and expenditure. It could be argued that budgets became the key drivers and evaluators of managerial performance.

The oil price shocks and subsequent inflationary pressures of the mid 1970s changed organisational competitiveness. From the 1980s onwards, there has also been a climate of volatile stock markets.

More recently, there have been several other impacts on business. Shareholders now demand that their organisations are at or near the top of their industry peer group. Intangible assets, including brand names and customer loyalty, are now key drivers of shareholder value. There are shorter product and strategy cycles, with prices and margins under increasing pressure. There is a focus on reducing costs and on customer satisfaction. The BBRT argument is that traditional budgetary or control practices are not sufficient to cope with these changing market trends.

Various commentators have identified the drawbacks of traditional budgets that they:

- rarely focus on strategy and are often contradictory
- are time consuming and costly to put together
- constrain responsiveness and flexibility
- often deter change
- add little value, especially given the time taken to prepare them
- focus on cost reduction rather than value creation
- strengthen vertical command and control.

The BBRT proposes an alternative management model which they feel supports the needs of modern business. They feel that a new set of coherent management processes and a new leadership style are essential to achieving the full potential of an organisation and its people.

Overview

BB uses a range of tools and techniques as a replacement for the traditional budgeting process. For example, BB might combine the Balanced Scorecard with rolling forecasts and shareholder value models.

BB offers an implicit performance contract to managers, with reward based on relative performance achieved. The targets which replace budgets must be aligned with incentives to support a new culture of accountability within the organisation.

Abandoning the traditional budgeting process has two goals:

1. A more adaptive set of management processes
2. A highly decentralised organisation

A more adaptive set of management processes can be achieved without decentralisation, but the reverse is not possible.

The BBRT includes a diverse range of companies in Europe and the US. They include banks, chemical and petrochemical companies, a wholesaler, a brewer, car and truck manufacturers, a food producer, an eye care company, a computer company and ball bearing manufacturer.

The case studies used by the BBRT to demonstrate their approach include the Swedish bank Svenska Handelsbanken, which ceased budgeting in 1972. It allows managers discretion to act within prescribed boundaries. It uses branch league tables to promote competition among staff.

Another case is the Swedish wholesaler Ahlsell which has over 200 decentralised profit centres. Further cases can be found in the BBRT book.

Application

In their book, *Beyond Budgeting*, Hope and Fraser describe the six shared common principles used by all the companies which have chosen BB as an alternative to traditional budgeting.

- 1. A governance framework based on clear priorities and boundaries**
This enables front line teams to take decisions. A coach and support style of management promotes community spirit and a seamless service for customers.
- 2. A high performance climate based on visible and relative success at all levels**
This promotes peer based performance reviews, internal competition and a sense of customer ownership.
- 3. Front line teams with the freedom to take decisions in line with the company's governance principles and strategic goals**
This advocates the abandonment of a safety first approach to open up the strategy process to all contributors. High standards, higher expectations and benchmarks are promoted.
- 4. Teams given responsibility for value creating systems**
This creates and empowers many small units within the company, who have the freedom to manage their own resources while remaining accountable.
- 5. Teams focused on customer outcomes**
This leads to greater accountability, as well as more satisfied and profitable customers.
- 6. Open and ethical information systems**
This generates more reliable information, greater transparency and more ethical reporting.

Hope and Fraser then describe how these companies did the following differently as part of the BB process.

Setting targets

Previously, targets were set on the basis of financial numbers and negotiated centrally. Under BB, targets are based on high level key performance indicators (Kips). These include return on capital, free cash flows or cost to income ratios. Goals are set to maximise short and medium term profit potential. **Reported benefits:** The BBRT argues that this is much faster than budgeting. The benchmarking bar is constantly raised to encourage maximum profit potential.

Rewarding people

In traditional budgeting, rewards were linked to a fixed outcome agreed in advance. BB rewards team success based on relative performance, not fixed annual targets. **Reported benefits:** The best performers are recognised and rewarded, not just the skilled budget negotiators.

Action planning

Previously in these organisations, planning had been driven by top management. Then they devolved responsibility for strategy review to business units or front line teams. These are responsible for reviewing the medium term outlook (goals, strategies, action plans and value drivers) annually and the short term outlook (actual and forecast performance indicators) every quarter. **Reported benefits:** BB argues that this continuous and open process allows teams to create value. They can respond to changing demand and anticipate business threats and opportunities.

Managing resources

Resources were previously managed on the basis of pre-negotiated budget contracts. They now make resources available to front line teams as and when required. Operational resources are managed by setting goals based on KPIs. **Reported benefits:** Resource decisions are devolved to front line teams, making them more responsive. Managers are more accountable; there is greater ownership and less waste.

Co-ordinating action

Previously plans were linked through central co-ordination of annual departmental and business unit budgets. Co-ordination now occurs through cross-company interaction. **Reported benefits:** Operating capacity rises and falls according to demand. There is less waste as fewer items are made for stock. The organisation acts like an integrated unit.

Measuring and controlling performance

Performance used to be controlled against predetermined budgets and corrective action was taken where necessary. Under BB, executives and managers see the same information simultaneously. **Reported benefits:** There is a greater focus on trends and forecasts.

Relative improvement contracts

This is the overall impact of the changes outlined above.

Nine practical steps

There are nine steps that Hope and Fraser consider to be essential to implementing the Beyond Budgeting approach.

1. Define the case for change and provide an outline vision.
2. Be prepared to convince the Board.
3. Get started.
4. Design and implement new processes.
5. Train and educate.
6. Rethink the role of finance.
7. Change behaviour – new processes, not management orders.
8. Evaluate the benefits.
9. Consolidate the gains.

For a successful BB implementation, Hope and Fraser argue that the following criteria are necessary:

- there needs to be a clear case for change, with the benefits fully explained
- managers should consider carefully the degree of decentralisation that might be possible within their organisation
- there must be a governance framework with clear priorities and boundaries
- a high performance ethos based on visible and relative success at all levels will be necessary
- front line teams need the freedom to take decisions within agreed parameters
- trust and openness at all levels of the organisation will be paramount.

Reported drawbacks of the BB approach

Several accounting academics have identified the following drawbacks in adopting the BB approach:

Without a budget, there is no overall framework of control which allows companies to plan, co-ordinate and control their activities.

- There is a lack of a road map which details where a business is and where it wants to go.
- Budgets may be very deeply ingrained in an organisation's fabric and operating culture.
- It may be very difficult or impractical for organisations to adopt the culture of decentralisation on which successful BB depends.

Opposing views – support for traditional budgeting

A 2005 survey by David Dugdale and Stephen Lyne found that all 40 companies in their research used budgets. Generally, both financial and non financial managers thought they were useful for planning, control, performance measurement, co-ordination and communication. The survey found that managers tended to disagree that budgets led to dysfunctional behaviour or that they provided little or no value.

There were only two areas where a majority of managers agreed that budgets were problematic. They were that:

- budgets are too time-consuming
- managers could be constrained by budgets and delay necessary action.

Although aware of the problems budgets could cause, managers largely regarded budgets and the budget process as indispensable.

Other research claims that 99% of European companies have a budget in place and do not intend to abandon budgeting. (Kennedy and Dugdale in Vuorinen, 1999). While a few companies do use the BB process, they are in the minority.

Why traditional budgeting is still commonly used

1. A framework of control

- a. The role of the budget is to give focus to an organisation, help the co-ordination of activities and enable control. Respondents in the 2005 survey cited control as the main reason why budgeting adds value to their organisation. Budgeting provides an overall framework of control without which it would be difficult or impossible to manage. Arguably, they provide a level of stability that could not be achieved using the BB approach.
- b. Large companies might struggle to plan, co-ordinate and control their affairs without a budgetary framework. Even smaller companies benefit from the budgetary road map that explains where the business is, where it wants to go and how it can reach its goals.

2. Organisational culture

- a. Another reason why budgets remain in most firms is that budgeting is so deeply ingrained in an organisation's culture (Scapens and Roberts, 1999). It may not be possible for the organisation to move away from such a fundamental method of operating. By their nature, budgets are a centrally co-ordinated activity within a business, and often the only one which brings together all aspects of the company. (Neeley et al., 2001). Budgets are often the one process which covers all areas of organisational activity. (Otley, 1999).

3. The need to decentralise

- a. It is recognised that banks and other financial institutions are more appropriate candidates for decentralisation than other types of businesses. For example, Norman Macintosh observed that branch managers at Transamerica Finance Corporation had a great deal of freedom to run their operations according to standard operating procedures. (Management Accounting and Control Systems, 1995).
- b. Similarly, Svenska Handelsbanken sets parameters for branch managers' discretion and then motivates its staff using competitive devices such as branch league tables. This approach can be successful in organisations where people work in similar but independent units.

However, it does not follow that this level of decentralisation can be adopted by all organisations. Every organisation is unique and it may be impossible to change the company culture to provide the necessary decentralisation. Successful decentralisation also depends on a great deal of trust being invested in teams throughout the organisation.

Better Budgeting

Various different approaches, addressing the drawbacks of traditional budgeting but still remaining loyal to the concept of a budget, have been drawn together under the umbrella Better Budgeting.

Dugdale and Lyne's 2005 survey revealed that budgets have changed significantly in the last 20 years. This research showed that over 60% of companies claimed to be improving the budgeting process. For example, the increased use of forecasting has led to more forward looking budgets which are better linked to strategic planning. Forecasts are seen as high level plans, while budgets contain greater detail. Several companies considered forecasting to be more useful than budgeting as the former can be updated more frequently.

In addition, new technology has changed the way data is collected and stored in organisations. Enterprise wide collection of information is another reason why the budgeting process has been able to evolve.

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