# Abandon Budgets

## And set your enterprise free

The budget process has been around for a long time – but a growing body of opinion believes budgeting has finally reached its managerial 'use by' date. Why do they feel like that? And is there really sustainable fiscal life beyond budgeting?

A growing clutch of companies in Asia, Europe, America and even New Zealand are starting to think that the budget process is a hindrance, rather than a help to management. One major international survey found that nearly 90 percent of chief financial officers (CFOs) were dissatisfied with their budget process and that there was often no link between the annual budget and the organisational strategy.

Jeremy Hope and Robin Fraser, the management gurus who wrote the book *Beyond Budgeting* and now head the United Kingdom-based Beyond Budgeting Round Table (BBRT), believe that not only is the budget process a time-consuming, costly exercise generating little organisational value but also, and more importantly, that budgeting is a major limiting performance factor. They quote numerous examples of companies that have adopted the philosophies they now expound and which consequently have "broken free" and achieved success well beyond their expectations.

They say, for instance, that "so long as the budget dominates business planning a self-motivated workforce is a fantasy, however many cutting-edge techniques a company embraces". And they ask that if "modern companies reject centralisation, inflexible planning, and command and control, why do they cling to a process that reinforces those things?"

According to an article entitled *Who Needs Budgets?* which Hope and Fraser wrote for the *Harvard Business Review* earlier this year, "The same companies that vow to respond quickly to market shifts cling to budgeting – a process that slows the response to market developments until it is too late."

But why is the budget process, as it currently stands, a "no brainer"? A survey performed on CFOs in 1998 by US consulting firm Hackett Benchmarking & Research, came up with a frightening statistic. There were 25,000 person-days invested in the budget process for every US$1 billion of revenue. The study also found:

- the average time for a budget process was four months;
- 66 percent of CFOs stated their budget was influenced more by politics than strategy;
- nearly 90 percent of CFOs were dissatisfied with their budget process;
- 60 percent of CFOs acknowledged that there was no link from their budgets to strategy.

In my experience, this level of dissatisfaction is similar among boards, CEOs, general managers and budget holders here. I have recently finished two consulting assignments, one with a public authority, the other with a manufacturing operation, and the findings were the same. Hope and Fraser state that for companies that have adopted the "beyond budgeting management model", the "spend it or lose it" philosophy that is at work in traditional organisations, has no meaning. Or as another writer put it; "incessant game playing invariably extends the budget round and limits the need for stretch or to seek breakthrough solutions".

The answer is to throw the budget process out. It takes too long, is not linked to strategic outcomes or 'critical success factors' and is a major barrier to success.

The existing budget model is useless for the following reasons:

- Budgets do not help companies focus on the performance drivers of today's organisations such as innovation rates, service levels, quality, and knowledge sharing. These are, however, clearly shown in a balanced scorecard.
- Budgets have been turned into fixed performance contracts and have led to dysfunctional behaviour with dire consequences. Managers in one study were found to be inclined to either try to beat the system or felt pressured to achieve targets at any cost – behaviour that generated many of the recent 'managed earnings' scandals.
- Budgets treat all employees as costs, whereas a team's talent, innovation and commitment are more important in determining performance than the 'personnel costs' of the team.
- The budget process builds silos, effectively compartmentalising a company into small units.
- Hope and Fraser believe that the budget process limits the ability of organisations

to make full use of new management philosophies such as economic value added (EVA), balanced scorecard, activity based management (ABM), customer relationship management (CRM) and rolling forecasts.

Now, however, there is hope – pun fully intended. European companies have joined the BBRT to free themselves from the budgetary process. The BBRT case study of the famous British cider maker, HP Bulmer, UK *(www.info-edge.com/samples/BI-3037sam.pdf),* sets out clearly the doubts and concerns that exist in most organisations and provides a pathway forward. If senior management, budget holders, the finance team and the board read this eight-page case study it will revolutionise your business – I promise you.

Bulmer's breakthrough began with the CFO attending a BBRT seminar. The CFO obtained permission from his board to assess the implications of the approach. The first step was a series of in-depth workshops across the company to ascertain the net worth of the existing budget system. To the company's horror it didn't find anybody who supported the present budgeting process. "We were absolutely overwhelmed by what we heard," said the CFO. The accountants worked every weekend for two months on the budget. They had, effectively, sat at their desks until 10pm to rework budgets nobody used. The budgets delivered only the variance analysis that each month resulted in statements like: "this variance is due to a timing difference because... ". Again, sound familiar?

The company now works on a 12-week cycle. Managers focus on sales growth targets, comparing sales against last year's actuals. They focus on the brands that have the potential to perform and investment is targeted to enable this capability. Costs are managed by measuring against a set of key performance measures. For instance, the manufacturing function's performance is measured against the KPI of cost per hectolitre rather than a fixed budget. Manufacturing now plans its timetable on a rolling 12-week basis so it can be more responsive to product mix changes. As the CFO says: "It is pointless having a fixed budget when you do not know exactly how much is going to be manufactured."

| Model | How the budget undermines the model |
|---|---|
| Economic value added (EVA) | The "silo based" budgeting approach is incompatible with an added process view of the organisation which EVA requires. |
| Benchmarking | The extent of under performance against best-in-class standards loses its visibility as the short-term budget (fixed performance contract) dominates thought and action. |
| Balanced scorecard (BSC) | It is easy to turn the BSC with its financial and non-financial measures into yet another fixed performance contract with the same dysfunctional behaviour. The silo approach to budgets again wins over the strategic and cross-functional focus that a BSC needs. |
| Activity-based management models | The budget process does not focus on cost drivers or critical success factors but instead forces management to sail a course that was set many months earlier which may have no relevance to prevailing conditions. |
| Customer relationship management (CRM) | The inside-out budget process is at odds with the outside-in CRM strategies. Sales staff are too frequently hell bent on meeting internal goals rather than customer satisfaction and customer profitability. |

Changes proposed by a beyond budgeting management model are challenging. Throwing out a process that has been around for centuries requires a quantum leap (in thinking). But the Bulmer case study is an inspiration and a practical start point.

There are, of course, homegrown examples though most of them are practices by the local offices of European multinationals.

A major telecommunications giant has replaced yearly budgets with four-quarter rolling forecasts. The word budget has been dropped. The new process provides forewarning of events it expects will take place and in turn this approach allows it to take corrective action at an appropriate time.

Another multinational company involved in innovation for a long time has been using quarterly forecasts, six quarters out, since the early '90s.

This process enables companies to finalise numbers for the next three months while giving flexibility to management provided they operate within key benchmarks and comply with existing strategy. This development, like the balanced scorecard in my opinion, is a major management breakthrough.

In some organisations, in the public sector for instance, budgets are a legal requirement. In this case, an annual plan can be set in a quick two-week process. The plan should not, however, be broken down into monthly budgets. Establish a quarterly forecasting regime in which management sets out the required expenditure for the next 18 months and seeks approval for expenditure for the next three months.

Each quarter, before approving these estimates, management sees the bigger picture six quarters out. They can also keep an eye on the new annual forecast. The annual plan fixes the goal posts (sets the ranges) and the new forecast is meant to pass through the posts as long as the assumptions have not changed. Hope and Fraser point out the necessity to ensure honesty with forecasts. It is important to give the best estimates no matter how unsavoury they may be.

Use the general ledger for this exercise by using the revised budget field. Rename it something appropriate, like forecast, target, expected etc. Then create reports from the general ledger comparing actual against forecast. The major benefit is that this forecast is at most only three months old.

Replace budgeting with a bottom-up forecasting regime and benchmarking. In my view there is no room for top-down forecasts. They exist only because organisations use Excel, an inappropriate tool to compile forecasts and budgets.

To do bottom-up forecasting every quarter you need a bolted down system. Some managers successfully use an intranet-based interface with their general ledger while others use enterprise-planning software like Advisor or Adaytum.

Benchmarking becomes more important as progress is compared against 'best in class', both internally and externally for teams and divisions.

Hope and Fraser blame the budget process for compromising the beneficial impacts of many newly introduced management tools (see chart on page 42).

The beyond budgeting success stories all suggest a strong corporate culture based on individuals taking personal responsibility both for their individual performance and for the performance of the team.

Hope and Fraser use a golfing analogy to explain it: "Golfers keep their own score. No one cheats on the course or misrepresents their score. Nor do golfers need anyone telling them what score to aim for. They know their handicap and what they have to do to improve relative to their peers. Their performance is continuously measured after each event and their aim is continuous improvement." **M**

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