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FOREWORD

The concept of 'Beyond Budgeting' has been around for nearly twenty years now. Although it has helped transform many businesses and has become part of mainstream management thinking in some parts of the world, I talk to many business people who have still not heard of Beyond Budgeting. And many of those that are aware of it find the concepts difficult to grasp.

I believe that these ideas are too important to be overlooked or ignored – so I wrote this book to fill these gaps in awareness and understanding.

The name of the organisation itself gives some clue as to why these gaps exist. 'Beyond Budgeting' (BB) describes what it wants to get rid of but not what should take its place. Furthermore, the alternative that it advocates is not a simple blueprint that can be copied and rolled out across an organisation. Rather it is a set of principles that have to be interpreted in the context of the unique challenges and opportunities faced by any particular organisation

In addition, BB sounds like a small idea, of interest only to the Finance community. But in reality it is a large and subtle set of concepts that have important implications for the way that work is done and how organisations are structured and governed. To use an analogy from computing, BB looks like an organisational 'app' but it is more like an operating system; largely hidden from view but critically important to the functioning of the entire system and how it performs for its users: its employees, customers, suppliers and shareholders.

I have a lot of sympathy with anyone who struggles to get their head around these ideas because I have spent much of the last two decades getting to understand them myself.

My journey started in 1998 when, after a 20-year conventional finance career, I persuaded my employer (a large division of Unilever) to become one of the first sponsors of the Beyond Budgeting Round Table (BBRT), the research collaborative that gave birth to the concept. The experience of discovering how many companies had not only survived but thrived without the budgets that had made my work so frustrating and unfulfilling, transformed my life – well, at least my working life!

Over the course of the next few years I designed and led a Unilever-wide change programme based on BB, while serving as the European Chairman of the BBRT. This experience convinced me that these ideas really worked. And as the BBRT discovered more and more striking similarities in the ways pioneering companies had chosen to organise their affairs – without being aware of each other's existence – I became obsessed with trying to understand why; a quest that led me to a PhD in a branch of systems science. So when I left corporate life to promote these ideas more widely, I co-authored 'Future Ready', a practitioner's guide to business forecasting – an essential part of the toolkit practitioners need to transition from traditional budgeting. At various times along the way I convinced myself that I had a firm grasp on these ideas only to find that when I pulled on an intellectual thread the fabric of my thinking about how organisations worked unravelled, which meant that I had to start rethinking again.

It is only now, after many cycles of unlearning and learning, that can confidently say 'I understand'. And, like Marco Polo on his return from his journeys to strange lands, I feel compelled to share what I have discovered.

The book you hold in your hand is my best shot at communicating what I have learned in a simple way. It was originally an appendix to 'Present Sense' (a companion volume to 'Future Ready') – a book that explores the practical issues of measuring and communicating business performance without the false security provided by the fixed reference points of budgets and other arbitrary targets. But as I was writing, it became clear to me that it needed to be liberated – to become a guidebook for a wider audience who would otherwise not come across these intriguing and powerful ideas, or who might be sceptical or suspicious of a method that flies in the face of much conventional management wisdom.

In this short book I have attempted to chart the depth and breadth of the BB ideas and set out the implications for business performance and organisational life generally. I have avoided detailed or technical arguments, except where I thought it necessary to explain how everything fits together. I have used straightforward logic to describe the forces at work and to explain why BB is important for the organisation as a whole, not just those who are living through the frustrations of working with budgets first hand. And throughout I have avoided rhetorical arguments, not because I lack passion for these ideas, but because they can put off as many people as they inspire…and there are other authors who can do this better than me.

In summary, **my aim is to answer the question 'what is Beyond Budgeting?' in a clear and succinct way to help you make informed choices about the way that you run your business,** as an alternative to blindly copying your predecessors. The goal is to help you build more adaptive organisations, better able to meet the challenges and exploit the opportunities thrown up by the modern world.

Amongst the things you will discover are:

How the operating model used to organise and run the affairs of an enterprise impacts many aspects of corporate life, not just the level of business performance

The universal law of complexity that explains why traditional budgeting will always fail to deliver what it promises: predictable performance.

How the Beyond Budgeting process model is better equipped to deal with the complexity of modern organisational life and the uncertainty of the world

Why and how an organisation

has to be designed to complement the processes used to plan and control its activities.

How to bring about this change

I can't claim that this is the correct or authorised version of the BB model. It is simply a way of explaining it, based on what I have learned from working with these ideas over many years, informed by practical experience. Neither does the book answer the many 'how' questions you might have. Think of this as a guidebook of the kind that you would consult if you want to find out about a place or you are planning a trip there.

You will find some ideas on how to get started along with an inventory of some practical resources you will need 'on the road' at the end of the book.

Enjoy the trip.

Steve Morlidge

TWO STORIES

Not Again!

The post has just arrived and Gerry is as mad as hell. 'The nerve of it' she fumes.

In her trembling hand she has a letter from her bank. It coolly informs her that she has to pay an eye-watering fee for going over her overdraft limit for just a few hours. But what really enrages Gerry is that what took her over the limit was a charge generated by the bank itself – for a product the bank insisted she have as a condition of getting a mortgage…but that she didn't want. The final indignity is the administration fee the bank charged for sending the letter!

Later, after she has calmed down a little, she rings the bank's 'customer service' number. She dreads this task since she knows it will involve wrestling with an automated routing system and then listening to a nauseating mixture of Mozart and Lionel Richie on a loop for 20 minutes. Isn't it odd that whenever she phones to complain the bank's customer service centre seems to be experiencing 'very high call volumes'?

'If you stay in credit, your current account is absolutely free', the customer service operative unhelpfully says when Gerry finally gets through, obviously reading from a script.

'But you should be paying me. I'm lending YOU MY money!' Gerry replies.

Nothing in the customer service scripts seems to cover this point. 'Do you want to speak to my supervisor?"

A Different Experience

In another part of town Jim gets a phone call; it's his bank manager.

"Hi Mr Jones, it's Angela here, I've noticed that you have more money in your current account than you need to cover your scheduled payments; do you want me to transfer some to your savings account?'

It took some time for Jim to get used to receiving calls like this from his new bank after he had moved his account. At first he was suspicious; it even felt a little creepy after being neglected for so long by his previous 'service provider' – which is what his old bank claimed to be. Now it actually felt like his new bank cared about him. He even had the branch manager on speed dial. OK, so they charged a small monthly fee but this paid for itself whenever he asked for help, like the last time he applied for a loan and received personalised financial advice rather than a sales pitch.

'I could arrange a loan for you, Mr Jones' she said, 'but there is a risk that changes to the taxation of overseas interest could make this costly. I suggest you hold off for a few months until things are clearer, then perhaps we can talk through our fixed rate deals, which might be a better fit for your needs.'

What these stories tell us

Although I made up these stories, many more of us will recognise the first story than will have experienced the second – the poor service from traditional banks is only too real for many of their customers.

It makes us angry. And the UK banking regulator isn't too happy either.

In the period since the 2008 financial crisis, the regulator has fined UK banks over £7 billion for the misleading selling of a range of financial products to consumers and small businesses, ranging from protection against loss of valuables and identity fraud, through Payment Protection Insurance (PPI) and exotic interest rate swaps. In addition, the banks have been made to pay back over £20billion to customers in respect of PPI alone; equivalent to over £1,000 for every household in the country. And this is on top of the other huge fines they have paid to authorities around the world for manipulating benchmarks and facilitating money laundering.

The usual explanation given for this catalogue of misdemeanours is that the culture of banks is 'bad'. According to this narrative, the consistently dishonest behaviour from our banks is because they employ greedy sociopaths who only care about their year-end bonus. It may quell our sense of self-righteous anger to pin the blame on someone, but is this fair? Have you got any friends who work for a bank? Is that how you would describe them?

The second story is based on the experiences of customers of Handelsbanken, a Swedish bank that has been quietly but relentlessly growing their UK business. Handelsbanken do not advertise – there is no need because most of their customers have stories like the one we heard and who unsurprisingly recommend the bank to their friends. While other UK based banks were paying massive fines to regulators and trashing their reputations, Handelsbanken was increasing its presence from just a handful of branches to a network of over 200; advancing into the High Street at the same time as their competitors are retreating from it for cost reasons. At the time of writing the UK accounts for 10% of Handelsbanken's global profits, so somehow they have managed to make money where other banks thought they could not.

Where does Handelsbanken find the paragons of virtue and rectitude that staff their branches? Other banks.

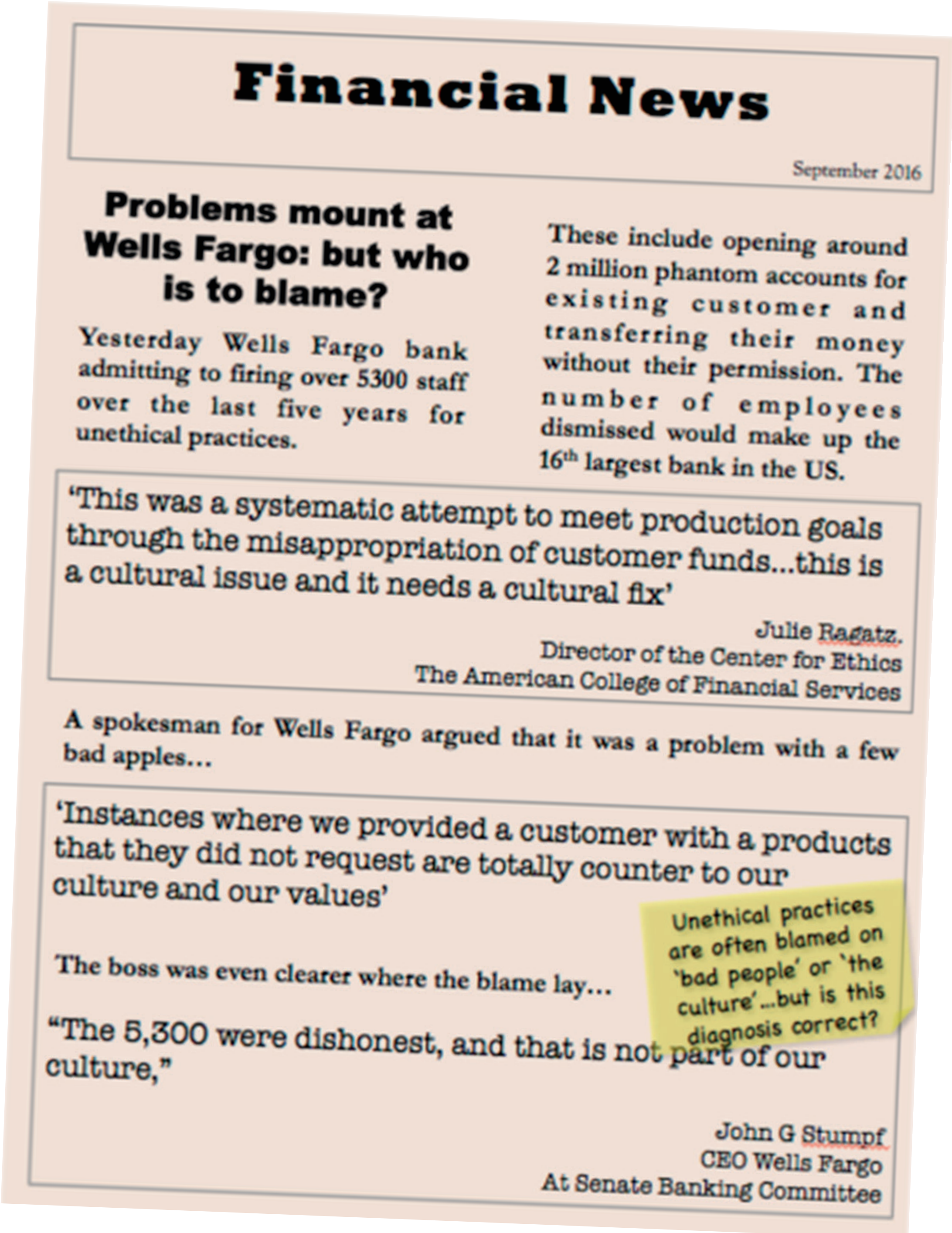
Handelsbanken recruit the people who we label greedy and unhelpful when they work elsewhere. Which raises the question: if 'the people' aren't the source of the problem with UK banks, what is? Is there some evil mastermind pulling the strings and making employees behave badly?

We all have a tendency to attribute the behaviour of the people we encounter to their personalities. In a simpler world, when business was more personal and conducted one to one, this might have been a useful shortcut for determining who to trust. But when we are dealing with modern complex organisations it leads us to look for the source of the problem in the wrong place.

The problem is rarely 'the people'; it is the system within

> "The problem isn't 'the people'; it is the system in which they work."

which they work. So the solution doesn't involve 'working on the people' by exhortations to do stop doing the wrong things. Instead we need to uncover and change the processes, practices and structures that discourage people from doing 'the right thing'.



Financial News

September 2016

Problems mount at Wells Fargo: but who is to blame?

Yesterday Wells Fargo bank admitting to firing over 5300 staff over the last five years for unethical practices.

These include opening around 2 million phantom accounts for existing customer and transferring their money without their permission. The number of employees dismissed would make up the 16th largest bank in the US.

'This was a systematic attempt to meet production goals through the misappropriation of customer funds...this is a cultural issue and it needs a cultural fix'

Julie Ragatz.
Director of the Center for Ethics
The American College of Financial Services

A spokesman for Wells Fargo argued that it was a problem with a few bad apples...

'Instances where we provided a customer with a products that they did not request are totally counter to our culture and our values'

The boss was even clearer where the blame lay...

"The 5,300 were dishonest, and that is not part of our culture,"

John G Stumpf
CEO Wells Fargo
At Senate Banking Committee

Unethical practices are often blamed on 'bad people' or 'the culture'...but is this diagnosis correct?

A typical example of the mis-diagnosis of a systemic problem

THE HISTORY OF BEYOND BUDGETING

The Beyond Budgeting movement 'discovered' Handelsbanken in 1998, shortly after BB was set up in the UK. But the 'Handelsbanken way' was already well known in Sweden and to observers of the banking sector. Handelsbanken has never made a secret of the fact that their way of working didn't involve traditional practices like budgeting. They have described their approach to business in every financial statement they have issued since 1978, and often refer to it in other corporate communications. While Handelsbanken believe their success is a result of their methods, stock market analysts (who work for financial institutions rather like traditional banks) tend to be dismissive, calling them 'idiosyncratic' or 'old fashioned'. But in 1998 the Beyond Budgeting pioneers had a powerful motivation for wanting to dig deeper:

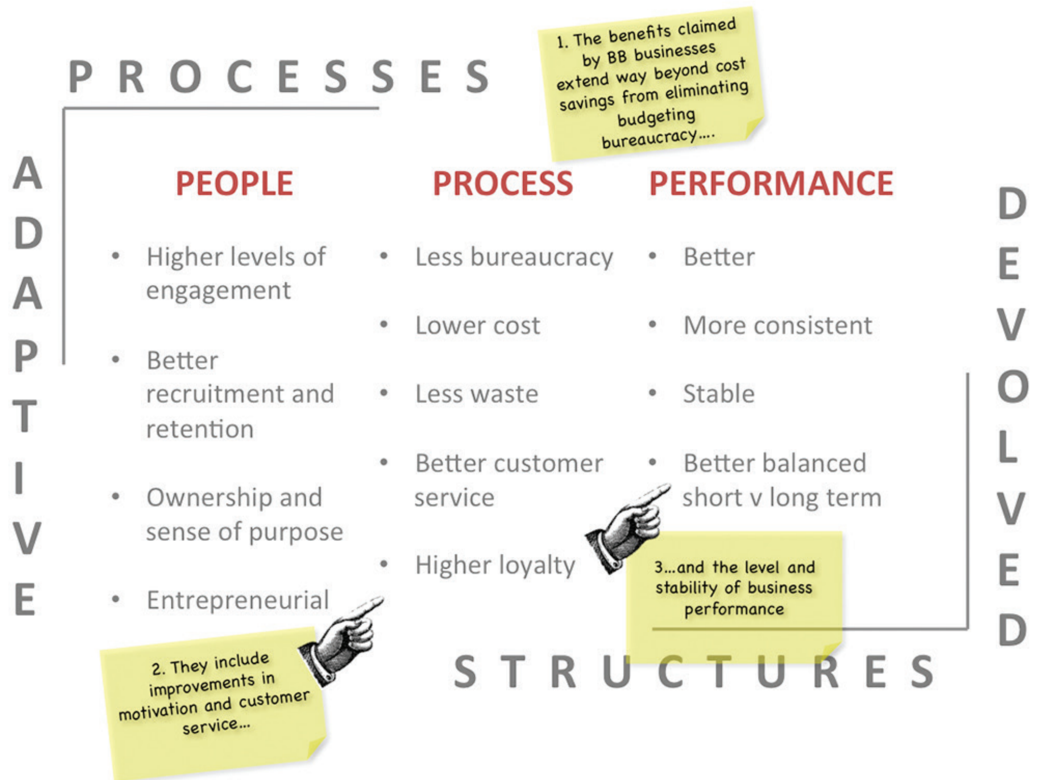
Were Handelsbanken's methods uniquely a product of their particular history, geography or culture?

Or were there hard and practical lessons that could be learned to make their model transferable to other companies, countries and industries?

In particular, we wanted to understand what exactly it was about their 'budget-free' approach that contributed to their spectacular performance across almost every important measure of business performance: customer service, employee satisfaction, consistent financial performance, stability and growth.

What we discovered was that Handelsbanken's success was not simply the result of their decision to abandon budgets in 1978. The Handelsbanken model was the result of a fundamental re-examination of the assumptions upon which traditional 'Western' management practice is based. And once we understood this and knew what we were looking for, we discovered that many other companies in other industries had independently come to similar conclusions about the best way organise and run their own businesses. This was clearly not the result of chance or a response to trends in thinking or fashion. All these 'BB' businesses had, through a combination of intuition and clear thinking, hit upon fundamental insights about organisations and how they should be run.

The key traits that all mature BB businesses shared, without exception, were flexible business planning processes and a devolved organisational structure, in place of the fixed annual budgets and functional hierarchies of traditional businesses. What was most interesting and unexpected was the range and nature of benefits that these businesses attributed to their way of working. Much more than you would expect if you thought "Beyond Budgeting" promised to merely to lighten the administrative burden.



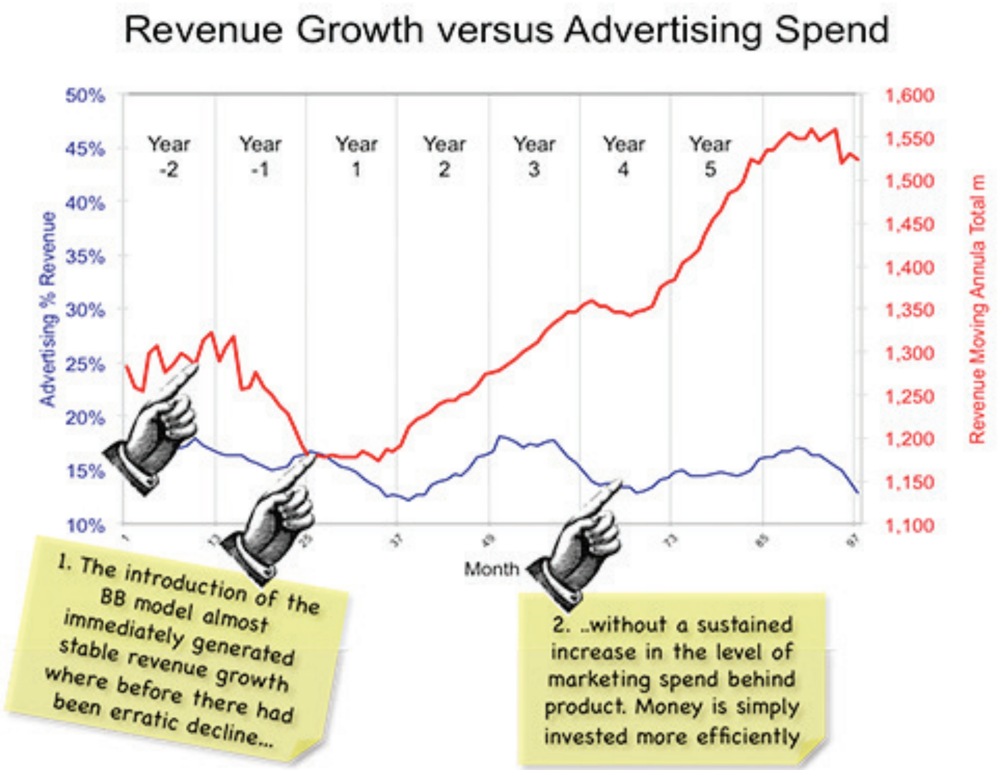
The benefits claimed by Beyond Budgeting organisations

Ultimately, the most powerful evidence comes from your own experience, and it was only when I personally witnessed the transformative impact of Beyond Budgeting ideas on the performance of a business that I had been involved with that I fully appreciated the power of these ideas.

To help share and promote these discoveries, the BBRT synthesised their learnings in a set of principles. But today, with the knowledge and understanding that comes from having worked with these ideas in practice for many years, I think we can do better. We can reveal the scientific logic that underpins the BB model to explain why and how it works and so provide deeper insight and better practical guidance to implementers.

Like any journey of discovery, the best place to start is at the beginning; by exposing the foundations upon which traditional management models are built and so help you understand better how the BB model differs. First we will explore the processes used to plan and control financial resources. Then we will tackle organisational structure and governance and the implications of BB for the management of people and ideas before finally discussing how to start a BB journey.

“The key traits that all mature BB businesses share are flexible business planning processes and a devolved organisational structure.”



An experience of the transformative impact of BB ideas in a subsidiary of a major Blue Chip company

THE TRADITIONAL PROCESS

Every traditionally run business manages its financial resources using a variant of a familiar routine:

Step 1: Build a Plan

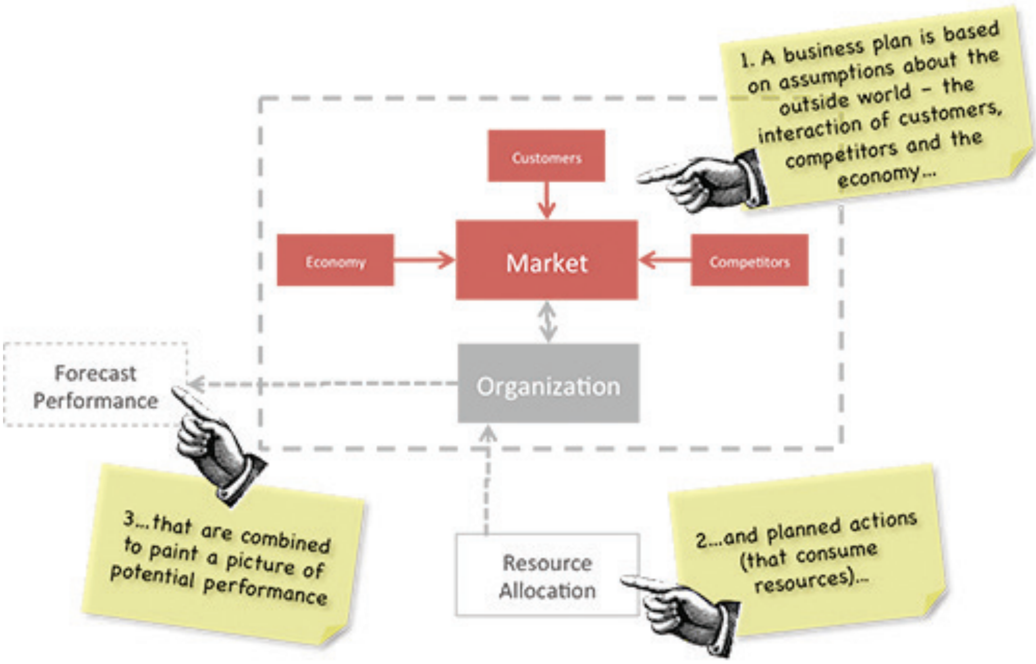
The first step involves creating a set of business plans for the forthcoming financial year.

The plans are built on assumptions about the external world – what is expected to happen in the economy and how customers and competitors will behave. These plans also use a set of internal assumptions, such as the initiatives the business will take, how much resource they will consume and their impact on performance.

These plans can be produced 'bottom up'- with business units preparing plans which are submitted to the corporate centre for approval – or 'top down' where the centre issues high level targets which business units have to work back to – or a hybrid of the two. Finally they are added together to build a comprehensive plan for the total enterprise for the financial year.

In principle this approach is uncontroversial and sensible. But, in practice many versions of the plan are produced using different assumptions. As a result, particularly in large or complex businesses, we find that the process will be spread over many months and consume so much management time and attention that other business activities can grind to a halt. Perhaps the worst example I've come across was an international bank that admitted to spending 13-months each year preparing their annual plans!

Generating multiple, alternative business plans in this way costs time and money, but the problems really start at the next stage of the processes.


1. A business plan is based on assumptions about the outside world - the interaction of customers, competitors and the economy...
Customers
Economy
Market
Competitors
Forecast Performance
Organization
Resource Allocation
2...and planned actions (that consume resources)...
3...that are combined to paint a picture of potential performance

Build a plan

Step 2: Fix the Budget

After a prolonged period of debate and negotiation between managers and subordinates, the business adopts a single version of the plan that strikes a balance between what it assumes will satisfy shareholders and what it believes can be achieved, based on the perceived credibility of assumptions on which the plan is built.

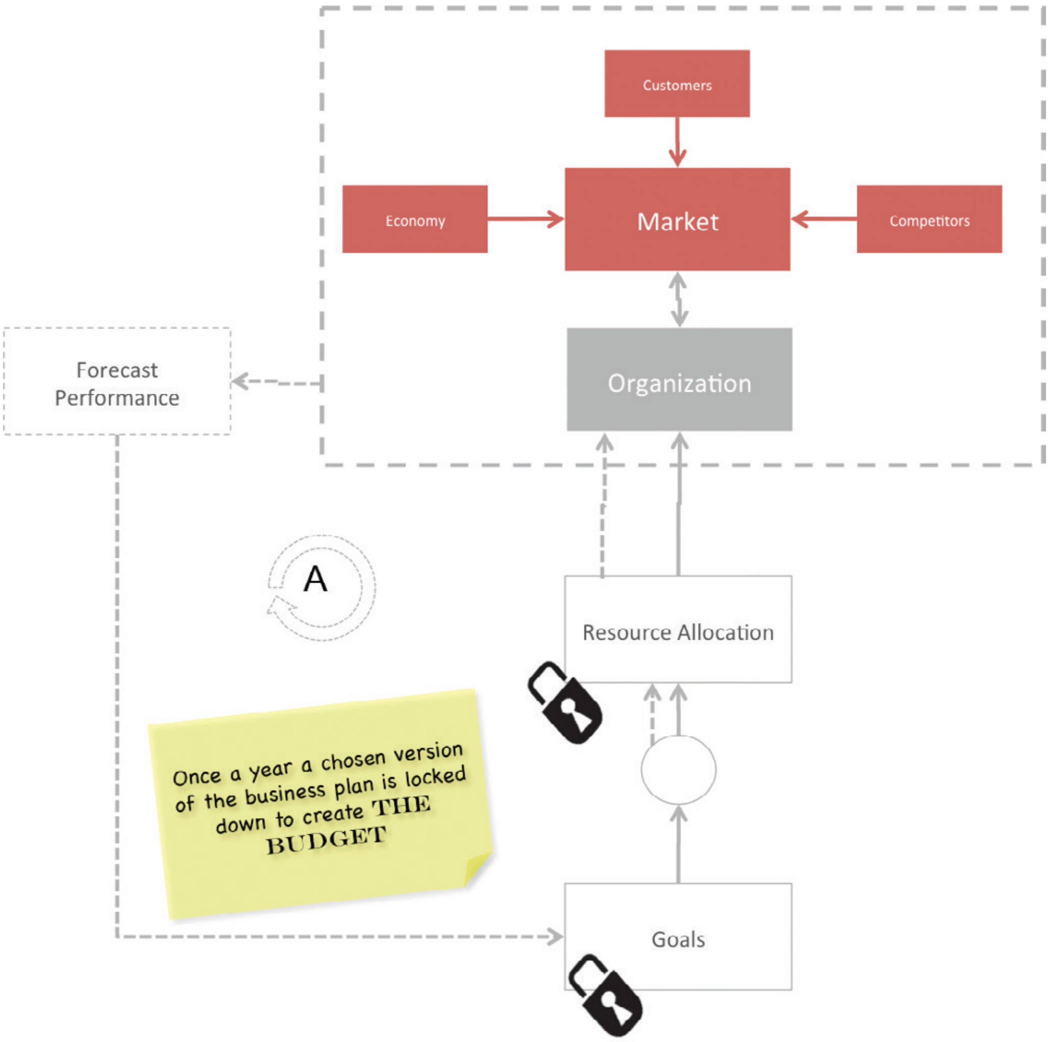
This final plan is then locked in place and becomes the basis for the budget for the financial year. The budget is then broken down into fine detail and 'phased' over the quarters or months within the year because it is used as a reference point for performance analysis and to help co-ordinate actions across the business.

Despite the fact that it is only one of an almost infinite number of possible future outcomes, many of which may be more desirable, the final detailed budget is thus used as the basis for the planning and control of the business for the following year.

The outcome of the budgeting process is a detailed, interlocking set of constraints for a financial year. These take the form of targets for numerous output variables, such as profit or sales, and budgets for input variables such as investment and operating costs.

In practice, however, revenue and profit targets can act as a ceiling since there is no incentive to exceed them whereas cost budgets become a floor as there is no motivation to spend less.

> “Revenue targets can act as a ceiling since there is no incentive to exceed them, whereas cost budgets become a floor as there is no motivation to spend less.”



Fix the Budget

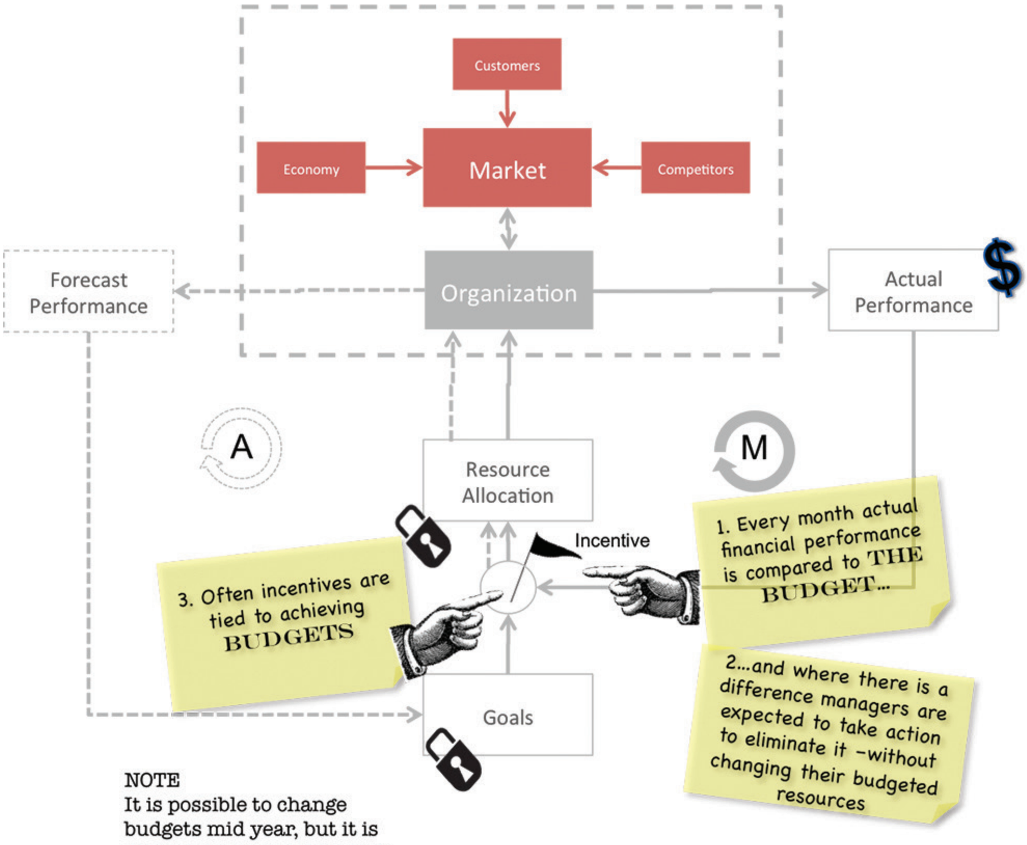
Step 3: Measure and manage performance

Over the course of the financial year control is exercised by comparing actual outcomes to the budget or target at a detailed level. The variance between an actual and the budget is assumed to represent good or bad performance, with managers expected to avoid or eliminate adverse variances (costs in excess of budget, or profit below target) by 'taking action' within the constraints of existing budgets.

In other words, the difference between the budget and the actual outcome is assumed to be the result of a combination of the effort and skill of managers. Consequently it follows that gaps can be closed by them 'performing better' or working harder, without the need for any changes in the allocation of resources. Little consideration is given to whether the assumptions on which the budget was based were realistic or, indeed, the inherent unpredictability of the world.

Often the budget also serves another purpose when they are used to construct 'performance contracts' with profit and cost centre managers. These are used to encourage people to 'hit their numbers' and to align behaviour with collective performance goals.

> "The difference between the budget and the actual outcome is assumed to be the result of a combination of the effort and skill of managers... little consideration is given to whether the assumptions on which the budget was based were realistic."



NOTE
It is possible to change budgets mid year, but it is difficult because of the link to incentives. Also because everything has to 'add up' every change requires a change somewhere else

M = Monthly

Measure and reward performance

In summary, a traditional budgeting system is made up of six tightly integrated key process components:

The Six Process Elements of a Traditional Budget	
Targets	Financial targets are fixed for a financial period and…
Incentives	Often tied to financial incentives. And…
Planning	Arrived at through a detailed annual planning process, which results in…
Resource Allocation	Investment budgets being fixed.
Measurement	Performance is monitored by analysing the variance between actual values and those in the phased budget, based on assumptions that performance should be managed back to plan, which, in turn, is based on the assumption that…
Co-ordination	Adherence to the plan ensures that the activities of different functions and business units are aligned so that collective performance goals will be achieved.

THE PROBLEM

The process used by most businesses today differs little from that first described in 1922 by James McKinsey in his book 'Budgetary Control'. Some advances have been made since then, especially in the use of IT to administer the process more efficiently. There are also nuances in the way different businesses implement budgeting, while management innovations such as Balanced Scorecard have broadened its reach. But none of these developments has fundamentally changed the basic architecture of the budgeting process set out nearly a century ago.

Budgeting might work well if it were possible to make well-founded assumptions about the future: if we were able to predict with confidence – twelve months in advance – what customers, competitors and the economy were likely to do, what decisions a business would make and what their impact would be and what external stakeholders would expect from the business.

The major problems with budgeting arise because we can't do any of these things in today's business environment – and we probably never have done. The interconnected nature of economies, businesses and customers makes their behaviour less predictable – and the task of anticipating the impact of decisions is even more difficult. Likewise, it is difficult to predict the needs of stakeholders because they base their judgements on the relative performance of the different organisations they could invest in, not on whether any one business has hit its own budget numbers.

'No plan ever survives contact with the enemy'

Helmuth von Moltke
Prussian Army Chief of Staff
'On Strategy' 1871

Businesses need to be able to change their plans to survive and prosper in an inherently unpredictable environment, but this is difficult with a budget in place. Because budgets have to 'add up', changing any one element will have a knock-on impact elsewhere, and any change will be resisted by those whose plans and pay are already 'locked in'. This is why adjusting budgets can be a time-consuming and fraught affair, even where the changes are relatively minor.

Budgets also sub-optimise performance by forcing the business to use the same set of numbers for competing purposes. On the one hand, good targets need to include an element of stretch, but forecasts need to be realistic, while cost budgets need to be 'tight' in order to constrain spending. It is simply not possible to fulfil all three purposes using the same number.

Finally, providing incentives for hitting budgeted targets (or taking sanctions against those who miss them) to motivate employees can have unintended consequences that run counter to the intended purpose.

Tying money to budgets almost inevitably leads to 'gaming' behaviour and suboptimal performance because it is in the financial interests of budget managers to negotiate targets that are easier to achieve. Finally, successfully focusing managers' attention on some targets by linking them to pay means those goals that are not, or cannot be, incentivised may be neglected, even if they are more important to the health of the whole organisation, such as maintaining high ethical standards.

Making a budget is an exercise in minimalization. You're always trying to get the lowest out of people, because everyone is negotiating to get the lowest number.

Jack Welch

In summary, budgeting is like a car that has been designed to operate only in ideal circumstances. As soon as it hits a bump in the road the wheels fall off. Why would you buy a car like that?

Problems with Traditional Budgeting	
Bureaucracy	The process of creating a detailed budget is inherently time consuming and costly…
Inflexibility	Making it inflexible and difficult to adapt to changing circumstances.
Sub-optimisation	Using the same number for competing purposes leads to the sub optimisation of performance…
Political	While using it for assessing performance and setting incentives encourages gaming behaviour (such as striving to negotiate lower targets and 'sand-bagging' cost budgets) and a focus on the internal affairs of the business rather than on markets or customers

These are simple, common sense arguments but there are more fundamental, systemic flaws in the traditional budgeting model. Understanding these will help us all to design better alternatives, so we need to dig a little further to understand something of the 'science' governing the management of complex systems. The key insights are enshrined in 'Ashby's Law of Requisite Variety', named after the systems theorist who first described them in 1956.