



The Budgeting Whirlpool

If you have sat through budget meetings where the entire group bewailed the fact that we had not spent 'enough' - and to hell with what the money was actually being spent on, then you will not need convincing that the budget process does not lend itself to good asset management outcomes.

And you will probably find yourself in agreement with Simon Caulkin's article "Needed like a hole in the head". I found this article interesting because it was the first I have seen that suggested that 'Beyond Budgeting' the management approach that has transformed some European and American companies, might have relevance to Government.

Here we look at the 'beyond budgeting' issue and ask the killer question:

If Asset Management Plans are budgets are they not subject to the same challenges?

And what might an agency look like that applied 'beyond budgeting' principles to asset management?

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The Right Question

Answer this: What would you rather have

- : A first rate solution to the **WRONG** question?
- : A fair to middling solution to the **RIGHT** question?

A 'no-brainer' – right?

Yet, every day we see people seeking 100% solutions to the wrong questions. Consider the following from my casebook:

Finance Director of a large rail authority some years ago when asset valuations were being introduced, was explaining how successful he had been in attributing historic cost values to his asset portfolio 'with a 95% accuracy' level. I asked him what his next step was – expecting that he would reply that historic costs were not very relevant to management needs and thus he would be estimating current value costs. He floored me with his reply 'improve the accuracy!'. He was seeking a 100% solution to the wrong question.

A Senior Clerical Officer in a Hospital Asset Management Unit had just completed a revaluation exercise. I asked my standard question: 'What's the next step?' She replied that she wanted to improve the accuracy of the data.

Me: Why are you doing this revaluation?

SFO: It is required for the financial statements and the Auditor General

Me: Is the data you have now acceptable to the AG?

SFO: Yes.

Me: Are there other uses that are made of this data?

SFO: Not as far as I know

Me: Does the Asset Management Unit use this data?

SFO: No, we just prepare it.

Why gild the lily? Another case of seeking a 100% solution to the wrong question!

What was the **RIGHT** question? How about:

*"Now that we have done what we *have* to do, how can we best spend our time to improve the *asset management job we should be doing*?"*

Are YOU asking the **RIGHT QUESTIONS?**

If you *know* the right question, you can research the solution – use the library, the web and other people, or you can do some experimentation.

But if you don't know the right question - then you need exposure to a wide range of questions, you need to open up your options. *As I look around, I figure most of us, most of the time, are in the situation of not knowing the right question—although we may not say so.* We need to keep our minds and eyes open. We need to scan a wide range of questions to see how they apply to our situation, now.

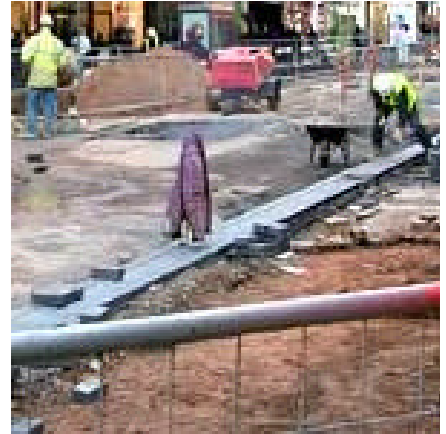
"Strategic Asset Management" is not designed to provide solutions – it is designed for the more strategic task of suggesting relevant questions - like the "Beyond Budgeting" scenario discussed in this issue.

Needed like a hole in the head

Fixation with budgets is holding up more than the roads,
fumes Simon Caulkin

Sunday March 21, 2004 The Observer

"Every year at this time, traffic grinds to a halt in London and other big towns as the streets sprout holes, stop signs, cones, piles of sand, JCBs, drunkenly-leaning temporary traffic lights and other paraphernalia of the March roadworks festival. Is this some mysterious urban rising of the sap, a mechanical equivalent of Wordsworth's daffodils or the arrival of the swallows in spring?



Well, yes and no. The plague of roadworks is indeed linked to the seasons, in this case the end of the financial year. But the cause is not nature but strictly man-made. It's the budget. Unless you're a taxi driver, you'll probably just shrug at this point. Surely budgets are a fact of life, whether for governments, big companies or the smallest tiddler? Budgeting, planning and monitoring against the plan is what managers do. It is management - or at least one version of it.

The Problem lies in the Budget

We shouldn't be so tolerant. In all the (long) list of dubious management practices, none is so incontrovertibly an emperor without clothes as budgeting. Its effects are deeply corrosive on both sides of the organisation. On the spending side, every budget-holder spends to the limit in the last months of the year to make sure they can ask for the same amount next year.

Of course there's no earthly reason why all the streets should be dug up at the same time - it would be much better if they weren't. In any case, the situation may have changed since the budget was set a year or more ago. London's New Oxford Street might not need resurfacing. Or that daft new one-way system might be less urgent (it always is) than spending on care for the elderly, schools or libraries. But there is no way of switching resources to match new priorities, because 'it's in the budget'.

Budgets don't control costs – they preserve them!

In this way, a process that is undertaken in the name of controlling costs actually ring-fences them. Through the incentives, the budget provides for budget-holders to create larger budgets and keep or spend surpluses - there is no incentive for anyone to give them back so that they can be used elsewhere - it is actually a powerful driver of inflation. The justification for next year's roadworks budgets is last year's, with no examination of real need.

The effects on the output side are, if anything, even worse. For example, in most organisations salespeople act like budget-holders in reverse. Instead of setting their budgets high, they have every incentive to keep their targets low, since they are paid for meeting them.

Here, too, there is a matching reverse-inflation effect. As sales targets are usually set monthly or quarterly, perversely there is little incentive for a salesperson to go on selling after he or she has met the target. They're getting the bonus, so why should they? From an individual point of view, it makes much more sense to get the next period off to a running start by postponing a new sale over the month-end.

Budgets Corrupt

It is no exaggeration to say that budgets corrupt. In a large company with many business units, product divisions and geographical regions, each with its own budget, the effects are compounded many times over. 'Managing' in such organisations is often as much a political as a business activity- gaming the system by negotiating low targets and high bud gets - and 'success' is about managing contingencies - hiding pots of resources at different levels that can be brought into play throughout the year to make up the numbers.

Budgets consume vast resources and are quickly outdated

Not surprisingly, budgets create despair and misery for many thoughtful managers, as well as massive organisational cost. In a large company, the budget process may take six months and consume 30 per cent of management's time - all for something, as they are well aware, that is out of date long before it is signed off and actually hinders real-time business adjustment.

As a fixed performance contract in a volatile world, budgets are the reverse of what's needed. They are as obstructive to rational business behaviour as the holes in the road to the circulation of traffic. The taxi driver's right: the world would be a lot better without them.

Rip up the budget

Despite the disadvantages, for most managers, the idea of doing without budgets is a scary one. No budget - how do you exert control?

Actually, budgets give the illusion of control not the reality, and the first step is to accept that fact. Managing the business to make it force-fit a set of pre-determined numbers (which happens now) is the wrong way round. Instead, the aim should be to use processes and measures that help the business to adjust dynamically to changes in the real world.

Networks such as the **Beyond Budgeting Round Table (www.bbrt.org)** have developed many of the building blocks needed for a more adaptive and agile system. They include using relative, rather than fixed, performance measures and making action planning a continuous and inclusive process. This may mean using rolling forecasts (not targets) fed upwards from operating units to build global totals and focus attention beyond the end of the financial year. It always involves removing incentives to play the system by breaking the link between pay and fixed targets set in advance.

Instead, rewards are based on relative improvement, judged after the event so the quality of results can be taken into account. You can improve the numbers by quietly stopping marketing support for the last quarter, but is that good for the business as a whole?

Importantly, moving towards a more adaptive planning system requires the centre to stop giving hostages to fortune by promising markets fixed improvements over a single period. The only way a company can consistently do that is to maintain a monopoly or play with the numbers. Either way, it can't last.

So What's Wrong with Budgets? - Let me count the ways!

A first rate source for information on Beyond Budgeting is the "Beyond Budgeting Round Table" at www.bbrt.org from which the following excerpt is taken:

1. **Budgets are time consuming and expensive.** Despite the advent of powerful computer networks and multi-layered models, budgeting remains protracted and expensive. The average time consumed is between four and five months. It also involves many people and absorbs up to 20 to 30 percent of senior executives' and financial managers' time.
2. **Budgets provide poor value to users.** In one agency the group board thought the budget gave them control, whereas operating managers thought it was completely irrelevant to their needs. A 1999 global best practices study showed finance staff spent 79 percent of their time on "lower value-added activities" and only 21 percent of their time analyzing the numbers.
3. **Budgets fail to focus on shareholder value.** Budgets focus on internally negotiated targets which tend to be incremental changes from the previous period's outcomes. The result is a target that is inwardly comfortable to you, yet appears outwardly difficult to your superior. There is no focus on the maximization of customer or shareholder value.
4. **Budgets are too rigid and prevent fast response.** Evidence suggests that only 20 percent of firms change their budgets within the fiscal cycle. Another survey result shows 85 percent of management teams spend less than one hour per month discussing strategy
5. **Budgets protect rather than reduce costs.** "Use it or lose it" is the manager's mantra. Not spending the budget is a cardinal sin in most organizations. The result is that superiors invariably question why the resource is needed and are understandably reluctant to allow it to pass into the budget for the next period
6. **Budgets stifle product and strategy innovation.** "Never take risks." It is just not worth it. If it's not in the budget, you might be exposed. Anyhow, if you did take a risk and it worked out well, your superior probably thought of it first! And if it didn't work out, your job might be on the line .
7. **Budgets focus on sales targets rather than customer satisfaction.** Though everyone wants to satisfy customers, that is not how they are measured and rewarded. So they meet the sales target, persuade customers to buy their products, and convince them that their slow-moving stock really is a great deal!
8. **Budgets are divorced from strategy.** According to a recent cover article in Fortune magazine, around 70 percent of companies surveyed were poor at executing strategy-a massive indictment of the performance management capabilities of budgets.
9. **Budgets reinforce a dependency culture.** The way to survive and prosper in a budgeting environment is to do what you're told, meet the budget (but never beat it!).
10. **Budgets lead to unethical behaviour.** Managing the results (also known as cooking the books) is a frequent outcome of budgeting. Many finance managers are well versed in "managing the slack" and feeding it into the results when needed. However, as we have seen, this practice can border on outright fraud

What's the Alternative?

'Beyond Budgeting' from www.bbrt.org

The six principles of managing with adaptive management processes

"The overall effect of the switch to 'beyond budgeting' is a performance management process based on a relative improvement contract rather than on a fixed performance contract. It assumes that it is not wise to make managers commit to a fixed target and then control their future actions against it. The implicit agreement is that executives will provide a challenging and open operating environment and that employees will deliver continuous performance improvement using their knowledge and judgment to adapt to changing conditions. It is based on mutual trust, but it is not a soft alternative to the fixed performance contract. High visibility of individual and team performance offers no hiding place. Managers must perform to high levels of expectation (relative to peers) or face the consequences.

Process-based Principles

1. Base goals on maximizing performance *potential*
2. Base evaluation and rewards on *relative* improvement contracts, *with hindsight*
3. Make action planning a continuous and inclusive process
4. Make resources available as required
5. Coordinate cross-company actions according to prevailing customer demand
6. Base controls on effective governance and on a range of relative performance indicators.

The six principles of managing with adaptive management processes

The delegation of decision-making and spending authority has always been one of the key functions of budgeting. However, this delegation usually occurs strictly within a regime of compliance and control. It differs significantly from the approach taken by 'beyond budgeting' organisations which have gone much further and transferred power from the centre to operating managers and their teams, vesting in them the authority to use their judgment and initiative to achieve results without being constrained by some specific plan or agreement. Thus, devolution of responsibility is about enabling and encouraging local decisions, not dictating and directing them.

Devolution-based Principles

1. Provide a governance framework based on clear principles and boundaries.
2. Create a high-performance climate based on relative success.
3. Give people freedom to make local decisions that are consistent with governance principles and the organisation's goals.
4. Place the responsibility for value creating decisions on the front line teams.
5. Make people accountable for customer outcomes.
6. Support open and ethical information systems that provide 'one truth' throughout the organisation.'

What does all this mean in practice? See over

Who Uses Beyond Budgeting Principles —and what are the benefits?

Svenka Handelsbanken is the first, and leading, exponent.

From Management Accounting, December 1997

'**Svenka Handelsbanken** abandoned traditional budgeting as long ago as 1979 and has since achieved dramatic success. It is now the largest bank in Scandinavia. Chief Executive, Anne Martensson, notes that a culture of thrift and improvement rather than imposed budgetary controls has enabled the bank to drive down costs to a level that is the envy of its competitors. By operating each branch like an independent business, adopting a unique profit sharing scheme based on performance relative to competitors, and developing a fast and open information system so that one branch can compare its performance against another, its cost/income ratio has been reduced to 45% (and falling]. This compares with around 70% for many of its rivals such as NatWest, ABN-Amro and Deutschebank.'

And from Steve Player "Moving Beyond Budgeting"
www.cfoproject.com/document.asp?id=2095

'Handelsbanken, a leading budgetless bank in Sweden, uses the cost-to-income ratio as a guiding metric throughout its branch network. Managers are free to add operational resources as they find necessary, but they realise each person, new equipment, or other resource added will increase costs. Managers must decide if it will also improve income.'

'Handelsbanken measures its return on equity against other banks in its region with the goal of being in the top quartile. This relative metric is then translated into relative metrics that are meaningful to the components of the organisation. For Handelsbanken this means measuring its branch organisations on the cost-to-income ratio. These relative metrics can be easily displayed in league tables where members of a group, such as a region, can be compared. Each of Handelsbanken's 10 regions compose a league table. The performance of all branches creates the regional total. Regional performance is also viewed in a league table, which combines to create the bank's total.'

Who Else?

(From presentation by John Bragg, BBRT Program Director – Australia and New Zealand (to the National Public Sector Convention 2003) Perth November. (a good person to contact: johnbragg@bbrt.org)

Asea Brown Boveri, Sweden/Switzerland, Various
AES, USA, Power Generation
Ahisell, Sweden, Distributiobn
Boots, UK, Retailing
Borealis, Denmark, Petrochemicals
Bulmers, UK, Brewing industry
Ciba Vision, USA, Eye care
Emerson, USA, Electrical products
Fokus Bank, Norway, Banking
Groupe Bull, France, Computer manufacturing

IKEA, Sweden, Furniture mfg & retailing
Leyland Trucks, UK, Truck mfg
Rhodia, France, Specialty chemicals
SKF, Sweden, Ball bearings
Schneider Electric, France, Electrical products
Sight Savers Int'l, UK, Charity
SlimFast, USA, Food sector
Sprint, USA, Telecomms
Svenska Handelsbanken, Sweden, Banking
Volvo Cars, Sweden, Car manufacturing

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Asset Management Plans are budgets

You may not think of them as budgets, but they are normally designed and treated just like budgets – a fixed commitment, not an evolving one. And most plans are based on planned expenditures – not planned outcomes! Often they stay constant for years! Talk about getting out of date – no wonder asset management often has a bad rap.

What would a 'beyond budgeting' framework look like for asset management?

For example:

Relative performance targets? Perhaps based on last year's achievements if industry comparisons don't apply – but if they don't, why not?

Rewards based on relative performance? - Now there is an interesting concept!
Front line maintenance crews empowered to make decisions on the spot to meet customer requirements in line with corporate goals?

Average annual life cycle costs/performance measures? Where any manager can request – and get – added capital resources, but they need to consider whether the added resources will add to performance – because that is what their pay is determined by. Makes for an interesting concept, doesn't it?

Additional References

In addition to the references previously cited, the following may also be useful

Books

Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap
by Jeremy Hope, Robin Fraser, Charles T. Horngren, Harvard Business School Press, 2003

Competing in the Third Wave: The 10 Key Management Issues of the Information Age,
by Jeremy Hope and Tony Hope, Harvard Business School Press

Website

<http://www.juergendaum.com/bb.htm> (A German based website but many of the articles are in English and are good)

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