Beyond budgeting …

Breaking through the barrier to "the third wave"

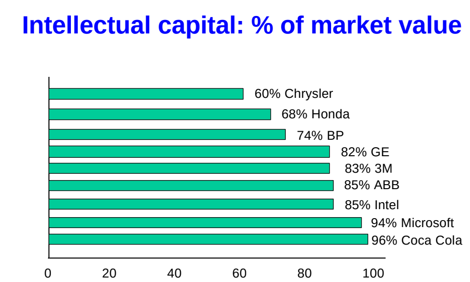
Jeremy Hope and Robin Fraser argue that the management accounting model that has served companies well in the second wave (industrial age) must be changed if companies are to compete successfully in the third wave (information age). They believe that the primary barrier to change is the budgeting system. They support their argument with evidence from highly successful Scandinavian companies who have completely abandoned budgeting. They also outline the further research that CAM-I is now undertaking internationally to develop a guide to help companies break through this barrier.

This article is based partly on Jeremy Hope's new book "Competing in the Third Wave" published recently by the Harvard Business School Press and partly on work already done by CAM-I in advance of their forthcoming research project the "Beyond Budgeting Round Table". Companies interested in participating in this research project should contact the authors or Dr Peter Bunce at CAM-I on Tel: 01202-670717 or Fax: 01202-680698.

Much has already been said and written about how traditional management accounting fails to support hard-pressed managers in today's highly competitive world. But simply adopting new techniques such as activity-based costing and the balanced scorecard will not bring the expected benefits if they do not fit well with the chosen management structure and style. Accounting systems invariably mirror the existing management structure and, as this structure evolves, so should the accounting model. The problem is that as firms try to adopt more flexible and responsive management approaches to focus on the customer, they often fail to support these changes by adapting the old accounting systems that were designed for a different competitive era. Indeed many of these firms are finding (often too late) that the second wave economic model that stressed volume, scale and the recovery of fixed costs, doesn't sit well in the competitive climate of the third wave where innovation, service, quality, speed, and knowledge sharing, are the defining factors.

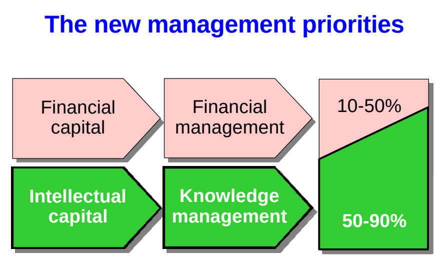
Moreover, the key competitive constraint is no longer land, labour or capital. It is, and will increasingly be, knowledge or intellectual capital (including competent managers, skilled knowledge workers, effective systems, loyal customers, and strong brands). Financial capital is now a commodity bought and sold on the open market like apples and pears. You only have to consider the huge levels of share buy-backs of recent years (even in persistent loss-makers like DEC) to realise that capital is now being "laid off" in the same way that workers have been laid off over the past 20 years. Moreover, there is already strong evidence that those companies that have focused on building their intellectual capital have provided excellent returns for their shareholders and have outperformed their competitors on every (financial) measure.

Figure 1



In most companies today, intellectual capital forms the greater part of their market value (see figure 1). And this applies to manufacturing companies as well as hi-tech and service businesses. In brand leaders like Coca-Cola, for example, intellectual capital forms an incredible 96% of market capitalisation leaving only 4% for the auditors to verify and report upon! But it is the two engineering giants of Europe and America – ABB (Asea Brown Boveri) and GE – that should really catch our eye. Both these companies have over 80% of their value in intellectual capital, reflecting more than anything else, the strength of their managerial capabilities.

Figure 2



Nor is this simply the result of high-flying stock markets. Many firms now recognise that the underlying source of future cash flows will increasingly come from the effective management of intellectual assets. Meeting the exact (and exacting) needs of the customer is what matters today, and this is more a function of leveraging knowledge to bid for contracts, solve problems, provide superior service and offer customised products, than simply investing, for example, in new productive capacity.

The implications for managers and accountants are obvious (see figure 2). Maximising the value of intellectual assets has a far greater impact on shareholder value than maximising financial assets. This shift in emphasis demands new forms of organisation and new ways of managing and measuring performance.

The emerging third wave organisation

Just as the multidivisional ("M-form") structure set the standard for the industrial age, a new managerial model is now emerging that is likely to become the

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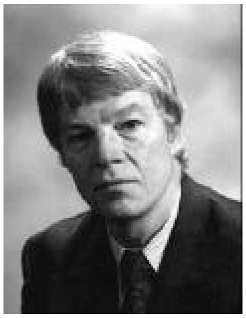

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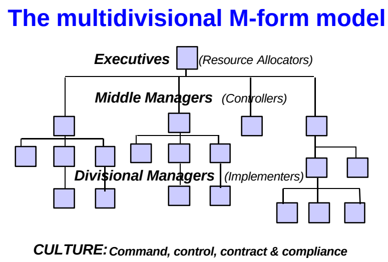
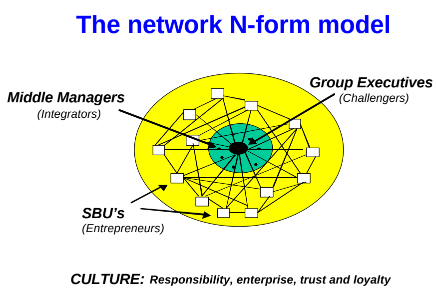
Figure 3



standard for the information age. In the "M-form" model (see figure 3), pioneered in the 1920s by US giants like DuPont and General Motors, top management is the fountain of knowledge, the strategist, and the resource allocator; middle managers are the controllers; and the front-line managers are the implementers. These structures were established to support the rapid growth of second wave companies as they expanded into new products and markets, and helped them to reduce the complexity of managing multiple strategies. These structures were created by devolving assets and acsupported by vertical information systems to enable top management to allocate resources and control their use. The so-called 'M-form' was right for its time (1920s to 1970s) because capital was the key strategic resource. But in today's business environment the model is too bureaucratic, rigid and unresponsive, and it creates a culture that is risk averse and gives a false sense of security.

Figure 4



Today we are operating in a highly competitive and rapidly changing business environment and, as we have already noted, the key resource is no longer *financial*, but *intellectual* capital. In the emerging model – let's call it the "N-form" (see figure 4) - front-line managers are the entrepreneurs, strategists and decision-makers, constantly creating and responding to new opportunities for the business; middle managers are the horizontal integrators building competencies across the organisation (and with external partners); and top managers provide inspiration and a sense of purpose while frequently challenging the status-quo. In contrast to the 'M-form', this is a model that is in tune with the times. It has a softer, more organic form that is market focused, lean and responsive.

ABB, recently voted by its peers as Europe's most admired company, has adopted many of the essential features of the 'N-form'. With over 200,000 employees, it has created a federation of some 1,300 distinctive and separate businesses, each with multiple profit centres. It has a very lean HQ (about 150 people) and is highly decentralised. R&D, for example, is devolved to operating units, but it is leveraged horizontally. Each unit manages its own finances as if it were an independent company, but information across and up-and-down the group is open and fast. By adopting the 'N-form' model, ABB has created a widely distributed network of entrepreneurs thus improving responsiveness while retaining the benefits of scale through mechanisms for horizontal integration.[1]

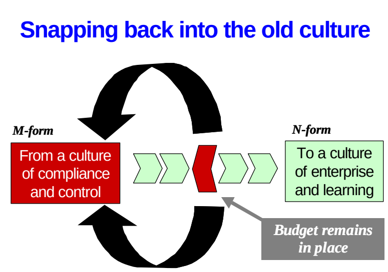
Another outstanding example of the 'N-form' is ISS, a Danish contract cleaning company. The company's success is built on its respect for its people and the belief that, at whatever level in the organisation, people will make the right decision if they are properly informed. Cleaning supervisors are encouraged to run their operations as if they were independent businesses. Once thoroughly trained, supervisors receive financial reports by cleaning contract, and, because they are at the front-line, treated as professionals and rewarded on team profitability, they exercise a control over costs that is far tighter than a financial controller could ever exercise remotely. With this philosophy, ISS has grown from a local office cleaning contractor to a multinational business with a $2bn turnover and 115,000 employees.

At the heart of the new model lie processes and teams. Indeed many firms have already adopted a process-based approach to management in an attempt to align their operations with the needs of the customer. Driven by the TQM and reengineering movements, processes offer managers a clearer view of which work should be done and, when new technology is applied, how such work can be done faster and more effectively.

The underlying philosophy in the 'N-form' company is one of maximising value rather than minimising costs, and the focus of measurement systems is on strategic performance, value-adding processes and knowledge management. But most important of all, it is a model based on trust between managers, workers, customers, and partners. And as many firms have discovered, this trust can be easily undermined when managers (typically when the "going gets tough") are quickly driven back to "managing by the numbers" – a path that invariably leads to arbitrary cost reductions, declining morale, and falling profits.

Whether they recognise it or not, many firms have already adopted many of the elements of the new organisational model. TQM, BPR, decentralisation, empowerment, economic value added, and the balanced scorecard, are all pieces in this new jigsaw.

Figure 5



However, studies show that for intended benefits. This failure is, more often than not, put down to poor communication or lack of top management commitment, but the real culprit is likely to be hidden within the accounting system itself. Indeed many well-planned changes and many attempts to shift the culture from one of *compliance and control* to *enterprise and learning* have foundered when management behaviour has been "snapped back" into its old shape by the invisible power of the budgeting system (see figure 5 below).

Scandinavians are dismantling budgeting

The extent of this power is all too obvious. Despite progress towards non-financial measures and the balanced scorecard, extensive surveys conducted by the leading accounting firms indicate that nearly all companies in Europe (irrespective of country, industry, or size) still operate with formal budgeting systems. While this is hardly surprising, a number of enterprising Scandanavian multinational companies have taken great strides down the path towards the 'N-form' model and, in some cases, have dismantled their traditional budgeting systems altogether.

Svenska Handelsbanken abandoned traditional budgeting as long ago as 1979 and has since achieved dramatic success. It is now the largest bank in Scandinavia and the most efficient of the big banks in Europe. Chief executive, Arne 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.[2]

"The budget is the bane of corporate America. It never should have existed. A budget is this: if you make it, you generally get a pat on the back and a few bucks. If you miss it, you get a stick in the eye – or worse … 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, CEO, GE
Fortune, 29 May 1995

IKEA, the world's largest furniture manufacturer and retailer, abandoned budgeting in 1992. Now its business managers merely have to keep costs within certain revenue ratios. Borealis, a Danish petrochemicals company with a turnover of £1.6bn, completely abandoned traditional budgeting in 1995 and its executives are delighted with the progress so far. Managers now use new mechanisms to steer the company including scorecards, rolling financial forecasts, trend reporting, and ABM. Several other Scandinavian companies (such as Volvo) are also at various stages of abandoning traditional budgets.

In all cases, these are large multinational corporations not prone to managerial experiments. They are making these changes for good business reasons that include improving competitiveness, enhancing the value of intellectual capital, and ultimately increasing shareholders' wealth.

Budgeting – "An unnecessary evil"

Some accountants may be alarmed at these radcal changes and they will not be surprised to learn of the obstacles and objections faced by the early pioneers. One such pioneer was Dr. Jan Wallander. When CEO of Svenska Handelsbanken, he encountered strong opposition when he decided to dismantle the entire budgeting system at a stroke. He called this opposition "the budget bureaucratic complex". To this, he says, belong all those people within companies who feel their position and their work is coupled to the budget system, as well as those professors, management consultants and other experts who write books, lecture and organise conferences about budgeting and its technical complications![3]

Why does Wallander (and others who have adopted the 'N-form' philosophy) see budgeting as "an unnecessary evil"? Let's look at the issue from the perspective of three "N-form" managers – those in charge of front-line business units; those in the middle; and those at the top of the organisation:

- **Front-line managers** become entrepreneurs and strategists in an organisation that is radically decentralised to meet the demands of a rapidly changing business environment. They see the budget as *a commitment* and therefore a *constraint*, as it is based on assumptions that are bound to be out-of-date as soon as the ink is dry. Instead of blindly following an approved financial plan (that may already be discredited), they need the freedom to operate within boundaries set by a clear corporate purpose and a measurement framework that will include challenging (but achievable) *strategic* targets.
- **Middle managers** become the "horizontal integrators" and the hands-on coaches of front-line managers. They see budgets (especially if reinforced by rewards) as encouraging parochial behaviour that opposes their efforts to build competencies across the group. They also see budgets as a mechanism for top-down control and thus in conflict with their aim of developing the responsibility levels and enabling the self-regulation of front-line managers. They also know that with a flattened hierarchy, there is no longer the resource available to fulfil their old tasks as controllers and administrators, and to revert back to this system would need many more people that would add cost but little value.
- **Top managers** become the creators and communicators of the group framework and values, challengers of the status quo, and leaders of renewal and improvement. They, like Jack Welch, CEO of US giant GE, see budgeting as "an exercise in minimalisation", rather than stretch. They also recognise that it is a poor mechanism for forecasting (because it is too inwardly focused) as well as being an inhibitor of enterprise and continuous improvement.

There are conflicts at every level. Traditional budgeting is clearly "out-of-sync" with the emerging third wave organisation. It strengthens the vertical chain of command and control rather than empowering the front-line. It constrains rather than increases flexibility and responsiveness. It reinforces departmental barriers rather than encouraging knowledge sharing across the organisation. It makes people feel under-valued - as "costs to be minimised" rather than as assets to be developed. And it is bureaucratic, internally focused and time consuming. In short, its time is up.

Alternative steering mechanisms

With all this talk of new organisational models and the inclusion of so-called "soft" measures, the reader might be forgiven for wondering where this leaves financial management itself. Let's try to understand how this will operate in practice by considering three of the purposes of traditional budgeting and how they might be achieved within the 'N-form' model: -

- **Forecasting and resource allocation –** In the 'N-form' model, front-line units will have direct access to capital, and are encouraged to share productive capacity across the organisation. Managers prepare rolling plans (usually quarterly) and these are used for cash forecasting *but not cost control*. There is an important distinction here. While traditional budgets are forecasts, they are also *commitments.* In the traditional system, managers must participate in a bureaucratic and time consuming process to build their understanding of and commitment to the figures against which they will be controlled. In the new model, forecasts are prepared quickly, up-dated when required, and need not be constrained by the annual planning cycle. They must also be as accurate and objective as possible. This requires good access to external data, fast and open information across the organisation and process based models to understand the relationship between outputs and resources.
- **Measurement and control –** While performance responsibility and accountability is devolved to the lowest possible level, it is still vital that senior managers monitor cash flows and have up to the minute information on profit performance. Aggressive performance targets will be agreed, but month-to-month measures will not be based on "actual versus budget" reports, but on *strategic* milestones and *relative* measures. There will also be an emphasis on what some management writers have called "double loop learning", or those "how and why" performance questions that budget variance analyses so critically fail to answer. This can lead to important tactical changes in strategic direction through the year. The new measurement system is set within a framework of the balanced scorecard used not so much as a measurement system but as a strategic *management* system. Borealis, for example, uses market-independent ROCE target setting and measurement, because the petrochemical business is very cyclical.
- **Cost management –** In the new model, effective cost management is achieved by creating a culture of thrift and continuous improvement, reinforced by a long-term organisation-wide reward system. Many firms, for example, are now educating their employees to understand such issues as which work adds value and thus helping them identify and eliminate non-value-adding work (e.g. encouraging sales people to spend more time with the customer). Once again, the emphasis is on managing value up rather than managing costs down. ABM and benchmarking are important weapons in the armoury of the N-form manager.

Surely, better budgeting is still possible?

The logic that we must change organisational form as we move from the industrial to the information age is compelling. But given that nearly all companies today[4] still operate with traditional budgets, we must accept that there is some way to go before most of these companies will be convinced by the argument. Some will wish to continue, for the time being at least, to believe that *better* budgeting is possible and concentrate on improving their planning processes. Others will be looking for an *evolutionary* rather than a revolutionary approach to organisational change and the abandonment of budgeting.

The only significant attempt in the past 30 years to address the weaknesses of traditional budgeting has been the development of Zero Base Budgeting (ZBB). ZBB is a highly effective process for occasional reviews to improve resource reallocation and make significant cost reductions. Moreover, linking ZBB with BPR, activity-based budgeting, and other improvement techniques, can enhance its effectiveness for enterprise-wide cost reduction. But such one-off projects should not disguise the fact that ZBB is not suitable as an on-going budgeting system. It is too bureaucratic, internally focused, and time consuming. Moreover, it is just as 'out-of-sync' with the information age as traditional budgeting. *Better* budgeting is not the answer.

Many companies are already in the process of transition from 'M-form' to 'N-form' but failure to address the budgeting issue is likely to deny them long-term success. Nor is this problem obvious. Few researchers or practitioners have been flagging the budgeting issue as a major barrier to success and there are even fewer guidebooks to help the unwary manager.

What we have outlined in this article is a strong *prima facie* case for abandoning traditional budgeting and adopting a new form of organisation with alternative steering mechanisms. What companies now need are more comprehensive answers to these key questions: -

- **Budgeting –** How in detail are those leading companies that have abandoned or significantly changed their budgeting systems now fulfilling the purposes for which budgeting has for so many years been used?
- **Context –** Is there really a coherent new form of organisation emerging that will provide a new context within which it will be clearer what steps should be taken and how they should link together?
- **Implementation –** What lessons have already been learned about how best to implement the necessary changes and what are the critical success factors?

CAM-I's sponsored research project

CAM-I, the international research consortium best known for its development of ABC, is now launching a sponsored research project (led by the authors), to find answers to these key questions.

The research programme, taking place throughout 1998, will be driven by the needs of a group of corporate sponsors. Our approach will be to build and test a working hypothesis concerning the role of budgeting within organisational change. With the help of the sponsors, we will select a number of target companies to visit and then use two main lines of enquiry: -

(1) **"Inside-out"** - How are these leading firms now fulfilling the purposes of the old budgeting process using new steering mechanisms or enhanced traditional methods?
(2) **"Outside-in"** – How are they responding to the pressures of the information age through change in organisational form and management processes, and how do they now see their budgeting systems?

The deliverables from the project will include: -

- **Case reports –** These detailed reports on the target company visits will provide a rich source of knowledge. We have little doubt that we will unearth a picture of trial and error, success and failure, feedback and learning.
- **Guidelines -** We expect to develop and enrich our understanding of the context for the changes required to meet the new business needs of the information age and will present guidelines and diagnostic tools that interested firms can follow, supported by practical examples.
- **Shared learning –** The opportunity for sponsors to steer and participate in the project will ensure that they receive far greater insights into its results than they would from just reading its conclusions when these are ultimately released.

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[1] The ABB case is based on a paper by Christopher A. Bartlett and Sumantra Ghoshal, "Beyond the M-Form: Toward a Managerial Theory of the Firm", http//www.gsia.cmu.deu/bosch/bart.html

[2] Economist, July 1997, Culture of thrift

[3] Dr. Jan Wallander, Svenske Handelsbanken, Budgeting - An unnecessary evil (A summary in English of a recent book written in Swedish)

[4] Coopers & Lybrand 1996 and KPMG 1994 Pan European financial management and budgeting surveys