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The Application of the Beyond Budgeting to Organisations

—An Example of Application of Borealis Company

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Abstract

Budget is a way of controlling for the managers to make decisions based on certain targeted figures which leads to their actual performance being compared with those targeted performance. However, as the concept of Beyond Budgeting was developed by the Beyond Budgeting Round Table by more than 50 global companies, the way of traditional budget has been questioned if it still need to be used in the organizations. This article is aim to analyze the key arguments of beyond budgeting which is used in the Borealis company. This paper also would like to evaluate the processes that Borealis implemented to replace budgets, and discuss whether abandonment of budgets are suitable for all originations.

Keywords

traditional budgeting, beyond budgeting, borealis company

1. Introduction

This paper provides all the critical information of tradition budgeting and beyond budgeting. It will discuss the four management tools: rolling financial forecasts, balance scorecard, activity based costing, and investment management. And related all these tools into the organization, then discuss beyond budgeting approach and abandonment of budgets in all organizations.

Borealis, headquartered in Copenhagen, Denmark, was formed by a 1994 merger between the petrochemical divisions of two Scandinavian oil companies. In the first phase, which lasted about three years after Borealis merger, Borealis abandoned its budgeting process. In the second phase, Borealis implemented the four specialized management tools. Overall, Borealis management and employees were satisfied with the four tools that guided the new organization.

2. Key Arguments of Beyond Budgeting

Daum (2002) advanced that fixed budgets don’t work today. A budget is too static instrument and locks managers into the past. To be effective in a global economy with rapidly shifting market conditions and quick and nimble competitors, organisation have to be value for customers and shareholders. As a result, a new budgeting model should be introduced.

According to Horngren (2003), Beyond Budgeting is a positive idea that uses the abandonment of budgeting as a trigger for improving the entire management control process. The concept of Beyond Budgeting was developed by the Beyond Budgeting Round Table (BBRT) which funded by more than 50 global companies management accounting also talking about it. BBRT has pointed out that beyond budgeting is not about new tools or techniques. It is more likely "a management philosophy based on a set of principles developed from real cases leading to adaptive performance management" (Bunce, 2004). The main objective of the Beyond Budgeting management model is to increase the adaptability of enterprises and to help those enterprises continuously improve their performance in a business environment that is market led, highly competitive and unpredictable (Bunce, 2004).

According to the BBRT research, beyond budgeting consists of two sets of principles. Firstly, process principles, which support adaptive management processes to allow enterprises to be more responsible to their competitive environment and customer needs. Secondly, leadership principles, which support greater decentralization of responsibility to teams accountable for improving customer outcomes (Bunce, 2004). The full information is shown in Appendix 2.

The Beyond budgeting uses a Key Performance Indicators (KPIs) as a tool of measurement that reflects the critical success factor for organization rather than a fixed budget (Daum, 2002). For example, it estimates future sale by monitor industries trend, market share and sales channel rather a fixed budget.

The beyond budgeting focuses more on the adaptability of an enterprise and innovation to maximize the customer and shareholder value rather than focusing on only the financial objective (Fraser & Hope, 2003).

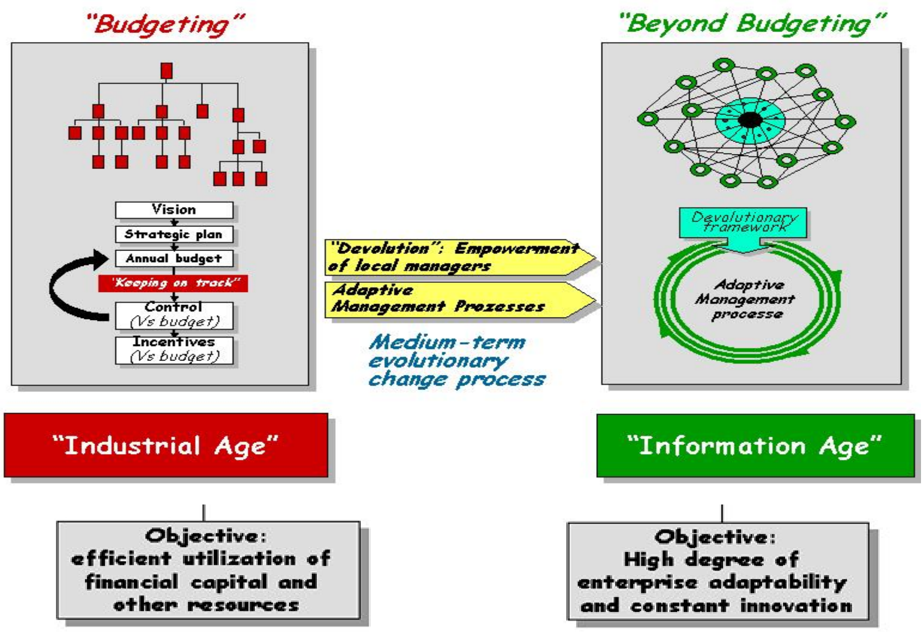

Figure 1. Medium-Term Evolutionary Change Process

Source: Daum, J. H., 2002.

http://www.juergendaum.de/bb.htm

The beyond budgeting also abandons the fixed performance contract, which means it is unnecessary for employees to achieve the fixed targets. It helps the company to win in the marketplace rather than achieving the internal targets. For example, in the beyond budgeting approach, goals are aiming at continuous improvement and the reward system is based on relative performance rather than meeting the fixed annual targets (Bunce, 2004). From most of the case studies, the benefits for Beyond Budgeting can be summarized in four major area, which are: Faster response, lower cost, greater innovation and more loyal customers (Fraser & Hope, 2003).

3. Reasons for Borealis Choosing Beyond Budgeting

In the Borealis case, with traditional budgets, managers have to make forecasting and target setting. This budgeting is like financial control, it not only set a ceiling on costs, but also a floor. The products and supplier markets were changing so fast, that the budget will out of date within weeks. As describe by Borealis "their merger occurred when their margin were among the lowest in industry history. But 12 months later, conditions had changed and their prior planning was now meaningless". Comparison between traditional and beyond budgeting is available in Appendix 1.

A manager's performance is often related to achieving targets set out in the budget, which inevitably leads to a conflict of interest. Managers will attempt to negotiate the lowest possible targets and avoid taking risks. Thus, when managers have to face uncontrollable volatility in its feedstock costs and product prices, manager may control cost spending on material in order to reach the target setting under budgeting. Such as purchase cheaper material. These materials used in production may result lower quality of products than we expect and this may reduce the company's competition in the market and cannot reach the competitive benchmarks.

On the other hand, firms have invested huge sums in quality programs, process reengineering, range of management tools and activity accounting. But they are unable to realize the new ideas, because the budget, and the command and control culture it supports remains predominant.

The traditional budgets in Borealis serve too many different purposes and it may create value in the past, but it does not work effectively in today's highly competitive environment.

As Bogsnes felt the budget process had become like the emperor's new clothes in the Hans Christian Andersen's fairy tale. This budgeting are time consuming, lower achievement setting and less employee incentive. So Borealis decided to abandon budgets.

Abandoned traditional budgeting in favour of their beyond budgeting and found that management gained a new sense of empowerment and a "can do" attitude. In addition, they benefited from faster and more adaptive decision-making, reduced bureaucracy and lower costs. The companies became more competitive and customer satisfaction improved along with many of the companys' KPI's (Key Performance Indicators).

The beyond budgeting centralized control systems with multilevel controls that include effective governance, fast financial actual, trend analysis, rolling forecasts, key performance indicators, performance ranking, and management by exception.

Its probably no surprise that annual budgeting is expensive and time consuming, but just how much time companies are spending on the process and how useful are the results.

4. Processes of Borealis to Replace Budgets

Borealis had implemented the budgeting process in its new combined entity. Initially, it is considered to be a useful tool to facilitate planning and control. But as the company attempted to restructure the management processes in general, budgeting is no longer seen as an effective method.

The same thing is also mentioned by James Creelman, author of a new Business Intelligence report Reinventing Planning and Budgeting for the Adaptive Enterprise, where organizations start to get more complex that (budgeting) starts to become dysfunctional (Bartram, 2006). This budgeting process is likely to consume a lot of time and effort, as the team had to prepare a detailed plan using various data from across organization, meanwhile the outcome might not like what they have expected.

In fact, this weakness of budgeting is not only Borealis' concern, but other organizations too such as in Volvo Cars, whose finance director mentioned that the budget and long range planning systems were no longer efficient when the business environment changed more and more rapidly (Business Europe, 2000). Since then, Borealis' management team finally came out with possible solutions to replace budgeting. There were four specialized management tools that were put into practice, which included rolling financial forecasts, Balanced Scorecard, activity-based costing, and decentralized investment management.

4.1 Rolling Financial Forecast

Firstly, rolling financial forecast can be defined as a forecast for sales, or for costs, but more often than not for both, that always extends a set number of financial periods into the future (Clarke, 2007). Under this approach, each department prepared its own forecast in detail for the upcoming period with requirement for regular update. In order to have the updated information available for use for one year ahead, Borealis constructed the forecast every quarter and prepared for the next five quarters. According to Bogsnes, this forecast technique benefitted more to the company than the previous budgeting process, especially in terms of reliability, as there were less risks associated.

At first, when the company implemented budget, there were chances for managers to game the budget and this could be harmful to the company. Gaming the budget included situations where managers spent money at the end of the budget period to avoid losing it in the next budget period (Libby & Lindsay, 2007) or they could also focus more on measures affecting their bonuses (such as sales) and ignore other things that may be more important in the long run (such as investment) (Bartram, 2006). But the possibility of such things happened is minimized through adopting rolling forecast. Furthermore, as it was an ongoing process, the result of forecast seemed to be updated as any change in business environment is taken into account. For instance, price information, inflation, and change in exchange rates. Therefore, in terms of quality of information, it was more accurate and relevant for manager's need in order to make decision for future operation.

Nevertheless, under rolling forecast approach, there were possibilities that the targets set by the company in the first place, may not be achieved successfully. As a result of the frequent update, the targets might become uncertain since they could change every quarter. This will subsequently affect to the employees' motivation towards the achievement of those targets, in which they will become less committed.

4.2 Balance Scorecard

Secondly, balance scorecard is defined as a performance measurement system that identifies and reports on performance measures for each key strategic area of the business (Langfield-Smith et al., 2006). Borealis developed balance scorecard as means of communication to its employees. The main purpose is to let them understand the company's strategic objectives in return for their participation by setting their personal objectives which are related to the corporate strategy. Through the using of balance scorecard, the company is allowed to measure its performance based on key performance indicators on several divisions. Borealis was able to assess its performance focusing on certain aspects such as, value creation to shareholders, customer satisfaction, improvement of overall competitive position, and winning through integrated people. According to the theory, the balance scorecard shall reflect four perspectives, which are financial, customer, internal business process, and internal learning & growth. It can be explained in Figure 2.

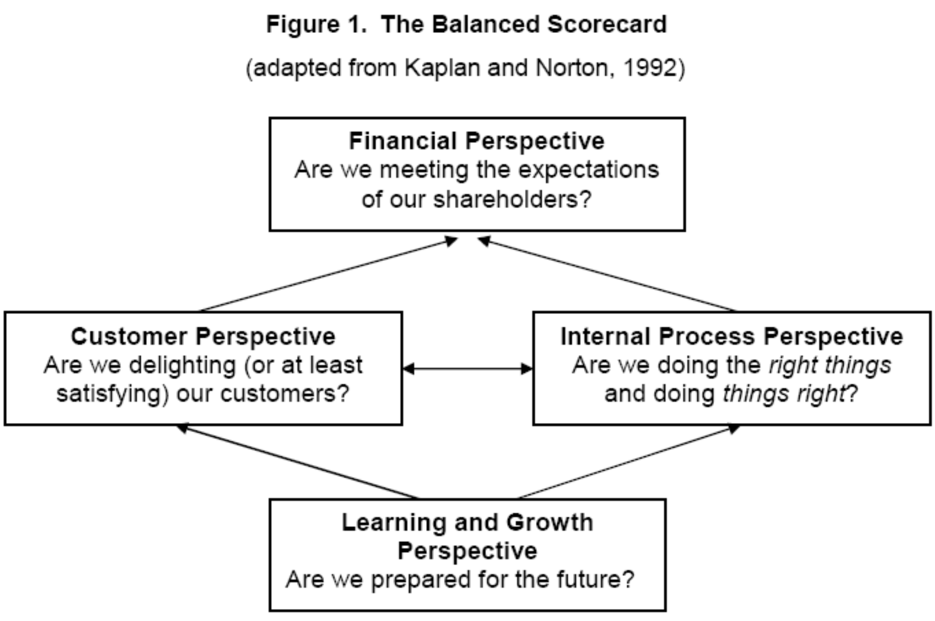

Figure 2. The Balanced Scorecard

So, all those four aspects that Borealis wished to achieve were basically reflected to these four perspectives.

Moreover, the use of balance scorecard for operational purpose seems to be advantageous to the extent that the communication between top and lowest level of management is enhanced. It provides incentives to the employees to work harder since their contribution to the attainment of objectives that they are allowed to set on their own is taken into account. Meanwhile, they are also held to be responsible for the area under their control.

However, the implementation of balance scorecard may not as easy as it looks. Especially, if the information required for evaluating performance across divisions is difficult to access, the outcome might be unreliable.

4.3 Activity-Based Cost Management

The third component of the four management tools is activity-based cost management. Nowadays, activity-based costing has been widely used through all kinds of organizations. This new approach has improved the techniques of tracing and allocating costs. As a result of implementing this tool, the whole process of the cost management will be more efficient and the outcome will be more accurate.

Before the activity-based costing system was introduced, the traditional cost-accounting system was used. In general, the traditional approach has significant negative aspects. By using that approach, it is likely that the data will be inaccurate. For example, when tracing the indirect and overhead costs, because each product may incur different proportion of these costs, so it is an inappropriate technique for company to allocate costs under the budget approach. Also when costs were traced through category and department, it is unclear to employers and managers as they were not aware that where and why do the costs incurred. So traditional budget system clearly has negative impact on the business management and which will lead to less effective decision making.

In contrast, activity-based cost management system creates a clear picture of assigning costs. After adopting the activity-cost system, costs are traced to activities. So company will now be able to allocate direct, indirect and overhead to activities more effectively. Thurs, managers and employees are able to see how the costs are incurred and which products are related.

In Borealis, before adopting the new system, the old budget process was used. According to that approach, capacity-related costs were budgeted and costs were traced at department levels. As a result, the cost information could be irrelevant due to costs could be traded inappropriate.

In order to improve performance, Borealis adopted Activity-based costing which the benefits are well established in the business operation. Activity-based cost system provides a better way to express costs and to set benchmark across plants and with other companies. So the company will be able to compare with the industries related to costs information. Moreover, rather compare costs to the budgeted amounts, now managers compare costs to an annual target and 12-month moving averages of activity-based process and product costs. So in both short and long run, Borealis will be able to review the overall trend of the costs information. Furthermore, the price and cost per unit of activity is determined based on maximal usage of capacity. Thus, based on these trends, managers will be able to identify any problems immediately and to make relevant decision more efficient.

Therefore, activity-based cost management has changed the traditional way of tracing and assigning costs. It is clear that the benefits are significant. This approach has guided businesses to a more convenient process and to receive a more accurate result in the end.

4.4 Investment Management

In place of the traditional hierarchy and centralized leadership, it enables decision-making and performance accountability to be devolved to front-line managers and creates a self-managed working environment and a culture of personal responsibility (Johnson & Brms, 2005). The key issue of investment management is decentralization.

Under this approach, Borealis separated the investment projects based on the scale to the extent that such projects cost must exceed certain limit. Managers and employees are now the decision makers on approval of any investment projects. They are also held responsible for control of their operations. Initially, the approval of a project was entirely influenced from executive board's decision (centralized control).

The strength of investment management approach allows the front line managers and employees to step up on any situations to make their own decisions in instant. They can execute the tasks independently, provided that all the criterions in a project are satisfied and they will not need to depend solely on executive board's perspective. Besides, the quality of decision may be superior to the one chosen by the board since front-line managers and employees knew the market better as they were closer to the customers. As long as the managers are taking the right projects, they are able to decide what suits best for the company. Furthermore, with the authority given, the managers will become more responsible to their decision-making process as this contributes to the overall company's performance. Hence, this could be used as a motivational tool to encourage them to work harder in order to realize the company's objectives. The higher the employees become motivated, the higher productivity achieved, which will result in a greater outcome.

However, decentralization can also cause some problems to the company. First, given the power that the managers and employees have in deciding on which project shall be taken, there might be possibilities for them to misuse it or cheating. Even if only the small investment decisions are made by the first line employees, the accumulated amount is still significant for the company. The employees can easily gain personal advantages using the given authority. For instance, they may have just decided to invest in the project that is actually run by their relatives, without even considering any other projects offered. Second, it is probably easier for the front-line managers and employees to complete their tasks by using the old system because they are more familiar with it. So maybe not all of them understand how they should make their own decisions and control them this time, since in the previous, they just need to accept what had been decided by the boards. The lack of skills and knowledge on how the investment management approaches actually works have became the main concern. Hence, the company will at least require managers with good conceptual, analysing, communication, and coordination skill, in order to take such responsibility, as this is an ongoing process, it may take some times to get them familiarized with the new system and that is what makes investment management approach seems to be costly. In addition, every decision they make is significant to the company's future operation. Thus, this approach must be carefully executed.

The six devolution-based principles can be applied to evaluate the company's decentralization process as well:

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 organization's goals.

4) Place the responsibility for value creation decisions at front line teams.

5) Make people accountable for customer outcomes.

Support open and ethical information systems that provide "one truth" throughout *the organization* (Rea, 2006).

5. Personal View on a Beyond Budgeting

If we refer to what Bogsnes had mentioned, budget was not really helpful due to its drawbacks such as inflexibility, the number crunching, and the gaming. All of those concerns were actually minimized when Beyond Budgeting approach was put into practice.

From our point of view, the Beyond Budgeting approach with four specialized management tools introduced to replace the budget might be the best possible solution for big company such as Borealis. It clearly gives better benefits than budgeting approach. With this method, it may encourage not only staff but plant workers too, to get involved in achieving the targets that their managers have set in compliance with the corporate strategies adopted. Employees will likely realize that every single task they did influences the outcome including and the whole performance of the company. Hence, they will highly contribute.

In addition, the Beyond Budgeting approach seems to keep the company informed to what is happening outside the organization and so it will remain competitive with today's business environment. As this point is related to one of its method, rolling financial forecast, where outside's information could be very useful in helping the managers to make prediction of what is the likely sales, cost, or capital, that the company will generate in the forthcoming year. Thus, managers can be more anticipated and avoid to execute any erroneous decisions that may disadvantage the company. Furthermore, we believed that this approach allows the managers to "think outside the box" that they should have not make decisions only based on "numbers on paper" but also to take into account the importance of other area outside organization such as customers.

Therefore, Beyond Budgeting concept is considered as the most effective management performance measures to the extent of giving a better and highly accurate planning and control system instead of budgeting.

However, with the introduction of Beyond Budgeting approach, employees will have to take extra time to get themselves familiarize to this new system. In a situation where only a few of them understand and know how to conduct one of the four tools introduced, the company may need to consider of hiring more people who expertise in such area. Besides, to certain organizations, the implementation of such method seems to be costly to develop and time consuming, if they do not necessarily require all the tools. For instance, the balance scorecard is less likely to be useful to improve communication in small to medium businesses. So even though the new approach is acceptable, it may not suitable in certain circumstances, just like the abandonment of budget decision.

We believe that abandonment of budget may not be suitable for all organizations since this traditional system has been implemented for quite a long time, by the majority of organizations. Most of them viewed budget as means of controlling to the extent of managers make decisions based on certain targeted figures which leads to their actual performance being compared with those targeted performance. It seems that the decision to abandon the budget is more appropriate for a larger organization rather than the smaller one. Because in smaller organization, the performance is likely compared against what it has been stated in the budget and it mostly focuses on short term. In other words, smaller companies tend to rely completely on budget. Meanwhile, in a large organization, the areas that can be compared to one another are much wider. If the decision is to discard the budget, the managers still can come out with another solution such as in Borealis' case, through benchmarking. As the organization gets more complex, every level of performance, yet financial or non-financial, are preferred to be compared against its competitors. By doing so, the organization is able to realize its strength and weaknesses that it must improve in order to succeed in the competitive market.

In other words, despite the time-consuming, out dated, and problems arose in the traditional budgeting system, it cannot be denied that budget is still needed. Although the chances for managers to game it are present, it actually assists them to facilitate the coordination of communication between divisions and to evaluate their overall performance. Eventually, the initial point where targets were set will be assessed against the final outcome and this is where budget will play its role as part of control system.

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Appendix

Appendix 1. Comparing Traditional and Beyond Budgeting Processes

Purpose of Performance management	**Traditional "Budgeting" processes**	**Beyond Budgeting Processes**
Goals-to balance the needs to maximize short- and long-term profit potential	Fixed annual targets(performance contracts)drive short-term actions	Relative and self-imposed KPI "aspirational"goals drive susutained competitive success
Rewards-to provide an effective basis for motivating and rewarding performance	Individual incentive build a "defend own turf"attitude and meet the target drives irrational behaviours	Team-based rewards build a "one-team"attitude, and peer pressure drives continuous improvement
Plans-to direct actions to maximize market opportunities.	Annual plans suppot a "make and sell"Or "company frist" approach to strategic anagement	Event-driven strategies support a "sence and respond" Or "customer-frist"approach to stratrgic management
Resources-to ensure that resource are available to support agrees actions	Certrally allocated resources inhibit fast response and encourage waste	On-demand rescources enable fast response capabilities and reduce wast
Coordiantion-to harmonize actions across the business	Centrally linked budgets provide slow, disjointed solutions that often fail to meet customer needs	Dynamic linking of customer demands provide, fast, seamless solutions that meet customer needs
Controls-to provide relavant information for strategic decision-making and controls	Financial variance that compare actuals with bugget provide a poor basis for learning	Multifceted and multi-level information systems provide patterns of information that inform strategic-makers

Appendix 2. Beyond Budgeting-Principles for Adaptive Performance Management

Process	**1. Goals**—Set aspirational goals aimed at continuous improvement, not fixed

principles	annual targets. **2. Rewards**—Reward shared success based on relative performance, not on meeting fixed annual targets. **3. Planning**—Make planning a continuous and inclusive process, not an annual event. **4. Controls**—Base controls on relative key performance indicators (KPIs) and performance trends, not variances against a plan. **5. Resources**—Make resources available as needed, not through annual budget allocations. **6. Co-ordination**—Co-ordinate cross-company interactions dynamically, not through annual planning cycles.
Leadership principles	**1. Customer**—Focus everyone on improving customer outcomes, not on meeting internal targets. **2. Accountability**—Create a network of teams accountable for results, not centralised hierarchies. **3. Performance**—Champion success as winning in the marketplace, not on meeting internal targets. **4. Freedom to act**—Give teams the freedom and capability to act, don't merely require adherence to plan **5. Governance**—Base governance on clear values and boundaries, not detailed rules and budgets. **6. Information**—Promote open and shared information; don't restrict it to those who 'need to know'.

Source: (Bunce, 2004).