CHAPTER 1

Problems with Traditional Management

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Introduction

In this chapter, we take a closer look at the many problems with traditional management, which I have only been hinting at so far. This is where we have to start. If there are no problems, why should we bother changing? Why fix something that is not broken? If we do not agree on the serious damage traditional management can cause, there is no common ground to build a new model on. There has to be a case for change.

Some of the problems with traditional management are directly linked to budgets and budgeting. Others are more indirectly linked, but often rooted in the budgeting mind-set of command and control.

Let us start with the budget. It is not the only problem, but it is a major one. Over the last 15 years, I have asked thousands of managers, in Borealis, in Statoil, and in hundreds of other companies what they think of the budgeting process. It is just like pushing a button. Everybody has a view. The response is loud and clear. The vast majority of people are critical, and many are extremely negative. The examples and stories people share vary, however, quite a lot. They typically list negative experiences within their own area of work. In sales,

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production, research, or administration, people often see quite different problems with how budgets and budgeting affect their jobs. Many see the main problem as all of the time and energy spent on budgets. Some feel it constrains them from doing the right things and a good job. Others are concerned about how meaningless the budget can be as a yardstick in performance evaluation.

Although most people are well aware of isolated symptoms, few see a bigger picture. One thing they all have in common, however, is a scary cynicism about the whole process in itself as well as the people behind it: the "bean counters" and "stupid managers" and all the other honest feedback you get in private conversations. When so many are so critical, why have more companies not radically challenged and transformed their budgeting process? Where is the revolution, when there is so much dissatisfaction boiling among the people?

I believe the main reason for lack of major change is a missing diagnosis. Many see the budget problems as an irritating itch but not as a dangerous disease. The local and often diverse problem descriptions do not easily translate into a broader and more structural problem. Although the symptoms are easily recognized, the disease is not. And even if some do sense or see the shades of a bigger budget problem, they are often unable to connect this to *other* weaknesses in the management model, such as a deep and hierarchical organization structure, lack of transparency, or a culture of fear and submission.

Some companies, however, see patterns and realize that something more serious is wrong. For these companies, the barrier to change might be the lack of an alternative. Leaving old and well-tested practices, including abolishing the budget, is considered an unthinkable paradigm shift. "Of course we know that much of what we do isn't very smart or doesn't work very well, but what should we do instead?" they wonder. Beyond Budgeting answers that question. The concept provides not just

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a comprehensive diagnosis but also advice on how to cure the serious disease that so many organizations are suffering from.

Our blind faith in traditional management is holding us back. It is time to challenge these myths that have dominated management thinking and driven management practices for far too long. These myths are firm beliefs like:

- No centralized control = Chaos and anarchy
- Good performance = Hitting the budget numbers
- No budget = Cost explosion
- No individual bonus = No performance
- More details = More quality
- Need to know = Enough to know
- I can explain = I have control

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You might hesitate to buy into this massive attack on traditional management and budgets without any supporting evidence. If you are skeptical, I hope we at least can agree that any process should from time to time be reviewed and pressure-tested. There is always a better way. It is wise to have a regular medical checkup even if you do not feel sick. So if your guard is up right now, please let it down during the next pages, while we examine more in depth whether we have a problem or not. I promise to provide hard evidence.

Which Way in a New Business Environment?

What is it that really drives good performance in organizations? What is it that makes people get up in the morning, go to work, wanting to do their best? How do we get the best possible results? How do we sense and respond faster than the competition? How do we release creativity and innovation? Why should people work for us and not someone else?

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These kinds of questions have probably been asked from the very early days of organizations and leadership. The *questions* are the same. It is the *answers* that have changed. The old answers were quite simple, and included strong doses of hierarchical command and control. Many of these answers probably did work well in the past. But the business world has changed radically since the days of Taylor, T Fords, and Threat management.

Across almost all businesses, the operating environment has become radically more dynamic, unpredictable, and turbulent. In addition, the performance expectations from customers, shareholders, and other stakeholders have also increased dramatically. So has the transparency of business. There are few places to hide anymore. Both the *need* for and the *expectations* for outstanding performance have never been higher.

It is almost as if we have been through a "global warming" of the entire business climate. The "climate changes" are faster, more unpredictable, and more violent than in those reliable and quiet summers and winters we recall from our happy childhoods. Just look at the volatility of oil prices. Many businesses, not just oil companies, have oil price as a key variable in their business performance. We try to make short- and long-term projections, and we all fail miserably. We simply do not know anymore. Look at the pace of technological innovation. Making a five-year business plan for a record company today must be a nightmare compared to the good old days before new digital formats and downloading. And why should it stop here?

The real global warming still has its skeptics, but no one seems to dispute this one. The evidence of change is everywhere. We are almost overwhelmed with uncertainty. The only thing that has become *more* certain is that our predictions about what lies ahead most likely are wrong. The future has become less "plannable." Whether we like it or not, "the future ain't what

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it used to be," as the American baseball player Yogi Berra once put it.

At the same time, life *inside* organizations has also changed dramatically. The massive difference between market value and book value in companies might be the most tangible proof that something has happened. The value of human capital, innovation, creativity, and people's desire to contribute and make a difference is often the only value that exists, and it can walk out the door any day. Actually it does, every afternoon, often becoming even more valuable because people then reveal additional talents. Employees do not see themselves as "workers" in such organizations, and they cannot be managed as "workers." They have different and higher expectations than earlier generations. Traditional management struggles when people regard leadership as something that must be earned and not assigned through stars and stripes.

As Gary Hamel says in his great book, *The Future of Management*, traditional management was invented to ensure an effective *replication*, from T Fords to Pentium chips. Today, it seems to have lost even that hegemony. Toyota now churns out cars faster and better than any other manufacturer in the world, because it did not adopt everything coming from the West after World War II. The company seems to lead and operate in a way the competition apparently is not. At Toyota, anyone working on the production line has the authority to make the very costly decision to stop the line if necessary. Likely this occurs very seldom, but simply *knowing* that you have the authority does something to how you feel about your job and your company.

At Semco, a Brazilian company that seems to have challenged every single myth of traditional management, all employees have the right to attend any meeting (with a few exceptions). They do not, but they know they can. I read *Maverick* 20 years ago, the first book by their CEO, Ricardo Semler. His

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story made a deep impression on me, and both his books are highly recommended.

These are examples of practices that one by one should be quite easy to copy. At both Toyota and Semco, these and many other practices seem together to form a holistic alternative to traditional management that is much more difficult to copy. Western car manufacturers have been studying and benchmarking Toyota for decades, and they are still scratching their heads. Perhaps one reason is that the old management mind-set still is so strong that they have not even attempted to replace it, so they end up with a bit of Japanese wisdom on top of and not instead of the good old way. As we discuss later, there is no simpler and more painless way to change than to add instead of replace. The only problem is that you get very little change.

If we agree that today there exists a radically new business climate, where the winds and waves are hammering the boat more viciously than ever, where expectations for sailing faster and for finding new routes and new land are increasing by the day, and where everyone in the crew expects to have a hand on the rudder and an eye on the map, then it should not be difficult to agree that there must be consequences. Whether we are in oil, cars, music, or any other business, this new climate must have *some* kind of implications for how we lead and manage. In such radically different circumstances, we cannot just keep sailing as before. The issue cannot be *if* a change is needed, but *which* change. In which direction, and how big?

Companies are not deaf and blind. Most do respond, but in very different ways. Some go for a fine-tuning only of their management processes. This typically means no real change at all, just a bit of singing and dancing: hiring consultants to help introduce some of the latest music in the charts, simplifying the budget process by asking for a little bit less than last year, in addition to the inevitable reshuffling of the organizational chart. Others are more serious and might already have

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tried some of the medicine mentioned. They believe the answer lies in "much more of what we already do." Their response is to pull harder and tougher on existing management levers. They go for longer budget processes, more analysis, more number-crunching, tougher budget interventions and instructions from above, with more negotiations and gaming, tighter budget follow-up, and higher bonuses for achieving budget targets. The strategy is simple: more of the old answers, more micromanagement and command and control in order to get back into the "control" they had or thought they had in the past.

This is a tempting strategy for many. It also represents a major paradox. The more uncertainty and turbulence and the more urgent need there is to break with the past and go for radical change, the stronger the fear of letting go and leaving what is perceived as a safe and calm harbor in stormy weather, namely those familiar and well-tested management practices, including the good old budget.

Not everybody responds like this. A small but growing group of companies realize that the answer neither lies in fine-tuning nor in radically increasing the doses of current medication. They realize that the disease requires a radically different lifestyle. They believe in moving in the *opposite* direction. They believe that in this new business climate, teams and people need *more* and not less room to move. They trust their people to make the right decisions when the hurricane hits or when they face any other unexpected situation that seldom can be foreseen in a budget made a year and a half earlier. They understand that business is continuous, with individual rhythms that seldom match the calendar year. They understand the need for a broader and more intelligent performance language. They appreciate that not all wisdom sits at the top. These companies understand that their leadership must be built *on* and not *against* human nature. They question every single myth in traditional management.

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In the sections that follow, I explain which problems these companies have identified and understood and why they are rebelling. These problems include:

- Trust
- Cost management
- Target setting and evaluation
- Bonus
- Rhythm
- Quality
- Efficiency

The Trust Problem

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Companies going in that opposite direction all have *trust* as a key ingredient in their leadership philosophy and their performance management process. Trust is perhaps the most important word in the Beyond Budgeting vocabulary. No one should consider leaving existing practices before being clear about where they stand on this one.

Where do you stand?

Do you believe that without tight control and short leashes, detailed budgets and sharp instructions, the organization will drift into anarchy where people will do all kinds of stupid things and spend money like drunken sailors? If that is your belief, you have a *really* serious problem, but probably not with your organization. If you hardly trust anyone and believe you are the only responsible person around, then maybe your problem rests much more with yourself than with anyone else.

Few would admit to thinking like this. Actually, I believe most managers do trust most of their people. So the starting point is the right one, and also the only one you can have. But what happens with this trust when we move from what we say

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to what we actually *practice* in our performance management processes? Then trust has a tendency to disappear, only to be replaced with a very different word. That word is *control.*

It is quite a paradox how "western" business leaders praise democracy as the obvious and undisputable model for how to organize a society effectively. When the same leaders turn to their own companies, then their beliefs and inspiration seem to come from a very different place, from the very opposite ideologies. Traditional management has more in common with old Soviet Union–style centralized planning and control than with the principles and beliefs of a true democracy. In democratic societies, we take for granted that we elect our own leaders, that everybody has a voice, that discussion and disagreement drives us forward, that information is open and free-flowing, and that big decisions are taken in referendums. We smile about the hopeless socialist idea of making centralized and detailed five-year plans instead of letting the market sort it out. It is a no-brainer that there cannot be a monopoly but a choice of capital sources open all year to fund new ideas and start-ups. This is what we preach and practice as members of a free society.

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But what happens when we put that other hat on? When we go to work and become managers or employees in companies, none of this seems so obvious anymore. We seem to surrender at the company gates all the trust and freedom we take for granted as citizens. The trust that managers have and people expect evaporates like hot summer rain when the scene changes from society to company. And worse, we hardly seem to question it.

Why does this happen? Why do employees surrender so easily what they take for granted as citizens? Many seem to be on autopilot, stuck in the same traditional management patterns as their bosses. Maybe some do not quite like it, but they accept it as the way things always have been. In many societies, democracy has a short history. The old regimes had perhaps

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less of this paradox, because the situation was very much the same on both sides of the company gates.

All of this is changing, and not only in political systems around the world. Young people who question the old ways vote with their feet as they are drawn toward companies that dare to challenge the past, that want to tear down that Berlin Wall between democracy and company principles.

What about the managers? They are also stuck in tradition and old habits. Many of them have built their careers on mastering traditional management. They actually might be in their current positions because they are very good at this way of managing. They also get support for sticking to old beliefs from the behavior of *some* people in the organization. Any organization has people who are either too smart or too immature to deserve or handle trust and freedom. You have them in your organization too. I am sure you can even name a few. Although we know they are few, and even if we do trust the large majority of people in the organization, far too often we let this small minority drive our leadership thinking and the design of our performance management models. We give people tight mandates and detailed budgets that are nothing but straitjackets. We issue instructions clearly aimed at the few but knowing they will apply to everyone. We do so because there might be *someone* who cannot be trusted. The strategy seems to be preventive control on everybody instead of damage control on those few.

It cannot be this way. If we trust most of our people, that big majority must be the design platform for our models rather than the small minority. At the same time, we shall not be naive. The minority is a reality that we must face and not ignore. We must be crystal clear on our values and performance standards. We need mechanisms that can reveal unacceptable behaviors and help catch these guys, and we must act decisively when trust is misused. And I mean *when*, not *if*, because it will happen.

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Our reaction must, however, *not* be a retreat back to the old way because "Trust does not work." The pressure will come, from the theory X supporters and all those longing back to the simpler days of command and control: "What did we say? We warned you! This trust thing will never work!" Do not let them push you. Deal swiftly with incidents, but do not let them drive you back. Exceptions must not be generalized. In a democracy, we do not lock up all potential criminals because someone some day might do something wrong. But we have clear boundaries, and crossing the line has consequences.

If the entire management model reeks of mistrust and control mechanisms against unwanted behavior, the result might actually be more, not less, of what we try to prevent. The more people are treated as criminals, the more we risk that they will behave as such.

If you still insist on a mistrust-based control approach, you are moving into a war with no end. People will always find ways of cheating if they really want to. Their motivation will be fueled by your behavior and your controls, and vice versa. It is a vicious circle and a lose-lose game.

In both Borealis and Statoil, the skeptics asked us again and again: What will prevent people from uncontrolled spending if we drop the budgets? Can we really trust these guys to manage their own costs? It was their concern number one, two, and three. But what kind of people were we actually talking about? It was people we trusted with building or working on million- and billion-dollar machines: crackers, pipelines, offshore platforms, oil refineries. It was people we trusted with trading crude oil or handling currency exposures for millions every single day. But manage their own travel costs? Are you kidding?

A good friend of mine is a pilot and captain with a large international airline. Despite the huge responsibility he is entrusted with, both people's lives and expensive airplanes, he still needs a written approval if he wants to change his uniform

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shirt more frequently than what is stated in the uniform procedures.

If we cannot trust these guys on the small things, how can we really trust them on the big things? Could it be that we are more concerned about what we understand (such as travel costs or shirt cleaning) than about what most of us understand less of (such as running a refinery or flying an airplane)? Many of these line managers have other financial targets on top of cost budgets—for instance, profitability or unit cost targets. Under these targets, they cannot spend more unless they produce more or sell more. But this self-regulating mechanism is obviously not sufficient; we also have to micromanage. No wonder there is a lot of cynicism around.

The less managers trust others, the more they may think about themselves and their own capabilities or heightened self-esteems. Often these same managers are the ones who cannot make a decision without calling in armies of management consultants because they do not trust their own judgment. These same managers litter their language and communication with buzzwords and the latest management jargon because they do not trust the power of their own plain English.

Lack of trust often goes hand in hand with lack of transparency. If you do not trust people, it is logical to also restrict the information they have access to. “Nice to know” is of course far too much access. Need to know, as defined at the top, is seen as more than enough. Traditional management offers several effective ways of restricting information. The organizational hierarchy is one favorite. The deeper the better, and even better if there are no horizontal leaks over to neighboring structures as selected information is passed down the chain of command, filtered as necessary at each level.

Then we have our performance management systems, which sometimes come with more filters than some governments have available for blocking undesirable Web sites. Instead

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of believing that everything should be open, and closed only where strictly needed, it is often the other way around. Another internal information channel, the company intranet, also has a certain Orwellian atmosphere in many companies, trying to give us that "Shiny Happy People" feeling. Many company home pages would benefit greatly both in trustworthiness and usefulness by turning down somewhat the one-way aren't-we-great messages. Instead, we need much more employee-driven discussions and information exchange. Why are there, for instance, so few internal company blogs when the external world is full of them? We need more two-way communication, sharing constructive challenge and dialogue on all the work-related issues that people want to discuss and improve. But there seems to be a fear among senior managers (and among communication people) of people speaking up, of critical viewpoints that might fit badly with the image companies try to paint of themselves. The parallel is found in totalitarian regimes more than in those democracies we want to be our models.

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So far, we seem to have used technology mainly to *automate* our traditional internal communication. Instead, we need to change it into something that perhaps is not more radical than what people meet when they walk out the company gates and log into cyberspace on their company-sponsored home PCs.

There is actually a major paradox here. Traditional management fears transparency because it threatens control. But as Jeremy Hope, cofounder of the Beyond Budgeting Round Table, puts it, "Transparency *is* the new control system." There is a reason why thieves and crooks prefer to operate at night. Maybe Enron would have been in existence today if there had been more transparency. When everybody can see what everybody spends and how everybody performs, it does something no formal control system is able to deliver.

It is easier to talk about trust than to practice it. Some of you might not even want to go close to what is recommended

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here, because you are too uncomfortable with the implications, or maybe because you simply disagree. But do you actually have a choice? Think about "global warming," the speed of change, and all the uncertainty surrounding us. The enlightened emperor making all decisions on behalf of the common people in the dark is not just old-fashioned thinking; it is simply not possible anymore. Whether you like it or not, you have to let go in more and more management arenas where you used to be king of the road. You have to take the backseat more often and let the front-line people read the maps; find the quickest route; and do the driving, turning, speeding, and braking. But do not worry; there is more than enough left for you to do in the backseat, including setting direction, coaching, motivating, and assisting when needed. Just do not become a backseat driver!

I love my parents. They have always trusted me, even when I did not deserve it. In their generation, there seldom was more than one driver's license in the family. Driving was a man's job. It would not have been easy for my father, or any other man of that generation, to let go if my mother had gotten a license as well. I do not think he was too comfortable the few times I did the driving either, even if he never said so. But those were different days. Today, almost everybody can drive. You do not have to do all the driving yourself. Lean back, trust the driver, and *lead* instead!

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The Cost Management Problem

The most stubborn myth in traditional management is probably that the only way to manage cost is through detailed cost budgets, with a tight follow-up to ensure that no more is spent than is handed out. Without such tight controls, money will be wasted and costs will explode.

The cost management problem is not the most serious one, but I have chosen to address it early. The consequences of removing cost budgets is what worries managers the most when they cautiously ask themselves "Could this work in our company?" or firmly concluding "This would never work in our company! We can't let things completely loose. Maybe budgets lead to suboptimal behaviors, but isn't that a price worth paying for keeping costs under control? Our people are not mature enough for this!" It is the *trust* problem again, as we discussed in the previous section. But beyond the trust issue, there are also a number of *other* reasons why traditional budgets are no longer the most effective way of securing an efficient use of resources. Let us take a look at these.

A cost budget is a kind of *ceiling* we put on cost: "This is how much you can spend and no more." In most companies, this ceiling seems to work quite well. It is simple to communicate and easy to track. Tight follow-up combined with a surprisingly high level of budget loyalty, given all the cynicism, typically results in actual cost coming in around budget, year after year. Great performance! What is the problem? The ceiling works, we do not spend more than decided. We have costs under control, have we not?

Yes, we have, if this is how we define control, if the goal is to spend no more than decided 15 to 16 months ago. But is this really what we aim for? Are we not after an *efficient* and *value-creating* use of resources, even if that should cost somewhat more or somewhat less than decided last year?

Let us take a look at what actually takes place here. We forget that the ceiling also works just as well and often better as a *floor* for the same costs. Cost budgets tend to be spent, even when the initial budget assumptions change (which they almost always do). Managers do not necessarily behave like this to cheat; they do it because the system encourages them to do so. Managers see budgets as *entitlements*, as bags of money

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handed out at the beginning of the year. Nobody gets fired for spending their budget. Spending too much is, of course, bad, but spending too little is not good either. Why did you ask for more money than you really needed? It is not very smart either, if you want to protect next year's budget.

When a bag of budget money is handed out each autumn, an artificial border of concern is created. As long as we are well within budget, we spend "our" money with a good conscience and few concerns. Why should we not? We got that bag from someone who is supposed to be a wise and competent person, our manager at the next higher level, did we not?

When we finally start to see the bottom of the bag, the concern starts to creep in. Now we finally start asking ourselves: "Should we really do this? Is this wise use of money?" These questions, which seldom are heard in January, are far too important to be asked in November and December only. They need to be asked all the time, from the first penny spent.

Another problem is that not only *one* bag is handed out. We are talking about huge mountains of bags. Each department gets its own, with a lot of smaller bags inside, "because we cannot just give you one big bag of money!" These smaller bags are labeled salary, overtime, travel, consultants, and so on, which then are split into even smaller monthly bags. There is actually some trust involved, because this last part we are sometimes allowed to do ourselves.

We end up with a budget close to or sometimes even equal to the accounting detail level (same accounts, cost centers, periods, etc.). Even in smaller companies with a few hundred cost centers and around 30 to 40 budgeted cost accounts, thousands of bags are handed out each year. In bigger companies, the number probably is hundreds of thousands. Fortunately, no physical packaging is required; otherwise the environmental impact would be a disaster. There is also a lot of work involved in

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negotiating what we believe is the right size on all of these bags every year. But if there are no surprises, no new opportunities, and no change in assumptions ahead, the problem could have stopped here. But it does not.

Combine this detailed allocation of money with the "global warming" and all the uncertainty about what lies around the next corner. How do we know, up to a year and a half in advance, exactly what the right and optimal cost level should be? Not just the right total amount, but also exactly how much to put into each of all those bags? What kind of insight into the future do we think we have?

"But I can just reallocate between the bags if things happen," you might say. Well, you are half right. You can give people more money, but just try to do the opposite: try to *reduce* the budget for someone during the year. You will be met with a thousand arguments for why this cannot be done, and what kind of disasters will happen if you try. It is the entitlement effect: "It is my money!"

The budget might be detailed and it might tie people's hands and feet, but at least it helps us to manage the cost pressure boiling in the organization, right? Well, really? What happens during the autumn budget negotiations? As the budget approving manager, you are presented with a long list of great new activities and projects. All of them are so good that you feel like a Californian Terminator once you start challenging or cutting. What you do not get, however, is that other list, the one of finalized activities and projects that would have pulled the need for resources in the opposite direction. And then there is inflation and contingencies. When the year starts, it does not take long before the first application for additional funds comes in, backed by convincing arguments and a strong business case. But do we ever see the opposite take place during the year, managers knocking on your door wanting to give money back

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because you gave them too much? The number of budget reductions and increases during the year should over time balance. In practice, it is a one-way exercise.

As the budget-approving manager, this is a game you are bound to lose. You will always have less information than the unit itself about the real need for resources, status on ongoing activities and projects, and quality of new projects. "But I am the boss," you might say. "I can just cut the crap and decide on their budget for next year." Yes, you can. But do not forget the "global warming." With all that uncertainty, and with less knowledge of the business than the unit itself, how do *you* know what the right number is? You can just add a percentage for inflation, you say. Yes, you can, and so can a monkey.

To make sure that money is spent from the right bag, there is also the detailed monthly follow-up of actual costs against the year-to-date budget (the one we were trusted to make ourselves). Deviations are spotted with accounting accuracy. Never mind the fact that our monthly reference point becomes more and more obsolete and irrelevant as months go by, assumptions change, and the real world moves on. We calculate and analyze, and then another budget myth kicks in. *We can explain*. We know where the deviations are, and even why. We have control. Mission complete!

The word "cost" is also interesting. "Cost" is an accounting term for how a financial transaction should be classified and treated. Cost is something negative; it is something we must deduct from our revenues. It reduces our results. For *internal* performance management purposes, we should, however, distinguish between two types of costs: *good* costs and *bad* costs. Good costs are actually investments, which accounting rules require us to classify as costs. You spend money but you get more back. As long as we have the financial and organizational capacity, good costs are something we want more of, because they create value. It is the bad costs we want to get rid of,

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because they are less generous; they destroy value by giving less back than we put in.

This brings us to another major weakness with traditional cost budgeting: The focus is typically on what we put in, not on what we get back. It is a myopic way of managing costs. Take variable production cost. What is more interesting, how much we spend in total, or how much we spend per unit? Is it bad to spend more if we produce more? Would we not expect less cost if we produce less? Unit cost says much more about efficiency and performance because it addresses both sides of the equation, both input and output.

Another mantra is *low* costs. We want costs as low as possible. Cutting budgets is the way to achieve just that. But what we want is not necessarily the *lowest* possible cost level. What we want is the *optimal* cost level, the one that maximizes value creation. How do we know what that optimal level is? Of course it is difficult to find. But turn it around. How do we know what the right *lowest* cost level is? Is it zero? Is it half of current level? Two-thirds? It is just as difficult to find the right lowest cost level as it is to find the right optimal one. But let us at least agree that it is the optimal cost level we are after and that it is bad costs we want to get rid of.

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Let us move to a slightly different resource issue. Our planning and resource allocation processes are based on the assumption that *financial capital* is the major constraint. We have established a common and well-understood language for reporting on and managing this scarce resource, and we are able to classify actual or planned spending down to the last penny. When new projects are evaluated and prioritized against expected financial capacity, we are able to describe in detail how we think these will draw on and later contribute to our financial resources.

In an increasing number of businesses, however, financial capital is no longer the main constraint or the main asset.

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Human capital gradually is taking this role. Our planning and resource allocation processes struggle with this shift. Finance has spent decades perfecting the financial language, through common charts of accounts; international financial reporting standards; and systems for data capture, reporting, and audit. Human resources (HR), however, is still in the very early days of trying to do something similar with human capital. We do not even have a common vocabulary for describing this kind of capital, and no systems and processes to collect such information. Our records might tell us how many employees we have, their ages, education, and job history. But this is a pretty thin language for describing our most important asset. What do we really know about people's competence, about their skills and knowledge? How can we talk about filling competence gaps when we hardly know what we have and struggle with describing what we need? In budgets and business plans, this key resource is reduced to a headcount only, and often we struggle even to get that counting right.

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Some companies are trying to establish common competence languages. The intention is good, but the result is often a range of languages, with limited possibility for a meaningful communication internally or with external stakeholders. Just imagine if the outside world had to relate to companies that all described their financial situation differently, through local languages developed in-house, without any common, agreed, and audited way of sharing the information.

This is an area where finance can help. The purpose is not to reduce competence mapping to a detailed and mechanical accounting exercise, but some structure and rigor is needed. Some of the principles applied on the finance side are highly relevant and could be adopted by HR.

Let us return to the cost management issue and address questions many of you probably have been jumping in your chairs to ask during these pages: "What if you are in a business

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where margins are counted in fractions of a cent? What if the financial situation is so bad that tight cost management is a question of life or death? It is easy to abolish budgets in an oil company drowning in cash!" Well, actually we are not swimming in money. The recent cost increases on drilling rigs, steel, engineering, and almost all other elements in our cost base does not leave much of the oil price increase in our pockets. In addition, governments across the world have increased oil company taxation. But that is another story. The question is still relevant and deserves an answer.

Borealis was by no means a "rich" company. Red numbers were no stranger to us, and tight and constantly falling margins were the name of the game. Still, all the problems with traditional cost budgets that I just have discussed were highly relevant also in such a business. The cost budget was just as much a floor as a ceiling. The concern questions were asked too late in the year, even if they sometimes came already in September. We spent far too much time first on negotiations and later on follow up and explanations. All these problems were actually even more serious because we lived on such thin margins. Doing away with cost budgets did not mean less cost focus and fewer cost discussions. On the contrary, we probably had many more. But those discussions were much better and more relevant than the old budget discussions, and we had them all the time, not just once a year. It absolutely made sense to drop the budget, and it worked. Costs did not explode in Borealis, in fact they came down. This surprised even me, as I will discuss in more detail later.

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But what if the situation is even more serious? Well, if I was running a company close to bankruptcy where you have to turn every penny every day, the last thing I would have done was to lock my spending for the next 12 months in a fixed and detailed cost budget.

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Beyond Budgeting is *not* about ignoring the need for good cost management. On the contrary, a key objective is *better* cost management than what traditional budgets are able to deliver in today's business environment. In both the Borealis and Statoil cases I promise a lot of practical and hands-on advice on how to manage costs without budgets.

The Target-Setting and Evaluation Problem

Quality in performance evaluation starts with quality in target setting. Good targets are the foundation of any meaningful performance evaluation, and the two must therefore be addressed together. But even if we should get the target setting right, we often fail when we reach the performance evaluation. The classic mistake is to abdicate the right to apply any kind of assessment or common sense in the evaluation phase. We tie ourselves to the mast and leave it all to the numbers, reading the meter only, actual versus target. But no target is perfect and bulletproof. Unforeseen things happen and assumptions change. Blindly ignoring such realities does not make sense; changes must somehow be taken into account. The way targets are delivered is not irrelevant either. We therefore need a broader and more intelligent performance language than what the old language of "within budget" or "green key performance indicator" (KPI) represents. We discuss this topic in more detail at the end of this chapter.

Back to target setting and why we so often get it wrong here. A "budget" target is a predefined absolute number, a cost number, an income number, a production or market share number. The problem with such targets is their often narrow and misleading way of describing performance. Is it always good performance to hit the budget number? What if great value-creating opportunities were turned down because job number one was

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no budget overrun? Should we celebrate a project finished on cost and time, if quality took the backseat? What if value-adding scope changes were dropped because they would have meant cost or time overruns? Should we call for champagne when we hit the market share target, if two competitors unexpectedly went out of business and we had the market almost to ourselves?

Of course performance is about continuous improvement and about delivering on promises (defined the right way). But at the end of the day, performance is about outperforming peers; about being better than those you naturally can compare yourself with, inside or outside the company. No football team would define its main targets for the next season as scoring 45 goals or winning 50 points. (I am talking "European football" here!) In sports, it is all about beating the competition. Before the season, ambitions and targets set are about holding the fort or climbing in the league standings (or league tables as we would say in Europe). When measuring performance under way, it is very much about current position and trend on the same table. And when looking back at the end of the season in celebration or despair, it is all about where the team finally ended up. We should bring this sports thinking with us into our business lives. We should not blindly copy, but we should use more of it than we do today.

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Although this is meant to be a "problem" chapter, let me also say a few words about possible solutions, because relative performance thinking is an important part of all the cases you will hear about later.

Benchmarking is nothing new in business. It has, however, mostly been used for sharing best practices, for learning and improving. That is a great purpose and something we absolutely shall continue doing. Yet there is an untapped potential in also using benchmarking more directly for *measuring and driving* performance, as a replacement for absolute targets, which

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typically get this job. These absolute targets tend to exist in parallel with the gentler best practice benchmarks, which is mainly conducted for learning purposes. We can do the learning purpose a big favor by lifting those benchmark tables into the strong spotlight that performance measurement enjoys in companies. There are important synergies in combining the two, because they reinforce each other.

League standings, internal or external, must of course consist of comparable teams that can learn from each other. League standings must also be based on relevant and meaningful performance metrics. Percentage ball possession or number of corners would not go down well as counting mechanisms in football. It is always debatable whether scoring more goals than the other team tells us who actually played best, but in this sport, it is agreed and accepted that this is how matches are won, 100% fair or not.

Beyond being a transparent performance measure, the league standing concept offers another major advantage. We can eliminate much of the target negotiation and the need for imposing targets from the top. This is important, because targets from above are never as motivating as those you set for yourself, based on external inspirations or on constructive challenges from above. The dilemma has been whether the sum of locally set targets will be ambitious enough when added together on a company level. But show me a manager or a team who is comfortable with lagging behind colleagues or competitors. How many will proudly declare "Below average is just fine with us"? This way of addressing performance reaches and pulls strings in teams and people that remain untouched in a traditional budget and target negotiation, where "everybody is negotiating to get the lowest number," as Jack Welch of General Electric put it.

Benchmarking is very much a *self-regulating* system, utilizing positive peer pressure to drive performance. It can

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simplify target setting drastically by setting such evergreen targets as "advancing in the standings," "being above average," and the like. It may even *remove* the need for targets. The purpose of a target is to get people to stretch and perform as well as they can. That is what a football team does, even if no specific league position is targeted. Again, nobody wants to be a laggard or to fall behind.

One of the less inspiring tasks in our company is monthly time recording. It is not a control mechanism but part of standard cost allocation mechanisms in the industry. It is easy to slip behind on this kind of duty. Some time ago the company issued benchmark data on missing hours across corporate staff units. There were no complaints, no order to improve, just the data. It did not take more than a month or two before a remarkable improvement had taken place in our time recording discipline.

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There is, however, a possible and very serious negative side effect we must watch out for. As I just discussed, the purpose of comparing performance should not only be to get units to compete with each other. It is just as important that benchmarking stimulate sharing and learning from each other so that we lift the performance of the whole company. You want those sinking or those at the bottom to call those at the top and ask: "What are you guys doing so well that we obviously aren't?" But why should those at the top respond, when the caller ID shows that the laggard is calling again? It is nice to be up there among the best. Why would anyone want to undermine his or her own position by helping others lower in the standings?

This leads us to another key Beyond Budgeting issue, namely individual bonuses. Such bonuses discourage phones from being picked up. I have totally lost my belief in these types of bonus systems. A *collective* bonus is different, when, for instance, it is based on overall company performance against competition. That gives those on top a very good reason to pick

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up the phone or even start calling those below. We discuss this important topic in depth in the next section.

Relative targets can be very powerful, whether they are about connecting costs with output and deliveries or about comparing with others, or both. Yet it can be difficult to find relative performance indicators in all areas. We normally end up with at least some targets in the "absolute number" category, such as production, sales, cost, or market share. How do we evaluate performance against such targets, when the real world blows our assumptions to pieces like fragile palm trees in a tropical hurricane?

Just as we struggle with allocating cost budgets in an optimal way, we seldom have the insight of knowing *up front* which exact sales, production, or bottom-line number represents good performance and which does not. Of course we can have a view on what performance level we believe is required and what we aim to deliver, given certain assumptions. But what we really want is the best possible performance. Knowing up front exactly which absolute number this represents is seldom possible, unless we have been given some kind of divine insight into the future.

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The answer lies in escaping the *mechanical evaluation* trap. When we evaluate performance against absolute targets, we must do more than just read the meter. We must *pressure test* the measured performance delivered. We need a quality assurance before we can conclude what kind of performance the actual outcome represents. There is so much relevant hindsight information available that is not there at target-setting time. Shall we, for instance, completely ignore the fact that someone had a massive tailwind that secured target delivery, while someone else had the opposite? Or that someone seriously violated company values in a blind chase for target delivery?

This kind of holistic hindsight evaluation must also be applied to relative targets. We will seldom or probably never

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find "perfect" metrics on which to build comparisons and league standings. Even a league standings position does not always reveal the full picture of the underlying performance.

What we talk about here is breaking the fixed and mechanical link between targets and performance evaluation. We can achieve this by using directional or relative targets where possible, but *always* combined with a holistic assessment where we appreciate and do not ignore hindsight information. Many people find this type of analysis more difficult than the mechanical way. It is more difficult, because it takes more leadership. The leader is hardly needed in the mechanical evaluation. A finance guy and a spreadsheet can do the job. I believe in simplicity, but not in this case. Leadership is not meant to be simple.

Let us close with a few final reflections on target setting. The first is about the SMART principles. These state that targets should be *s*pecific, *m*easurable, *a*chievable, *r*elevant, and *t*ime bound. It is a good test, but it easily can be misused in the hunt for the perfect target. Consider an example of a market share target. Should we set the target as % number or as a league standings position? Applying the SMART principles, the answer seems clear. There is no doubt that 17.2% is a more *specific*, or precise, target than "minimum number 2." But which one says more about performance? Is 20% great performance if those two competitors unexpectedly went out of business, and we could easily have been well above 25%? Precision does not always equal quality. The more accounting oriented we are in our performance thinking, the more we tend to emphasize precision and sacrifice relevance.

Target discussions are very often about data and numbers. Let us not forget that a target or a goal also can be expressed in *words*. A well-formulated goal or strategic objective can often motivate and drive performance better than cold numbers. The power of words should not be underestimated. Many people are more inspired by engaging and directional messages than by

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hard numbers. It is relevance versus precision again. We must, however, be careful with the detail level when we formulate "word" goals. Very specific and action-oriented ones can easily become the kind of straitjackets that budgets often are.

I can almost hear the reaction from some of my finance colleagues. "How on earth can we measure against something like that? It is only words!" Well, if that is what inspires people to do their best, what is most important: to get good performance, or to be able to measure exactly? Finance people should remember Albert Einstein's wise words: "Not everything that counts can be counted, and not everything that can be counted counts."

I recommend using the SMART principles with caution. Here is some advice to ensure that these principles actually help, not hinder, us in target setting.

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- **S**pecific—but not a straitjacket
- **M**easurable—but do not forget words
- **A**chievable—but do not forget Aristotle
- **R**elevant—do not forget strategy and what we aim for
- **T**ime bound—do not leave it all for year-end

You will hear more about Aristotle later, who said: "Our problem is not that we aim too high and miss, but that we aim too low and hit."

The Bonus Problem

When I am presenting Beyond Budgeting in Europe, the first question I normally get is how costs can be managed without a budget. In the United States, the first question is often "What will drive my bonus if there is no budget?"

The smallest problem with individual bonuses is that they often are tied to delivery of budget numbers. Why this is not

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very smart has to do with how bad budget numbers often function as targets, as we discussed earlier. The other and much more serious problem with bonuses is their negative effect on motivation and performance, which this section is about.

I have already stated my position: I have totally lost my belief in individual bonus systems. I am convinced they do much more harm than good. But I have to admit I was once a believer. In my HR career, I was involved in both design and implementation of such systems. My skepticism has grown over time, and today my faith in them is gone. Again and again I have seen how not only do they fail to deliver what they promise, but also how much unintended damage they can cause. There are few areas with a bigger gap between what research says and what business does. Fifty years of studies almost unanimously discounts individual bonuses as an effective way of motivating and driving performance. Despite this, bonuses are alive and kicking; in fact, the trend is toward more bonuses, not less. But something is wrong. Satisfaction with the results cannot be what causes companies to change their bonus system, on average, every second year.

My views on this topic are rooted not only in the overwhelming number of supporting research conclusions. I have been on different individual bonus schemes myself since 1995. I know what makes me tick and what does not, and I do not think I am that different from most other people. At least that is what I hear when discussing with colleagues who are participating in the same bonus system. We all appreciate the money, but that is not what drives us.

Even if HR owns and operates this process in most companies, the economic theory that finance people (and most managers) subscribe to is where the problem starts. The assumption that has underpinned economic theory for a long time is the view of the human being as the rational, economic individual. Decisions and behavior are felt to be driven solely by

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optimization of one's own well-being and benefits, expressed and measured where possible in financial terms. The consequence of this assumption is that an employer-employee relationship becomes a "principal-agent" contract, where the main focus for both parties is to maximize one's own benefit. There is an assumed conflict of interest between the two, and the relation is reduced to a commercial transaction regulated in a detailed "performance contract" with an exchange of performance for money. If this is where we are coming from and what we believe in, then theory X and traditional management absolutely makes sense, including the bonus practices to be challenged in this section.

In my many meetings with management teams and employees, I often ask people their views on individual bonuses. I hear very much the same cynicism as I hear about budgets, not just from employees but also from managers. The vast majority of people do not like individual bonuses, do not believe they work, and can provide countless examples of how they lead to suboptimal behavior and have no or negative effects on motivation and performance. The paradox repeats itself: With so much dissatisfaction among people, where is the uproar, where is the revolution that we are starting to see on the budget side? I am, however, optimistic. I believe that one day individual bonuses will be driven out of town, shamed and undressed. But we need more little boys raising their hand, shouting what everyone in the crowd also can see: This emperor has no clothes on. Let me try to explain why he is naked.

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The bonus system I am criticizing is the one that rewards individual performance for a limited group of executives and professionals, based on predefined targets. These targets are often budget or KPI numbers.

For more routine and transaction-oriented jobs, where the tasks themselves provide limited motivation, where individual results are easily measured, and where quantity is more

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important than quality, then individual bonuses might often work. What we are discussing here is something completely different; we are talking about leaders, professionals, and other knowledge workers charged with radically more challenging tasks and responsibilities, and where the link between individual effort and business results are far from mechanical and obvious.

Most companies have bonus systems for two quite different and unrelated reasons. The two are constantly mixed when the system is explained and justified. The first has to do with *market*, the second with *motivation*. The market reason is about recruiting and keeping good people. The argument is that the company needs to offer bonuses as a part of the total reward package in order to be competitive and attract and retain the people it wants to have onboard.

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I can partly buy into this one. However, are we too quick in pulling the bonus lever? Are we creative enough in looking for alternative elements to put into our compensation offers? If it has to be money, does it have to be an individual bonus? Why does a collective system have no attraction power? Can sign-on fees sometimes be an alternative? Does it always have to be money? If we also include nonfinancial elements, the alternative menu available is even longer.

Are we underestimating the value of the company brand (assuming it is a good company we work for!)? The positive effect from employees proudly talking to friends and neighbors about how it feels to work with us can be extremely strong. When they talk about the opportunities and support they get, the right to raise their voice and also be heard, how they feel they make a difference, then they create a market pull much stronger than what any bonus system can provide. If, however, they share the very opposite messages, then no bonus system can fix it for us because the problems lie in a very different place. In the story about the Swedish Handelsbanken in Chapter 2,

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you will learn how this bank is able to attract great branch managers locally in the United Kingdom, even if the competition has massive individual bonus schemes and Handelsbanken has none.

My skepticism begins with the paradox that we recruit a person into what we proudly claim to be a knowledge organization boiling over with interesting tasks and challenges. We offer a fair base salary, but then add that "We really do not expect you to do your best. The tasks and the environment we can offer is probably not motivating enough. We will therefore put you on a bonus system. Only then do we expect you to go that extra mile." Unintentionally, this kind of message says quite a lot about the company and our new colleagues.

If the market argument does not come across convincingly enough, then "bonus believers" pull a very different argument out of their sleeves. Individual bonuses are great for motivation and performance! By tailoring the system the right way, we can almost program people into doing what we want them to do! We put a lot of effort into designing the nuts and bolts of the system. Which strings should we pull and how hard in order to make the marionettes dance as we want? Which targets? Which percentages? Which thresholds and ceilings? Which triggers and funding mechanisms? There is a whole consulting industry out there ready to help out on these questions. Coincidentally, there are some important issues these guys seldom bring up, because it might put them out of work. Those are the issues we will discuss here.

I am struck by how quickly we move to money as the lever to pull in order to motivate people. What happened to all those other levers we used to pull, before bonuses became the dominant one? It is almost as if we have given up on that old craft called leadership. Across cultures, research shows that autonomy, belonging, and mastering the job consistently is what people rate as most important. Money is way down the list.

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Interestingly, respondents often believe that *other* people in the organization have money much higher up on the list than they themselves do. Autonomy, belonging, and mastering all have one thing in common: They require a much stronger leadership effort than dangling a financial carrot in front of people. Money is so much simpler. But again, leadership is not meant to be simple.

Bonus design work tends to focus entirely on the intended motivational effect on *those included* in the bonus system. A silent assumption is that there are no negative effects on those *not* included. Well, is that true? What about the guys just below? How motivating is it to work a certain body part off for your manager's bonus and get nothing yourself? The motivation effect is negative, not positive. Farther below the bonus borderline, the negative effect is probably smaller. It is more like an irritation, talked about around the lunch tables. People share stories and laugh about how senior managers pretend they are not acting in strange ways because of the bonus scheme. The negative effect on each person around the table is not that big, but the number of people being "only" irritated is huge, because they make up the rest of the organization. If we add up all these negative effects below the borderline and deduct these from the possible positive effect above, how much is really left? Is there anything left at all? Could it be negative? I hope you noted that I said "the *possible* positive effect," because I will challenge that assumption as well a bit later. Then the bonus problem becomes even worse.

Then there is the issue of *individual* bonuses. In the complex and interlinked reality in companies today, how individual is performance really? Isn't the Lone Ranger really something out of the past, riding into the sunset with a smoking gun after having solved the day's troubles completely alone? The large majority of us are highly dependent on others when doing our work and delivering on our goals, even when these

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goals have been set as individual ones. There is always someone behind or next to us, contributing directly or indirectly to what we too often herald as individual success.

Next I would like to turn to another serious problem with individual bonuses. I did not want to start with this one, because it is the most difficult problem to get across. It goes straight for the throat of the motivation argument used by bonus believers. If you are among them, I needed to warm you up for this one. And just for the record, what you will hear is well documented in solid research and tons of studies, all quite easy to access.

A financial incentive is an external type of motivation; as psychologists would say, it is an artificial or *extrinsic* motivation. It is a carrot hanging there to stretch and motivate people beyond what we believe the internal—or the natural or *intrinsic motivation*—coming from the job itself is able to provide. It sounds quite logical; turbo-charge the intrinsic motivation by adding on external rewards. We get *more* motivation, right?

The problem is that research shows exactly the *opposite* effect; extrinsic motivation *reduces* intrinsic motivation. Please read that again. Extrinsic motivation *reduces* intrinsic motivation. Why this happens is still being debated. One explanation lies in what a bonus is all about: "Do this and get that." By introducing a bonus to get something done "more of" or "better," the focus naturally shifts from being just on the job or the task itself, to also what you get for it. The bonus *undermines* some of the interest in the job itself. Another related reason might be that bonuses *reduce* the value of the job and the tasks it pays for, even though the intention is the opposite. By offering bonuses, the message we send is that we do not believe you are sufficiently motivated by the intrinsic motivation coming from the job itself: solving problems, achieving goals, improving and innovating and everything else that has to do with thriving, blossoming, and growing both yourself and your job. All of this is obviously not enough. Carrots are needed in addition.

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Giving blood is a great thing to do. Experiments have shown that when hospitals have increased the pay in order to get people to give more blood, the effect has been the opposite. Perhaps this is because most people feel that it reduces the noble act of giving blood to something closer to "selling body liquids," something you have to do for the money.

Even more disconcerting is what research says about work where a lot of *creativity* is involved or required. In such jobs, the negative effect of extrinsic motivation is even higher. This is bad news for most companies with individual bonus systems, because few would claim to have many jobs where no kind of innovation, creativity, and ability to think for yourself is required. This research finding becomes even more interesting if we think about *who* in companies are put on the bonus system. It is normally the higher management positions. Aren't these supposed to be among the most interesting and stimulating jobs there are in a company?

In his book, *Punished by Rewards*, social scientist Alfie Kohn tells a story about an old man who constantly is shouted at and insulted by a group of teenagers. One day he goes over to them and says, "I'll pay you a dollar for every insult you guys are able to come up with." The f-words immediately come flowing. The old man duly pays up, and asks the youngsters to come back the day after. "Then I will pay you 25 cents for the trouble." The boys show up and the insults again come strong and fast. The old man pays what he owes, but then tell them that from now on he will only pay them one cent per insult. "One cent!" the boys respond. "Forget it!" And they never come back.

Beyond illustrating how you can kill interest by rewarding people for something they used to do without a reward because they thought it was fun, the story also reminds us that incentives do not create any lasting and sustainable change in behavior unless you keep paying up. We should also remember that although a bonus is intended to be a positive reinforcement, it

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is just as much a punishment because it is also something that can be held back. The carrot is also a stick.

There are, however, a few camps in psychology that see things differently. The behaviorism theory of the famous American psychologist B. F. Skinner strongly advocates extrinsic motivation. The only small problem is that most of Skinner's supporting studies and experiments were conducted on mice, rats, and pigeons. The studies were about simple, mechanical, and repetitive tasks where individual results are easily measured—not exactly what life in today's knowledge organizations is about.

Kohn refers to more than 70 studies on people and organizations that all confirm the negative effects on motivation and performance. "This is one of the most thoroughly replicated findings in the field of social psychology," he says. "No controlled scientific study has ever found a long-term enhancement of the quality of work as a result of any reward system. For five years I have challenged defenders of incentive systems to provide an example to the contrary, and I have yet to hear of such a study," Kohn wrote in *Compensation & Benefits Review* in 1998. Still, this insight does not seem to have reached management theory, nor our HR functions. I find this very worrying. One reason why most managers and finance people are unaware of these findings might be that *any* knowledge and insight from psychology is met with suspicion and skepticism: "We are businesspeople, not shrinks!" *Leaders*, however, are more likely to be aware and understand what we just have talked about. HR, however, has no excuse for this ignorance or failure to act on this research.

You might, however, still be skeptical, so let me try another angle. A bonus system is a combination of *targets* and *rewards*, often introduced at the same time. When we claim that bonus systems work, which part is actually working? Could the real driver behind the observed effects actually be the

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increased effort we put into *communicating* around performance: direction, targets, progress, status, and next steps? Could it actually be all the increased attention that is delivering, not the bonus money? Some years ago a unit in Statoil introduced a local bonus system. This was a great success in terms of the performance improvement achieved, but the money involved was symbolic. The program worked, but obviously it was not because of the size of the bonuses offered.

What about other extrinsic motivation, like the public clap on the shoulder or a new exciting assignment? Although these examples are in the extrinsic category, research shows that positive feedback does not cannibalize intrinsic motivation in the same way as money does. Could this kind of motivation be more effective than we think? Are we simply throwing money out the window through our individual bonus systems?

Another serious side effect of bonus systems is so easily observed that I am amazed the bonus believers get away with it. It is the simple fact that bonuses drive people toward setting *lower* targets instead of the opposite, leading to lower performance and not higher, as is intended. Bonuses stimulate sandbagging, gaming, negotiation, and so much else that we hardly connect with a high-performing organization. Everybody knows this, even the bonus believers, even HR, but nobody reacts. It is a shame.

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All the criticism so far has been directed at bonus systems designed as individual carrots. Team or collective bonuses are different, if they are designed more as a hindsight reward for shared success, in such a way that they encourage, not discourage, phones from being picked up. This is an important distinction. The individual bonus is intended to provide *both* up-front motivation as well as positive hindsight feedback. Collective bonuses are often criticized for not delivering that up-front motivation. But they are not meant to, for the reasons already discussed. Collective bonuses are mainly meant to create

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a positive feeling around common efforts and shared success being rewarded in a *fair* way. Creating such positive vibrations in the entire organization has, of course, a positive *indirect* motivational effect. Even if not everyone in the organization sees it like this, the possible negative motivational effect on these few people is small compared to the opposite positive effect on the large majority. With individual bonuses it is the other way around, to the extent that they produce any positive effects at all.

A frequently used argument against common bonuses where everyone is onboard is the "free rider," the person who never contributes but loves to share the prize. Free riders are real. They exist in every company and on many teams. But they still belong to a small minority. Again, we cannot organize our performance management around the minorities. We must use other mechanisms to deal with these guys.

If we really want money to do the job for us, with all problems we have just discussed, the bonus size and the prize at stake have to be so high, through increased bonuses and reduced base salaries, that it becomes a question of food on the table and a roof over the head. Beyond the moral aspects, such massive bonuses is about launching missiles where we abandon all control once the launch button has been pushed. We can only hope and pray that touchdown takes place as planned. Is this really something we want? Have we not seen enough examples of how terribly wrong this can go?

One additional argument sometimes comes up in my discussions with bonus believers when they realize that their other ones have failed to convince me. "We can save money. Bonuses are cheaper ways of paying people, because they are variable, not fixed." I do not buy this argument either. If we believe bonuses work, would we not actually want bonus costs as high as possible, because that reflects high performance?

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Could it actually be that we pay *more* than necessary because it is actually not the money that works? Would it have been cheaper to revive that forgotten old craft called leadership instead? Remember autonomy, belonging, and competence?

If the cost argument holds, should we not get the same potential "savings" also with team bonuses? It will, anyhow, be a very costly saving if we also take into account all the negative consequences of individual bonuses just discussed. If affordability is the main issue, then a common profit sharing solves just that

It is interesting how bonus money somehow avoids any scrutiny when companies look to cut costs. How often do managers mention "reducing bonuses" when they are asked to come up with deep and radical cost-reducing actions? It is as if bonus money is some other kind of money, a very different currency protected by Harry Potter's invisibility cloak.

I accept that my views may be quite surprising if you have not heard individual bonuses being challenged before. If this is new for you, then you are not alone. The myths are strong and long-lived. If my arguments have not moved you, could we at least agree on one thing? Is it not fair to say that we at least need to *better understand* how the bonus system actually works in our own organization, because we spend quite a lot of money on it? Does it not make sense from time to time to check if the medicine is working? We should perform such a study ourselves, not hire management consultants, and we need to ask not just those who are in on the bonus system but also all those who are not. Perhaps we should do some research reading as well.

Let me close with a reflection on how the bonus area normally is organized in companies. This is not an attack on good friends working on the reward side, just something I find a bit strange. Usually the HR function is responsible for designing

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and operating the bonus system. Fair enough, but where in the HR function do we normally find this responsibility? It lies in the compensation and benefits department, together with pensions, employment contracts, union negotiations, and similar issues. We know why; bonuses are about money or variable pay. What is more logical than to place it with those responsible for all other compensation issues?

There is, however, an important difference between bonus and other pay issues. The smallest and simplest part of a bonus system is the compensation part, which is about market-relating payout levels. The complexity lies in designing what should *drive* the payout. This is a very different area. If the company is big enough to have a separate compensation and benefit unit within the HR function, there would normally also be a performance management unit or something similar in HR. *This* is where such an important topic belongs, because bonus is much more about motivational theory than it is about compensation. The compensation and benefit role in a bonus system should be limited to providing data on market levels. If this had been the case in more companies, I believe there would be far fewer individual bonus systems around. I actually sense much of the same skepticism in parts of HR as there is in the rest of the organization. There must of course be a close cooperation between these two HR units, but if there must be a bonus system, at least the responsibility should be moved.

Wherever the responsibility is placed, the big question remains. Why should we have individual bonuses at all? A survey by the major U.S. compensation and benefits consulting firm William M. Mercer sums it all up when concluding that "most merit or performance-based pay plans share two attributes; they absorb vast amounts of management time and resources, and they make everybody unhappy." Kohn recommends a simple way out of the misery: "Pay people fairly, and then do

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whatever possible to make them forget everything related to pay and money."

The Rhythm Problem

A very different type of problem in traditional management has to do with rhythm. As already discussed, business rhythm is uneven and unpredictable, and it is getting worse. Although we recognize the "global warming" effects, so far they have had few consequences for how we slice and structure our management practices. We still stick to a rhythm adopted from the fiscal year: January to December. We work harder and harder, trying to force the messy realities around us into the calendar year. It looks so logical and orderly in our schedules and flow charts. In reality, trying to adapt to the calendar year is more like forcing a wild tiger into a cage.

Just look at budgeting and planning. When finance people orchestrate this annual autumn ceremony, we tend to divide what is happening around us into three categories. In the first category we have the events that take place *before* the summer. These are OK. We would, of course, have preferred stability and as little new stuff as possible, because this makes planning even easier. But we accept that we live in a dynamic world. We have time to include these events in our instructions and budget assumptions and reflect them in next year's budget in an orderly way. We have control. So far so good!

Then we have all those events occurring *during* the budget and planning process. There can be many of these, given the increasing length of this process. We do not like these events very much. Shall we include them or not? Maybe we have to issue revised instructions and assumptions. They mess things up!

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Finally, we have the stuff that strikes like lightning *just after* the budget is approved. Those events we simply hate. Why could not these things have happened earlier? Now our perfect budget is ruined, and our monthly deviation analyses next year will need to explain again and again that "This was not included in the budget." But we prefer it like this, at least compared to the unthinkable alternative of going back to the board with a new budget. We are professionals; we must demonstrate that we have control.

There is more we do not like in the real world. Projects and activities that run past year-end also mess things up. Even if a project stretching over several years is approved as a total at the project decision point, these long-term commitments often must be reapproved in each annual budget.

We see many of the same problems on the HR side. We organize almost everything around the calendar: annual goals, semiannual and annual performance reviews, manning budgets in the autumn, competence and deployment reviews in the spring. At the same time, in the real world, people change jobs all the time, projects and activities are assigned and completed as the business needs them, competence and resource gaps occur and are addressed continuously. Somehow we cope, but more *despite* than because of the calendar cycle.

Our forecasting rhythm is another example. It almost looks like driving a car with a very peculiar use of the car lights, the low beams for the short range and high beams for the long range. These lights help us see what lies ahead. We switch between the two in a fixed pattern that would create quite some attention in real traffic. During long autumn months we have the high beams on, not because it is a dark time of the year but because it is budget and planning time. They light up next year (budget) and also farther into the longer-term planning horizon. There is light all over the place. And of course a lot of light is needed to catch all the details we want to see. Then we turn the

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high beams off and start driving into next year with low beams only. At the beginning of the year, these lights illuminate all four quarters ahead. As we drive on and the quarters pass, the low beams gradually get covered with mud and become weaker and weaker, covering a shorter and shorter distance. But we do not mind, as long as we can see until year-end. Finally they cover only one quarter ahead, the fourth. Then we stop and clean the lights, so that we again can see farther ahead, into the whole of next year (budget time again!). We also turn the high beams on for a couple of months. And the pattern repeats itself.

Is this a safe way of driving in the dark? Why do almost all "business cars" use their lights in the same way, even if some travel on well-lit highways, others on dark and bumpy gravel roads, and some off-road in the wilderness where no car has driven before?

There might seem to be a very simple solution here: *rolling forecasts* that continuously look five or six quarters ahead. Is it really that simple? Is a rolling forecast not just another fixed and calendar-driven way of driving, still not recognizing the broad variety of roads business cars are traveling on? More about this in Chapter 4 on Statoil.

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One reason for having lights all over the place is because we want to *coordinate*. We want to make sure that, once a year, projects are prioritized and scheduled, resources are matched with planned activities, and sales and purchases are coordinated and reconciled. We want everything to hang perfectly together, at least once a year. I have forgotten how many nights I have spent trying to reconcile internal services budgets because those idiots could not agree on how much one of them should to sell and the other one buy.

But why should everybody be coordinated around *one* cycle that feels like tomorrow for some and is beyond any reasonable planning horizon for others? How many can demand that their

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external customers already in the autumn commit to all orders for the whole of next year?

This is not an attack on coordination in general, only on the *annual* coordination stint. We need a coordination that is *continuous* and *customized*, where those who need to should communicate as they choose themselves, on a schedule and time horizon relevant for their business relation. This will seldom be once a year and for a January–December period. Coordination should also be very much about people meeting in networks and processes that run across the organizational structure, where direct contact between involved units at different levels is the norm that is encouraged and not blocked by the respective management layers above.

There are similar rhythm effects in other areas. Think about resource allocation, which is another purpose of budgeting (more about this and other purposes in the next section).

Steve Morlidge, who headed up Unilever's Beyond Budgeting project Dynamic Performance Management, has a wonderful metaphor on cost and capital budgeting. Imagine a bank telling its customers: "From now on, we are only open four weeks in the autumn. If you want to borrow money for a new car or for refurbishing your kitchen, you better be there in October. The rest of the year we are closed." That would be a pretty stupid thing for banks to say, and of course they do not.

But traditional budgeting by the book is very much like this. During "budget time" we have to identify all activities and resource needs for next year. Of course it is *possible* to ask for money also during the rest of the year. Yet just one look at the application process is enough to realize that this is not something the system encourages you to do. One of my old core competencies, in addition to explaining budget deviations, was to review such applications. We finance people both loved and hated this. We felt quite important when even senior managers had to submit written applications to us. But these reviews were

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a lot of work. Why had the managers not thought about this expense earlier and just put it in the budget? That would have been so much easier for all of us!

Business would come to a standstill if we actually followed the budget book by the letter. Fortunately, real life in companies is more flexible. There is a small back door into the bank that can be used the rest of the year. So what is the problem?

There are a few. First, the perception in the organization is often one of less flexibility than there actually might be. We have been quite successful in getting the message across: Budgets numbers are there to be met and not changed all the time. The consequence is that opportunities are lost or spending is suboptimized. People cannot find or do not want to knock on that back door.

Second, if we say that we are more flexible in practice, we are unclear in our communication. What actually are the rules of the game? Is it the strict process described in our budget procedures, or is it a somewhat more relaxed practice? Should we apply the same flexible approach in the ethics area as well?

It is not easy to force the real world into our well-organized processes. We are trying to make order out of chaos. We struggle and fail, year after year. Maybe the time has come to do the *opposite* and adapt our processes to the real world instead. Imagine if we started from scratch, with no baggage or historical constraints, and designed a process based on business rhythms. Would everything be squared into years, quarters, and months? Would everybody in the company be on the same rhythm? Would all targets have the same deadlines? Would all forecasting have the same time horizon? I doubt it. But we are on autopilot, stuck in historical traditions, comfortable with the convenience of doing things as we always have done them. "Change is good, but you go first" seems to be the mantra.

Let us hold that thought until we reach the Statoil case.

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The Quality Problem

Most companies make budgets and business plans for at least three quite different purposes. They shall at the same time provide:

1. Good targets
2. Reliable forecasts
3. An effective resource allocation

All these three purposes are important elements in a good performance management model. What can be more efficient than having it all done in one go?

There are some serious problems involved in trying to do just that. These three purposes do not go well together. They are, in fact, very often in conflict with each other. Trying to force them into one process that produces "one number" often hurts the quality of all three purposes.

Take the forecasting purpose. A forecast should be our best guess on the future, the expected outcome, whether we like what we see or not. The purpose of a forecast is to get issues on the radar screen early enough to be able to take the necessary corrective actions. My experience is that when it is relevant and possible to make forecasts (which often is not the case!), people are reasonably good at doing so. They know their business and normally have a relatively good feel for which way the wind is blowing. They cannot make exact predictions but they can make good enough indications.

The budget and planning process is, however, not the place to hope for any high-quality forecasts. Let us take an example. Assume it is budget time again, and we are starting out with the forecasting purpose. We want to make a good sales forecast for next year. If we get this right, we have a good basis for also understanding expected production, manning, and cost

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levels. What happens, however, when we introduce one of the other purposes, like target setting? The minute a sales manager understands that the indicated sales forecast number will come back as a target, that number will start moving in a certain direction. Everybody wants to reach their targets, and everybody knows the consequences of missing out, whether they are on the bonus program or not.

The same happens on the cost side. If a sales or production manager is asked about the expected level of resources required for next year, and knows that the same number will become next year's cost budget, and also understands the consequences of a budget overrun . . . guess what?

By combining target setting or resource allocation as parallel purposes in a forecasting process, we pollute the quality of both the forecast and the other purposes. We should not blame the managers. Their response is both natural and predictable. We should blame our process, which puts people in difficult positions.

Another reason why we cannot combine targets and forecasts is because a good target needs to have an element of stretch and ambition. When setting targets, we cannot just sit in a dark room, or look back to last year and add on a few percentages. We need to look out the window to the world outside, to customers, shareholders, communities, and all the other external stakeholders, with expectations about our performance and behavior. While the window is open, it might be wise also to take a look at the competition and how fast it is running. When we close the window and reflect on what we have seen, it is not unlikely that what we have observed has an effect on our ambition level. Setting ambitious targets is less a decision we take and more a consequence of what is happening around us, whether we like what we see or not. At the same time, we need those good and reliable forecasts. We must understand where we are heading, how big the gaps are against our ambitions and

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targets, and where we need to focus our attention and energy to catch up. Forcing a target and a forecast into one number in one process is almost guaranteed to result in either a bad target or a bad forecast. Or very often both, since we negotiate and compromise and end up with a number somewhere in between.

By not clearly separating the two, we can forget about getting any early warnings in our budgets and business plans about possible gaps against targets. A forecast polluted by target setting or resource allocation cannot be trusted. These gaps do not disappear just because we do not see them. They just remain in the dark until it is too late to do something about them.

It is not possible to achieve any real quality improvement in target setting, forecasting, or resource allocation without first separating the three purposes. A two-step approach is needed: separate then improve. Going straight for the second step is guaranteed to fail.

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The Efficiency Problem

It is an indisputable fact that we spend an enormous amount of time and resources on budgets and plans, first in making them and later when reporting against them. I have yet to meet anyone complaining about the opposite. According to the Hackett Group, companies spend on average 25.000 man-days on budgeting per billion USD in revenue.

I am addressing this problem last. Even if the figures are scary, it is still the smallest problem. Compared to most of the other problems, this is more like a mosquito bite: very visible but only irritating. It is not a mortal disease, just a very costly one. Still, this is where many companies believe they have their biggest problem, and therefore it is where many budget reengineering projects start.

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Why do we spend so much time and energy on budgets and budget reporting? One reason is another of our traditional management myths: The more details and places of decimals we have in our plans and budgets, the more "control" we believe we have on the future. Or at least that is the impression we create, that these are "quality numbers." Isn't there something suspicious about people presenting a few rounded numbers only? Are these people just guessing? Have they done their homework?

There is no problem with details when describing where we have been and where we are. On the contrary, here they are needed and necessary to help us understand our business, the value and cost drivers and product and customer profitability.

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The problem starts when we carry the same or almost the same level of detail with us into the future. The past does not carry uncertainty, but the future does. The farther ahead we look, the more uncertainty there is. This must have consequences for how detailed we try to describe the future. But the myth is strong: More details equal more quality. It does not look very professional or trustworthy to present expected sales or cost developments as a range with only a few numbers and a simple what-if analysis, although often this would be more "right" and certainly more honest.

It is amazing how blind people can become to the stupidity of fine-tuning, for instance, the expected USD exchange rate 10 years out in time, when doing it within the uncertainty span of what kind of superpower the United States will be by then. But somehow, working on those details seems to shield us and make all the big and scary uncertainties disappear.

My first budget process in Statoil in 1983 was a manual one, with roll after roll of paper consumed by our calculating machines as visible evidence of hard work and long nights. Today spreadsheets and software packages are an indispensable part of any budget process. But what happened to those promised

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IT efficiency gains? Though I do not in any way miss the "manual" days, we have not utilized technology development to save time but to crunch more numbers.

Since we are on this topic, I would like to share a little story about my first encounter with the PC. The first one came to Statoil late 1983, to the planning department, which of course was separate from the budget department where I was based. It took the planning guys half a year to convince their boss to make this $8,000 investment. It was probably not in their budget. The second PC landed with us budget guys a few months later. It was a very early IBM model, with a double floppy disk station and no hard disk. Those floppy disks were just that, very floppy. We carried them like diamonds to avoid any damage. Saving and backup was a slow and time-consuming effort, but we learned our lesson after having lost our work for the third time because the cleaning lady pulled the plug to fire up her vacuum cleaner. "How should I know there are people in the office this late at night?"

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The PC was located in a common area for everybody to use. The first couple of weeks a few colleagues and I had it almost for ourselves. Then the interest picked up, and we had to put up a booking list. I spent several months transferring a range of manual tasks into SuperCalc spreadsheets (anyone remembering SuperCalc?). Then I started to harvest from my intensive investment. Apart from the cleaning lady, it was a great experience—at least for a couple of months. Then a colleague came over, telling me that he had some good but also some bad news. "There is a new and much better spreadsheet coming, called Lotus 1-2-3. Unfortunately, it's not compatible with SuperCalc." I spent the next months redoing all my work. For a few years I was actually one of the company spreadsheet experts. I left that role many years ago, with no regrets. Today, my younger colleagues smile when I ask them for help on those rare occasions when I open Excel.

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But back to budgets. Another fascinating phenomenon in the annual budget game is the "elevator rides." The bigger the company, the funnier (or more tragic) it is. It starts early, with the initial data production in the front line. The numbers are then consolidated, level by level, week after week, until they one day reach top management. For corporate budget and planning people, this is an important moment. The suit and tie is put on, and the ceremony starts. After the CEO has thanked everyone for all the hard work through long nights and weekends, the message comes: "Is this really the best we can do? I had expected higher sales, lower costs, more of this, less of that. I want you back next week with better numbers."

And then the numbers are sent down the elevator again. At the lower floors, people are almost waiting at the sliding doors. Everybody knows they are coming and what the message is. And everybody is well prepared. Of course there is something to give, on costs, on manning, on sales budgets. Some of the fat is sliced off, ambitions are increased, but only a bit. And up again the numbers goes. This time the atmosphere is slightly more positive. "Great work, but is this *really* the best we can do?" And down again they come . . .

I would not be surprised if we talk about three to four elevator round trips in larger companies. But everybody is happy: top management, because they believe they have stretched the organization to the limit; people in the organization, because they got away with it this year as well.

We might smile about all of this, as we picture Dilbert on his way up the elevator. But it is not very funny. How many customers out there are really willing to pay us for spending time on such stupidity? Is there a better example of a non–value-adding activity, even before we include the negative effects on morale and motivation?

But the resource waste does not stop here. Now comes all the reporting against budgets. Monthly detailed deviation

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analyses explain down to the last penny where and why we are off track. This is a core competence with many finance people. I have been there too. I once kept track of different types of deviation analyses produced during the year. On a top-10 list, there was one explanation coming out on top, year after year. Can you imagine which one? It was: "The monthly distribution in the budget is wrong." What a deep and insightful analysis from a highly paid finance guy! A great piece of advice to help a management team get back on track!

By the way, consider a bit the word "deviation." It is a negative word, something unwanted. Something else happened compared to what we had planned, and we do not like it. The real world has taken a different route. A more natural word would be "variance," but that is probably not negative enough.

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