HARVARD BUSINESS Press

The Annual Performance Trap

Why the Budgeting Process Must Change

Excerpted from

Beyond Budgeting:
How Managers Can Break Free from the Annual Performance Trap

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Harvard Business Press
Boston, Massachusetts

ISBN-13: 978-1-4221-4876-1
4866BC

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Chapter One

The Annual Performance Trap

> Uncertainty—in the economy, society, politics—has become so great as to render futile, if not counterproductive, the kind of planning most companies still practice: forecasting based on probabilities.[1]
>
> —PETER DRUCKER

Like them or loathe them, everyone has a view about budgets. CEOs like the warm feeling they get when they see the year-end profit forecasts. But they might be anxious about the reliability of the assumptions and the firm's ability to respond to change. CFOs like the way they are able to tie operating managers to fixed performance contracts (fixed targets reinforced by incentives). But they also know that the process takes too long and adds too little value. Operating managers like "knowing where they stand." But they are also concerned about the time wasted and, more important, that fixed performance contracts lead to decision paralysis and cosmetic accounting rather than decisive action and ethical reporting.

Though this ambivalence toward budgeting has existed for decades, the balance of opinion has swung decidedly in favor of the "very dissatisfied." Even within the financial management community, nine of ten have expressed their dissatisfaction, finding the budgeting process too "unreliable" and "cumbersome."[2] According to a recent cover article in

Fortune magazine, around 70 percent of companies surveyed were poor at executing strategy—a massive indictment of the performance management capabilities of budgets.[3] It turned out that most companies were characterized by incremental thinking, sclerotic budgeting processes, centralized decision making, petty operating rules, and controllers who demanded answers to the wrong questions. It is perhaps not so surprising that financial directors now rank budgetary reform as their top priority.[4] We will examine why these high levels of dissatisfaction have arisen in a moment. First, we must define what we mean by "budgeting."

One recent management accounting textbook defined a budget as a "quantitative expression of the money inflows and outflows to determine whether a financial plan will meet organizational goals."[5] But such a plan is the result of a protracted process. We have used a broader definition, one that defines budgeting not so much as a financial plan but as the *performance management process* that leads to and executes that plan. So when we use the word *budgeting* from here on, we mean the entire performance management process. This process is about agreeing upon and coordinating targets, rewards, action plans, and resources for the year ahead, and then measuring and controlling performance against that agreement. This process, the resultant negotiated fixed performance contracts, and their impact on management behavior are the focus of attention in this book.

How have we arrived at such high levels of dissatisfaction with budgeting? There are three primary factors: (1) Budgeting is cumbersome and too expensive, (2) budgeting is out of kilter with the competitive environment and no longer meets the needs of either executives or operating managers, and (3) the extent of "gaming the numbers" has risen to unacceptable levels. These problems have not happened overnight. Budgeting has been a festering sore for many decades, but its problems have, by and large, been swept under the carpet. It has taken the rapid changes in the competitive climate of the 1990s and the corporate governance scandals of 2001–2002 to expose them fully.

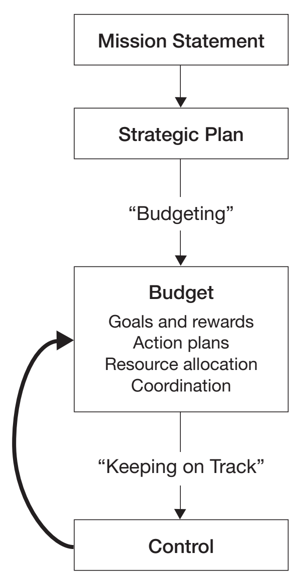
Budgeting Is Cumbersome and Too Expensive

For most participants, the budgeting process is an annual ritual that is deeply embedded in the corporate calendar. It absorbs huge amounts of time for an uncertain benefit. It typically begins at least four months prior to the year to which it relates. As figure 1-1 illustrates, it starts with a mission statement that sets out some of the aims of the business. This is followed by a group strategic plan that sets the direction and high-level goals of the firm. These form the framework for a budgeting process that grinds its way through countless meetings at which points are traded as targets are negotiated and resources agreed upon.

It starts when budget "packs" are sent out from the corporate center to operating divisions and departments, accompanied by forms to be completed that include sales, operational, and capital expenditure forecasts. For a whole business unit, the bottom line will be a profit and cash flow forecast for the year ahead. Once completed, these packs are returned to the corporate center (or to intermediary points in the hierarchy) and then subjected to review. Thereafter multiple iterations take place as each unit negotiates the final outcome. Once the budget is agreed upon, regular reports are required by the corporate center to enable senior executives to control performance.

FIGURE 1-1

The Traditional Budgeting Process



Despite the advent of powerful computer networks and multilayered models, this process remains protracted and expensive. The average time consumed is between four and five months.[6] It also involves many people and absorbs up to 20 to 30 percent of senior executives' and financial managers' time.[7] Some organizations have attempted to place a cost on the whole planning and budgeting process. Ford Motor Company figured out this amounted to $1.2 billion per annum.[8] A 1998 benchmarking study showed that the average company invested more than 25,000 person-days per billion dollars of revenue in the planning and performance measurement processes.[9]

The perception of the value provided by the budgeting process varies widely. In one firm we visited it was apparent that the group board thought the budget gave them control, whereas operating managers thought it was completely irrelevant to their needs. One of the primary reasons that financial directors rank budgetary reform as their highest priority is that their staffs spend too little of their time adding value. One conclusion from a 1999 global best practices study was that finance staff spent 79 percent of their time on "lower value-added activities" and only 21 percent of their time analyzing the numbers.[10] Nor does it help when hard-pressed managers have to wait eleven days into the following month before they can compare monthly management accounting results with the budget.[11]

For any firms involved in mergers, acquisitions, disposals, and other reorganizations, the budgeting workload can be overwhelming. The result is a finance team under constant pressure to reconfigure the numbers rather than support hard-pressed managers with the information they need to make decisions. A few comments in a recent survey of U.S. accountants are telling. "We have just been burning people out. They have been working incredible hours. . . . They are giving up family life. . . . We are all concerned."[12]

Budgeting Is Out of Kilter with the Competitive Environment and No Longer Meets the Needs of Either Executives or Operating Managers

If you had asked senior executives in the 1970s what they wanted from their management processes, they would likely have emphasized the need to set reasonable return-on-capital targets and then formulate detailed and coordinated plans for the year ahead to meet them. Executives would have expected compliance with these plans throughout the organization, supported by tight cost control and measures geared to monitoring performance against the plan. In other words, they expected to plan, coordinate, and control their operations from the corporate center.

The budgeting process was tailor-made for the job (although it was already becoming cumbersome and expensive). IBM was a classic example. In 1973 its planning bureaucracy had grown to three thousand people and its "annual" planning process approached an eighteen-month cycle.[13] But it played a part in enabling the company to become the dominant player in the global computer market. Its ability to design, make, and sell its computer hardware and software to compliant customers was supreme. Every division, business unit, and individual salesperson knew from their performance contracts what they had to achieve in the year ahead. Growth and prosperity seemed unstoppable.

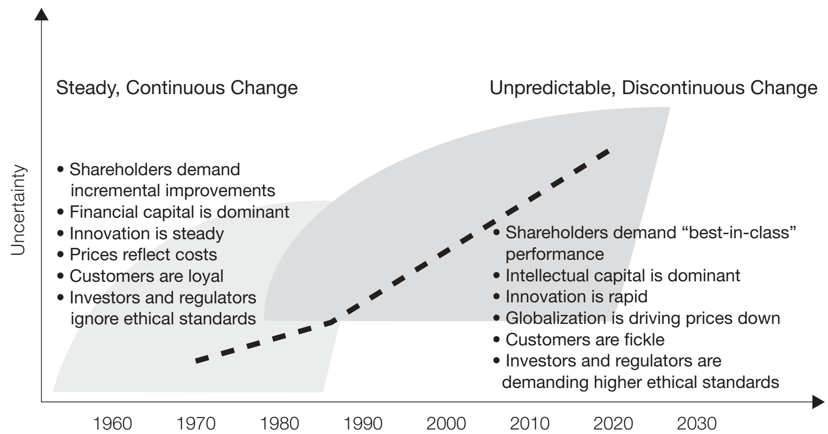
The oil price increases and subsequent inflationary pressures of the mid-1970s changed the competitive climate. Leaders became concerned about rising costs. Bloated bureaucracies and their associated fixed costs were a key factor, and a number of managers began to realize that the budgeting process failed to challenge them. One solution promoted by consultants was called *zero-base budgeting* (ZBB). ZBB starts with a blank sheet of paper in regard to discretionary expenditure. It proved to be a useful (though usually one-off) exercise to review discretionary overheads. However, the process was so bureaucratic and time-consuming that few companies used it more than once. Moreover, like traditional budgeting, it was based on the organizational hierarchy. It thus reinforced functional barriers and failed to focus on the opportunities for improving business processes.

In the late 1980s, IBM stumbled badly as it misread the personal computer revolution and found itself surrounded by more nimble competitors with lower costs. Like many other firms, it had to make tough decisions as it faced gut-wrenching changes, or it would fail to survive. Discontinuous change had become the norm (see figure 1-2).

From the 1980s onward, uncertainty increased and the pressures on corporate performance became more intense. Shareholders were demanding that firms be at or near the top of their industry peer group

FIGURE 1-2

The Changing Business Environment



on a range of measures. Intellectual capital such as brands, loyal customers, and proven management teams had risen to be the primary drivers of shareholder value. Product and strategy cycles had shortened, emphasizing the need to continuously innovate. Prices and margins were constantly under pressure, requiring action to slash structural costs and reduce bureaucracy. And customers were increasingly fickle, calling out for more decentralized authority to enable front-line people to respond to changing customer needs. Moreover, "command and control" had become a pejorative term for an outdated management style. Leaders had recognized that to become more "agile" or "adaptive" meant transferring more power and authority to people closer to the customer.

In these turbulent times the budgeting process struggled to cope. Goals and measures were internally focused. Intellectual capital was outside the orbit of the budgetary control system. Innovation was stifled by rigid adherence to fixed plans and resource allocations agreed to twelve to eighteen months earlier. Costs were fiercely protected by departmental managers who saw them as budget entitlements rather than scarce resources. The internal focus on maximizing volume collided with the external focus on satisfying customers' needs. And far from being empowered to respond to strategic change, front-line people found that it was easier to do nothing than to try to get multiple signatures on a document authorizing a change in the plan.

Many firms responded to changes in the competitive climate by introducing more frequent and streamlined planning and budgeting processes. These included budgets done half-yearly or quarterly instead of annually, and "rolling budgets" that tended to have a twelve-month horizon (updated every quarter). Though these approaches offered more current (and thus more relevant) numbers for managers to follow, they suffered from an increased workload (even if done with fewer line items) and thus, more often than not, even higher cost.

Implementing strategic management models such as the Balanced Scorecard was another approach taken by an increasing number of firms that tried to shift their emphasis from being "budget-focused" to being "strategy-focused" organizations. The Balanced Scorecard is one of the most innovative tools to emerge in recent years and offers organizations a robust framework for overcoming many of the problems we have just outlined. But its full power is too often constrained by the short-term performance drivers of the annual budget. These remain focused on "managing" the next year-end rather than supporting medium-term strategy. Indeed, the evidence from Scorecard users is that, far from transforming their companies into strategy-focused organizations, they have simply added some strategic indicators to their annual budgets. Scorecard indicators, according to a 2002 global survey, remained predominantly financial (62 percent) and lagging (76 percent).[14] Moreover, in many cases, Scorecard targets are compared with actuals, and variances are reported in a similar way to the traditional budget.

Few of the innovative management tools of the past decade have been used to fundamentally transform the performance management process. At best they have made marginal improvements to a broken system. At worst they have had negative effects as they ruptured the coherence of a flawed but otherwise working traditional model. Few have achieved their potential.

The Extent of "Gaming the Numbers" Has Risen to Unacceptable Levels

Budgets started life in the 1920s as tools for managing costs and cash flows in such large industrial organizations as DuPont, General Motors, ICI, and Siemens. It wasn't until the 1960s that they mutated into fixed performance contracts. It was at this time, according to Professor Tom

Johnson, coauthor of the ground-breaking book *Relevance Lost: The Rise and Fall of Management Accounting* (and one of the United States' foremost accounting historians), that companies "increasingly used accounting results such as costs, net income, or return-on-investment (ROI) not just to keep score, but also to motivate the actions of operating personnel at all levels."[15]

By the early 1970s a new generation of leaders, schooled in the finer arts of financial planning, began to use financial indicators to manage the business. As Johnson points out,

> [A]ccounting results dominated most managers' attention to the point where they no longer knew, or cared, about the production, technological, and marketing determinants of competitiveness. By 1970, moreover, business education itself reinforced the practice of managing through the accounting numbers.[16]

This led to the increased use of fixed performance contracts as the basis of setting fixed targets against which performance was evaluated and rewarded. The fixed performance contract typically begins with an "earnings" contract between senior executives and external parties (such as investors or bankers) and then cascades down the organization in the form of "budget" contracts between senior executives and operating managers.

The budget contract is usually fixed for a period of twelve months. Its purpose is to *commit* a subordinate or team to achieving an agreed-upon outcome and then to enable a superior to *control* the results against that outcome (reserving the right to interfere and change the terms if necessary). The terms of such a contract typically include the following:

- *A fixed target.* Targets are fixed for the year ahead and specified in terms of financial numbers. Typical targets include sales, profits, costs, and ratios such as return on capital.
- *An incentive or reward.* Incentives are usually fixed to the agreed target and cover a range of outcomes (e.g., from just below the target to just above the target). Other positive outcomes, such as recognition or promotion, can also be contingent on the achievement of targets.
- *An agreed-upon plan.* A plan expressed in strategic and financial terms will usually be attached to the contract. The process lead-

ing to this agreement can be top down, prepared by leaders or central planning departments, or more likely bottom up, with local teams preparing their plans and then negotiating and agreeing upon them with superiors.

- *A statement of resources.* Once plans have been agreed upon, the "master budget" can be prepared and resources allocated to functions and departments. Each contract will have a budget statement encompassing the resources (both capital and operational) attached to the plan.
- *A commitment to cross-company actions.* The agreement will specify the commitments that one business or operating unit makes to another. For example, production units must commit to meeting the sales plan.
- *A reporting schedule.* The agreement will specify the type and frequency of reporting. Senior executives will normally have the right to step in and demand corrective action to ensure that performance remains on track with the agreed plan. Managers will also need to explain any variances and provide updated forecasts as a basis of such action.

The terms and conditions of this contract can either be explicit (usually a written letter from a superior to a subordinate) or implicit (custom and practice tell the parties what the likely outcomes will be). It is not, of course, legally binding. It is more of a promise or a commitment than a legal transaction. And its interpretation can be different across and within organizations. Indeed, budget contracts range from highly authoritative to highly participative.

If used in a responsible way, such contracts provide the basis for a clear understanding between organizational levels and enable senior executives to maintain control over multiple divisions and business units. The problem, however, is that in the wrong hands, such a contract leads to undesirable and dysfunctional outcomes at every level of the organization. These problems multiply as the pressure to improve performance rises, especially if, at the same time, economic conditions are deteriorating.

Few senior executives seem to be aware of these problems. They see outcomes in terms of numbers rather than behaviors. In this context, budget contracts can act like drugs. They seduce executives into believing that they have control over their future financial outcomes. But, like most drugs, they have serious side effects. They lead both senior executives and operating managers into an annual performance trap from which it is difficult to escape. All actions focus on the current fiscal year. It is when the gap between key budget assumptions and emerging reality widens to the point at which the two bear little relation to each other that the problems begin. Few CEOs want to miss their earnings targets and risk ridicule in the media and the investor community. Equally few operating managers want to see adverse variances, risking the wrath of their superiors as well as missing bonuses and promotions.

The all too frequent outcome is that organizations resort to such practices as "managing their earnings" (e. g., at Gillette, Coca-Cola, and Citicorp).[17] In some cases it leads to outright fraud (e.g., at Enron and WorldCom). The fear of failure, more often than not, is the underlying cause. This was evident at both Enron and WorldCom. The WorldCom culture, say those who worked there, was all about living up to CEO Bernard Ebbers's demands. "You would have a budget, and he would mandate that you had to be 2 percent under budget. Nothing else was acceptable."[18]

These are not isolated cases. Business magazines and newspapers have been replete with similar examples of malpractice. They result from senior executives and operating managers committing to overly aggressive targets and then fudging the numbers to meet them. None of this is new. A number of British accounting scandals in the late 1980s and early 1990s, including Maxwell Communications, Pollypeck, and Colorol, should have alerted investors and executives to the dangers of the fixed performance contract. Though corporate governance procedures were tightened in their aftermath, the underlying lessons were ignored.

These high profile cases have captured the attention of the investment community. But such practices are also rife deep inside many other organizations. One major study of over four hundred U.S. companies in 1987 found that budget games and manipulation were widespread, noting that:

> Deferring a needed expenditure [was the budget game] used with the greatest frequency. . . . Getting approvals after money was spent, shifting funds between accounts to avoid budget overruns, and employment of contract labor to avoid exceeding headcount limits

are the other relatively popular games. Almost all respondents state that they engage in one or more of the budget games.[19]

Many front-line managers need to use their political skills more than ever to keep them out of trouble. This applies not only to the planning and budgeting process (one recent survey showed that 66 percent of respondents believed that their planning process was influenced more by politics than by strategy[20]), but also to the process of setting targets and evaluating performance. Many examples of dysfunctional behavior driven by fixed performance contracts have been given to us in the course of our research. Here are ten typical comments:

1. *"Always negotiate the lowest targets and the highest rewards."* This is the desired outcome of the budgeting process from the manager's perspective—a target that is inwardly comfortable to you, yet appears outwardly difficult to your superior.
2. *"Always make the bonus, whatever it takes."* Any actions that need to be taken to reach the maximum bonus are fair game. Stuffing the distribution channel with "sale-or-return" products is a classic example.
3. *"Never put customer care above sales targets."* Though everyone wants to satisfy customers, that is not how they are measured and rewarded. So they meet the sales target, persuade customers to buy their products, and convince them that their slow-moving stock really is a great deal!
4. *"Never share knowledge or resources with other teams—they are the enemy!"* The main competition is not in the external marketplace. It is with other divisions, business units, and departments, all trying to obtain a higher share of the central resource pool than you. There is also the NIH ("not invented here") syndrome to block any sharing initiatives. The arrogance and inflated egos of business leaders prevent good ideas being taken on board.
5. *"Always ask for more resources than you need, expecting to be cut back to what you actually need."* This merely anticipates the negotiation process. Superiors will always want to reduce your requirements, so by increasing your demands, you are more likely to end up with what you want.

6. *"Always spend what's in the budget."* "Use it or lose it" is the manager's mantra. Not spending the budget is a cardinal sin in most organizations. The result is that superiors invariably question why the resource is needed and are understandably reluctant to allow it to pass into the budget for the next period.
7. *"Always have the ability to explain adverse variances."* One of the first skills a junior manager learns in any organization is how to explain away an adverse variance. There will always be some cause beyond your control. But you know that financial variances reveal little about the real causes of problems. Often these can be "upstream" in another department. For example, although salespeople have to deal with customer complaints, these are often caused by poor order taking, wrong deliveries, or inadequate training.
8. *"Never provide accurate forecasts."* Never share bad news while you still have time to do something about it. Superiors will either berate you for your poor performance or demand a higher than agreed result because of some unexpected additional revenue that was not generated by your efforts. The other approach is to tell your superior what he or she wants to hear and trust in your good fortune.
9. *"Always meet the numbers, never beat them."* Managing the results (also known as cooking the books) is a frequent outcome of budgeting. Many finance managers are well versed in "managing the slack" and feeding it into the results when needed. However, as we have seen, this practice can border on outright fraud.
10. *"Never take risks."* It is just not worth it. If it's not in the budget, you might be exposed. Anyhow, if you did take a risk and it worked out well, your superior probably thought of it first! And if it didn't work out, your job might be on the line.

Of course, not all the blame can be placed on the shoulders of the budgeting process. As noted earlier, like all management processes, it is *how it is used* that is important. However, the increasing propensity to use it as the springboard for aggressive performance contracts between companies and investors and between parents and subsidiaries has turned the budget into an annual performance trap. By 2001, the fixed performance contract had become accepted practice in the majority of global corporations. According to a 2002 survey of two thousand global companies, the linkage between fixed targets and incentives was confirmed in 60 percent of cases.[21]

The fixed performance contract is a deadly virus at the core of many organizations today. It can lie dormant for years until an aggressive "management by the numbers" leader comes along and activates its viral properties. It is a dismal way of managing a business.

Toward a Vision of a New Management Model

Although very few firms have attempted to reengineer their whole management model, most leaders would likely agree that the model should support the organization's main goals. What are these goals? While each leader will have his or her own list, we have selected six generic goals: to satisfy shareholders by achieving sustained competitive success, to find and keep the best people, to be innovative, to operate with low costs, to satisfy customers profitably, and to maintain effective governance and promote ethical reporting.

If these goals are representative of how leaders see their organizations in the future, they are a long way from where most of them are now. The traditional budgeting model conflicts with every one of those goals. We need a new management model that eliminates these conflicts and positively supports these goals.

Leaders need to act. This is indeed what a number of them have done. The rest of this book is about their experiences. We will show how they have adopted a coherent set of management processes that are less complex, less expensive, and more relevant than those they have replaced. Some have achieved their visions. Others are making progress. And some have slipped backward as new leaders have undone much good work. By liberating their people from the fixed performance contract, most are transforming themselves into organizations fit to compete in a twenty-first-century environment in which the only certainty is uncertainty and change.

Chapter Summary

- The budget, or to be more precise, the budgeting process, is universally disliked. It takes too long, costs too much, and adds too little value.
- The budgeting model is also out of kilter with a competitive environment that is now subject to discontinuous change. Shareholders now demand that firms be at or near the top of their industry peer group on a range of measures. Intellectual capital, including brands and loyal customers, has risen to be the primary driver of shareholder value. Product and strategy cycles have shortened. Prices and margins are constantly under pressure, requiring action to slash structural costs and reduce bureaucracy. And customers are increasingly fickle, calling out for more decentralized authority to enable front-line people to respond to changing customer needs. All of these changes make it more difficult for managers to operate with budgets that were designed for a more stable environment.
- Whereas the *budget* is a simple estimate of future income and expenditure and has few behavioral implications, the *budgeting process* typically results in a fixed performance contract between superiors and subordinates and is one of the primary drivers of managerial behavior. Budgets and fixed performance contracts are now being used to drive and evaluate managerial performance. This can (and often does) cause managers to behave in dysfunctional ways at every stage in the budgeting process, particularly if they find they cannot meet these contracts. At best this results in "managing the numbers." At worst it results in outright misrepresentation and fraud.
- Though some progress has been made to make budgeting faster, cheaper, and more strategic, few firms have been able to overcome the undesirable (and often pervasive) behavioral side effects caused by the fixed performance contract.
- We need an alternative management model that supports the goals of businesses in the twenty-first century. But achieving this

vision requires more than fixing broken budgets. It requires a new set of management processes, and a new style of leadership. Moreover, it requires a new *coherence* among these management processes and leadership principles to liberate the full potential of the organization and its people.

Glossary

ACCOUNTABILITY: The outputs that a work unit is expected to produce, and the performance standards that managers and employees of that unit are expected to meet.

ACTION PLANS: Business unit initiatives geared toward improving performance against an agreed-upon goal or strategic objective.

ACTIVITY: A unit of work, or task, with a specific output. Activities are distinct, normally are steps in a process, and are capable of being flow-charted and measured. Examples of activities are processing an order and issuing a check.

ACTIVITY COST DRIVER: A unit of measurement for the level (or quantity) of the activity performed.

ACTIVITY-BASED COSTING: Under activity-based costing, costs are analyzed by applying them to activities (or pieces of work, such as processing an order) rather than general ledger accounts (e.g., salaries) that tell little about the drivers (i.e., causes) of costs. Activity costs are then traced to cost objects (e.g., a branch or set of customers) in accordance with how the activities are actually consumed (e.g., how many orders were processed by a central department for a branch). This is done by identifying output measures (e.g., the number of orders processed) and unit costs (e.g., $10 per order).

ACTIVITY-BASED MANAGEMENT (ABM): The management processes that use the information provided by an activity-based cost analysis to improve organizational profitability. The overall aim of ABM is to cut across the functional hierarchical view of costs, align work and resource consumption with customer value, and manage the business through its processes. The goal of ABM is to enable customer needs to be satisfied while making fewer demands on organizational resources.

ADAPTIVE AND DECENTRALIZED ORGANIZATION: An organization that operates with adaptive management processes and that devolves performance responsibility to front-line people close to the customer.

ADAPTIVE MANAGEMENT PROCESS: A process of planning and decision making that is not tied to a specific plan or budget. Operating managers and teams have significant local discretion to use their knowledge and judgment to make decisions that are congruent with the organization's purpose and strategy.

ANTICIPATE-AND-RESPOND: A description of a business that takes an "outside-in" view of business planning, first anticipating what customers will need and then responding to that need by acquiring the resources necessary to satisfy it.

ASPIRATIONAL GOALS: Goals that are set based on significant step-changes in performance and that are likely to be reached only with exceptional changes in performance over a number of years.

BALANCED SCORECARD: A strategic management and measurement framework that views a business unit's performance from four perspectives: financial, customer, internal business process, and learning and growth. It enables managers to map and describe a business unit's strategy, and review its progress periodically.

BENCHMARKING: The process of studying and comparing how other organizations perform similar activities and processes. These organizations can be either internal or external to the firm and are selected because they are known to have excellent performance for the benchmarked process or result.

BEYOND BUDGETING: A set of guiding principles that, if followed, will enable an organization to manage its performance and decentralize its decision-making process without the need for traditional budgets. Its purpose is to enable the organization to meet the success factors of the information economy (e.g., being adaptive in unpredictable conditions).

BUDGET: A plan expressed in financial terms, a basis for controlling performance, an allocation of resources, an entitlement to spend, and a commitment to a financial outcome.

BUDGET CONTRACT: A commitment resulting from the delegation of accountability for achieving agreed-upon outcomes to a divisional, functional, or departmental manager.

BUDGET GAMES: Attempts by managers to manipulate information and targets and take non-value adding actions to achieve their budgets and to attain high bonuses.

BUDGETING PROCESS: The practice of preparing, submitting, and agreeing upon a budget between one organizational level and another.

CAPABILITY TO ACT: The capabilities that people have to execute their decisions. This includes the resources, tools, training, and information at their disposal, and the removal of bureaucratic constraints.

CAPACITY CONSTRAINTS: Limitations on the quantity that can be produced because the capacity committed for some activity resources (e.g., plant space or number of machines) cannot be changed in the short run.

CENTRAL CONTROL: The control exercised by senior executives over decisions taken by managers in divisions and business units to ensure that their actions conform with group policies, plans, and directives.

CONTINUOUS IMPROVEMENT: An approach to performance management that aims to continuously improve against benchmarks or competitors.

COORDINATION: The linking of commitments between one part of an organization and another to satisfy the needs of external customers.

COST CENTERS: Responsibility centers whose managers and other employees control costs but not revenues or investment levels.

COST OF CAPITAL: The return that the organization must earn on its investments in order to meet the requirements of its investors. This is the interest rate that organizations use in their time value of money, discounting, or compounding, calculations.

CUSTOMER ACCOUNTABILITY: The emphasis placed on individuals being accountable for satisfying customers' needs both internally and externally.

CUSTOMER PROFITABILITY: The *net profitability* of individual customers or groups of customers (e.g., channels and market segments) after assigning income and all the costs consumed (e.g., production, marketing, selling, distribution, and administration).

CUSTOMER RELATIONSHIP MANAGEMENT (CRM): The process of knowing and satisfying customer needs profitably.

CUSTOMER VALUE PROPOSITION: The unique set of promises (e.g., price, quality, product features, and service convenience) that defines the company in the eyes of the customer.

DECENTRALIZATION: The devolution of decision-making responsibility from the corporate center to divisions and business units. *Radical decentralization* delegates *performance* responsibility to managers and teams at (or near) the front line.

DEVOLUTION: The act of transferring performance responsibility from the center to operating and front-line managers and teams without defining this responsibility in terms of a specific plan or budget.

ECONOMIC VALUE ADDED (EVA): An evaluation of a business unit or product line's financial desirability using its residual income. EVA is defined as the (adjusted) after-tax profit for the period less the (weighted average) cost of capital. Thus, if a company has after-tax profits of $20 million, shareholder funds of $100 million (with a cost of capital of 12 percent), and borrowings of $50 million (with a net of tax interest cost of 4 percent), its EVA would be $6 million (profit of $20 million less equity cost of $12 million and debt cost of $2 million).

EMPOWERMENT: The act of providing employees who are closest to operating processes, customers, and suppliers with the freedom and capability to make decisions that are consistent with the company's strategy and values.

ENTERPRISEWIDE INFORMATION SYSTEMS: Computer-based management information systems that connect every part of an organization and provide information to those who need it when they need it.

ETHICAL INFORMATION: Information that is transparent and untreated by managers in an effort to make it look better than it really is.

FAST AND OPEN INFORMATION: Relevant information that can be accessed by individuals when required from an organization-wide data repository and interpreted in any way that supports their decision-making requirements.

FIXED PERFORMANCE CONTRACT: The outcome of a process of agreeing upon targets, incentives, plans, resources, cross-company commitments, and performance measures between a superior and subordinate for a specified period. Its terms and conditions can either be explicit (usually a written letter between the parties) or implicit (custom and practice tell the parties what the likely outcomes will be). In addition to the six elements just identified, the terms of such a contract are likely to include a time period within which targets must be achieved, the limits of authority, and the reporting intervals.

FIXED TARGET: A financial or nonfinancial target that is represented by a fixed number to be achieved within a specified period of time (e.g., an annual budget or Balanced Scorecard KPI target).

FORECAST: A periodic financial statement of the most likely outcome of income and expenditure related to a business or project for a specified period of time. Forecasts are often used to evaluate whether the current year is on track to achieve the approved budget. A forecast may also be made for a nonfinancial measure.

FREEDOM TO DECIDE: *See* empowerment.

GOVERNANCE: The framework of principles, values, boundaries, and control systems that is defined for managing empowered actions.

INCENTIVE COMPENSATION: The linking of rewards agreed upon in advance to the achievement of fixed targets within a specified period of time.

INTELLECTUAL ASSETS: There are three types of intellectual assets: Human capital or competencies include the experience, skills, and capabilities of people. Structural or internal capital includes patents, trade marks, and copyright; the store of knowledge in databases and customer lists; and the design and capability of information systems. Finally, market-based or external capital includes the profitability and loyalty of customers and the strength of brands, licenses, and franchises.

INTERNAL MARKET: The simulation of an external market between buyers and sellers but operated inside an integrated organization. Thus, internal service providers become suppliers to operating unit customers. Prices are negotiated and service levels agreed upon.

KEY PERFORMANCE INDICATORS (KPIs): Performance measures used to set goals and assess an organization's performance based on its critical success factors.

KEY VALUE DRIVERS: Those elements, such as quality, time, cost reduction, innovativeness, customer service, or product performance, that create long-term profitability for the organization.

KNOWLEDGE MANAGEMENT: A process that makes the most effective use of the intellectual capital of a business. Its purpose is to enable people across a large organization to share information and insights that lead to performance improvement.

MAKE-AND-SELL: A description of a business that takes an "inside-out" view of business planning, first planning what to make and sell and then persuading customers to buy its output.

NET PRESENT VALUE (NPV): The summation of the current value of a stream of future net cash flows after adjusting for the time value of money.

NON-VALUE-ADDED ACTIVITY: An activity that presents the opportunity for cost reduction without reducing the product or service value potential to the customer.

OPERATING BUDGET: A forecast of revenues and expenses based on a plan that has been agreed upon by management as the target for the next operating period (typically one year). The operating budget also authorizes spending on discretionary activities, such as research and development, advertising, maintenance, and employee training, and is the basis against which such expenditure is controlled.

OPERATING MANAGEMENT CYCLE: A cycle of operating management reviews during which day-to-day operating issues are addressed.

PERFORMANCE MANAGEMENT MODEL: The whole process of setting goals and rewards, deciding strategies and action plans, managing resources, coordinating activities, and measuring and controlling performance for an organization.

PERFORMANCE RANKINGS (LEAGUE TABLES): The comparison of performance outcomes between a company and its subunits with their peer groups. The position in the league table can act as a spur to higher levels of achievement.

PROCESS: A specific ordering of work activities across time and place, with a beginning, an end, and clearly identified inputs and outputs, and in which resources are consumed.

PROFIT CENTER: A responsibility center whose employees control revenues and costs but not the level of investment.

RADICAL DECENTRALIZATION: The devolution of performance responsibility to managers and teams at (or near) the front line.

RELATIVE IMPROVEMENT CONTRACT: An implicit agreement between a superior and subordinate to use their best endeavors to continuously improve performance against specified benchmarks, peers, competitors, or prior years. Performance is evaluated with the benefit of hindsight.

RESPONSIBILITY CENTER: An organizational unit for which a manager is accountable in the form of cost (a cost center), revenue (a revenue center), profits (a profit center), or return on investment (an investment center).

ROLLING FORECAST: A financial forecast (usually including a few high-level figures such as sales, costs, and cash flows) that is updated on a rolling basis. A typical rolling forecast would be prepared each quarter to cover the following five quarters. It is not tied to a particular fiscal year-end review but enables managers to continuously review strategy and cash requirements.

ROLLING REVIEW CYCLES: The process of reviewing performance that is not tied to a particular fiscal year. Typical review cycles are annual (looking two to five years ahead) and quarterly (looking five to eight quarters ahead).

SHAREHOLDER VALUE MODELS: Models such as EVA (economic value added) and VBM (value-based management) that enable managers to make decisions on the basis of their impact on shareholders' wealth.

STRATEGIC CONTROL: The process of providing information about the competitive performance of the overall business unit, both financially and in meeting customers' needs, for control purposes.

STRATEGIC INFORMATION: Information that guides the long-term decision making of the organization. Strategic information can include the profitability of products, services, and customers; competitor behavior and performance; customer preferences and trends; market opportunities and threats; and technological innovations.

STRATEGIC MANAGEMENT CYCLE: A cycle of strategic management reviews during which major strategic issues are addressed.

STRETCH TARGETS: Those targets that represent significant increases in the targeted amount or goal above the existing targets or goals, and is more than an incremental improvement over current performance.

TOTAL SHAREHOLDER RETURN: The sum of gross dividends plus the increase in share value expressed as an annual compound rate of growth (of the original share acquisition cost) between two points in time.

TRANSFER PRICE: An internally set transaction price to account for the transfer of goods and services between different parts of the same firm.

VALUE CHAIN: A sequence of activities whose objective is to provide a product to a customer or to provide an intermediate good or service in a larger value chain.

VALUE-ADDED ACTIVITY: An activity that, if eliminated in the long run, would reduce the product's service to the customer.

VALUE-BASED MANAGEMENT (VBM): A decision-support process that combines historic and predictive views with financial and nonfinancial drivers of the business. It enables managers to evaluate alternative plans by measuring their impact on (future) free cash flows and thus, by applying an appropriate cost of capital discount rate, on shareholder value today.

VARIANCE ANALYSIS: The decomposition of differences between actual and estimated costs into amounts related to specific factors causing the variance between actual and estimated costs.

WORK UNIT: A grouping of individuals who utilize the firm's resources and are accountable for performance.

ZERO-BASE BUDGETING: An approach to agreeing on discretionary expenditures that assumes that the starting point for each item of discretionary expenditure is zero, and involves a process of ranking expenditure options.

Notes

Chapter One

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