

# Beyond Budgeting – Breaking free from the Annual Fixed Budget

## A Discussion between Experts from Borealis, Nestlé, Unilever und SAP



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By Juergen H. Daum - with Dr. Rainer Gunz, Jean-Daniel Luthi, and Steve Morlidge

*This article has been published in: Measuring Business Excellence – The Journal of Business Performance Management, Volume 9, Number 1 2005, p. 64-70.*

What are the opportunities and challenges organizations are confronted with on their way in implementing more flexible and more effective enterprise control and performance management systems? Abandoning the annual budget – is this a realistic and feasible objective? Why do companies consider it at all? Where can they start? Three experts from companies that already have gained for some years experiences with a Beyond Budgeting Performance Management System or that have started recently their Beyond Budgeting journey are discussing with Juergen H. Daum the practical consequences of this approach.

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**Juergen Daum:** Mr. Luthi, Nestlé is one of the largest consumer products companies in the world. Can you imagine that it is possible to manage such a large organization without any budget?

**Jean-Daniel Luthi:** When we are discussing about budgeting or abandoning budgeting, I think first of all you would have to properly define what a budget is. Depending of to whom you talk to in the organization, the understanding of what a budget is can be very different. You have to ask yourself, for what are you using the budget? We as Nestlé, a multinational company with about 175 reporting entities worldwide, we have to have an idea of where we are going. We have to know, whether our strategy, our vision is really taking place in the world and whether we are going to achieve our company objectives. And for this we need tools and procedures. Many years ago, when I started my career in Nestlé, communication facilities were very poor. I never called Switzerland from Indonesia for several years, where I was a CFO of a local Nestlé company - you could not get a line, you could not call. So at that time the annual budget was really the only way to have an understanding between headquarters and the countries. And it was o.k. to do budgeting once a year and to focus on the financials, as our country organizations were acting more or less independently from each other and had their own local strategy. Also the environment was much more stable at that time. But nowadays, when things are changing so fast, you have to be much more reactive. And with today's global markets, it's not just enough to have a strategy for one particular country.

So I agree that the traditional annual budget might not be any more the right tool today to steer and manage a company like Nestlé. We need something, which allows us to become more dynamic and to not just focus on financials, but to manage the strategy of the group. But I cannot imagine having nothing for the future, to have no steering tools, if this is what you mean with having no budget.

**Juergen Daum:** Mr. Morlidge, what is your view? Is it possible to manage without a budget and what means Beyond Budgeting?

**Steve Morlidge:** The budget and traditional budgeting institutionalizes in companies a set of tools and procedures that lead to a fixed annual performance contract – between headquarters and business units, between business unit leaders and operational managers and so forth. It creates an interlocking set of fixed annual plans, typically arrived at by a process of negotiation, that has few to do with customers and market demand, and that is tied to rewards in a deterministic way. As a consequence everyone in the company is focused on making the budget numbers, not on satisfying customers, not on beating the competition or on reacting to markets changes as fast as possible in order to leverage them as opportunities for growth and for building competitive advantage. So in essence, Beyond Budgeting means, getting rid of the fixed annual performance contract. And any move away from these fixed processes locked together is a move towards Beyond Budgeting. There is an extreme example like Svenska Handelsbanken<sup>1</sup>. They created over the last 30 years an organization that is self-adaptive, where customer orientation, entrepreneurship, immediate reaction to market development and to new customer demands have become a natural behavior of every employee and it is now part of the company's culture of it's organizational genes so to say. But not every company is able to fully follow the Handelsbanken model and to emulate that success – for various reasons. But nevertheless I believe, any step away from the fixed contractual management system is not only good for business, because it allows you to be more flexible, but I also think it's a more humane workplace. One of the reasons for doing what I am doing at the moment (as project leader Dynamic Performance Management at Unilever and as chairman of the European branch of the BBRT) is that I am not willing to tolerate anymore seeing so many talented people spending too much of their live doing something really stupid, such as budgeting and adhering to a budget, and knowing, they won't adding any value. It is possible to be like Svenska Handelsbanken? Theoretically yes, but any move away from where we are now is a good move. That's my point of view.

**Juergen Daum:** Mr. Gunz, Borealis has already made the experience of living without a budget. Borealis was one of the pioneers of "Beyond Budgeting" and abandoned budgeting already in 1995. What would you define as the most important "lessons learned" during the process?

**Rainer Gunz:** First of all Beyond Budgeting doesn't mean that you have no border and no target. When Borealis decided to skip budgeting, our vision was not, just to abandon it and then have nothing. Instead we asked us first, what had been the purposes of the budget for us, what had been the problems with the budget approach, and then we tried to develop tools, which are better suited to meet our purposes. One of the first things that became very clear was, that we had to separate financial forecasting from target setting and performance management. You never will get accurate and honest forecasts if bonuses and performance appraisal of people are linked in some way with these forecasts. So we introduced rolling financial forecasting that looked beyond the fiscal year. We implemented it as an independent tool and process, independent from target setting and performance management. In general we have split the budget apart into four separate tools: rolling financial forecasting, the Balanced Scorecard, rolling investment management and benchmarking. This allowed us to become more flexible and to reduce the gaming with the financial numbers. So Beyond Budgeting doesn't mean that you have nothing – the contrary. It means to develop and implement tools that are more appropriate to help you to manage your specific business than the traditional fixed annual budget is able to do. And it worked for our company, for several years. But it's mainly an issue of mindset, not of tools. Basically it comes back to the one question: Do you have a fixed contract or are you prepared to live with moving, relative targets? That is: targets based on benchmarks that are dependent on factors and developments outside the company. The

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<sup>1</sup> for the Beyond Budgeting case of Svenska Handelsbanken see the interview with Svenska Handelsbanken's CFO Lennart Francke at [http://www.juergendaum.com/news/02\\_24\\_2003.htm](http://www.juergendaum.com/news/02_24_2003.htm))

important task is then to explain to and to challenge people to accept a moving target. A moving, relative target, means, that managers actually do not know, at the time they agree to the target, where they really will end up in terms of absolute numbers. That requires the turn of a mental switch, if you come from traditional budgeting. You have to understand that it is important to see the target, but that you do not need to know an absolute number in advance. This will help that people give their best, that they look at the competition, what they are doing, to the market, how it is developing, and not at a internal budget that need not to reflect reality.

**Juergen Daum:** Mr. Luthi, Nestlé has decided recently to implement a new concept that you call “Dynamic Forecasting” that should replace somehow the old fixed annual budget and that should serve in the future as the foundation for your performance management process. Can you tell us why you choose to implement “Dynamic Forecasting” and how it will work?

**Jean-Daniel Luthi:** As I have already explained, the main objective for us, when we talk about Dynamic Forecasting, is to become more flexible in managing the performance of our company. And that starts with strategy. We had what we used to call a long-term plan that should focus on strategy. But my experience is, if you start mixing strategy together with planning, sooner or later planning takes over. And that's what happened after a few years. We were focusing on numbers, not on strategy any more. So when I proposed to discontinue the long-term plan, management agreed instantly. So our Dynamic Forecasting starts first with the agreement of strategy. This is discussed at the top and then communicated down. It is a top down process. And once strategy is approved you then translate it into objectives, long term and mid term objectives and milestones. And these objectives are then updated once a year, because you don't change your strategy all the time, normally.

**Juergen Daum:** What are the other elements of Dynamic Forecasting at Nestlé?

**Jean-Daniel Luthi:** It's the forecasting process, which relates to another problem with the traditional budget. It always stops on 31st of December or whatever period you have. One of our managers said, it's like you die on every 31st of December and then you are reborn on the 1st of January. But real life is different, things continuously evolve and change all the time. So you shouldn't just look out until the year-end. And this is, where rolling forecasting will help us to look in a rolling way several quarters out into the future, beyond the 31st of December.

**Juergen Daum:** How do you use these forecasts in the performance management process?

**Jean-Daniel Luthi:** These forecasts show the gaps, gaps between your targets or milestones and between your estimates according to the forecast, which show where you probably may end up, if you change nothing. It shows negative gaps but also positive gaps that may represent new opportunities. Why should you stick to your budget, if new opportunities come up? You want to make use of them. So you have to be tolerant. You have to allow those gaps. And you even have to allow a gap, where you have no explanation for the moment. As the responsible manager you are then going to work on it. You are analyzing the gap and you will decide, what you are going to do about it. And three months later you report back. And setting up the forecast shouldn't be that complicated. It should be simple. Why not, for a start, just copy last year's, last period's actuals? That is what I suggested. And somebody said, “But that's wrong, we can't do that”. But if you say it's wrong, you are already making a forecast. You see what I mean? This will focus you not on the numbers, but on the real activities of your business unit or market. It focuses you on why things should change. If you do not manipulate forecasts, if you do not modify it, because your boss wants you to show something better, you are going to show the gaps. And that creates conflict. And we would like to have creative conflict. We should not be afraid of conflict. We have to manage trade-off. We have to manage priorities. And this it what counts.

**Juergen Daum:** Mr. Gunz, after you have implemented the Beyond Budgeting tools at Borealis, what was different then compared with the old traditional budgeting process?

**Rainer Gunz:** When we skipped the traditional budgeting we focused on the main points, the critical issues for us. A critical issue for us was and still is, for example, investment management. Because business conditions are changing so rapidly, a key requirement that we defined was, that we needed a more flexible approach for investment management that allows us to dynamically adapt overall investment volumes, also during the fiscal year, to changing economic conditions. So we implemented a rolling investment management process, which allows us to continuously reconcile our investment projects with our business strategy, with the current economic potential and with opportunities that show up. With this approach it is now possible, that profitable investment ideas that come up “late” – after the timeframe of the annual budgeting and investment appraisal process has been finished - have still the chance to be realized.

**Juergen Daum:** And the other tools, what was the main benefit they provided?

**Rainer Gunz:** The Balanced Scorecard gave us a broader perspective in performance management than the traditional budget, which was focusing just on the financial numbers. It gave us the ability to include the driver perspective. That is to focus on the driver of business and financial performance, such as intangible assets or other non-financial business drivers, instead of just on financial results. The rolling financial forecast was going to solve another problem, which was the same that Jean-Daniel Luthi already mentioned: to break out of the limited annual time horizon, that becomes shorter and shorter as you approach the year end and that narrows step by step your view in performance management and reduces step by step your options to act. Therefore we said, we want to have a continuous view on the next eight quarters, to see more than just the actual year and to have at least two years in front, when we look at our estimation and when we think about changing our priorities or about corrective actions. When doing the rolling financial forecast we focus on the most important driver information such as changes in prices, exchange rates, volumes etc..Then we calculate forecasts based on a model, by taking these driver informations as input parameters. That speeds up the process and allows us to forecast every quarter using a minimal amount of resources. It’s a straightforward process, much simpler and faster than budgeting. And because we have now every quarter a new forecast, we can better plan for example required financial funds or liquidity. It also gives us a lot of early warning information that may trigger strategy adaptation.

**Juergen Daum:** How does the fourth tool, benchmarking, fit into that picture?

**Rainer Gunz:** Benchmarking means comparison in relative terms. You compare yourself against a peer group – usually a set of competitors. Also investors and other company stakeholders compare your performance with that of other, comparable companies. If the market goes up, all companies, for example in the petrochemical industry, will show better results. If you want to show better performance in the eyes of an investor, you have to have higher result grows than your competitors have. The same applies vice versa, if the market goes down. That is the basic principle of benchmarking. But if investors judge companies that way and evaluate their performance that way, you should manage your performance internally according to the same principle. That is the reason, why we are doing benchmarking. We benchmark the efficiency of operational processes, activities and costs - on different levels. For us benchmarking is also very important, because it enables us to define relative targets that move with the environmental developments. Such a target could be for example, to be best in class or in the first quartile of your peer group in a specific area. In addition, benchmarking forms an important foundation for our other performance management tools and processes: it is an important measure in rolling financial forecasting to show, if things are moving in the right direction. It helps us to define challenging targets and prioritize targets and measures for the Balanced Scorecard. And, finally, it helps us to prioritize investment projects from a market/competitor perspective.

**Juergen Daum:** Recently, you have introduced a fifth tool, rolling business planning. Can you explain why and for what?

**Rainer Gunz:** The reintroduction of the 3-years-business plan could be seen as a response of several requests. When the Austrian OMV and IPIC from Abu Dhabi became investors in Borealis in 1998, they

asked for something like a budget that they can use as input for their own budgeting and financial reporting process. Beside this the new owners and also the new management had been not satisfied with the overall performance of the company. Both facts had an effect on our beyond budgeting approach. But we wanted to avoid losing all the good effects of our four tools. So we came up with a solution that serves both requirements: flexible steering and control of our business within Borealis, where it is necessary, based on the four Beyond Budgeting tools, and a disciplined, financials-oriented management of our internal units. With the 3-years business plan we also can supply our owners with the numbers that they need to oversee their investment and to steer the business from a shareholder value perspective. The business planning process is integrated with the other four tools. It is a rolling process that looks 3 years ahead into the future. And we are also using the business plan to define annual bonus and incentive targets for management. So what we tried was, to combine both of best worlds: to combine an internal Beyond Budgeting management approach that gives us the necessary flexibility we need in our business, combined with the possibility to oversee and steer the business from a more high level financial and owner perspective.

**Juergen Daum:** Mr. Morlidge, as a BBRT member and chairman, in terms of tools needed, what would you tell companies, their CFOs and controllers, who want to make the first step in the direction of Beyond Budgeting? What are the most important tools to begin with?

**Steve Morlidge:** That's the question I am asked most often. And there is a danger, the danger being, that you think you can just put in some new tools and that's it. I often see this attitude in the consulting community. Consultants are often too desperate to be able to say, in order to do Beyond Budgeting you need one of these, this software, or you need a Balanced Scorecard, or you need this. That's not a good development, because Beyond Budgeting is not about tools. It's about – and that was said already several times here – it's about a mindset, about trying to move from a fixed view of the world to a dynamic view of the world. You have to make that move first. It's like to turn a switch in your mind, as Rainer Gunz said. If you have done that, the question of tools is not a big problem any more. I believe that most competent finance people, once you decide to make that transition, they will find ways to make it work, they will find, develop and implement the right tools. But as I said, fundamentally Beyond Budgeting is not about tools. However, the easiest place to start in terms of tools, and that is the experience from the Beyond Budgeting Round Table, is in measurement. It's very easy to say, what we will do is moving to annual totals instead of year-to-date and year-to-go type measures. It's very easy to say, we will stop doing variance analysis against plan and may be do variance analysis against last year or move from variances to time series, e.g. cost control based on moving averages. These are easy steps to take. And our experience is, that this starts the process to changing the mind set, particularly if you present it in the right way. The area where a single change would make the biggest difference is rewards, but it's not the easiest.

**Juergen Daum:** Mr. Luthi, what are your intentions to approach the implementation of “Dynamic Forecasting” within Nestlé and to initiate the required changes?

**Jean-Daniel Luthi:** Well, first of all, you need the full support of the management. If we start to change our enterprise and performance management approach, we are touching the culture of business, that is, how the management wants to deal with the corporation, how they want to drive the corporation. Therefore you have to start with the general management team. Management must really understand that first. The objective is to change the mindset, to move to a more dynamic view of the world, as Steve Morlidge said. It's not just another reporting tool. And not everybody sees the need to change right away. You have to be patient. You have to go and repeat and to discuss and re-discuss these issues. And even sometimes, when everybody seems to understand and to agree, you have to come back on it, because you find out the agreement is not exactly as it should be.

**Juergen Daum:** So the first step is, that you have to create awareness in the management team and that you have to try to get their commitment. What is the next step?

**Jean-Daniel Luthi:** The next thing we had to do, was to get support in the organization. So the next step was, to present the idea to the heads of finance&control of our market units. In the presentation I started to name all the problems we had with the current system. And they all agreed. They all agreed that we have to change. I said not more. It didn't promise anything. I didn't say what we are going to do. But we had a common agreement that we need to change. Afterwards we started to work on it and the second presentation was made again to management to keep them in the loop and to get their commitment. Then we presented our new concept to what we call our top 15 large market heads, people who are running businesses. And they also agreed. We then found relatively fast four pilot markets and we started to work with them.

**Juergen Daum:** What else was critical in the process, beside the fact that you have to get full management support and support from the business?

**Jean-Daniel Luthi:** You have to include the people from the business in the decision making process. So you have to really understand that this project, what we now call Dynamic Forecasting, is not about financial reporting. It's about to manage the business in a much more flexible and dynamic way. Therefore you have to talk to the business people and they are usually in favor of getting rid of the old fixed annual budget and to replace it through something more appropriate. They often see the need to change faster and they perceive it as more urgent than central staff people do. This is because they have to introduce new products and they have to plan promotions in a constantly changing market environment. They are already starting now, in June, to deal with the retailers for next year. And they want this to be captured, to be taken into account somehow. So who should really drive the change process? I basically believe that finance&control people should not drive this process. But the problem is, if you put the finance&control people aside and then ask, "who else?", you are usually back to finance&control. Why? May be because we are more used to systems, more used to be agent of change, to communicate, we have a strong internal network. But even if finance is running the project, you have to make sure that it is not be perceived as being a finance project, that it is regarded as an implementation project for new financial tools. That's a key issue.

**Juergen Daum:** Mr. Gunz, based on your experience at Borealis, what would you recommend to other companies who want to become more flexible, who intend to implement some type of "Beyond Budgeting" concept?

**Rainer Gunz:** When you only want to change performance management, then the focus is usually on changing your tool box, on developing and implementing new tools. And that's the easier part. But when you want to go one step further, to really empower people, to have a different leadership model behind, then you are entering an area, where things become more complex. Then you have to deal with the culture of a company, with the soft facts and skills. Usually you cannot fully separate the two areas. We mentioned it earlier, also changing the tools in order to become more flexible requires some changes on the behavioral side, in the mindset. I fully believe that an approach from the leadership model can create much more benefits than just improving the tool set. But you have to be aware that this is a hard job and such a fundamental change is not easy and it will take some time. And it will take at least the senior management to support and to drive the change process. But a good start will be to move from fixed target to relative target.

**Juergen Daum:** Mr. Morlidge, you mentioned earlier, in your presentation before this discussion, that trust is one of the most important things it takes to move away from the budgeting model, from the fixed performance contract. Many people say, that traditional budgeting is nourishing mistrust in the organization. So if you have a typical budget organization, where people so far have been used to gaming and where mistrust is present all the time, how do you move away from that to an organization that can work on a trust basis?

**Steve Morlidge:** In order to answer that question, I will tell you a story from my private life. My organization there is my family. I have three children. The eldest is nineteen, the youngest is ten, and my middle one is sixteen. We have a very relaxed household, with a very few rules. We just rely upon the kids to do the

right thing, to help without being asked and all that kind of things. But my middle daughter is different temperamentally to the other children. Now for the eldest and for the youngest, we give them freedom and they don't abuse it. So for us, control is not a problem, because we know, we can rely upon them. My middle daughter however, is, as I said, different and it has got to a point, this weekend actually, where my wife was getting so upset with my middle daughter, that we had to have a family conference. I am telling you this not to unburden myself of my family problems. But for me, that illustrates the issue. Trust is about letting go. But then, when somebody abuses that trust, as my daughter did, you have to tackle it. And I tell you, I hate having these conversations, because you have to sit down with her and tell her some things that she doesn't like. When you love your children, you hate doing these things. But we had to do it. And we drew up an agreement about what she will do and what she will get from us and we have now to police that agreement and hopefully she will abide by that agreement. So for me, establishing trust, is about letting go, accepting the consequences, but when those consequences are negative, taking action. So, the only way for me to establish trust is to start. Start, let go, and react to what happens.

**Juergen Daum:** Thank you very much Mr. Luthi, Mr. Gunz and Mr. Morlidge for this interesting discussion.

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