

Going “beyond budgeting” in the public sector

By Jeremy Hope and Peter Bunce

Annual budgets have been a feature of UK public sector internal planning and control processes for as long as anyone can remember. They enable organizations to prioritise their operating programmes and plan their spending. In recent times, however, planning and budgeting processes have been severely criticised, both in the private and public sectors. They are felt to take too long, cost too much, add too little value and, most importantly, encourage dysfunctional behaviour. And in the past few years the tightening of the target setting culture has made these problems much worse. There has to be a better way. This article will list some of the problems, examine what can be done about them, pinpoint some areas for further research, and describe a new interest group that will focus on improvement options.

What are the problems of planning and budgeting?

That annual plans and budgets take too long and cost too much is almost taken as a given. But it is how they impact the planning and operational dynamics and management behaviour that is the real problem. And it is getting worse. Here are just a few of the criticisms:

- They are used to set internal cost or activity targets that have little or no connection with satisfying external customer needs or achieving the agreed purpose of the organisation. In other words, they can't answer the question “How well have we improved over the last year and over the past three years?”
- They provide little encouragement for organisational units to improve or ‘stretch’ their performance. Success is defined as ‘meeting the budget’ rather than maximising potential.
- They encourage a ‘spend it or lose it’ mentality leading to valuable resources being wasted in one area while another area desperately needs more.

Jeremy Hope and Peter Bunce are directors of The Beyond Budgeting Round Table (BBRT), an independent members sponsored international research consortium. See www.bbrt.org or contact peterbunce@bbrt.org for more details about the BBRT. “Who Needs Budgets”, an article by Jeremy Hope and Robin Fraser was published in the Harvard Business Review in February 2003, and the book *Beyond Budgeting* (by the same authors) was published by Harvard Business School Press in April 2003

- They have spawned a growing inspectorate bureaucracy that demands adherence to multiple targets mandated by different agencies that distracts and demoralises professional staff.

One particularly insidious development has been the increasing use of targets (ostensibly to drive performance improvements) at every level. Failing to meet specific targets can have severe implications for hospitals, schools, and police services, yet the media has been replete with stories of how managers have taken irrational decisions to meet targets while neglecting patients, students and victims of crime. It seems that the government is finally getting the message. A report by the Public Accounts Committee in July 2003 stated that, "performance measurement should primarily take into account whether services are improving – not whether they have hit an absolute target...Fear of failure has led to fiddling of figures so that creativity is being directed more to ensuring that the figures are right than to improving services...Front line workers should be much more involved in target setting...A focus on progress would show which hospitals, schools, councils and police forces were making progress and which "are going nowhere or backward".

Ed Balls, Chief Economic Advisor to the Chancellor of the Exchequer, noted in September 2003 that, "the command and control approach used in the Labour Government's first term across local government, education, health and much else *saps morale*...It *destroys innovation and experimentation*, it fails to allow different policy areas that must in fact be interconnected to be joined up...In a complex world it is simply not possible to run economic policy or deliver strong public services using the old, top-down 'one size fits all' solution".

What can be done?

Clearly the government is dissatisfied with the performance of many public service organisations but their efforts at addressing these problems through detailed targets and micro-management has failed to win the hearts and minds of key people or produce the expected results. However, just rewinding the tape and erasing the target setting approach *without a better alternative* is unlikely to be an option.

In the past six years the *Beyond Budgeting Round Table (BBRT)* has been working with a range of organisations (including some in the public sector) to understand these problems and derive practical solutions. The "Beyond Budgeting Model" has been derived from the 'best of best practices' of leading-edge organizations and consists of two sets of six principles that redefine performance management. The first six support a more

adaptive set of management processes that enable organisations to be more responsive to the environment and to customer needs. The second six support greater devolution of responsibility to teams accountable for improving (internal and external) customer outcomes and relative performance.

<u>Adaptive Management Process Principles</u>	
1. Target setting	Set aspirational goals based on continuous relative improvement not fixed targets
2. Rewards	Reward shared success based on relative performance not on meeting fixed targets
3. Planning	Make planning an inclusive and continuous process not an annual event
4. Resources	Make resources available as required not through internal annual budget allocations
5. Coordination	Coordinate cross company interactions dynamically not through annual plans and budgets
6. Controls	Base controls on relative performance indicators not variances against plan

<u>Devolved Responsibility Principles</u>	
1. Governance	Base governance on clear values and boundaries not on detailed rules and budgets
2. Performance	Build a high performance culture based on relative success not on meeting targets
3. Freedom to act	Devolve decision making authority to frontline teams don't micro-manage them
4. Accountability	Create a network of small units accountable for results not centralized hierarchies
5. Customer focus	Focus everyone on improving customer outcomes not on meeting internal targets
6. Information	Promote open and shared information don't restrict it to those who 'need to know'

These principles represent a holistic model (not a menu of options) but different organizations will place different emphases on different elements at different times. Sydney Water is a good example.¹ Until about four years ago, the budgeting process was very traditional. Aubrey Joachim, financial manager of Sydney Water's asset management division, gives some examples of the problems they encountered. "This is how ridiculous it got. Our budget was being compiled from 1400 accounts. I remember one of these line items was an amount of \$6198 for parking, another for postage of \$3250, made 18 months in advance. Yet once the managers were given those dollars, no one really monitored what happened afterwards," says Joachim. Take training. "The manager would include an amount in his budget, but would have no idea what he was going to give training for, nor who he was going to train. It would just lie there, until someone asked to go on a course. The control was not 'do you really need to go to that course, will it add value to your work?' Rather, the question was directed to the accountant: 'how much money is there left in the training account?'"

The impetus for change came from Sydney Water's corporate finance division, which told the Asset Management team it needed to cut the division's proposed budget from \$600 million to the available funding of around \$564 million. Joachim says the usual method of asking the various managers to identify where

¹ See "How to Beat the Budget Blues" by Bernard Kellerman in CFO Magazine Australia, May 2003

cuts could be made had virtually no effect. "If you look at every account level, it becomes too difficult. Try as they might, the divisional managers wouldn't, or couldn't, accept more than a total of two or three million to be cut from the budget,' says Joachim. Around this time, he heard about the concept of Beyond Budgeting. 'I looked at our costs, and identified around \$80 million that could be classified as discretionary costs. If I could somehow influence management not to spend some of this discretionary amount, then we could achieve this reduction,' says Joachim. He then told managers, "there are no budgets, and I'm not telling you what the numbers are".

The discretionary funds were to be kept in a pool, and each business area manager was required to justify why they needed extra funds to the rest of the managers. "I told them to spend what was required and I'd monitor. Everyone, from top executives to the plant managers, went crazy. The group accountant asked me, "How the hell will you be able to tell me what the variances are?" I said, "Don't worry - I won't tell you". And he hasn't asked me since," says Joachim.

The process has required Joachim to look at costs differently. Re-categorising them into discretionary and non-discretionary leaves managers to consider the true purpose of their expenditures. Joachim has worked on refining mandatory and discretionary costs to arrive at the point where he now believes he has identified the division's major underlying costs. "If these go outside an expected range, I can then ask, 'What went wrong?' and start looking at possible problems immediately. For example, the business is very much affected by the weather. In dry weather there are a lot more pipes cracking, and in wet weather there are a lot more things like overflows of the sewer system," Joachim says.

Another major benefit has been to remove the 'silo effect', which had encouraged managers to build 'fat' into their budgets. "We have broken this down by pooling our discretionary funds. These projects will be across all business areas, so the managers must justify them, not because they have the money to spend - as in the past - but according to need," says Joachim.

Joachim says there were tangible results after the first year, and these continue as the process of revising and redefining costs as either mandatory or discretionary continues. He says the resource savings so far have added up to 'tens of millions of dollars' over the three years since the new approach was introduced. He also says that despite the angst, no managers have left his organisation as a direct consequence of the changes.

Areas for research

We believe that by applying Beyond Budgeting principles, public sector organisations can break free from the annual budgeting cycle by, for example, moving to three-year rolling plans. They can also better prioritise and utilise their resources, devolve more responsibility to front line teams, and be in a better position to answer the question “How well are we doing?” However, there is more research to be done. For example:

- How can organisations better define “what success looks like?” and relate these success factors to actions and measures?
- How have other countries tackled these problems? Sweden and Switzerland have recently made significant progress, but what have they done and how can we learn from their experiences?
- How best can organisations use balanced scorecards and rolling forecasts to better plan and manage their resources?
- How best can organisations use systems thinking to improve work processes and, for example, better align them with customer outcomes?

A New Public Sector Interest Group

The BBRT is setting up a special interest group to address these (and other) issues. An initial introductory meeting was hosted by Scottish Enterprise in Glasgow. Julian Taylor, Director, Network Learning and Performance, is looking forward to the second introductory meeting and the formation of the Public Sector Interest Group: “Scottish Enterprise has been a member of the BBRT for over 12 months and we have been keen to explore best practice in other organisations. At a recent “beyond budgeting” workshop we realised that there are many positive steps that we can take ourselves in improving the performance management process and culture. However, we certainly do not feel that we have all the answers and could have a great deal to learn from working collaboratively with other public sector organisations. Together, I believe we can really make some progress and find better ways of measuring success, managing resources, and providing more stimulating and challenging work for all those involved”. Contact peterbunce@bbrt.org or call 01590-679803 for details of the second introductory meeting.

