CHAPTER 1

Problems with Traditional Management

> "Most of what we call management consists of making it difficult for people to get their work done."
>
> *Peter Drucker*

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? There has to be a case for change. Some of the problems we will discuss are directly linked to budgets and budgeting. Others are more indirectly linked, but often rooted in the budgeting mindset of command and control.

Let us start with the budget. It is not the only problem, but still a major one. Over the last 20 years, I have asked thousands of managers across the world (and many employees, too) what they think of the budgeting process. It is just like pushing a button. Everybody has a view. The vast majority is very critical, and many are extremely negative. These are the problems they typically bring up:

Weak links to strategy
The strategy and the budget are developed in isolated processes, facilitated by different functions without much mutual respect and contact.

A very time-consuming process
Budgeting consumes a scary amount of time and energy, both when made and when followed up.

Stimulates unethical behaviors
The gaming, lowballing, and hidden agendas that normally would not be accepted are seen as normal and unavoidable in a budget regime.

Assumptions quickly outdated
Many, and sometimes most, of the budget assumptions turn out to be wrong.

Provides illusions of control
Most of the controls the budget offers are nothing but illusions of control.

Decisions are made too early
Decisions about activities, projects, and spending are typically made too early, without fresh enough information to make the right decision.

Decisions are made too high up
Lack of autonomy forces decisions upstairs, often making them worse, not better.

Often prevents the rights things from getting done
"I can't do the blindingly obvious, because it's not in my budget!"

Often leads to the wrong things being done
The flipside is people doing what they shouldn't, because it *is* in the budget: "Spend it or lose it!"

The world ends December 31
The budget year creates shortsightedness and a start/stop rhythm, which is often artificial from a business perspective.

A language ill-suited for performance evaluation
"Hitting the budget number" is a narrow and often meaningless way of defining performance.

That is a pretty long list of problems, representing a massive level of frustration. What I find just as problematic, however, is that while so many complain, the vast majority of organizations continue budgeting, year after year. When so many are so critical, why haven't more done something about it? Where is the revolution, when there is so much dissatisfaction boiling among people?

I have thought long and hard about why. I see only two possible reasons. Maybe managers see no alternative: "What shall we then do instead?" They haven't heard of Beyond Budgeting. Fortunately, this group is getting smaller as Beyond Budgeting finally has entered the global management vocabulary.

Those who have heard of Beyond Budgeting may not regard these problems as big enough to justify the long and hard change journey required. They are seen more as irritating itches than as symptoms of any serious disease.

They are dead wrong. These problems are much more than irritating itches. They are symptoms of something much bigger and deeper. The management technology "budgeting" was invented a hundred years ago, with the best of intentions, to help organizations perform better. It probably worked well back then and maybe even 50 years ago. Today, however, we are in very different times. Not only have our business environments become much more dynamic and unpredictable, but they are just as much about people: the birth of the knowledge worker and the demise of organizations as obedient machines. In this environment, budgeting has become more of a *barrier* than a support for great performance, something that instead *prevents* organizations from performing to their full potential.

This serious problem is not fixed by addressing budgeting only. The purpose of Beyond Budgeting is therefore not just, or not necessarily, to get rid of budgets. The purpose is to create organizations that are more *agile* and more *human*, because this is both good and necessary for great performance today. This requires radical change in traditional management. At the core of this kind of management we find the budgeting process and the budgeting mindset, which seldom can be left untouched and unchanged.

You might hesitate to buy into this massive attack on traditional management and budgets without 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. So if your guard is up right now, the only thing I ask for is to let it down during the next pages, where we examine more in depth whether we have a problem. I promise to provide hard evidence. Maybe you won't be convinced. Fair enough. But please give me a chance!

Which Way in a New Business Environment?

What is it that really drives great 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 release creativity and innovation? How do we sense and respond faster than the competition? Why should people work for us and not for someone else?

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. Much of it probably did work well in the past. Today, there is so much more VUCA out there: Volatility, Uncertainty, Complexity, and Ambiguity. In addition, the expectations from employees, customers, shareholders, and society have also increased dramatically. So has the transparency of business. There are few places to hide anymore.

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 summers and winters we might recall from our childhood. Just look at the volatility of oil prices. Many businesses, not just oil companies, have the oil price as a key variable in their business performance. They try to make short- and long-term projections, and keep failing miserably, as the 2014 price crash once again demonstrated. Look at the pace of technology innovation. Making a five-year business plan for a record company today must be a nightmare compared to the days before digital formats, downloading, and streaming. 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 ain't what 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 and book value in most companies is tangible proof that something has happened. The value of human capital: innovation, creativity, passion, 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 as many then mobilize and 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. I learned that lesson the hard way during my short military career.

Companies are not deaf and blind. Most do respond, but in very different ways. Some believe the answer lies in “even 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 targets, tighter follow-up, and higher bonuses. The strategy is simple: more of the old answers in order to get back into the “control” they had or believed they had in the past.

This is a tempting strategy. It also represents a major paradox. The more VUCA out there and the more urgent need there is to break with the past and go for radical management innovation, 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.

Some realize that there are problems with the old way, but they lack the insight or the courage required. The go for symbolic change only. 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; or maybe introducing a rolling forecast in addition to the inevitable reshuffling of the organizational chart.

Not everybody responds like this. A growing number of companies realize that the answer lies neither in increasing the doses of current medication nor in symbolic change. They realize that the disease is serious and potentially deadly and requires a radically different lifestyle. They believe that in this new business climate, people need more and not less room to move. They understand the need for a broader and more intelligent performance language. They appreciate that not all wisdom sits at the top. They understand that business is continuous, with individual rhythms that seldom match the calendar year. These companies understand that their leadership and their management models must be built *on* and not *against* human nature.

In the sections that follow, I will share which deeper problems these companies have identified and understood and why they are rebelling. Many of these go way beyond the budgeting problems we discussed earlier, as they address the much broader issue of traditional management. These problems are about:

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

The Trust and Transparency Problem

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

Where do you stand?

Do you believe that without tight controls 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 this is your belief, you do have a very 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 more with yourself than with anyone else. By the way, who actually hired all these people that can't be trusted? Someone must have done a pretty bad recruitment job! If they on the other hand became so non-trustworthy only after they joined, then that is also something to reflect on.

Few would admit to thinking like this. Actually, I believe most managers do trust most of their people. So the starting point might be the right one, and also the only one you can have. But it doesn't help to have Theory Y leadership visions if there are Theory X management processes. All those nice words become hollow if the management processes have the very opposite messages, creating poisonous gaps between what is said and what is done. It doesn't help to talk about fantastic employees being the backbone of the organization—"You are all so great and we trust you so much" (but not that much); "Of course we need detailed travel budgets, if not . . . ."

Unfortunately, such gaps exist in most organizations. One reason is a lack of Finance and HR communication and cooperation. HR might be preaching Theory Y leadership while Finance is pushing Theory X management. The two are seldom aware of the inconsistency, as they seldom talk together, although they talk a lot about each other. I know, because I have worked both places! Out in the organization, however, these gaps are very visible as conflicting messages keep hitting frontline teams.

There are similar interesting gaps found also between society and business, between how people think about themselves as citizens or politicians in a free society compared to what they believe in as employees or managers.

Most of us would praise democracy as the best way of organizing and running a society fairly and effectively. Here, we take for granted that we elect our own leaders, that everybody has a voice, that having different views drives us forward, that information is open and free-flowing, that big decisions are taken in referendums, and that there should be full transparency around public spending and finances. 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 rather a choice of capital sources open all year to fund new ideas and startups. This is what we preach and practice as members of a free and market-based society.

When it is time to go to work, all of this suddenly becomes unthinkable. Now, our beliefs and inspiration seem to come from very different places, from the very opposite ideologies. Traditional management has more in common with how the Soviet Union was run than with the principles and beliefs of a true democracy.

What about our private lives? Here, most of us face and make a number of big decisions as the years pass by. Which education? Whom to work for? Whom to marry? Buying a home? Having children? We neither want nor expect anyone else to make these decisions and take this responsibility from us.

But what happens when we put that other hat on? When we become managers or employees, none of this seems obvious anymore. On the contrary, we seem to leave behind or surrender at the company gate all our beliefs and values as citizens, and quite voluntarily.

Why does this happen? Why do we so easily give up on what we take for granted as citizens and in our private lives? Many seem to be on autopilot, stuck in the same traditional management pattern as their managers. Some do not like it, but accept it as inevitable. In many societies, democracy has a short history. The old regimes had perhaps less of this paradox, because the situation was 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 way now 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 how society and business is being run.

What about managers? Many are also stuck in tradition and old habits. Some might have built their career on mastering traditional management. They also get support for their beliefs from the behavior of *some* people in the organization. There are always people who are either too smart or too dumb to deserve or handle trust and autonomy. You have them in your organization, too. I am sure you can even name a few. Although we know they normally are few, and even if we do trust the large majority, far too often we let this small minority drive the design of our management models. 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 drive the design of our management models rather than the small minority. At the same time, we shall not be naive. The minority is a reality that must be faced and not ignored. We must be crystal clear on our values and performance standards, and we must act decisively when trust is misused. And I mean *when*, not *if*, because it will happen.

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 who long for the simpler days of command and control: “We warned you! This trust thing doesn’t work!” Do not let them push you. Deal firmly and swiftly with incidents, but do not let these drive you back.

Exceptions must not be generalized. In a democracy, we do not lock up everybody as potential criminals because someone did something wrong. Within certain boundaries we are all free citizens, but crossing the line has consequences.

If the entire management model reeks of mistrust and control mechanisms, 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 start to behave as such.

Those still insisting on a mistrust-based control approach are moving into a war with no end. People will always find ways of cheating if they really want to. Any control system can be gamed. People are smart. Their motivation to do so will be fueled by new controls. It is a vicious circle and a lose–lose game.

What kind of people are we talking about? In Statoil, it is, for example, people we trust with building or working on million- and billion-dollar machines: offshore platforms, oil refineries, and pipelines. It is people we trust with trading crude oil or handling currency exposures for millions every single day. Why shouldn't we trust them to also manage their own travel costs?

A good friend of mine is a pilot and captain with a well-known 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 shirt more frequently than what is stated in the uniform procedure. For those working further back in the cabin, a "thumbs-up" used to be enough when tasks had been completed. Now, there has to be a signature. As a passenger, I am not sure if I feel much safer.

If we cannot trust these guys on the small things, how can we 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 much less (such as building or operating offshore platforms, or flying airplanes)?

Some managers don't even seem to trust themselves and their own capabilities. Many cannot make decisions without calling in armies of management consultants because they do not trust their own judgment. They litter their language and communication with buzzwords and the latest management jargon because they do not trust the power of their own plain mother tongue. Try "Bullshit Bingo" next time you hear one of them rambling on!

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. "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. What is important is not what you know but what you know that others don't.

Then we have our management information systems, which sometimes come with more filters than governments have available for blocking the Internet. Instead of everything open, and closed only where needed, it is often the other way around. Much of the internal communication would also benefit greatly both in trustworthiness and usefulness by turning down somewhat the one-way "aren't we great" messages. The result is often the opposite—cynical employees laughing about all those polished corporate 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 horizontal communication: sharing, challenging, and learning. But there seems to be a fear of people using these forums to speak up, voicing critical viewpoints that might fit badly with the image companies try to paint of themselves. Again, the parallel to totalitarian regimes is disturbing. It's mushroom management; keep them in the dark and feed them shit.

It is, by the way, interesting to observe how enterprise management software vendors mainly think about the transparency their systems offer in "drill-down" terms. They boast about how executives can drill down all the way into any thinkable detail: How many customer visits were made at the Italian sales company? How much gasoline was used? How many lunches were held? But why on earth does someone at corporate need such information? What we need instead is much more "drill-across"—people learning from each other—and "drill-up"—people seeing the bigger picture.

There is actually a major paradox here. Traditional management fears transparency because it threatens control. But as Jeremy Hope, cofounder of the Beyond Budgeting Roundtable, put it, "Transparency *is* the new control system." There is a reason why thieves and crooks prefer to operate at night (although in some businesses it seems to happen during daytime, too). The Swiss pharmaceutical company Roche did an interesting experiment on transparency. In a pilot, they kicked out the travel budget and most other travel rules and regulations. Instead, they introduced full transparency around travel cost. With a few exceptions, everybody could see everything. Where did you travel? Did you fly, sleep, and eat cheap or expensive? Everything was open for colleagues to see, and vice versa. Guess what happened with travel costs in the pilot? They fell, even though (or because) Roche tore out pages in the rulebook instead of adding new ones. It is a great example of transparency as a self-regulating control mechanism.

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 here, because you are too uncomfortable with the implications, or maybe because you simply disagree. But do you actually have a choice? Think about the VUCA, the "global warming" of business environments, and the speed of change. 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 on more and more arenas where you used to be king of the road. You have to take the backseat more often and instead let frontline people drive; read the maps; find the quickest route; and do the turning, speeding, and braking. But do not worry; there is more than enough left for you to do in the backseat: setting direction, coaching, motivating, and assisting when needed. Just do not become a backseat driver!

In my parents' 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 drove, 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!

The Cost Management Problem

According to French friends of mine, the word *budget* has French origins. They tell me that *bouge* is an old word for bag, with *bougette* being a small bag. That was the small purse filled with gold coins that the shipowners gave to the sea captains before sending them off to the Far East to buy spices and other goods to be brought back to Europe. It was a very physical constraint on available resources. Too bad if great unexpected purchasing opportunities popped up. When the *bougette* was empty, it was empty. The word later found its way into English, converted to *budget*. In 1922, James O. McKinsey introduced budgeting as a management technology: "Budgetary control is urgently needed as the basis for centralized executive control."

The *bougette* reminds me of a company where the Finance department literally deposits each department's budget in bank accounts. Again, empty means empty! Some years ago we did a workshop in Kuala Lumpur with a large Malaysian company. Their wise CEO opened the workshop. He described the cost budget as "… this cage we build. We know it will constrain us. When finished, we squeeze ourselves in, lock it, and throw away the key. It all happens voluntarily, no one forces us."

One of the most stubborn myths in traditional management is that the only way to manage cost is through detailed annual cost budgets, with a tight follow-up to ensure that no more is spent than is handed out. The many problems this practice creates are not necessarily among the most serious ones, but I have chosen to address them early as the consequences of removing the cost budget are definitely what worries managers the most when considering Beyond Budgeting. This is also where we find the two most common misunderstandings about Beyond Budgeting. First, many believe the concept only is about a different way of managing cost. Yes, it is, but it is also about so much more, as we will discuss in Chapter 2. Second, many think, "No budget means cost is not important and I can spend whatever I want." No! Cost is still important, but we need more intelligent and effective ways of managing than what traditional budgeting can offer.

"But we can't let things completely loose!" worried managers would say. "Maybe the cost budget has its problems, but isn't that a price worth paying for keeping cost under control? Our people are not mature enough for this!" It is the *trust* problem again. But beyond the trust issue, there are a number of *other* reasons why traditional budgets are no longer the most effective way of securing an efficient and optimal use of scarce resources. Let us take a look at these.

A cost budget is a *ceiling* we put on cost: “This is how much you can spend and no more.” As a ceiling, it definitely works. 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 spot on or close to budget, year after year. Great performance! What is the problem? It works; managers did not spend more than they were given. We have cost under control, right?

Unfortunately, this is just half the story. That ceiling 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 changed (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. This is simply rational management behavior in a budget regime. Managers see budgets as *entitlements,* meaning “my money.” 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, if you want to protect next year’s budget.

But Finance is happy. Executives are happy. The board is happy. Everybody is coming in spot-on budget! Aren’t we great! What fantastic control we have! Well, really? The *only* thing we know is that everybody spent their budget, every single cent. This is, however, no guarantee whatsoever that it was the optimal use of scarce resources. Assumptions might have changed; threats and opportunities might have popped up. Some should probably have spent less and some more. I can hardly think of a bigger illusion of control.

When that 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, did we not?

When we toward year-end 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? Can we do it cheaper?" These questions, which seldom are heard in January and February when the bag is full, are far too important to be asked in November and December only. We should be concerned all the time on every single cent spent.

The problem gets bigger because not only *one* bag is handed out. There are a lot of smaller bags inside: "Of course, we cannot just give you one big bag of money!" We are talking about a huge mountain of bags, labeled *salary*, *overtime*, *travel*, *consultants*, and so on, often split further into even smaller monthly bags. There is actually some trust involved, because the organization is sometimes allowed to do monthly budget distribution themselves.

We end up with a budget close to or sometimes even equal to the accounting detail level (same cost item lines, cost centers, periods, etc.). Even in smaller companies with a few hundred cost centers and "only" 30 to 40 budgeted cost item lines, thousands of bags are handed out each year. In bigger companies, the number quickly reaches millions. Fortunately, no physical packaging is required!

There are, however, managers who love to be given detailed budgets, the more detailed the better: namely, those who don't like to make decisions (yes, they do exist!). Someone has then made all those decisions for them. They even have someone to blame if those are unpopular decisions!

There is a lot of work involved in negotiating the right size of all of these bags, which often stimulates behaviors bordering on the unethical. As the budget-approving manager, this is a game you are bound to lose. You will always have less information than those below you about the real need for resources, status on ongoing activities and projects, and the quality of new projects. There is serious information asymmetry, and not in your favor. "But I am the boss," you might say. "I can just cut the crap and decide." Yes, you can. But with all the uncertainty and with less knowledge of the business than those below, 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 your secretary.

The budget might be too 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 seem so great that you feel like a butcher with bad conscience once you start challenging and 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 there are contingencies and more.

But if there are no surprises, no new opportunities, and no change in assumptions for the future ahead, the problem could have stopped here. But it does not. Combine the detailed pre-allocation of resources 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 the right and optimal total cost level, and also exactly how much to put into each of all those bags? What kind of divine insight into the future do we think we have?

"But I can just reallocate between 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 why this cannot be done, and what kind of disasters will happen if you try. It is the entitlement effect again: "It is my money!"

When the year starts, it does not take long before the first applications for additional funds come in, backed by convincing arguments and strong business cases. But do we ever see the opposite take place—managers knocking on the door wanting to give money back because they got too much? Shouldn't the number of such budget adjustments generally balance? In practice, it is a one-way exercise.

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). Variances 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 illusion of control kicks in. *We can explain*. We know where the variances are and why. The more detailed finance people make the budget, the more comparisons can be made and the more they can impress executives with their detailed variance analyses. The controller is in control.

I used to be quite good at variance analysis. But when that backward-looking, explanation-and-excuse-oriented job was finished, there was seldom much time left for turning around and addressing much more important and forward-looking issues: Where are we heading and what do we do if we don't like what we see?

The word *cost* is interesting in itself. "Cost" is an accounting term for how a financial transaction shall be classified and treated. Cost is something negative; it is something we must deduct from revenues, reducing profits. We should, however, distinguish between two types of costs: *good* cost and *bad* cost. Good cost is actually investments, even though accounting rules require us to classify them as expenses. You spend but you get more back. As long as we have the financial capacity, good cost is something we want more of, because they create value. It is the bad cost we want to get rid of, because these are less generous; they destroy value. Frontline teams normally know the difference between the two much better than corporate.

The dominance of the cost budget often leads to a myopic way of managing. Take variable production cost. What is more relevant—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. Costs should be as low as possible and cutting the budget is an effective way of achieving that. What we want, however, is not necessarily the *lowest* possible cost level. What we want is the *optimal* level, the one that maximizes value creation. How do we know what that level is? Of course, it is difficult to know. But turn it around. How do we know what the right *lowest* cost level is? It can hardly be zero. It is just as difficult to find that right lowest cost level as it is to find the right optimal one. But let us at least agree that it is the optimal level we are after, and that it is the bad cost we want to get rid of.

Let us move to a different resource issue. Our planning and allocation processes are based on the assumption that *financial resources* always are the main constraint. We have established a common and well-understood language for reporting on and managing this scarce resource. We are able to classify actual or planned spending down to the last cent. When new projects are evaluated, we can describe in detail how we believe these will first draw on and later contribute to our financial resources.

In an increasing number of businesses, however, this resource is no longer the main constraint, at least not all the time. Instead, *human capital* is often taking this role. Our processes struggle with this shift. Finance has spent decades developing and perfecting the financial language and process: common charts of accounts; international financial reporting standards; and systems for data capture, reporting, and audit. HR, however, is still in the very early days of trying to do something similar with human capital. There is no common vocabulary, and hardly any processes and systems 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 what we often claim is our most valuable resource. What do we really know about people's competence, about their skills, knowledge and potential? 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, it is all often reduced to headcount only, and often we struggle even to get that counting right.

Some organizations are trying to establish common competence languages for their own workforce. The intention is good, but the result is often a range of functional languages, with limited possibility for a meaningful communication internally or with external stakeholders. Just imagine if the financial market 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 must not be to reduce competence mapping to a detailed and mechanical accounting exercise, but some structure could probably be useful.

Let us finally address a question many of you probably have been jumping in your chairs to ask during these pages: "What if you are in a business where margins are wafer-thin? What if the financial situation is so bad that tight cost management is a question of life or death?"

Borealis was by no means a "rich" company. Red numbers were no stranger to us, and tight and constantly falling margins was the name of the game. Still, all the problems with traditional cost budgets that we have discussed were just as relevant in this type of business. The cost budget was just as much a floor as a ceiling. The concern questions were asked too late in the year. 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 had many more, and these were better and more relevant than the old budget discussions. We also had them all the time, not just once a year. Costs did not explode when the budget was removed; in fact, they came down. This surprised even me, as we will discuss in more detail in Chapter 3.

But what if the situation is even more serious? Well, if I were running a company close to bankruptcy, where you have to turn every cent every day, the last thing I would do is to lock my spending for the next 12 months in a fixed and detailed cost budget. In such a situation, flexibility is needed more than ever!

Again, Beyond Budgeting is *not* about ignoring the need for good cost management. On the contrary, it is about *better* cost management, better optimization of scarce resources than what the traditional budget offers. In the Borealis and Statoil cases you will find practical and hands-on advice on how to manage costs without traditional budgets.

The Control Problem

Control is an important word in the management vocabulary. Some Finance people are even called Controllers. I recall the first time I got that title. I felt pretty good about myself!

When managers are asked about their biggest concern in abandoning traditional management practices, including budgeting, invariably the answer is "losing control." When asked to be a bit more specific, they all continue with "losing cost control." When asked what else they mean, everybody agrees the list is much longer but most actually struggle with providing specific examples for the controls they would be losing. Some talk about "avoiding variance"; they dislike the real world taking a route other than planned. Some mention avoiding people and making too many decisions on their own. Others might say "understanding what is happening," which makes sense. But generally, they struggle. They all insist that control goes way beyond cost control, but few can immediately name exactly how, even if this is what they fear to lose the most! I find this quite fascinating.

You might be struggling to put a finger on this as well, so let us sort this out right away. There is some control we want to keep and some control we want to get rid of. We still want to understand where we have been and where we are, through quality accounting and reporting. We still need effective processes with no waste and order in the house. We still need to understand when we are performing well and when we are not, and what might lie ahead if this is possible and useful to predict. These kinds of controls have nothing to fear from Beyond Budgeting; on the contrary, they are *good* controls. Transparency, as already discussed, is a great example of a good control mechanism. So is a strong, values-based culture.

There are, however, two other types of control that we want much less of. The first one is too much *controlling* of what people shall and shall not do, through detailed budgets, tight mandates, detailed job descriptions, rigid organizational structures, smartly constructed bonus schemes, and all other Theory X–driven control mechanisms. Some of these controls might seem real and effective, but are often nothing but illusions of control. People are smart, and any system can be gamed if people want to.

The second type of control we need less of is maybe an even bigger illusion. It is the perceived control of the future, the one we think we get if we only have enough details in our plans and forecasts. We try to cope with increasing complexity and uncertainty by adding on more and more. When we have that binder with a voluminous and single outcome set of numbers, it all seems less scary and more orderly and manageable. This perceived control of the future we carry with us when tomorrow becomes today. If we hit the numbers, we definitely feel in control, although it is no guarantee whatsoever that we got the best possible performance. If we on the other hand didn't hit because we once again got it wrong, we feel at least somewhat in control because we can at least explain in detail both where and why!

There is no problem with details when describing the past: where we have been and where we are. On the contrary, here they are needed and necessary to help understand how we are doing: results, value and cost drivers, and product and customer profitability. The problem starts when we carry the same or almost the same level of detail with us into the future. The big difference between the past and the future is uncertainty. The past carries none, the future a lot. The farther ahead we look, the more uncertainty there is, with obvious consequences for the relevant detail level. But the myth is strong: More details equal more quality. It does not look very professional or trustworthy if someone presents expected sales or cost developments as ranges, with a few numbers only and a simple what-if analysis, although often this would be more "right" and certainly more honest. Isn't there something suspicious about people presenting a few rounded numbers only? Are these people just guessing? Haven't they done their homework?

It is amazing how blind we can become to the stupidity of fine-tuning, for instance, the expected USD exchange rate 10 or 20 years out, while doing this within an uncertainty span of what kind of superpower the United States will be by then. Somehow, working on those details seems to shield us and make all the big and scary uncertainties disappear. William Gilmore Simms was a bit more forgiving: "I believe that economists put decimal points in their forecasts to show they have a sense of humor."

The budget variance analysis is another classical example of control illusion. Detailed explanations of the difference between actual and budgeted numbers might provide a comforting feeling that the past is both understood and well explained. The past is normally much better understood by using alternative methods for analyzing historical data and time series. One great method is the control chart, which reveals signals of importance in all the data noise generated by arbitrary variations.

There are more illusions: "If we don't manage performance, there will be no performance. If we don't develop people, there will be no development." Many Finance and HR functions seem to be built on such assumptions. Admitting they are merely illusions is of course hard. The famous Norwegian playwright Henrik Ibsen described it as, "Taking the life lie from man takes away his happiness as well." These illusions are, however, more than merely painful when undressed. They can also be dangerous as they can lead to wrong and even stupid behaviors and decisions. Most of us have been on the receiving end of one or more of those.

Some of the fear of losing control probably comes from the term *Beyond Budgeting* itself. The headline always runs faster than the rest of the story. As a standalone label, many believe the term stands for anarchy and unlimited spending. Most usually calm down when they get the full picture. When they understand *why* we are abolishing budgets and other worn-out management practices, and what we offer instead, most agree that it probably makes sense, even if many still have questions and concerns. Most people also relax somewhat when they understand that we will continue doing the things a budget *tries* to do but fails at so miserably. We will still set *targets,* provide *forecasts,* and *allocate resources*. We will even do all of this in a much better way. That doesn't sound like losing control, does it? Losing controls doesn't mean "losing control" when it is stupid controls we talk about. On the contrary, the result is *better* control: more about this in the "Quality Problem" section later in the chapter.

The Target-Setting Problem

A target is not necessarily "the target." What we *really* want and aim for is the *best possible performance, given the circumstances*. Setting targets is one way of achieving this, but not the only way and not always the best way. It is a performance mechanism that comes with a number of challenges and negative side effects.

It is hard to set good targets. We are trying to describe what good performance looks like at some point down the road, for instance at next year-end. If there is a lot of uncertainty around what we are trying to target-set, it can be quite difficult. We often need to make a number of assumptions: How will the market develop? What can pop up of threats and opportunities? Where is the oil price going? And exchange rates? If we move from macro to micro and individual goals, it isn't easier. When managers are setting goals for their employees, it is useful to understand their full performance potential. I don't think I will know mine before the day I pass away.

Key Performance Indicators (KPIs) are often used to set targets. As we will discuss later, we must remember what the *I* stands for. KPIs are trying to *indicate* if we are moving toward where we want to be, but they are not always able to reveal the full truth. They are *not* called KPTs, Key Performance Truths!

When using KPIs to set targets, these must always be seen together with the bigger and longer term objectives toward which we are trying to measure progress. These objectives are actually the goals we are trying to accomplish. KPIs and KPI targets are just there to help us.

You have probably heard about the SMART principle. Targets should be **s**pecific, **m**easurable, **a**chievable, **r**elevant, and **t**ime bound. It is a fair test, but be careful with making them too smart. Consider the example of a First Time Right quality target. Should we set it as "95.2 percent" or as being "first quartile" versus competitors? Applying SMART, the answer seems clear. There is no doubt that "95.2" is a more *specific* and precise target. But which one says more about performance? Is 96 percent great performance if all competitors made 97 percent or better? Precision does not always equal relevance. The more accounting oriented we are in our performance thinking, the more we tend to emphasize precision and sacrifice relevance. I will come back to the powerful concept of relative targets in the Borealis and Statoil chapters.

Targets are very often about numbers. Let us not forget the power of words. A well-formulated goal or objective can often motivate and drive performance much better than cold numbers. Many people are much more inspired by engaging messages about direction and ambitions than they are by hard numbers, including me. It is again relevance versus precision. Also here, we need to be careful with the detail level. Very specific and too action-oriented goals can easily become just as much a straitjacket as a detailed numerical target.

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 this is what inspires people to do their best, then what is more important—good performance, or something to measure against? Let us not lose track of what performance management is meant to be about. Remember Albert Einstein's wise words: "Not everything that can be counted counts, and not everything that counts can be counted."

I recommend using the SMART principles with caution. Here is some advice to ensure they actually help and not hinder the ultimate goal, which is the best possible performance given the circumstances:

Specific—but not a straitjacket

Measurable—but do not forget words

Achievable—but do not forget Michelangelo (see below)

Relevant—do not forget strategy

Time bound—but do not leave it all for year-end

Someone once added **e**thical and **r**easonable to the acronym to make it SMARTER. Nice!

A target can easily create the same ceiling/floor situation we discussed on cost. After managers have negotiated and low-balled, they might strive to hit their targets, but they have normally few reasons to go beyond, especially if results can be lifted over to next year. Michelangelo expressed it like this: "The problem is not that we aim too high and miss, but that we aim too low and hit."

As with cost budgets, any target process can be cheated on if people want to and have a reason to. The solution is not to try to close another loophole, but to instead reflect on *why* people are gaming the system, and do something about this instead. The bonus system is often a good place to start (more about that later).

How targets are set is also important. There is a big difference between targets that you set for yourself, compared to those set for you. The assumption in traditional management seems to be that unless targets are set from above, ambition levels will always be too low. This is not necessarily the case. There are ways of achieving this great combination, for instance by using benchmarked or relative KPIs. Nobody likes to be a laggard!

Nothing beats ambitious targets that teams or people have set for themselves.

Most Finance people believe that all target numbers must add up exactly to the corporate target, and that this can be achieved only through top-down cascading. The fact that such cascading often destroys ownership, commitment, and motivation is ignored: "That is HR stuff, we work in Finance."

Top-down target setting isn't always dictatorial. There might be room for negotiations and bargaining, sometimes even starting with targets proposed from below. But which behaviors does such a process typically trigger? Lowballing, gaming, and sometimes even cheating and lying, all to get away with the lowest targets possible. We shouldn't be surprised. Again, this is rational management behavior. Finance can go on until the cows come home about the need for setting ambitious targets. For a manager, this only reduces the chance of hitting the target and reaping the rewards. It is Michelangelo all over again.

Do we always have to set targets? Could there be other ways of inspiring and motivating people to do their best, of achieving the best possible performance given the circumstances, while reducing or even avoiding the negative side effects? Is traditional target setting about leaders choosing that easier option, because inspiring and motivating is harder? Is it also about underestimating people? Do they not understand strategic direction? Have they no ambitions and no clue whatsoever about what good looks like?

I am not saying that we never should set targets, but we shouldn't be on autopilot. We don't have to set a KPI target just because we measure the actual development on a KPI. There are a number of organizations out there who have either dropped targets or radically changed the way they do it. There are some exciting examples later in the book.

In my own private life I have set very few targets, if any. I certainly have had my dreams and aspirations, and I know quite well what good looks like. When I many years ago was diagnosed with diabetes, I knew I had to lose weight. I never set any targets about how much and by when. But I changed my lifestyle, and I measured frequently that things were moving in the right direction, both weight and blood sugar. These are now where they should be. I am not saying that giving myself a target would have prevented that. If it on the other hand had come from my wife or my doctor, I am afraid I still would have been struggling.

As for measurement, nothing happens just because we measure. You don't lose weight just by weighing yourself. I tried that, too, with no success. I recall my wife's dry comment: "Bjarte, maybe you didn't stand there long enough . . . ."

The Performance Evaluation Problem

The better the job we do on target setting, the easier performance evaluation is. But we can still get it wrong.

First, let it be clear that performance can be evaluated even if no targets are set. We normally know what good looks like when we see it, and there are always strategic direction and performance standards to relate to. As discussed, we probably set too many targets.

One of the problems with performance evaluation is that the process serves different and conflicting purposes, just like the budget does (more about that later).

These purposes are:

- Feedback and development
- Reward
- Legal documentation

There is tension between the three, especially between the first two. If the evaluation focus is on feedback and development, then not only strengths and achievements but also challenges and development needs should be at the center of the appraisal dialogue.

If instead the reward purpose dominates, it easily pulls the dialogue in the opposite direction. The rational employee might instead focus on "I'm so great" successes, and avoid anything that can taint the polished performance picture he or she is trying to paint. The manager's job becomes to balance the picture by emphasizing the opposite—not very motivating for any of them.

The legal documentation purpose isn't very motivating, either. It is about the employer needing to have the paperwork in case there should be a need for drastic action. The purpose is seldom the opposite: a legal justification needed for praise, promotion, or pay increase.

Of these three evaluation purposes, it is probably only reward that requires any numerical rating. Here, it could be argued that even without a rating, there will always be a number at the end when pay raises are announced. These would, however, not only be performance driven, but also reflect other reward issues like market level and career phase.

The development purpose requires no rating at all. The best appraisal dialogues I have experienced have been rating-free, with managers providing open, honest, and constructive feedback, focused more on my strengths than on my weaknesses. Rating can actually "dumb down" the dialogue because the number easily replaces or shortens the much more important words.

In the Statoil chapter we will discuss how this serious problem of conflicting evaluation purposes can be solved. There are as mentioned striking similarities with a very similar budget problem explored later in this chapter.

Performance evaluation and rating is something we encounter as early as school. Also here, different purposes are at play. Many argue that grading is needed for learning and development. Again, that is highly debatable. The justification is maybe stronger from a "reward/legal" perspective, where grades work as a *sorting* mechanism for further education.

Let us now move to another aspect of performance evaluation: the need for subjectivity and a *holistic* assessment, as opposed to a mechanical, metric-oriented, and seemingly more objective evaluation.

First, we need to remember that performance is not the same as results. A result is a measured outcome. Performance is the behavior and effort behind. When a runner completes a 100-meter sprint, there is a measured time, but this does not necessarily reflect performance. Performance is about how well the runner *executed* the sprint, how well movements fine-tuned through thousands of hours of training were applied. The *result* of that performance is a measured time, in both absolute and relative terms—how does it compare to the other runners.

Because of the target problems described earlier, we can't lean on measurement only—neither in absolute nor in relative terms. Before we conclude, we need to take off our measurement glasses and look at what measurement didn't pick up. We need to take into account hindsight insights: significant changes in assumptions, tailwind/headwind, and other information that wasn't there for us at target-setting time. Maybe values and behavior should also be taken into account. *How* were those results delivered?

We need a broader and more intelligent performance language than the old one of "within budget" or "green KPI." Is it always good performance to hit the budget? What if great value-creating opportunities were turned down because job number one was no cost budget overrun? Should we celebrate a project finished on cost and time if quality took the backseat? Should we call for champagne when we hit the market share target because a competitor unexpectedly went out of business?

Some leaders find this kind of more holistic performance evaluation too soft and also more difficult, because it involves assessment and not only measurement. They claim it involves too much subjectivity, and prefer to narrow it all down to "hitting the number," which they regard as much more objective.

This is an illusion. A performance evaluation can *never* be entirely objective. There will always be subjectivity. As we discussed earlier, target setting is about trying to describe what good performance looks like at some point in time, which is 12 months down the road in the case of annual targets. We do this surrounded by a lot of uncertainty, forcing us to make a lot of assumptions. Should the target be 80? Or 100? Or maybe 120? When we finally decide on 103.5 (a decimal or two makes the whole exercise look more thorough and scientific), it is a relief. Soon, all that uncertainty and all the subjectivity we just applied are behind us and forgotten.

But we have just been forced (we had no choice) to be very subjective at a point in time when it is actually quite difficult, due to all the uncertainty forcing us to make all those assumptions. Why on earth should we forgo the opportunity to be subjective also afterwards, when uncertainty has become certainty and there is so much more information and hindsight insights about whether hitting 103.5 was great performance?

True objectivity is therefore wishful thinking. There will always be subjectivity when targets are set. It might seem easier not having to go through it one more time. But again, leadership is not meant to be easy. If performance evaluation is reduced to only counting the number of green and red KPIs and making conclusions based on this alone, then the only qualifications needed are the ability to count and not be colorblind. Although I would pass the first test only, shouldn't we have somewhat higher requirements toward this important task?

I am no big fan of performance ratings, but when rating is also used in a forced ranking of employees we are entering the realm of stupidity. A number of companies are now abandoning this hopeless management practice. According to *Washington Post*, 10 percent of the Fortune 500 companies have now abolished the traditional annual performance appraisal, including Microsoft, Accenture, Deloitte, and Expedia. Even GE is experimenting with alternatives.

I am by the way pretty tired of those in HR banging on about managers having to use the full rating scale, and also their concern about too positive ratings. Most people are actually average! And what is really the problem with people feeling they are somewhat above and getting a somewhat higher score than “deserved”? People who feel good about themselves actually perform better! If the concern is pay, there is no need to pay more even if the average rating is higher. Reward is very much a relative thing: how people are paid compared to others.

The Bonus Problem

When presenting Beyond Budgeting in Europe, the first question I normally get is how cost can be managed without a budget? In the United States, the first question typically is, “What drives bonus if there is no budget?”

The smallest problem with bonuses is that they often are tied to delivery of budget numbers, which as we have discussed is a language quite ill-suited for performance evaluation. A much more serious problem is the negative effect on motivation and performance, which this section is about.

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 have been involved in both design and implementation of such systems. My skepticism grew over time. Again and again I observed not only how they failed to deliver what they promise, but also how much unintended damage they cause. There are few areas with a bigger gap between what research says and what business does. Fifty years of research almost unanimously discounts individual bonus as an effective way of motivating and driving performance in knowledge organizations. Despite this, bonuses are alive and kicking. But something is wrong. Satisfaction with the bonus system cannot be what causes companies to change it, on average, every second year.

Note that my criticism is directed at *individual* bonus. A common or collective bonus scheme is something very different, as I will elaborate on later. In the complex and interlinked reality we find in most organizations 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 having solved the day's troubles completely alone? Aren't most us highly dependent on others when doing our work and delivering on our goals, even when these 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.

The problem starts with economic theory and assumptions about the rational, economic man who is assumed to be driven solely by optimization of own well-being and benefits as measured in financial terms only. The employer–employee relationship becomes a "principal–agent" contract, where the main focus for both parties is to maximize their own gain and benefit. With these lenses on, there is an obvious conflict of interest between the two, and the relation is reduced to a commercial transaction that needs to be regulated in a detailed "performance contract," exchanging performance for money. If this is where we are coming from, then Theory X and traditional management absolutely makes sense, including the bonus practices to be challenged in this section.

I hear very much the same cynicism about bonuses as I hear about budgets, not just from employees but also from a number of managers. The vast majority seem not to believe they work as intended. The paradox repeats itself: With so much dissatisfaction, 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 the idea of individual bonus will be driven out of town, shamed and undressed. But we need more little boys (or corporate rebels) raising their hand, shouting what everyone in the crowd also can see: This emperor has no clothes on. Let me explain why he is naked.

Most companies have a bonus system for two quite different and unrelated reasons. The two are often mixed when the system is explained and justified. The first reason has to do with *market*, the second with *motivation*. The market reason is about recruiting and retaining good people. I can partly buy into this one. Of course, we need to be competitive. However, are we too quick in pulling the bonus lever? Are we creative enough in looking for alternative ways of competing? If it has to be money, does it have to be individual bonus? Why can't a collective system be an alternative? Can sign-on fees sometimes be an alternative? Does it always have to be money? There are many other perks to compete on.

Are we also underestimating the value of the company brand (assuming it is a good company we work for)? The power of employees proudly talking to friends and neighbors about how great it is to work with us should not be underestimated. This creates a pull no bonus system can provide. It also attracts those we want to join, which hopefully aren't those who are only in it for the money. When Australian Atlassian decided to abandon their sales bonus system, they knew they would lose some of their salespeople. They did, but those they really wanted to keep stayed on.

Even corporate giants are on the move. In 2013, the pharmaceutical company GSK (GlaxoSmithKline) announced a new compensation program abolishing individual targets within sales. Instead, sales professionals who work directly with prescribing healthcare professionals will be evaluated and rewarded for "their technical knowledge, the quality of the service they deliver to support improved patient care and the overall performance of GSK's business." The purpose was clear: ensuring that patient interests came first, just like in Swedish Handelsbanken, where they want nothing that can create a conflict of interest with their customers. In Chapter 2, you will learn how this bank is able to attract great branch managers locally in the United Kingdom, despite offering no individual bonus in a market where this seems unthinkable.

What about the other justification for individual bonus: motivation? This is where my doubt started, many years ago. How could I argue (as I did) that individual bonus is a great motivator when it didn't work for me? I don't think I am that special. Asking my colleagues, almost all said the same: "I enjoy the money, but it is not what makes me tick." I then started reading and discovered 50 years of research, with quite unanimous conclusions. Here we go:

Individual bonus can be a very effective motivational mechanism for *simple work* where there is *little motivation* in the job itself, where the link between individual efforts and outcomes is *easy to measure*, and where *quantity* is more important than quality. So for picking fruit, catching rats, and similar simple, repetitive work, individual bonus definitely works.

But when moving to more complex tasks, where more cognitive skills and teamwork are required, research shows that individual bonus loses its power. For this kind of work, *purpose, belonging, mastery*, and *autonomy* drive motivation and performance: the great feeling of together being part of something bigger, the joy of mastering something challenging and not being micromanaged from above. Money is on the list, but further down. Interestingly, people often believe that other people have money higher up on the list than they do.

Most managers acknowledge this internal or *intrinsic* motivation as powerful. It might sound logical that we get more motivation by adding a dose of external or *extrinsic* motivation on top of the intrinsic, like for instance an individual bonus. Unfortunately, research arrives at the very opposite conclusion. Again, for simple work, it definitely works. More fruit is picked, more rats are caught. But for more complex tasks, external motivation typically has either no effect or a negative one, reducing the internal motivation. It is called the "crowding out" effect.

One explanation lies in "do this and get that." By introducing a bonus to get something done, the focus shifts from being on the task itself onto also what you get for it. A bonus can *undermine* the interest in the job itself and *reduce* the value of the task it pays for, even though the intention is the opposite. The message we send is that we do not believe people are sufficiently motivated by the intrinsic motivation coming from the job itself. Carrots are needed.

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." Nasty 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 tells them that from now on he will only pay them one cent per insult. "One cent!" the boys respond. "Forget it!" And they never came 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 is just as much a punishment because it is also something that can be held back. The carrot is also a stick.

Giving blood is a great thing to do. Experiments have shown that when hospitals have introduced financial rewards in order to get people to give more blood, the effect has often been the opposite. Donors feel that it reduces the noble act of giving blood to something closer to "selling body liquids."

Hundreds of studies on individual bonus arrive at similar results, across borders and cultures. There is probably no other area where there is a bigger gap between what research says and business does. How come? Is it lack of knowledge or pure ignorance? Or is it simply laziness? Dangling a financial carrot in front of people is undoubtedly much simpler and easier than motivating through great leadership. Money is so much simpler. But again, that old craft called leadership is not meant to be easy.

What about other types of extrinsic motivation, like a 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?

Individual bonus is another example of illusion of control. By tailoring the system the right way, we believe 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 to pull and how hard in order to make the marionettes dance as we want? Which targets? Which weighting? Which thresholds and ceilings? Which triggers and funding mechanisms? There is a whole consulting industry out there ready to help out on these questions. Managers, however, quickly find ways of gaming the system. Imagine if all the energy and creativity spent on this could instead be directed toward simply performing better!

Journalist and author David Sirota sees it like this: "The main question for management is not how to motivate, but rather how management can be deterred from diminishing or even destroying motivation." Bonus systems can definitely be one way of destroying motivation, although there are probably those who find satisfaction and motivation in cheating the system. That is definitely not the motivation we want to stimulate, and are these the ones we really want on board?

There is another aspect of the motivation discussion that often is forgotten. There seems to be a silent assumption that there are no negative effects on those *not* included in the bonus scheme. Really? What about those 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 smile 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 may not be that big, but the number of people being merely irritated is huge, because they make up the rest of the organization. Even if individual bonus should motivate those on board with the scheme, how much is left if we add up all these negative effects below the borderline, both the very pissed off and those merely irritated, and deduct from the possible positive effect? Is there anything left at all? Could it be negative?

By the way, if bonus is meant to motivate, how come the biggest dose is needed at the higher manager and executive levels? Is this where we find the most boring jobs? I just don't get it!

Even executives realize that something is wrong. Here is John Cryan, co-CEO at Deutsche Bank: "I have no idea why I was offered a contract with a bonus in it because I promise you I will not work any harder or any less hard in any year, in any day because someone is going to pay me more or less."

There are, however, a few camps in psychology that see things differently. The behaviorism theory of the 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.

Alfie 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, these insights do not seem to have reached much of management theory or many HR functions. I find this worrisome. One reason why so many managers and finance people are unaware might be that *any* knowledge and insight from psychology is met with suspicion and skepticism: "We are business people, not shrinks!" HR, however, has no excuse. This is supposed to be their home turf.

Maybe you are still not convinced, so here is my final argument. A bonus system is a combination of *targets* and *rewards*, often introduced at the same time. When we claim that it works, which part is actually working? Could the real driver behind the observed effects actually be the *targets*: the increased effort we put into communicating around performance, ambitions, and progress? Could it actually be all the increased attention that is delivering and not the bonus money?

As mentioned, my criticism has been directed at bonus systems designed as individual carrots. *Team* or *collective* bonuses are very different, as they are designed with a different purpose: hindsight reward for shared success. This is an important distinction. Individual bonus is intended to provide *both* up-front motivation *and* hindsight feedback. Collective bonuses are often criticized for not delivering that up-front motivation. But they are not meant to. Collective bonuses are meant to create a positive feeling around common efforts and shared success being rewarded in a *fair* way. Creating such positive vibrations has, of course, a positive *indirect* motivational effect.

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

There is, however, one challenge with team bonuses that shouldn't be ignored. The more interdependencies there are between teams, the more careful we should be. If one team is rewarded higher than another, and the latter feel they are part of the reason why the other team performed well, we are in trouble. The positive motivation in the first team is easily wiped out by the pissed-off feeling in the other team.

We have discussed two different reasons why companies have bonus systems—*market* and *motivation*. There is actually a third—*affordability*. It can be a cheaper way of paying people, because bonus is variable, not fixed. Could it, however, be that we still pay *more* than necessary because it is not the money that works? Would it have been cheaper to revive that forgotten old craft called leadership? Remember belonging, purpose, mastery, and autonomy? The Institute of Leadership & Management (ILM) recently did a study on the use of bonuses in British companies. It seriously questioned the business value of the £37bn companies spend on bonus annually, as only 13% of respondents said the bonus made them work harder.

A common bonus scheme like profit sharing does provide a much more precise affordability protection. It is also cheaper to operate because we avoid the huge and hidden cost incurred by all the problems with individual bonus described earlier. Talking about affordability, it is interesting how bonus money and especially executive schemes typically avoid scrutiny when companies look to cut costs. How often is "reducing bonuses" mentioned when the task is to come up with deep and radical cost-cutting actions? It is just as if bonus money is some other kind of money, a very different currency protected by Harry Potter's invisibility cloak. Often it is actually the other way around. Tough times are used as an excuse for increasing bonus levels, to motivate executives for all the difficult decisions ahead. As if it isn't their job!

Fortunately, there is management innovation taking place also here. Companies like Google, HCL, and Zappos are experimenting with peer-to-peer bonuses or non-financial rewards. The thinking behind is that colleagues and people you work with often have a better view of your performance than your manager. One model actually combines "common" and "individual." Everyone receives a flat share of a common bonus pool. No-one can keep it. You have to pass your share on to one or more of your colleagues. It is done monthly or event-based, and in some organizations the required justification is posted for all to see. There are already software vendors offering the full administration of such a process.

Let me close with a reflection on how the bonus process is normally organized in companies. This is not any criticism of good friends working on the reward side, just something I find a bit strange. Where in HR do we normally find this responsibility? Typically in the Compensation and Benefits department, together with pensions, employment contracts, union negotiations, and similar issues. We know why; it's about money. 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 about market-related payout levels. The complexity lies in designing what should *drive* the payout. This is a very different area. If the company is big enough for HR to have a separate Compensation and Benefits unit, there would normally also be a Performance Management unit or similar. *This* is where such an important topic belongs, because motivation is a much more complex issue than compensation. The compensation and benefit role should be limited to providing data on market levels. If this had been the case in more companies, I am convinced there would be far fewer individual bonus systems around.

Wherever the responsibility is placed, the big question remains: Why should we have individual bonuses at all? A survey by the 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 whatever possible to make them forget everything related to pay and money."

The Rhythm Problem

There once was a finance manager who met a fisherman. "Could you please tell me about your life and your work," the manager asks. "Well," the fisherman replies, "I am at sea for five months, then I am home for five months." The finance manager becomes very quiet and is thinking hard before his next question: "What are you then doing the two last months?" Something is wrong, five plus five is only ten! Yes, something is wrong, but not with the fisherman's work cycle.

It is amazing how the calendar year has been allowed to impose its stringent rhythm on so many aspects of business and organizational life. The fiscal calendar year makes sense for statutory accounting and tax purposes. Here, we have no choice, either. It creates few problems beyond quarterly short-sightedness. It makes, however, less and often no sense at all to organize all our forward-oriented management processes on the same rhythm. I once worked in Statoil's oil marketing and trading unit. Anything beyond three weeks was quite foggy for many of the traders. When I worked in Statoil Netherlands, it could take years from being awarded exploration acreage till we actually drilled. If a discovery is made, many more years are needed before there is any production. Why should we force businesses with such a different pulse into one and the same calendar rhythm?

Imagine a bank telling its customers, "If you want to borrow money for a new car or for refurbishing your kitchen, you better be here 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 don't. But isn't traditional budgeting by the book very much like this? During autumn "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 variances, was to review such applications. We both loved and hated this. Although we felt quite important when even senior managers had to submit written applications for us to review, these also meant a lot of work. Why had these managers not thought about this 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 somewhat more flexible. There is normally a small back door into the bank that can be used the rest of the year.

When Finance orchestrates the annual autumn ceremony of budgeting, events happening around us seem to fall into three categories. First, we have events that take place *before* the summer. These are quite okay. We would, of course, have preferred stability and as little new stuff happening as possible, because this makes planning easier. But we accept that we live in a dynamic world. We have time to include these events in our budget assumptions and reflect them in next year's budget in an orderly way. We have control. So far, so good! Then we have those events occurring *during* the budget process. There are many, given the increasing length of this process. We aren't too happy about these. Shall we include them or not? Maybe we have to issue revised instructions and assumptions. They mess things up! Finally, we have the stuff that strikes like lightning just *after* the budget is approved. These events we simply hate. Why could they not have happened earlier? Now our perfect budget is almost ruined, and our monthly variance analyses next year will need to explain again and again that "this was not included in the budget."

There is more we do not like in the real world. Projects and activities that run past year-end also mess things up. An approved project stretching over several years must be reapproved every autumn. We need control!

We see many of the same problems on the HR side. Almost everything is organized around the calendar: annual goals, semi-annual and annual performance reviews, staffing 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 business needs them, competence and resource gaps occur and are addressed continuously. Somehow we cope, but more in spite of than because of the calendar cycle.

The traditional 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. 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. A lot is needed to catch all the details we want to see. Then we turn the high beams off and start driving into next year with low beams only. At the beginning of the year, these 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; it is long-term planning time again. 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 ever driven before?

There is an *accordion* rhythm to this way of forecasting, which seems to assume that the world ends December 31. One solution is *rolling forecasting*. Here, every time we update we always illuminate the same length ahead, for instance five or six quarters. This is definitely better than the traditional "against the wall" forecasting. However, if there is a broad variety in pace and rhythm between different business units, then other solutions might work better, as we will discuss in the Statoil case in Chapter 4.

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 sell and the other one buy. In the real world, how many can demand that their external customers already in the autumn commit to all orders for the whole of next year?

I must however admit that I do miss that wonderful moment when everything was coordinated and reconciled, all the way down to the last cent. Pressing Enter for that last time was such a triumphant experience! Sadly, it was so extremely short. My fingers had hardly left the keyboard before something had happened somewhere, and all that beautiful coordination and synchronization was now out of synch. It would take another year before that magic moment would appear again.

It doesn't make sense. Why on earth should everybody be coordinated around *one* cycle that feels like tomorrow for some and is beyond any reasonable planning horizon for others? Coordination is about people needing to talk together. Some need to talk together every day about next day, some every week about the coming weeks, and some every month about the coming months. For some, once a year might be the right cycle, but those are probably a minority. For others, there can't be a predefined cycle, as they simply need to talk when things happen.

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.

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 and realities. 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."

Could there be a better way? Let us hold that thought until we reach the Statoil case.

The Quality Problem

"*Why* do we budget?" The answer to this simple question became the catalyst that got us started in both Borealis and Statoil. Most managers would list several *different* reasons for undertaking this massive process. Budgets are used for setting targets, mostly financial. At the same time, those budget numbers shall also reflect an expectation of what next year might look like. Finally, cost and investment budgets are a pre-allocation of required resources. We therefore want *three* different things from this process:

- Good targets
- Reliable forecasts
- An effective resource allocation

The three purposes are all important elements in a good 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 necessary actions. It is not necessarily about being right, but about being ready. 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, seldom the place to hope for any high-quality forecasts. Assume it is budget time again, and it is important for us to understand financial capacity and expected cash flow. We start on the revenue side with sales, asking our sales managers for their best sales forecast for next year. What happens, however, when the sales manager knows that the forecast number will come back as a sales target, and maybe with a bonus attached? We shouldn't be surprised if a lower number comes up. Maybe we feel this forecast is on the low side, but we are in busy budget times and we need to move on to cost and investments. Here, managers know this is their only shot at getting access to resources for next year, and whatever number they come up with, it will be cut. Last year it was 30 percent. What happens? This time numbers move the opposite way—up.

Every time I have this discussion with managers or finance people, there are both smiles and laughter. "Of course we know this is how the game works!" But this is not funny. It destroys the quality of the numbers, but even more worrisome is the unethical behaviors the process triggers. We should not necessarily blame managers. Their response is both natural and predictable. We should just as much blame our process, which is putting them in a difficult position.

It should also be quite obvious that an ambitious target can't at the same time also represent any expected outcome, unless we have very low or no ambitions. A target is what we *want to happen*; a forecast is what we *think will happen*, whether we like what we see or not. Forcing a target and a forecast into being one number in one process is almost guaranteed to result in either a bad target or a bad forecast or both, as we often negotiate and compromise and end up with a number somewhere in between that nobody is happy about.

As we will discuss later, it is hard to achieve any real quality improvement in target setting, forecasting, or resource allocation without first separating the three. A two-step approach is needed: *separate* and then *improve*. The Borealis and Statoil chapters will discuss in depth what this can mean in practice.

The Efficiency Problem

It is an indisputable fact that we spend an enormous amount of time and resources on budgets, 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 resource waste is scary, this is probably the smallest problem. Compared to most of the others, this is more like a mosquito bite: very visible but merely irritating. It is no mortal disease, just a very costly one. Still, this is where many companies believe they have their biggest problem, and therefore where many budget reengineering projects start.

Why do we spend so much time and energy on budgets and budget reporting? One reason is the illusion of control that we discussed earlier. The more details and decimal places we churn out in our plans and budgets, the more control we believe we have, and the safer it feels to set sail in those treacherous business waters.

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. I still have it in my fingers! Today, spreadsheets and software packages are an indispensable part of any budget process. What happened to all those promised IT efficiency gains? Though I do not in any way miss the manual days, we seem to have utilized technology to crunch more numbers, not to save time.

Since we are on this topic, here is a story about my first encounter with the PC. The first one came to Statoil late in 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 huge investment. It was probably not in their budget. The second one 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. Saving and backup was a slow and time-consuming effort, but I learned my lesson after having lost many hours of 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?”

The PC was located in a common area for everybody to use. The first couple of weeks a few of us had it almost to 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 remember SuperCalc?). Then I started to harvest from my intensive effort. Apart from the cleaning lady, it was a great experience—at least for a couple of months. One day, a colleague came over, telling me that he had good but also 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 short period I was actually the company spreadsheet expert. 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. Even my children tease me about my computer skills. I gently remind them that I was the one teaching them how to eat with a spoon.

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 consolidated, level by level, week after week, until they one day reach top management. For corporate budget people, this is an important moment. The suit and tie is on, and the ceremony starts. After the CEO has thanked everyone for all the hard work through long nights and weekends, the inevitable 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 down again the numbers come. 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 staffing, on sales budgets. Some of the fat is sliced off; a few ambitions are increased, but only a bit. Up again the numbers go. This time the reception is slightly more positive. "Great work, but is this *really* the best we can do?" And down again they come.

In larger companies there will be many elevator round trips before the budget finally is approved. But everybody is happy: top management because they believe they have once again stretched the organization to the limit, line managers because they got away with it this year as well.

We might smile 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 for us 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 the budgets. Monthly detailed variance analyses explain down to the last decimal 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 variance explanations we produced. On a top-10 list, there was one explanation coming out on top, year after year. "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! It feels good to be able to explain, but it is too often just another of those very time-consuming illusions of control.