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The World Has Changed—Isn't It Time to Change the Way We Lead and Manage?

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Bjarte Bogsnes, a leader and popular speaker in the Beyond Budgeting movement and author of Implementing Beyond Budgeting: Unlocking the Performance Potential *(John Wiley & Sons, 2009), described his company's latest step in its dynamic management journey in the September–October 2009* BSR*. Here, he draws on Statoil's remarkable successes to offer a holistic view of dynamic management and its power as a management approach when used within the BSC framework.*

The year 2010 marks the fiftieth anniversary of *The Human Side of Enterprise* (McGraw-Hill, 1960), the landmark book on organizational behavior by social psychologist Douglas McGregor. In it, McGregor introduced Theory X and Theory Y, two opposing views of the organizational human. Theory X sees most people as potential thieves who must be managed on a tight leash; otherwise, everyone will misbehave and chaos will ensue. (I'm paraphrasing here, of course.) Theory Y posits that most people are responsible and mature. They want to be involved and heard. They are driven more by the intrinsic motivation of the job than by the extrinsic motivation of sticks or carrots. In short, they can—and want to—make a difference.

What do McGregor and his 50-year-old labels have to do with management models for the 21st century?

First, when choosing a performance management model, every organization should begin by defining its view of human nature. A management model based on Theory X would (and should) look very different from one founded on Theory Y. In which camp do the *majority* of your employees belong? Whether informed by observation or by personal philosophy, this view must serve as the basis of your performance management model. The minority should be handled through other mechanisms.

Second, Theory X—the negative view—is very much alive, as if little had happened in the past 50 years. Many executives vaunt the "flattened" organization and employee empowerment, but they don't walk the talk. Why must my airline pilot friend, a captain who is a trusted and valued employee, get written approval if he wants a new uniform shirt more often than the manual stipulates? What good is a Theory Y leadership vision if your management practices are rooted in Theory X?

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It actually makes things worse because a gap between words and actions makes people cynical about their organization.

In their hearts, most company leaders would probably subscribe to Theory Y, and yet in their minds, they still might see it as a risky and painful basis for their management practices and processes. *But do they really have a choice?*

Actually, no. Employees have become more educated and competent, with increasingly higher expectations of their employers. At the same time, the business environment has changed radically, becoming much more dynamic and unpredictable. Today it is much harder to see what lies around the next corner than it was almost 30 years ago, when I began my finance career. Although the navigational charts and forecasts are more abundant than ever, we cannot rely on them for guidance; shotgun forecasts simultaneously predict everything from calm seas to gale-force winds. Our assumptions about the future are repeatedly off base. All that's certain is that we will be wrong again. We just don't know in which way or by how much.

In such treacherous seas, it is becoming increasingly difficult for large companies to maintain a centralized command-and-control (or micromanagement) approach. Unexpected opportunities and threats keep cropping up, and they demand rapid, intelligent responses. Management cannot be reduced to an annual exercise of cascading targets, budgets, and instructions, in which any deviation from plan is more likely to be seen as mismanagement than as a sensible and value-adding response to reality.

In this new environment, senior managers must allow more authority to flow to the front lines. We also need better, more intelligent ways of establishing goals, motivating people, and evaluating performance. We need more flexible and dynamic processes for making forecasts, allocating resources, and setting targets. In short, we need a new set of management processes—one that ensures greater consistency between our processes, our people philosophy, and the realities of the world around us.

Change in leadership	Change in processes
Values: Govern through a few clear values, goals, and boundaries and not detailed rules and budgets.	**Goals:** Set relative goals for continuous improvement; don't negotiate fixed performance contracts.
Performance: Create a high-performance climate based on relative success and not on meeting fixed targets.	**Rewards:** Reward shared success based on relative performance and not on meeting fixed targets.
Transparency: Promote open information for self-management; don't restrict it hierarchically.	**Planning:** Make planning a continuous and inclusive process and not a top-down, annual event.
Organization: Organize as a network of lean, accountable teams and not around centralized functions.	**Coordination:** Coordinate interactions dynamically and not through annual planning cycles.
Autonomy: Give teams the freedom and capability to act; don't micromanage them.	**Resources:** Make resources available as needed and not through annual budget allocations.
Customers: Focus everyone on improving customer outcomes and not on hierarchical relationships.	**Controls:** Base controls on relative indicators and trends and not on variances from the plan.

FIGURE 1: *THE PRINCIPLES OF BEYOND BUDGETING*

Beyond Budgeting is often misunderstood. It doesn't compete with, but rather complements, the BSC system. The two together constitute a powerful combination, as the author's experiences at Statoil testify.

The Beyond Budgeting movement provides a new alternative for the new business realities. Beyond Budgeting is about much more than cost management; it's about creating agile ways of managing, ways more aligned with human nature than against it, ways more suited to managing knowledge organizations that are competing in turbulent and dynamic business environments.

The 12 Beyond Budgeting principles (see *Figure 1*) offer a coherent view of management, addressing leadership as well as processes. They seek consistency between words and actions. Specifically, the Beyond Budgeting principles on planning, coordination, and resource allocation all address the need for more dynamic, less calendar-driven management processes.

Toward a Dynamic Management Approach

In a September–October 2009 *BSR* article,[1] I described a new process Statoil was piloting—*dynamic forecasting*—to replace traditional *calendar-driven* forecasting. Most Beyond Budgeting companies adopt *rolling forecasts,* which typically have a five-quarter horizon and are updated every quarter. Dynamic forecasting, an approach we developed in-house, is event driven; it is not done at fixed frequencies, nor does it follow fixed time horizons. Rather, it accepts the unpredictable rhythms and uncertainties of the real world.

The purpose of forecasting is to get issues on the radar screen early enough to act on them if necessary. No company is like a single vessel; with its various units and activities, it's more like a fleet of vessels ranging from speedboats to supertankers. Why equip these different vessels with identical radar screens that have identical reach and resolution? The speedboats may not even need radar, because they can react and adjust on the spot. Forecasting is actually a way of

1 *B. Bogsnes, "Dynamic Forecasting: A Planning Innovation for Fast-Changing Times,"* BSR *September–October 2009 (Reprint #B0909C).*

compensating when we lack this kind of agility—as with the less maneuverable supertanker.

Our three pilots—in our exploration and production businesses in Norway and Azerbaijan and our Danish refining business—tested three main issues.

1. *Do we need a common definition of "event"?* The only definition we deemed necessary was "big enough for your unit." An event is anything from an unplanned shutdown of an oil platform to the approval of a new project (where the forecast is updated with the project's business case).
2. *How does dynamic forecasting change management discussions?* So far, it seems to be shifting their focus to the longer term rather than the year-end.
3. *Will it simplify or eliminate the need for a fall planning process?* In principle (and in combination with dynamic action planning), yes.[2] But we have done fall planning for so long that it is ingrained in our notion of performance management. We have already changed *what* we do in the fall (from budgeting to action planning and forecasting). Changing *when* we do it challenges another accepted truth. However, we believe that changing from a process driven by the calendar and fixed time horizons to one driven by events and relevant horizons will actually make it easier for people to appreciate the difference between traditional budgeting and the new ways of target setting, forecasting, and allocating resources.

The fact that external stakeholders still follow an annual rhythm may also make it a bit harder to adopt the new habit, although our ability to tap in to the latest forecast data whenever any stakeholders need information should not require additional work. The job is already being done on a continuous basis.

Our 2009 pilot was a success, and business areas throughout Statoil have begun implementing dynamic forecasting. Because it is not mandated, adoption may not happen quickly, but the increase in ownership, commitment, and sustainability we'll experience will more than compensate for the slower pace.

Dynamic Resource Allocation

Dynamic forecasting represents another step on a journey that we hope will further liberate our management process (which we call "Ambition to Action") from the calendar year.[3] Our first important step was introducing *dynamic resource allocation* a few years ago.

For executives considering Beyond Budgeting, perhaps the most difficult question is how to manage costs without preallocating resources every year through detailed budgets. Is there really a better way to manage costs than handing out all those little bags of money every fall?

Imagine a bank informing its customers, "We have now changed our hours, so if you want to borrow money for next year, we are now open only in October."[4] It sounds ridiculous—but isn't this exactly what people in companies experience every year with the budget process? With dynamic resource allocation, on the other hand, the "bank" is open 12 months a year. Your funding request might still be refused; we should be just as good at saying no as yes. But why should we make all those decisions in the fall, before we have to? Isn't it better to make them as late as possible, when we have better information—not only about the project or activity itself, but also about our capacity to fund or staff it? A project that arose yesterday should have the same funding chances as one that arose nine months ago and would have, in the old system, already been budgeted.

To illustrate how the combination of dynamic forecasting and dynamic resource allocation provides a dynamic framework for decision making, let's look at capital investments. At Statoil we abolished the annual capital investment budget in 2006, when we segregated forecasting from resource allocation and abolished the annual preallocation of resources. Dynamic forecasting provides a continuous update of our expected short- and longer-term financial capacity (within the range of uncertainty created by future oil and gas prices). The investment forecast includes approved and ongoing projects and proposed projects, along with extended "generic forecasts" to reflect unforeseen projects we know will come. This forecast keeps changing, because of delays or accelerations in individual projects or any of the many other factors beyond oil and gas prices that influence our expected cash flows.

Management cannot be reduced to an annual exercise of cascading targets, budgets, and instructions, in which any deviation from plan is more likely to be seen as mismanagement than as a sensible and value-adding response.

2 *Dynamic action planning is the actual planning of activities required to advance toward strategic objectives and deliver on key performance indicator (KPI) targets. These activities are funded through dynamic resource allocation, either directly (in the case of a new project) or indirectly (e.g., managing exploration costs by unit-cost and volume targets).*

3 *Ambition to Action, initiated in 1997, is Statoil's version of the BSC management system and the cornerstone of its performance management process. It translates strategies into* strategic objectives *("Where are we going?"),* KPIs *("How do we measure progress?"), and* actions *("How do we get there?").*

4 *Thanks to Steve Morlidge, coauthor of* Future Ready: How to Master Business Forecasting *(John Wiley & Sons, 2010) and a Beyond Budgeting veteran, for this wonderful analogy.*

We allocate resources for projects when they get the final go-ahead at Decision Gate 3 (of the stage-gate model). The latest forecasts will indicate our financial capacity; if they show negative development capacity, there need to be more noes than yesses to new projects—and vice versa. An annual investment budget would have been of little help here. It would have forced us to say yes or no to projects before we had to—and provided a view of our financial capacity that would have quickly been outdated.

The prioritization once performed by the budget is now performed through a continuous investment-portfolio prioritization process that ranks investments in the portfolio based on a set of strategic, financial, and operational criteria. The prioritization guides the organization in approved as well as proposed projects, while helping local teams allocate resources and coordinate work. The priority list is updated when needed—at a minimum, biannually.

Handling Operational and Administrative Costs

Operating without an annual budget is easier when the resource spend involves large, discrete projects. They typically have clear business cases and go through rigorous, transparent decision processes. Operational and administrative costs are different and must be managed in more diverse ways. The old budget mechanism—handing out bags of money each year—might seem an effective way of capping such costs, especially if managers are reminded of the consequences of overspending. The problem is that setting a ceiling also sets a floor; managers know that not spending their budget is not smart if they want to ensure the same level of resources next year. The result is much less budget variance up or down than what we actually should see. But we feel very much in control!

Instead of asking the budget question ("Are budget funds still available?"), we want people to ask themselves, "Can I justify this expenditure?" If they're in doubt, we recommend they imagine their yes decision being questioned; "Was this really the right thing to do?" If someone believes he will struggle with this question, then maybe his decision should be no, or at least he should discuss it with someone first. This question should be asked from the first penny spent and not only when budgets are about to be exceeded.

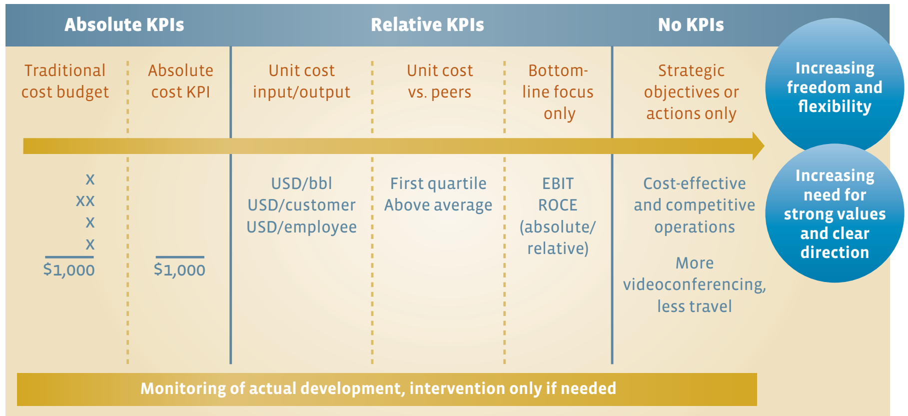

FIGURE 2: *MANAGING OPERATIONAL COSTS WITHIN A DYNAMIC RESOURCE ALLOCATION FRAMEWORK*

Statoil has instituted three mechanisms that units can use to manage their own operational costs: absolute KPIs, relative KPIs, or no KPIs. The progression from absolute to no KPIs provides increasing freedom and flexibility but also requires strong values and clear direction.

Our unit, for example, does not have a travel budget. Some of my trips abroad are expensive in money and time. But it's much easier to decide whether any single trip is justifiable at the time, instead of having to decide months in advance what our travel costs should be. (See sidebar, opposite.)

We are not, however, naive. We don't believe that Scandinavia's largest company can manage costs through such questions alone. These questions are necessary but not sufficient. At Statoil, we therefore instituted three mechanisms that units can use to manage their own operational costs. (See *Figure 2*.)

They can still use *absolute KPIs* (key performance indicators) to set an overall cost target (in some cases, it might be set from above), but we don't recommend or require any details, as a traditional budget would. This policy provides a great deal of flexibility.

But if what lies ahead is uncertain, how do we know exactly what that target should be? We then might use *relative KPIs*. For instance, variable production costs can be managed through unit costs instead of absolute costs because it's OK to spend more if you're producing more—and vice versa. Unit costs can also be benchmarked against peers, with targets, for example, set as "above average" or "first quartile." Cost can be managed even more indirectly through ambitious bottom-line targets. If you have a tough bottom-line target, absolute or relative versus the competition, you cannot just spend money like a drunken sailor. A bottom-line target discourages "bad" costs. Importantly, it also acknowledges that the frontline unit responsible for that particular bottom line is almost always better equipped to distinguish between good and bad costs than any management layer above.

In some circumstances, we eliminate cost targets altogether *(no KPIs)*. For example, our corporate staff unit has no absolute cost targets, and can't use unit-cost or bottom-line targets. We address costs by setting a clear objective for the

Reducing Travel Costs Without a Budget

When you're trying to reduce costs, instead of targeting specific cost types (e.g., travel, consultants), think in terms of activities. Some travel costs add value, but others less so. It's hard to determine which is which if you don't understand the reason for the travel. It's the less-value-adding activities that we should aim to reduce.

The problem is that few companies can describe their costs in terms of activities; they typically rely on cost types as defined in the chart of accounts. Consider travel costs—a favorite target of cost-reduction programs, and, in some cases, a sensible one. Travel is a visible cost type that affects many employees, so it's a useful and easy area in which to promote a change in behavior and practices.

Here's how Statoil reduced its travel costs during the financial crisis without reverting to traditional budget approaches.

- *We set a goal of reducing travel activity within a 25% range.* This target was a corporate target and not one to be cascaded throughout the organization.
- *We made it a priority to improve—and communicate—the alternatives.* Our videoconferencing room, for example, was significantly upgraded and expanded.
- *We adjusted the company travel standard* from "business class" to "flexible economy" for travel within Europe. Note the distinction between a centrally determined *standard* and a centrally determined *budget* circumscribing individual teams' travel.
- *We improved cost transparency significantly,* in two ways. First, we launched a "meeting calculator" on the company website to help people determine whether traveling to a physical meeting was necessary. If travel was recommended, the calculator estimated the full cost of the meeting. Often, when that became visible, the decision to go was reversed. Second, we improved the reporting of actual travel costs in our accounting system, helping local teams better monitor the trends and developments in their travel costs.
- Finally, *we intensified communication* about travel cost goals, alternatives, and cost-reduction trends.

Within six months, we reduced travel costs by more than the 25% goal—without having to reintroduce travel budgets—that is, without any "cutting." Corporate simply created conditions conducive for employees to reduce their travel expenditures. This occurred largely without the suboptimization, frustration, and cynicism that typically follow a traditional top-down cost-cutting program.

We did learn a few lessons. Despite our messages, some units perceived the 25% corporate ambition level as a fixed target to be further cascaded within their own units. The word "cutting" was also still being used, even though we worked hard to communicate that this was not our intent. Clearly you can never overcommunicate intentions and principles when you want to change behavior.

cost mentality we want to cultivate and by defining actions like "travel less and use videoconferencing more."

Finally, all units monitor their actual cost development, as does the level above them. In our unit, that would be the CFO. He hasn't abdicated his right to intervene if we abuse his trust; he can move us back to a traditional budget overnight. He hasn't had to: in fact, our team discusses costs more often now than when we had a budget. It was actually easier to spend money in the old days when someone told us up front exactly how much and on what. Now, we must decide every day what constitutes wise or unwise spending.

Eliminating cost budgets is easy compared with changing the mind-set they reflect. This change takes time—as it should. We cannot instruct people to change. We cannot abolish command-and-control by command-and-control. Everybody needs to recognize the limitations of the old way and come to terms with the new way on her own timetable. We expect it will take several more years before this aspect of Beyond Budgeting is embraced throughout our organization.

From Cascading to Translating: Balancing Alignment and Ownership

Among the growing numbers of companies that are abandoning traditional budgeting, many have made the Balanced Scorecard a cornerstone of their new management model. Some have introduced the BSC as a wholesale replacement of the role formerly played by the budget. Others have used BSCs in parallel with traditional budgeting for years with reasonable success (Statoil, since 1997), only to discover that abolishing budgets turbocharged their scorecard process, significantly amplifying its benefits. These companies realized that when run in parallel, the two systems often sent mixed signals to bewildered managers—with the budget invariably prevailing. (Don't blame managers; few get fired for hitting their numbers.) When Statoil dropped the budget altogether in 2005, that action triggered a revitalization of our scorecard process at a magnitude we had not expected. Everyone realized we were serious about the scorecard. Ambition to Action, our BSC program, has become a household word, with 1,100 unit scorecards built thus far.

Our decision to address the conflict between scorecards and budgets was part of a major reorientation of our management principles. We wanted to respond to an increasingly dynamic and unpredictable business environment. We also wanted to achieve greater consistency between our words and our actions by making our values and our management processes consonant. And, as we say in our values, we wanted to "challenge accepted truths."

But eliminating the budget process and moving exclusively to the scorecard were in themselves no guarantee of achieving these goals. The scorecard can, in fact, enable much more centralized, microlevel management than a budget, given the broader menu of buttons to push and strings to pull at corporate's disposal.

The way the BSC is used is therefore just as important as *whether it is used at all*. Scorecards can quite effectively reinforce Theory X ("people can't be trusted") command-and-control tendencies. But BSCs can also be used for the opposite purpose—to make Theory Y visible, tangible, and credible in the organization. The X or Y choice that organizations make, consciously or unconsciously, is often manifest in the way they ensure alignment between corporate strategy and frontline goals and priorities. Alignment is, of course, crucial to strategy execution, because strategy is about making choices. If you never say no, you don't have a strategy. And scorecards ensure that we actually do what we have said yes to—and don't do what we have said no to.

But alignment is only part of the equation. We also need the commitment and ownership of local teams. If a local scorecard is nothing more than a landing ground for instructions cascaded from above, ownership takes a serious hit. Ownership requires participation by teams at every level. You can't just copy and paste directives from above. Flowery strategy statements that resonate with board members often sound hollow to frontline employees. Local KPIs must be perceived as relevant and sensible, and KPI targets as ambitious without being overly aggressive. The need for "stretch" must also be both understood and accepted.

Flowery strategy statements that resonate with board members often sound hollow to frontline employees. Local KPIs must be perceived as relevant and sensible, and KPI targets as ambitious without being overly aggressive.

Management must allow sufficient local freedom and flexibility to allow for opportunities to be grabbed and threats to be fended off when (not if) the unexpected occurs. This is difficult if scorecards are carved in stone (like an annual budget) and if unplanned—but appropriate—actions need a nine-floor journey for approval.

Securing alignment is therefore a delicate balancing act. To make things hang together sufficiently, we need to apply enough glue to ensure a common understanding of direction, goals, and priorities throughout the organization. But if we squeeze the tube too hard, we risk gluing away all the agility and flexibility that companies need just as much as perfect alignment.

"Cascading," a popular word in the Balanced Scorecard lexicon, is the way many organizations create alignment. In my view, that's unfortunate because it can have serious side effects. Cascading is typically a top-down, one-way instruction about local scorecard content (and not necessarily from corporate down; it can issue from any level). Although it's effective in achieving alignment, it does so at a cost: reduced local flexibility, commitment, motivation, and ownership. In some organizations, corporate uses cascading as an opportunity to micromanage through scorecards on a scale greater than the budget process ever allowed.

There is, however, a better alternative, and one that's based more on "pull" than on "push." You can create sufficient alignment without sacrificing local ownership. It starts with using a different word: "translating." Translating is not a one-way, top-down exercise. It involves two parties, with roles reversed: the lower-level party is responsible for translating strategy from the level above.

Consider, for example, translating a divisional scorecard into business unit scorecards. The business units would take the lead, each looking at the divisional scorecard (and, if necessary, at other divisions' or corporate's BSC) and asking the following:

- What should our scorecard look like to reflect the direction and priorities of the scorecards above it?
- How should we formulate our strategic objectives? Should we simply copy the objectives from the level above, or should we translate them into more concrete terms?
- Which KPIs will best show whether we are moving toward our strategic objectives? Should we copy or replace existing ones—or add new ones?
- Which KPI targets do we need to set?
- Which actions do we need to take to advance toward and ultimately achieve our strategic objectives?

Instead of cascading these elements downward, the division now oversees and supports each business unit's scorecard work, ensuring it is directionally correct. The division can, of course, challenge proposed objectives, KPIs, targets, and initiatives, and it has ultimate say when a disagreement arises (although this authority should be used sparingly). Equally important, the division should stimulate scorecard best practice sharing among business units, as well as promote horizontal alignment, when necessary, across units.

This process is replicated level by level throughout the organization, always between two levels, with the higher level ultimately responsible for sufficient alignment between the two. Everybody can, however, check alignment with everyone else because all scorecards should be visible to all (except those portions containing sensitive information). Remember, transparency is a key Beyond Budgeting principle, promoting learning as well as effective, self-regulating control.

Translation does not inherently exclude the possibility of applying traditional top-down cascading. From time to time, traditional cascading will be the right (and needed) way. But it should be the exception and not the rule.

The word "translation" is already part of the Balanced Scorecard vocabulary, but I hope it becomes a household term in practice. I also hope that the term "Balanced Scorecard" comes to mean a balance between alignment and ownership, because, as we've learned from hard experience, local ownership, commitment, and motivation are just as important as perfect mechanical alignment.

Are We Losing—or Gaining—Control with the New Dynamic Management Approach?

Beyond Budgeting, and the whole notion of dynamic management, prompts interested but still skeptical professionals to wonder, "Won't we lose control?"

Yes and no. We actually want to lose some forms of control—the "bad" ones, such as the micromanagement of people who neither need it nor want it. As the late Peter Drucker put it, "Most of what we call management consists of making it difficult for people to get their work done."

We also want to lose the illusion of control we get through board-approved budgets and plans that describe in detail what next year will look like. Such reference points may be reassuring when the real world takes a different route, as it inevitably will, but do they constitute control?

As for "good" controls, we actually gain more of them. Transparency is a great control; there's a reason thieves operate at night rather than in broad daylight.

Emphasizing values rather than rules provides a robust and self-regulating way of guiding behavior in a world where no manual is thick enough to address every possible situation or dilemma that employees might face.

We also get better control through better quality of information by segregating the three processes within (and three purposes of) the budget: target setting, forecasting, and resource allocation. Separating them enables us to improve each of them in a way not possible when they are bundled. We can set more ambitious goals and make them both relative and directional. We can get more unbiased forecasts than we got when those budget projections also served as targets against which people are incentivized—or penalized. And we improve resource allocation by making it dynamic and continuous and by viewing costs as inputs that create outputs and not something that can be managed in isolation.

The holistic performance evaluation is yet another type of good control that we gain. It's an effective way of avoiding the kind of unwanted behavior and suboptimal decisions you otherwise get when people are trying only to "hit the numbers." Remember: the "I" in KPI stands for "indicator." Hindsight insights and management judgment must be used to pressure-test mechanically measured performance before we can draw conclusions. It's worth recalling Einstein's words: "Not everything that can be counted counts, and not everything that counts can be counted."

Let us not forget that control is not a goal in itself. The goal is the best possible sustainable performance in our organizations, within the boundaries set by society and by ourselves. It is that simple—and that difficult. ■

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To learn more

Statoil, a 2007 inductee into the Palladium Balanced Scorecard Hall of Fame for Executing Strategy®, was profiled in the 2008 BSC Hall of Fame Report *(Product #2797) and in* BSR *January–February 2008: "Statoil: Scorecard Success–the Second Time Around" (Reprint #B0801B). Both are available at* ***www.hbr.org.***

Also at hbr.org, check out the BSR Reader Planning for Results: Linking Planning and Budgeting *(a compilation of important articles on these subjects; Product #1893). And consult the* BSR Index 1999–2009 *(available free of charge at www.index09.hbr.org) for more articles on planning and budgeting.*

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