Exploring the objectives of borealis new budgeting system

ASSIGN BUSTER

Borealis abandoned its traditional budgeting system in 1995 and implemented a new system, which is set to achieve 4 objectives:

Improve financial management and performance measurement.

Decentralise authority and decisions.

Simplify the budgeting process.

Reduce the resources used in the process.

In this report, we would examine failings in the current budgeting process and modifications that would make the existing system more useful. We would then provide more suggestions to Borealis' new system and evaluate if Beyond Budgeting is a suitable system for other companies.

Introduction

Borealis is the world's fourth largest polyolefins producer and its main competitors are Dow, Exxonmobil, Basell (Shell & BASF), Equistar, BP, Du Pont and AtoFina.

Borealis operates in a rapidly changing, cyclical business environment where profit margin is highly affected by volatile input prices. Barriers to entry are high due to high initial capital investments. Overall industry capacity had increased despite demand being stable, leading to low prices and profitability. Therefore, gaining operating efficiency is important in keeping the required profit margin.

Failings in Borealis' Previous Budgeting Process

Fixed and not Flexible

The problem with Borealis' previous budgeting process lies in the way that the management used the system. Borealis operates in a business arena where their products demand/supply and cost/profit are highly volatile and dependent on short-term oil price movement, which can have significant impact within a short 1 week cycle. For example in 2008, oil price had a spread of USD60 within a short period of 3 months which had a significant impact on companies' short-term commitment and strategy.

The traditional budgeting institutionalises in companies a set of tools and procedures that lead to a fixed and static annual performance contract between top and lower management etc. it creates an interlocking set of fixed annual plans, typically arrived at by a process of negotiation and assumption, that has few to do with customers and market demand, and that is tied to rewards in a deterministic way (Daum, 2004). Resources and incentives are allocated and set centrally and in advance, regardless of the changes in market condition. Consequently, everyone in the company is focused on making the budget numbers, and not on satisfying customers or beating the competition or reacting to markets changes as fast as possible in order to leverage them as opportunities for growth and for building competitive advantage (Daum, 2004). This budgeting exercise becomes more of an internal role playing game among different business units and managers to ' look within' the company and set targets among themselves rather than ' look outwards' at the existing market condition and set targets relative to competitors and market.

For example, many companies projected budget has to be redone when oil price move from USD40 a barrel to USD120 a barrel. The same cycle of undoing the budget has to be performed again when oil price falls back to USD40 a barrel. However as budget is already pre-committed and reviewed only at the end of a financial year, managers have to wait till a new financial year to highlight the effect of the changes. By the time this effect is communicated in the new reporting year, the cyclical effect is over and revision to budget and business strategy would have lagged behind the changes.

Fixed annual performance contract should be removed. The applied tools and procedures should be self-adaptive, where customer orientation, entrepreneurship, immediate reaction to market development and customer demands would be a natural behaviour of every employee. The tools should be guiding the business unit and employees towards a more flexible and adaptive system, where employees use their full potential, benefiting the company and themselves and not spending time and resources on gaming and adhering to an outdated budget.

A Budget Serving Too Many Purposes

Traditional budgeting tries to serve too many purposes i. e. a single set of report is used to i) chart long-term strategies; ii) communicate between top management and employees; iii) forecast yearly business volume and expenditure; iv) set future targets; and v) appraise performance of business unit and employees.

It is clear that we have to separate financial forecasting from target setting and performance management as we will never get accurate and honest forecasts if bonuses and performance appraisal of employees are linked with these forecasts (Daum, 2004). This encourages gaming among business units and managers i. e. negotiate a higher budget for cost and lower targets so that they can meet the performance for the year at the expense of the company long-term strategy and competitiveness.

In addition, as quoted in the case study: ‘ budgets not only set a ceiling on costs, but also a floor’. The budget constraints hinder decentralised decision-making. It may have controlled the cost but does not truly reflect the value and profit creation that a business unit should be focusing on. For example, a manager might have to incur more costs beyond the allocated budget on certain business activities, which will produce a higher ROCE. However, in order to adhere to allocated budget which is tied to his performance appraisal, he has to forgo the profit creating business opportunities, which is in conflict to the business objective of creating more value for the company and shareholders.

Abandoning Budgets

Borealis replaced the functions of traditional budgeting with a set of tools that allows it to achieve its objectives. Rolling financial forecast, Balanced Scorecard (BSC), Activity-based costing and investment management provide Borealis the following abilities.

Flexibility to adjust investment priorities, policy and volumes in accordance to market opportunities and threats without the need to adhere to a ‘ cut-off’ time and ‘ investment limits’ set by a budget. This allows investment in the right area which supports corporate strategy and growth in accordance to the changing economic conditions.

A continuous view of performance and financial forecast that is generated using up-to-date information such as prices, exchange rate, volumes etc. This rolling financial forecast allows early warning information that may trigger strategy adaption (Daum, 2004) and also provides a longer term financial analysis to study the need for any change in priorities or need for corrective actions. As forecast is updated quarterly rather than annually, the effect of any changes can be captured and reacted promptly.

Benchmarking business performance, operational efficiency, activity and cost to a relative target, set by market environmental developments and competitors’ achievement. This adaptive and continuous benchmarking encourages efforts to be fundamentally better-than-your-peers by setting relative performance against them and also to improve what you have achieved the previous quarters.

A system of performance management that reward and incentivise employees on a broader perspective instead of just on financial result. Staff will be incentivised to focus on creating values both on short term financial performance as well as longer term strategic drivers of the business e. g. enhancing values to companies’ non-tangible assets such as corporate image.

Decentralised decision making by providing front line people with strategic, competitive and market-based information. Hence they can self-regulate and implement appropriate operational strategy to deal with competitors' threats, rapid changing business environment and market demand effectively. Control is achieved by holding them accountable for their costs through benchmarking with transparent market information.

Additional Suggestions to Borealis system

Borealis Beyond Budgeting approach has the essence of removing the constraints and time limit set by a budget and put in place a more fluid and dynamic mechanism that encourages company to become a more productive, nimble and adaptive organisation.

Decentralise does not mean No Control

The performance management practices discussed above are consistent with transitioning to an empowered organisation. However, some fundamental decentralisation principles are also necessary to maintain adequate control and avoid unpleasant surprises (Libby et al., 2003). Employee needs the freedom to act, but freedom to act does not mean giving employees a blank cheque. They need to be given boundaries within which to make decisions and also broader base strategic boundaries which have to take into consideration the company's macro strategic goals. People need the appropriate training and support to act decisively and be able to access timely and complete information to deal with problems and opportunities.

Comparison of Performance

Quantitatively, any applied mechanism to control or to monitor performance has to be relative and not absolute, both in space and in time, and it has to achieve the purpose of reporting the problem areas. A set of relative comparison has to be put in place to quantitatively show and highlight performances relative to the market, the competitors and yourself. For example, if we are looking at the ROCE trend of Borealis from 1998 to 2000, what could be derive from it is that the ROCE had been decreasing over the years. Net sales volume had increased substantially from 1999 to 2000 but operating profit had dropped drastically from 216mil€ to 92mil€. A fall in ROCE might be a general trend of the industry at a period and not because the company is not doing well. A customised set of tools has to be implemented to chart this performance variance, inform and incentivise employee accordingly.

Using another example to illustrate, a comparison of the cost-to-sales percentage changes over the year would have indicated that Sales and Distribution departments are in fact performing well even though there was an absolute increase of cost of 66mil€ (or 25%) (see Exhibit 1) and drop of operating profit by 124mil€ from year 1999 to 2000. The cost/sales decrease from 8. 84% to 8. 79% (Exhibit 1), which represents a lowering of unit cost-to-sales from year 1999 to year 2000.

When evaluating the performance of Production department, there was an increase in absolute value of 817mil€ (or 35. 3%) (Exhibit 1) from year 1999 to 2000, while operating profit only increased 25. 7% (Exhibit 1). Unit cost/sale had in fact risen from 73. 9% (year 1998) to 77. 5% (year 1999) to 83. 4% (year 2000) (Exhibit 1) when other departments had registered an improvement over the years. However, this relatively poor performance has to be compared to the existing market parameters i. e. is Dow/UCC doing better than 83. 4% of cost/sales? If so, Borealis management needs to review the internal activity-based costing again for the production department.

Target Variance as KPI

Target variance should be set for various business units. Assessment, which is relative to market performance, is done on the variances to effectively distinguish the high performance business units from the low performance ones. The management can utilise this to focus on the problem areas.

For example, Sales and Distribution cost/sales has improved while profit level has drop. The rolling forecast or target for the next few quarters should show a positive variance of improvement relative to the market and what you have achieved from the previous quarters.

Performance measurement and incentives paid should not be tied to an absolute number e. g. KPI based on return of assets i. e. EBIT/NA *. This is to effectively exclude the exogenous market factor and the misalignment of objectives between different business units. Sales would want to increase EBIT by dishing out discount to achieve a higher KPI while management might want to maintain competitiveness of the group by investing in low yielding assets for sustainability of market leadership. The incentivising method will have to take into account the importance of collective team effort, in order to steer the direction of achieving the target performance as a group rather than as different business units with differing objectives.

Conclusion

Is Beyond Budgeting Model for everyone?

In principle, this model should work for any organisation. The objective of the various tools implemented has the in principle of, get better and beat the competition, not negotiate a budget and compare yourself to it (Daum, 2004). The various tools that are developed and implemented for measuring and rewarding can come in any form, but the essence of it all is to look ‘ outwards’ at the competitors and not ‘ inwards’ at a rigid committed numbers.

* EBIT – Earnings before Interests and Taxes

* NA – Net Assets