Is the traditional budgeting process worth all the time and effort that it requires? “There’s a better way,” was the conclusion of one large Midwestern integrated delivery system.

At a Glance

- Beyond budgeting transcends the limitations of traditional budgeting by replacing fixed financial targets with targets based on key performance indicators.
- For Park Nicollet Health Services, the decision to implement beyond budgeting coincided with a larger move to adopt a Lean approach to management.
- Park Nicollet’s process to implement beyond budgeting—from submission of the initial proposal through two test runs with process refinements to full implementation—lasted about one year, from January 2005 to January 2006.

Traditional budgeting is a thing of the past for Park Nicollet Health Services. The large IDS, serving greater Minneapolis, recently underwent a management transformation in which it embraced the Lean thinking and practices exemplified by the Toyota Production System. As part of this transformation, Park Nicollet eliminated its traditional budgeting process and moved “beyond budgeting.”

Actually a term coined by management experts Robin Fraser and Jeremy Hope, beyond budgeting refers to an innovative, more flexible approach to budgeting that avoids many of the pitfalls of traditional budgeting. Fraser and Hope describe its underlying principles and concepts in their book Beyond Budgeting: How Managers Can Break Free from the Annual Performance Trap (Boston: Harvard Business School Press, 2003).
BEYOND BUDGETING CONCEPTS

The following explanation of the concepts underlying beyond budgeting is extracted with permission from the website of the Beyond Budgeting Round Table (www.bbrt.org), an international research consortium founded by Robin Fraser and Jeremy Hope, among others, in 1998 to promote and disseminate the beyond budgeting model.

From Fixed Budgets to Adaptive Processes
Compared with the traditional management model, beyond budgeting has two fundamental differences. First, it is a more adaptive way of managing. In place of fixed annual plans and budgets that tie managers to predetermined actions, targets are reviewed regularly and based on stretch goals linked to performance against world-class benchmarks, peers, competitors, and prior periods.

From Centralized Hierarchies to Devolved Networks
Second, the beyond budgeting model enables a more decentralized way of managing. In place of the traditional hierarchy and centralized leadership, it enables decision-making and performance accountability to be devolved to line managers and creates a self-managed working environment and a culture of personal responsibility. This leads to increased motivation, higher productivity, and better customer service.

Individually, these two main features can produce significant benefits, but in combination they can meet a leadership vision that has, up until now, been strong on vision but weak on delivery.

Because it is a coherent model in which all of its components work in harmony, it can produce outstanding and sustained success. This success is driven by four direct value drivers: innovative strategies, low costs, loyal and profitable customers, and ethical reporting. However, these drivers will be ineffective unless front-line people have the scope, knowledge, and power to deliver. The result is an organization that is lean, adaptive, and ethical and that has the potential to remain at the top of its peer group league table.

Source: Beyond Budgeting Round Table (www.bbrt.org). Used with permission.
Park Nicollet was all too aware of traditional budgeting’s pitfalls. Like other large organizations, the IDS had been spending many months developing the annual budget and then countless hours accounting for and explaining variations from a budget that had no inherent mechanism for predicting future events and circumstances. A significant portion of the annual performance bonus was tied to how well managers “managed” to their budgets—never mind whether the results made the best sense for the organization’s overall financial well-being. Park Nicollet’s leaders ultimately concluded that time was being wasted on a budget that never truly reflected actual organizational performance.

The impetus to eliminate the traditional budgeting process came in 2003 with the concurrence of two events: Park Nicollet’s CFO, David Cooke (one of the authors of this article), attended a seminar on beyond budgeting, and the organization’s CEO, David Wessner, began to investigate the Lean practices of the Toyota Production System to improve the “production” side of the business. On sharing what they learned from these experiences, the two executives recognized that the principles of beyond budgeting were well aligned with Lean practices and could be used to leverage the efforts to initiate Park Nicollet’s Lean journey on the production side. The Lean idea of eliminating waste in processes, including management processes, met with the beyond budgeting idea that the traditional budgeting process produced more waste than positive results.

**Reason for Change**
Before entering a more detailed account of Park Nicollet’s adoption of beyond budgeting, it is helpful to consider some of the limitations of traditional budgeting that led Park Nicollet to eliminate it, and outline some of the essential differences between traditional budgeting and beyond budgeting processes.

Traditional budgets set targets that are financial and typically negotiated between operating managers and the budget committee. The targets are set for the year and typically serve the dual purpose of being the basis for organizational planning and control and a key component of performance contracts. The enterprise is then managed to meet these targets, with the result that decision-making behavior becomes subservient to the budget rather than to the demand of customers and the long-range financial well-being of the organization.

Among the typical problems of traditional budgets are that they quickly become out-of-date; the budgeting process is extremely time-consuming, and thus highly wasteful; and a process meant to provide insight into operational requirements ends up focusing exclusively on financial outputs.

When an organization eliminates the traditional budgeting process and institutes the more adaptive management processes of beyond budgeting, it begins to manage in a way that is in alignment with Lean production practices. Fixed financial targets are replaced with targets based on key performance indicators.
Fraser and Hope argue that breaking free from a traditional budget that incorporates fixed performance contracts for managers is the key to unlocking stretch targets, implementing adaptive processes, and eradicating gaming behavior. The benefits of such changes are many.

Consider the consequences of gaming behavior, for example. At Park Nicollet, for each of the five years before traditional budgeting was eliminated, the organization was always over budget on supplies. Why? To bring their submitted budgets into alignment with organizational goals, it was easier for managers to cut their supply budget rather than their salary and wages budget. So that is what they did—without having a plan in place to actually reduce supplies expense.

Once traditional budgeting is eliminated, an organization’s performance is no longer viewed against the backdrop of a set of fixed financial targets developed for a one-year period. The planning and control functions become part of a continual process that develops from practical operational action plans. These plans are reviewed on an ongoing basis to ensure that each business segment (referred to as “service lines” at Park Nicollet) is meeting performance expectations that reflect continual improvement. Planning and control are still important, but the focus of planning becomes one of midterm and long-range forecasting, and control becomes a measure of the organization’s ability to make continual improvements, which becomes the organization’s goal.

By focusing on making incremental improvements rather than meeting budget targets, the organization unleashes the creativity of its people to do their best work.

**Transition to Beyond Budgeting**

Recognition of the potential benefits of beyond budgeting prompted Park Nicollet’s leaders to initiate a more in-depth analysis of how the organization might best proceed in eliminating traditional budgeting in favor of the new approach. The initial steps in this analysis began in May 2004, and by January 2006, Park Nicollet’s transition to beyond budgeting was complete. The overall transition process can perhaps best be summarized in six steps.

**Step 1.** Gather information. Two financial managers—Tony Gold, manager of budgeting and financial planning, and Catherine Lenagh, vice president and controller—were charged with investigating beyond budgeting and producing a viable implementation plan. Gold and Lenagh attended a course presented by Robin Fraser, in which Fraser recounted how beyond budgeting replaces annual budgeting with a system of regular performance reviews, action planning, and relative performance goals.

**Step 2.** Develop the initial plan. Gold and Lenagh drafted a proposal for a new process, based on what they had learned in the seminar and using many ideas derived from the “six principles of managing with adaptive processes” from Hope and Fraser’s book. As an initial exercise, Gold prepared a document explaining what each of the six principles could mean to an organization like Park Nicollet. Says Gold, “Completing this exercise convinced me for the first time that we could make this work for a healthcare system.”
Before it was presented by the CFO to Park Nicollet’s executive leadership, Gold and Lenagh’s proposal was reviewed internally by other members of the finance staff. They recognized that if the finance staff could agree internally on a workable model, the CFO would be more comfortable presenting the idea to operations and ultimately to the Board.

The finance department’s initial plan was simple: Establish quarterly performance reviews at the service-line level in which the finance department would compare the most recent quarter’s performance with that of the prior quarter, with the expectation that each service line’s performance would continuously improve. Two performance measurements would be used for this review: cost per unit of service and units of service per FTE. If a particular service line’s performance declined, that service line would develop an action plan to correct the decline.

Working with the finance department, Park Nicollet’s service-line managers would also establish a new five-quarter forecast at the close of each quarter, to be discussed at the quarterly performance review. Five quarters would give management a picture of an entire fiscal year, with one quarter in advance. Park Nicollet would ease into the new plan while it still had a budget in place, giving the organization the opportunity to test its effectiveness and work the kinks out of the process before the existing budget year was over.

**Step 3.** Present the plan to Park Nicollet’s operational leaders and board. The initial plan was met by Park Nicollet’s operational leaders with mixed reactions. The board endorsed the new approach with the understanding that they would establish an annual operating margin goal, stated as a percentage of revenue, which management would target to achieve. The plan to have managers throughout the organization tune up their forecasts each quarter was seen as swapping out annual budgeting with

### IMPLEMENTATION OF “SIX PRINCIPLES OF ADAPTIVE PROCESS” AT PARK NICOLLET

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<th>Six Principles</th>
<th>Examples of Implementation at Park Nicollet</th>
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<td>Base goals on maximizing performance potential—i.e., set stretch targets.</td>
<td>Operating margin target set at 3.8%, which is the margin needed for bond rating, to fund the capital budget, and to secure the growth of board designated assets.</td>
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<td>Evaluate performance based on relative improvements with hindsight.</td>
<td>Evaluation basis is improvement in cost per unit of service and units of service per FTE each quarter.</td>
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<td>Make action planning a continuous and inclusive process.</td>
<td>A continuous and inclusive action planning process is used to align actual performance with expectations.</td>
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<td>Make resources available as required.</td>
<td>Resources are made available to achieve 3.8% operating margin target and relative performance improvements.</td>
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<td>Coordinate cross-company actions based on customer demand.</td>
<td>Each service line presents its trends and action plans at quarterly meetings to ensure coordination of activities.</td>
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<tr>
<td>Base controls on effective governance and a range of relative performance indicators.</td>
<td>In addition to the first two principles, each service line is given goals related to greater patient satisfaction and reduced wait time.</td>
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quarterly budgeting. On the positive side, the operational leaders believed that including five quarters with each review—thereby allowing the same quarter from the previous year to be included—would be beneficial in eliminating any variance caused by seasonality. The performance numbers from the corresponding quarter of the prior year became the basis for capturing and isolating any seasonal variances included in the current quarter’s performance.

**Step 4.** Refine the plan. The finance department revised the process based on this feedback. The revised plan was to review the forecast at the service-line level only, and have finance staff work with service-line vice presidents on their forecasts. This approach relieved nearly 200 front-line managers of the burden of forecasting.

The forecasts would be discussed at a separate review to keep the quarterly performance reviews focused on current performance. The quarterly performance reports were redesigned to have the most recent quarter, the previous quarter, the same quarter last year, and the variances between the most recent quarter and both historical quarters.

**Step 5.** Test the plan and make adjustments. Under the new process, Park Nicollet’s finance department conducted its first quarterly reviews and discussed with service-line leaders the variances from the historical periods, as well as any known items that could materially effect the next five quarters. If a particular service line’s performance had declined significantly in the most recent quarter, the service line’s managers were asked to develop an action plan to correct the decline.

Only minor changes to the process were made following this first set of reviews. Some service lines had to be redefined because dissimilar services were performed within the service lines. Commingling materially different services created variances to the cost per unit of service and the units of service per FTE that were difficult to understand.

The appearance of the reports was also changed so that key performance indicators appeared prominently at the top of the reports to further emphasize their importance. It also was decided that a review of the forecasts should again be included in the quarterly performance reviews.

**Step 6.** Retest the plan and make further adjustments. The next quarter’s reviews exposed two violations of the principals of beyond budgeting. First, performance incentives had not yet been redefined to be based on “relative improvement with hindsight.” Inviting service-line leadership to adjust their forecasts produced a consolidated forecast loaded with decreased expectations. This result was most likely driven by concern that their future performance would be measured against this forecast. To correct this problem, Park Nicollet removed the linkage between financial incentives and evaluation of performance against forecasts.
Second, beyond budgeting requires that forecasts be a product of the finance department, not operations. The forecast must be an unbiased projection if it is to be meaningful, with at most a couple of calls to service-line leadership to clarify material variations to the trends. The finance department developed two principal drivers upon which the annual overall operating margin goal is now based:

- The needed level of income to finance the capital budget
- Expected improvements in the cost per unit of service and units of service per FTE

Later, four additional adjustments were made to the forecast mechanics:

- Material nonrecurring changes to operations in the last year were being projected out as recurring events. To correct for this, nonrecurring changes were removed before running the trend projection.
- Variance limiters that had been written into the forecast models were removed. The forecast model would not allow variances greater than plus or minus 50 percent to be projected forward. Park Nicollet decided it would rather see these large variances projected so they could be addressed rather than have the model bury them.
- Initiating forecasting at the department level and then rolling up and reporting the forecasts at the service-line level resulted in leaders questioning the validity of the forecasts because they could not look at the historical data and duplicate the forecasts. It was therefore decided that forecasting should begin at the service-line level, where the leaders could more easily confirm their validity.
- A projected sixth quarter was added to the forecast model to allow more time to provide the board with an enterprisewide goal for the forecast fiscal year before the year began. Waiting until the end of the third quarter to begin this process allowed too little time to come up with a reasonable goal.

The Changed Role of the Budget Department

The budget department’s initial worries about job security proved unfounded. Tony Gold summed up those worries saying, “The idea of eliminating budgeting, when the ‘B’ word is in your job title, was a concern at first.” The new quarterly financial performance process, however, gave the department a new, more productive focus for its work.

“The days of the insane budget season are gone,” says Gold. “We now spend our time in the constant routine of forecast development and performance measurement reporting.”

The quarterly performance reviews generate adjustments and exceptions to the forecast models, which in turn generates topics to be addressed at the next reviews. Preparing for and performing the reviews has paved the way for collaboration between finance staff and operational leaders in the performance of meaningful variance analyses.

Gold still sees opportunities for improvement: “Each quarter, our list of ‘central forecast items’ grows. These are the items that must be actively manipulated in the forecast by appropriate staff because of
the material impact to our margins, such as deductions from charges, depreciation, and interest expense.” Gold also observes that the six-quarter forecast needs to be performed independently of the five-year plan, to identify the organization’s business direction relative to the five-year plan. He further observes that balance sheet projections do not effectively keep pace with the rest of forecasting. “We have yet to develop a quarterly balance sheet model that produces reliable results,” he says.

**Benefits of Beyond Budgeting**

Embracing beyond budgeting has significantly affected the way that Park Nicollet operates. Because beyond budgeting has allowed Park Nicollet to focus on improving current and future financial performance rather than on retrospectively reviewing budget performance, managers and physician leaders have stopped arguing about deficiencies in their budgets and have become more responsive to what is happening in their practices and what to expect in the future. Continuous financial improvement is now the focus of financial discussions and planning within the leadership ranks. Improving cost per unit performance is an organizational goal that makes sense and provides tangible value to patients and payers.

Paul Terry, president of Park Nicollet Institute for Research and Education, summarizes the benefits of beyond budgeting from an operations perspective: “For a long-time administrator who has used budgets as a marker of progress, beyond budgeting encourages a broader field of view for navigating my division’s direction. On the revenue and expense compass, budget targets tended to have a ‘go north’ orientation. Now, I’m better oriented to all four points. An experienced orienteer knows that where you’ve been is a vital reference point for determining where you’re heading. Instead of ‘go north,’ I’m now looking for true north. Instead of taking a bearing once a year and hoping I reach my destination, quarterly forecasting allows me to adjust for changes in the landscape and benefit from continuous monitoring. It makes sense that the distance I’ve covered is the best indicator of the distance still ahead.”

Park Nicollet’s financial leaders also have enjoyed the benefits of beyond budgeting. Instead of discussing budget errors, they are asking more salient questions. If, for example, they see that lab tests have increased by a dollar per test, they can begin to question how this increase affects the organization’s cost of care. They also can assess how this cost is likely to change over the next six quarters, why, and what can be done about it. Or if nurse staff turnover increases, they can focus on evaluating the immediate effect on Park Nicollet’s cost per admission, the effect over the next six quarters, and the means to minimize these effects.

In a nutshell, gone is a four-month budget preparation process that results in a static one-year look ahead. In its place is a solid six-quarter forecast that is updated each quarter and that is built on concrete action plans. Instead of wasting time analyzing variances to budget, Park Nicollet is making good use of its time developing action plans to mitigate forecasted unfavorable trends.

As a footnote, the 3.8 percent operating margin that Park Nicollet’s financial managers forecast for 2005 was right on target with actual performance.
Beyond Budgeting: Six Principles of Managing with Adaptive Processes

1. Base goals on maximizing performance potential
2. Base evaluation and rewards on relative improvement contracts with hindsight.
3. Make action planning a continuous and inclusive process.
4. Make resources available as required.
5. Coordinate cross-company actions according to prevailing customer demand.

Source: www.bbrt.org/bbprinc.htm. Used with permission.

Beyond Budgeting: Six Devolution-Based Principles

1. Provide a governance framework based on clear principles and boundaries. 2. Create a high-performance climate based on relative success.
3. Give people freedom to make local decisions that are consistent with governance principles and the organization’s goals.
4. Place the responsibility for value creating decisions on front-line teams.
5. Make people accountable for customer outcomes.
6. Support open and ethical information systems that provide “one truth” throughout the organization.

Source: www.bbrt.org/bbprinc.htm. Used with permission.

About Park Nicollet Health Services

Park Nicollet Health Services is an integrated delivery system serving Minneapolis and its suburbs. Park Nicollet comprises the 426-bed Methodist Hospital with approximately 960 physicians on medical staff, the Park Nicollet Clinic with a 650-physician multispecialty medical group practice, a research and education institute, and several joint ventures. It has more than 7,500 employees in both clinical and administrative positions. Park Nicollet has the leading market share in its service area and holds an A bond rating from Standard & Poor’s. It is internally organized by service line rather than entity (for example, the leadership of Surgical Services is responsible for all aspects of surgical care, including the specialty departments, the operating rooms, and the freestanding ambulatory surgery center).

What Is Lean?

Lean is a combination of organization, management philosophy, tools, and techniques to deliver greater value to the customer in the form of the right service at the right time, in the right place, at the lowest possible price, and with no defects. Lean focuses on continual elimination of waste from processes.
The Link Between Strategic Planning and Beyond Budgeting

A budget is nothing more than the expression of a planned course of action stated in dollar terms. Strategic planning is the disciplined review of the current environment that leads to an action plan in response to that environment. These responses are quantified and then included in the annual operating and capital budgets. In beyond budgeting, the resources required for the action plan are approved on a quarter-to-quarter basis and are used to explain changes in performance between the current quarter and the previous quarter and the same quarter in the previous year.

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