



PERGAMON

Scand. J. Mgmt. 15 (1999) 405–421

Scandinavian Journal of
Management

www.elsevier.com/locate/scajman

Budgeting — an unnecessary evil

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Abstract

Almost 30 years ago — in 1970 — the largest commercial bank in Sweden, Handelsbanken, was in a major crisis. Profitability was low and the bank was in conflict with the authorities. As a result of the crisis the executive director left the bank, as did several of the top officials.

At this point the board of the bank asked me to become executive director. At that time I was head of a provincial bank in the northern part of Sweden – Sundsvallsbanken. I had been at that bank for ten years. Before that I was a professional economist, head of a major research institute and an associate professor at the University of Stockholm. I did not have any practical business experience and knew nothing about banking, but after 10 years in Sundsvallsbanken, I had learned a lot and developed some firm ideas about how to run a bank with a large network of branch offices. © 1999 Elsevier Science Ltd. All rights reserved.

1. The new policy of Handelsbanken

To solve the problems we made a number of changes in the organization of the bank and its policies.

The operations of the bank were divided into eight regional divisions which were so equipped as to be able to handle all kind of bank business and all kind of customers themselves. They and their branch offices had to conduct their business in compliance with the overall policy of the bank according to their own judgement. The organization was thus radically decentralized.

A measure of the decentralization is that slightly more than 50% of the employees working at the branch offices and regional headquarters today have independent lending authority.

Until that time the main aim of the bank had been to be the largest bank in Scandinavia, and in 1970 this was also the case. As a result of that policy there was strong emphasis on getting more business to enlarge the operations.

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That aim was now changed, and the new policy was that the bank should be the most profitable and best of the commercial banks in Sweden. It was of no interest whether the bank was the largest or not. It was stressed that the main instrument to achieve the new goal was to have the lowest costs of all the banks.

It so happened that a couple of years later two of the other major banks in Sweden were merged, with the result that Handelsbanken was no longer anything like the largest bank. Ironically enough, 23 years later Handelsbanken had overtaken the merged bank in size.

An important part of the new policy was also to institute a profit sharing system for the employees.

At that time it was not common practice among Swedish banks to have a budget. Handelsbanken was a pioneer in the field, however, and was deeply involved in long-term planning and had started to install a sophisticated budgeting system. That work was stopped and since then there has been no budgeting at Svenska Handelsbanken.

The subject of this article is to describe the reasons that lay behind this decision and what kind of steering and control systems we have at the bank.

2. The proof of the pudding is in the eating

But before doing so let us see how the bank has fared as compared to the other commercial banks in Sweden.

As a matter of fact its performance has been very good. From the start of the new policy the bank has had a profitability that has been higher than the mean of the other Swedish banks listed on the stock exchange. Most years the bank has had the highest profitability, and in the other years it has been number two or number three.

This was during a period when the economic circumstances differed greatly at different times. During the first part of the period lending by the banks was rigorously regulated by the Swedish government. At that time competition between the banks was at a low level.

During the first part of the 1980s these regulations were abandoned one by one. From the middle of the 1980s there was complete freedom and new competitors entered the field.

For the first 20 years there was full employment and high inflation in Sweden. On the other hand, during the nineties there was low or no inflation and the economy was hit by a major financial crisis which caused great losses in the banks. All the major banks except Handelsbanken turned to the government to discuss help to solve their problems and almost all of them obtained help.

Under all these very different circumstances Handelsbanken has thus fared very well.

The outcome of the profit-sharing system depends on the profitability of the bank compared to the other banks. As the bank has performed so well since the system started, considerable sums have been set aside for the employees every year during the

period. The share of the employees in the profits of the bank is paid to them when they retire. A person who retired at the end of 1997 and who had worked at the bank since the system started in 1972 received a share which amounted to 1.7 million Swedish crowns. Approx. \$ 230.000.

As mentioned we made many changes at the bank to solve our problems and they all contributed to the outcome. But it seems that abandoning budgeting, which was an essential part of the changes, had no adverse effect on the performance of the bank compared to the other banks, which all installed budgeting systems during the period.

3. Attitude of the business community to the bank's steering system

In 1979 I described in a pamphlet our new steering and control system and at the beginning of 1994, 15 years later, I published a book where I described in greater detail our system and the reasons why we had abandoned budgeting. The pamphlet gave rise to a lively discussion. But in the foreword to the book I noted that as far as I knew no other bank or company had followed in our footsteps and tried to operate without a budget. I was somewhat astonished because I thought it natural that some other bank or company would have ventured to experiment a little with alternatives to the budget system. Personally I felt like someone who had been spitting on a stone for a long time without it even becoming damp.

In the book I tried to analyse why there was such a strong resistance to the idea of abandoning budgeting and trying alternative steering and control systems. To give this resistance a name I called it the “budget bureaucratic complex”.

This complex is made up of all those within the companies who feel that their position and their work is coupled to the budget system and that their job and their position might be impaired if the budget system is abandoned. To the complex also belong all the professors, management consultants and other experts who write books, lecture, organize conferences, etc., about budgeting and its technical complications.

To this complex also belongs the board of directors. It gives them a nice feeling of power to have to make a decision upon the budget presented by the CEO. That is something they do not want to give up.

Two years later my book was out of print and there was a new edition.¹ In the foreword I could now note that there had been a complete change in the scenery. Some of the leading companies in Sweden had abandoned budgeting or were on their way towards doing so. Internationally well-known Swedish companies which have done so are, for instance, Volvo, SKF and IKEA.

4. The reasons why

When I came from Sundsvallsbanken to Handelsbanken in 1970 there was no doubt in my mind that we should abandon budgeting.

¹ Budgeteten — ett onödigt ont (Budgeting — an unnecessary evil) (2nd ed.). SNS 1995, ISBN 91-7150-615-2.

My first reason was a pragmatic one. Handelsbanken had been the main competitor of Sundsvallsbanken in the northern part of Sweden where that bank had its activities. However, during the 1960s, Sundsvallsbanken had enlarged its local market share at the expense of Handelsbanken. The bank also had much higher profitability than Handelsbanken. But in Sundsvallsbanken after some experimenting, we never made any budgets and we had no problem in controlling our business. Of course this outcome could be the result of many differences between the two banks, but in any case the lack of a budget did not hurt us.

The main reason for my attitude towards budgeting, however, was the experience that I had had as a professional economist. The research institute of which I had been in charge for 8 years before becoming a banker had specialized in making long-term forecasts for different economic variables.

The institute — The Industrial Institute of Social and Economic Research — had in fact been a pioneer in Sweden in making long-term plans. In the late 1940s on behalf of the government the institute made the first long-term plan for the Swedish economy. It covered five years. Also the next five-year plan was to a large extent made within the institute. This activity was then taken over by the ministry of finance. But people at the institute continued to take part in this forecasting. The last job that I did for the institute before leaving was to make a detailed forecast for different sectors of Swedish industry during the first five years of the 1960s.

We also made long-term forecasts for different types of consumer goods and for the demand of automobiles, television sets, etc. I had been deeply involved in these activities and made a lot of forecasts myself. As a result of this work I was familiar with the more sophisticated techniques and theories underlying forecasts of economic variables. I had no reason to feel disappointed as my forecasts fitted very well with the actual outcome as far as I could follow them. Nevertheless, I had become more and more sceptical to the whole idea of forecasting as a sound foundation for dealing with economic issues in a firm or in the business of government.

You can make forecasts very complicated by putting a lot of variables into them and using sophisticated techniques for evaluating the time series you have observed and used in your work. However, if you see through all this technical paraphernalia you will find that there are a few basic assumptions which determine the outcome of the forecast.

When we try to foresee what will happen in the future — make a forecast — we have no alternative but to study what we have experienced in the past and how different economic variables are related to each other: what has happened to demand when the price has gone up or down, how changes in income have influenced demand for different commodities, etc. We also try to establish if there is a trend in the economic variables, cyclical or long-term.

What we are really doing when we are making a forecast is to make a projection on the screen of the future using our historical experiences. But there is a limit to how many variables and time series can be put into your calculations. In the end you have to make some basic assumptions according to what seems plausible to you.

In looking at different forecasts I have found that there are two main types of basic assumptions made by the forecasters.

The first type I call: Same weather tomorrow as today. This means you have observed the variables that you are interested in have been steadily rising or declining or have had a regular cyclical development. You will now assume that this behaviour will continue into the future. A variant of this assumption is to presume that the development will be the same as in some other country which is ahead of you economically.

In many cases a forecast based on this type of assumption turns out very well as there is a high degree of stability in many economic variables for long periods. From time to time there will be a break in the curves and the forecast will prove wrong.

The second type is a situation where you feel strongly that what you are experiencing is something abnormal. If it does continue, your curves will go through the ceiling or through the floor and you cannot imagine that this will happen. You will then make the assumption that there will be a return to “normal”; the curves will level out. You feel strongly that to make another assumption would be irresponsible.

In some cases your assumption will prove right. In other cases it will not. There will be a real break or the curves will not level out. Something will happen of which you have no previous experience, or the similar event lies so far back that you have no memory of it. The financial crisis in the Swedish banks in the 1990s was of that type. The crisis was primarily the result of a collapse of the real estate market, which hit the banks very hard. You have to go back 75 years to find a similar situation.

It is obvious that it would be of immense value to you if you were able to foresee the breaks in the curves. That is not possible however. It is natural that you cannot foresee anything of which you have no previous experience. No intricate mathematical formulas will help you to do so. But as a matter of fact the situation in many cases is even worse. Experience shows that we even have great difficulties in comprehending that there is a break developing before our eyes. Afterwards people will say that it is unbelievable that nobody understood what was happening. The writing on the wall should have been so clear to anyone.

But in reality there are a lot of psychological obstacles which make it so difficult for us to understand what is developing around us. If there is a break, it is something that will turn our world upside down. It will make it necessary for us to change our plans, to change our organization, it might even affect our own situation. Perhaps it will be necessary for us to move to some other place, to root up our family and so on.

We all have a built-in psychological filter that prevents us from realizing what is really happening. Unpleasant facts are filtered away. We will say of some revolutionary technical innovation that it will be of no interest on the market, will be of only minor importance, will meet with unsurpassable technical obstacles etc. Anyhow, we will say, we have analyzed that idea a long time ago and found that it was of no interest.

We will say to ourselves that the small signs we have observed that something new is developing are only ripples on the surface and everything will certainly return to normal.

In my book I have given a lot of Swedish examples to prove my point that we cannot foresee the breaks in the curves, and that when they do happen we

underestimate them. These examples are derived from planning and forecasting in industrial firms and in government.

For 20 years — 1970 till 1990 — I was a member and vice-chairman of the board of the Ericsson Company. During that time the breakthrough of the electronic switches as well as the mobile telephones took place. Ericsson successfully took part in these developments and put the extremely successful AXE-switches on the market. At the time of the breakthrough of the electronic switches the main product of the company was the old type of electromechanical switches, while the electronic switches played a minor role. Every year we made forecasts covering the next three years as the basis for our budgeting. As you can see from Fig. 1, year after year with few exceptions we underestimated the speed at which the change took place. Every year we knew that we had underestimated the rate of change in the past but there were always lots of good reasons why the curves must now “level off”.

In the middle of the 1980s we made the same type of mistake. As a result it took us a dangerously long time to realize what was happening on the market for mobile telephones.

In the book I also take a lot of examples from the planning and forecasting of different government bodies and their experts. These forecasts and plans are especially important, not only because they form the basis for political decisions, but also because they are an important base for forecasting in private firms. My examples show that in many instances these forecasts have been disastrously wrong. The ministry of finance and all its experts have had as little ability as the rest of us to foresee the breaks in the curves. A drastic example of this is the crisis that hit the financial system in the 1990s. The government bodies as well as industry itself had no idea what was going to happen. The same applied to Moody's who gave the major Swedish banks an AAA long rating a couple of months before the crisis broke out.

5. Consequences for budgeting

A budget is a forecast and a plan for the company for the next year, and in some cases for the next two, three or even five years. The budget is built on forecasts concerning the general development of demand, prices, exchange rates, wages, costs and so on. Ordinarily, these assumptions about the future are made by outside experts and government bodies. They are then given to the different departments within the company by the head office. The departments then have to draw their conclusions and make their forecasts on the basis of these general assumptions and their knowledge about what is happening in their department and on their specific market. Thus the extent to which the budget will come true depends on how accurate all these assumptions prove to be.

Now let us suppose that your forecasts are made on the “same weather” assumption. If you make forecasts of that type and let them be the basis of your budget, what you are really saying to the people in the company is that they should continue to work as they are doing. They should try to be a little more efficient, however, sell some more cars, etc., just as they have done in the past. But to tell them that, you do not

need to have an intricate budgeting system. It is sufficient just to tell them to do so, and then to check that that is what they are doing.

If the basic assumption is that the curves will now level off, what you are telling the people in the company is that they should return to “normal”. There will be no continuation of the revolutionary experience that they have just had. That is also a very trite conclusion and a meagre result of all your work with the budget.

In either case there is no reason to disturb the people in the organization with filling out all forms that you need to make the budget. The best you can do as a manager is not to disturb them but to help them to solve the problems they will meet in the course of their normal job.

My conclusion so far is thus, that the best you can do is to heave your budgeting department and all their forms overboard.

Now if the budget you have constructed showed that something completely new was going to happen, a revolutionary departure from earlier trends so that you will have to reconsider your whole operation, and if such a forecast prove true, then of course the budget would have been extremely valuable.

As I have argued above, however, this is something that the budget will not show. The main reason for this is that we have no ability to foresee something of which we have no previous experience. I have also argued that in reality the situation is even worse. It is extremely difficult for us to perceive that something new is on its way even when, looking back, we will wonder how we could have overlooked all the signs.

To believe in something that deviates from common opinion is not only difficult but also risky. If the whole flock of sheep is running in one direction it is very trying to be the single little sheep that runs in quite another direction.

Managers are just like teenagers following the latest trend in fashion in jeans and in management ideas and concepts. To leave the flock is difficult. If the single little sheep happens to be right he will be looked upon as a genius. But if he is wrong, he will quickly disappear from the scene. He is thus taking a great risk. The risk in following the other sheep is much smaller. If they are running in the wrong direction you will not be criticized very heavily because you only did what all other sensible managers did. Such a mistake is permissible.

There are thus many reasons why budgeting will not help you to foresee the breaks in the curves, something that would be extremely valuable. Rather, the budget will actually rather make it more difficult to adjust to these breaks when they materialize.

There is no point in making a budget if you do not believe in it. And if you believe in it you will have a strong tendency to look upon deviations from your budget curves as accidental occurrences. There is thus a risk that the budget will not help you to adjust to new circumstances but will rather retard the adjustments.

A budget will thus either prove roughly right, and then it will be trite, or it will be disastrously wrong, in which it will be dangerous. My conclusion is thus: Scrap it!

6. The alternative

Well there may be something in what you are saying, but if I have no budget, how can I as a manager control my business? And how do I steer the company? I also feel

strongly that it is very important for me to give the people in the company a target towards which they should strive. All these things I get from my budget. If I have no budget, I must have other instruments to achieve those important purposes. What do I do?

In my opinion, and according to my experience, you do not have to construct any complicated system to solve your problems. The solution is quite simple and you already have the material for much of the basic instruments needed in the ordinary accounts of your company. You just have to use your common sense. However, that type of sense is not very common.

When I am discussing these issues with managers in industry, I have found that the real problem is not to construct alternative instruments but something else. Since the days of Alfred P. Sloan and Pierre Du Pont managers in the industrial world have all been trained and indoctrinated in business schools and in their earlier careers to construct a budget and to think in budget terms. It is extremely difficult for them to heave all those mental goods overboard and look upon the basic problems with fresh eyes.

What they have to do is to clean their mental blackboard and wipe off all the ideas and formulas relating to budgeting and try to look upon their problems without any preconceived ideas. What they primarily have to do is to define their basic needs for information.

Those needs naturally differ from company to company. Moreover, what I am talking about here is primarily related to companies of some size. In a small company the problems are the same but it is much easier to see them clearly and also to take care of them in a straightforward way without using much technical paraphernalia.

Many times it can be fruitful to reason in metaphors, if you are aware of their limitations and do not press them too hard. When I think of a big company, the metaphor that comes to my mind is a beehive or an anthill.

Every morning the small bees and ants arrive and put their cars in the parking lot and enter the offices and the workshops. Your job as a manager is to induce them to put in a good day's work. Preferably they should do a little better than they did yesterday, produce a little more at lower cost and better quality. All the time trying to develop their product and their way of working, being a little more customer-orientated etc. You also want them to be more innovative and willing to adapt themselves to changes in the organization and procedures of their work. Your experience is also that in order to get a first-class job out of them a necessary prerequisite is that they feel involved in what they are doing, so that what they get out of their job is not only money but also a feeling of satisfaction.

We have a saying at the bank that the prime responsibility for managers at all levels is that the people who work for him or her should feel that it is a joy to go to work every day. Of course that is an ideal and often the employees will not have that type of satisfaction. But it is very important that the managers continually and firmly aim to achieve it.

What kind of information do you and your employees need, if they are to behave as you wish them to?

Obviously, you and they need a detailed account of what is produced in the firm: the costs, the earnings and the result and quality of the operation and the different

products. You also want to know if initiatives are being taken and changes in the market are being acted upon, etc. This information is needed quickly. The interesting thing is not what people were doing six months ago, a quarter or a month ago but what they are doing right now. It is also very important that the figures pertain to the units — profit centres — for which people feel that their actions influence the result and for which they have a responsibility.

Now let us presume that the figures obtained from your information-system look good and correspond to your expectations. In that case you just carry on.

The other situation is that they do not look so good. In that case it is very important that the figures give some indication of what is wrong, so the people in the different units will have some idea what problem they have to solve. The figures should be action-oriented, as we say in the bank something that is by no means always the case.

In modern companies we are flooded with information on our screens. Our attitude to much of this information is that it is interesting, but we cannot do very much about it. It will not influence our actual behaviour. Such information should not be sent out. When you construct your information system it is essential that you ask yourself the following question:

If Miss X in YY department obtains this type of information, will it tell her whether she is doing a good job, or not? If not, will it tell her what the problem is and give her a hint as to what she should do about it?

If the figures do not answer these questions, they should not be distributed to Miss X.

Of course the system should also give you as manager the same type of answers.

It is evident that the kind of information I am talking about are the figures that to a large extent you already have or should have in your profit and loss account and balance sheet and your ordinary information systems. What you have to do is to organize and construct them in such a way that they fit the demand that I have formulated above. It is also obvious that it is important that you and the people in your company get the information very quickly. The shorter the period to which it pertains the better.

It is also very important that your organization is based on a number of relatively small units which have a considerable degree of independence and authority. In other words that your organization is decentralised. Without this, it is very difficult for your employees to become involved in their work, which is so extremely important.

7. The year — an out-of-date concept

From time immemorial our lives have been governed by the sun. As a result of the movement of the earth in relation to the sun we have day and night and different seasons. Technical progress has made us more and more independent of the sun, however. When it is dark we turn on the light and to a large extent our activities go on, irrespective of seasons. They are a continual occurrence — a flow. The important and interesting thing is what is happening right now, its speed and direction. That is what you should try to influence.

It is obvious that this is how it is and how you should look upon your operation. However, that is not how we look upon it in our accounting systems. In this context we are bound by conventional thinking, where the year is a basic unit. A quarter after the termination of the year when we send out the annual report, what information does that report really give us and the shareholders? What it shows in reality is a picture of the mean activity in the company and the result of that activity three quarters ago. The report tells us very little about the situation in the company today.

For legal reasons we have to make annual reports. However the less interest we take in them the better. The annual budget is an outflow of this outmoded way of looking upon the year as an important concept in the lives of firms.

8. How to achieve a target

An important feature of the budget is that it gives you a target. Every month, quarter, etc, you can compare how you are doing with the budget. If you are doing better, all is well. If you are doing worse, you feel that you have a problem. If I have no budget, how do I achieve a target?

The target that you get in a budget is a sum in dollar and cents. The first thing you have to ask yourself is if this is the kind of target that you should really try to reach? In fact this is not the case.

The fundamental purpose of a firm in a market economy is to deliver as high a return on the capital invested in the company as possible. A company is successful and will survive if it gives a higher return than other companies in the same field and — in the long run — if the return is higher or at least equal to the return in other branches of industry. The target is thus not an absolute sum in dollar and cents. The real target is a relative one, a return on capital that is better than what the other firms in your branch are achieving.

If you have the alternative kind of information-system, which I have outlined above, it will be quite natural for you to work with relative targets. Primarily you should try to compare your return on capital with that of other firms in the same branch. In banking in Sweden it is easy to do this, as most of the banks work in a similar way and their method of presenting results is very much standardized as a result of the activities of the financial authorities. In other branches it might be more difficult to get comparable figures. But as far as I know, the obstacles in most cases are not insurmountable.

We have also found that a very effective way to get targets is to compare the results of different regions and branch offices within the bank. These figures can be obtained very quickly and are very effective. The aim of every region and branch office will be to get above the mean of all other regions etc. However the more they try the more the mean will move upwards. The struggle will thus never end.

Another way is to compare the result of the last quarter with the quarter before that or the corresponding quarter a year ago.

The best thing would be to make these comparisons every day, but for practical reasons you will have to content yourself with every month or so. The comparisons

will tell you if you are doing well or not so well. In the latter case you should do something about it and formulate plans for action. These plans should have a suitable time-span tailored to the type of action that you are contemplating. If you find that you will have to change your prices, this might take one day. In other cases you have to print new and voluminous price-lists that might take a month or even more to produce. An advertising campaign covering the whole country and all types of media will have to be planned at least six months in advance. If you have to lay off staff, in Sweden this will take several months to plan and execute.

It is not unusual to look upon the yearly budget as a planning instrument, a basis for action, but in most cases the year is not a natural time-span for your actions. You should not sit down once a year and discuss what you are going to do during the coming year and leave it at that. What you should do is to constantly observe how your company is doing and discuss and formulate plans for action as the performance of your company or changes in the economic conditions give an indication that something should be done.

Bench-marking has become a very popular technique in recent years. The type of target I have been talking about above is clearly a kind of bench-mark.

You can also say that what we are doing in the bank is to use the same technique as in sports. The challenge is to beat the other one or the other ones.

9. Other objects of budgeting

As part of the budgeting process, companies also construct liquidity budgets and similar types of instrument. Usually they also make investment budgets. If you do not have a budget, how do you handle issues of this type?

When you are contemplating what will happen to your stock or your liquidity in the near future, for instance, I think it is fruitful to look upon the company as a big machine. To run that machine you have to know what will happen if you press button A or pull lever B. The basic features of your machine are described in your profit and loss account and your balance sheet. You could say that they give you a model of the machine. By studying and describing your machine in more detail you can figure out what will happen to your liquidity if you expand production by A percent in six months, and what will be the effect if your customers pay your invoices not in three but in four weeks etc.

I have found it very fruitful to look upon a company in this way and to make an economic model of the machine, a model in which you have established the basic relationships in the company. Such a model will be the natural basis for your short-term planning. It will tell you what the effects of your actions will be, and what it is necessary to do to achieve a certain result.

Consulting firms can deliver data-based models of this type for your company if you give them the basic data. These models can be very comprehensive and intricate. However, in most cases I do not think it is necessary to make a very complicated model. I usually say that it is something you should be able to sketch on the back of an envelope. The important thing is that you as the CEO have a vivid picture of the

“machine” in your brain, something that is always in your mind when you are contemplating how to solve the different problems you encounter.

The same type of thinking is applicable when you plan your production. In the book I describe in more detail all the motions the management of a car factory have to go through when they plan their production. Their actual production is the result of decisions they have made months or even a year or several years back. If they want to be able to produce X cars a year from now, they have to figure out when they have to place their orders with their subcontractors. In the course of that planning activity they have to make a lot of medium-term forecasts about demand, prices etc. Their natural ambition in this context is to place their orders as late as possible and thus not bind their hands more than necessary and keep their inventories as low as possible.

This type of planning is something that is going on all the year round and has nothing to do with the annual budget. To try to incorporate it in that activity is a mistake.

So much for short- and medium-term planning. But you also have to make long-term plans. Whenever you make decisions that will influence the life of your company for a long time, perhaps for 10, 20 or even 30 years, you have to make a forecast. If you invest in a huge new machine in your paper-mill, that will influence the life of your company for a very long time. To make that decision, you have to make a long-term forecast whether you like it or not. In making the decision you have in reality presumed that the machine during its lifetime will give an adequate return on your investment and pay back the money you have put into it.

If you look upon forecasts in the way I do, you will recognize the great risk that the forecast you are making will prove wrong. But there is no way around it.

How do I handle a situation like that?

Firstly, I say to myself, that I am willing to pay a price if that will make it possible for me to get out of my ten-years investment without loss after e.g. five years, if I then begin to suspect that my forecast will prove wrong. There are financial techniques to achieve such an outcome, leasing arrangements, etc.

Secondly, I will try to construct the investment in such a way that I can rebuild or change my investment without incurring heavy costs. Nowadays, for instance, it is common practice that office buildings are not tailor-made but constructed so that they can be used for different types of activities.

If my general view is that there is a great risk of my forecast being wrong, I will also try to make the decision as late as possible, close to the time when circumstances compel me to make a decision. In such a case I will be able to incorporate the latest available information in my forecast.

Usually, when they work on their budgets during the fall, companies will also make a plan for the investments they intend to make during the coming year or perhaps even the coming two or three years. That is not an advisable practice. You should delay your investment-decisions for as long as you can. The risk that you will miss the train is normally grossly overstated.

Now you could argue that it is not possible to work like that. If you contemplate making a large investment at some time in the future it is necessary to plan for it now. If you do not, you may not have the necessary financial resources when the final

decision comes up. If you have a large investment in mind, there are certain minor investments that you should abstain from in the present situation, etc.

Yes, that is true. But the situation is seldom so clear-cut in real life that you know exactly what you have to do today to make a considered investment possible in a year's time. Anyway, if a year's advanced planning is needed, then there is nothing to say that the year starts when you are making your budget.

However, in connection with long-term investments the manager and the board have to face a much more serious problem. That problem is bound up with the quality of the information that you as a manager and the board will get when you and they have to make a decision about investments.

Supposedly such decisions are made on the basis of unbiased facts and a rational and unbiased analysis of these facts. However, in many cases this is not true.

There has been quite a lot of research in the Scandinavian countries about how investment decisions are made in reality. These studies show that in real life the documents on which you are basing your decisions are coloured by a lot of irrational and subjective considerations on the part of those who have formulated the memos, assembled the facts and made the analyses. That is also what I have experienced as a member of the board of many large Swedish companies.

What your staff and your technical experts will deliver to you is something which mirrors their need of prestige, their envy and jealousy towards other people and other divisions in the company. Their guarding of their own territory, their eagerness to use the most sophisticated technique and so on.

You cannot do very much about this, but it is very important that you are aware of this human tendency for distortion and try to minimize the effect of it. One thing that you should avoid is to put an investment in a budget covering one or several years. However, it is common practice to do so. At the same time the CEO will tell the board that the investment budget is just a framework, an indication of what management is planning, and the members of the board should not be worried because the CEO will come back to the board and ask for a final decision before he starts to use the allotted sum.

But the same moment that you have put the investment in the budget, the machinery will start to work. The people in the organization will take it for granted that the final decision will be made by the board according to the plan, even if that final decision lies a year or more ahead. They will all start to act accordingly. As a result of that the members of the board will find, when the day for the final decision arrives, that it is almost impossible for factual and psychological reasons to put a stop to the investment or radically change the plan. It is like trying to stop with your bare hands a heavy freight train that comes thundering through the night. So do not start the irrational game before it is absolutely necessary.

10. Strategies and visions

In many companies, conceptions of what will happen in the long run and ideas about how to cope with problems expected to arise in the future, take the form of more or less detailed long-term budgets and plans.

Many times I have taken part in board meetings lasting several days, where I have heard the CEO talk about his visions and long-term plans presented in lengthy memos. The idea is that we are now to discuss his picture of the distant future. A meeting of this kind always makes me feel rather uneasy. My general attitude is that there is a great risk that the picture of the future will be wrong. It might then be very dangerous to believe in it if you are not forced to do so for some reason, as might be the case when you have to make a long-term investment decision.

Happily, in most cases of this type I have found that in reality the CEO acts in a different way and not according to these grand long-term plans. But they are well suited as a basis for his statement in the annual report where he looks the shareholders straight in the eyes on glossy paper and tells them about the fascinating future lying ahead.

What most successful managers are really doing — as research shows — is to cautiously move along under the assumption that the weather tomorrow will be about the same as today. Simultaneously they are looking for new opportunities that might arise and changes in the environment that form the basis for the activities of the company. It is always important to be ready to act swiftly and decisively when you detect that a plum is ripe and going to fall, or that your world has changed drastically.

At the same time it is very important that you and your organization have a general idea of the principal course which you are following. This is a necessary prerequisite so that the people in the company will work in harmony. Otherwise the result cannot be very good. Your movement forward is the result of thousands of small decisions taken by different people in the company. How successful you will be depends on how well they are all aware of and loyal to your ideas and your business concept.

When you try to give your organization a general idea of that course, what we in the bank call our “philosophy”, the important thing is not to describe it as some target in the distant future. You will probably not reach a target like this because so many things will happen along the way. There will always be changes in the factors that influence your business. Those changes will make it necessary for you to adjust your course and gradually or swiftly shift the emphasis from one market to another, from one product to another.

When you wish to elucidate your ideas and your concept to the people in your company I have found that in most cases the essential thing is to clarify what you do not want to do, what kind of actions you do not contemplate. That clarifies the limitations within which you act and it will help to give a clearer picture of what you want to do. To explain the “noes” is the hard part, because it makes it necessary for you to make choices, which is always difficult.

Management does not mean sitting down once a year discussing and formulating long-term plans and visions. The task is something quite different. It is to ask yourself — every day, every week.

Are we on the right track? Has something happened that should cause us to reconsider our course? If we and the rest of the economy develop as they are doing right now, where will we be a year from now? Is that where we want to be?

It is a never ceasing forecasting and analysing of the situation at hand. That is the real task.

Recent research has also shown that this is the way good and successful managers actually behave.

11. Summary and conclusions

In this paper I have explained my reasons for looking upon traditional budgeting as an outmoded way of controlling and steering a company. It is a cumbersome way of reaching conclusions which are either commonplace or wrong. In the latter case the budget might even be dangerous. It is dangerous because if you believe in your budget it might hinder you from adapting to new situations. If you do not believe in it, there is no point in making it.

In the latter part of the paper I have tried to explain the general principles that I think should form the basis for constructing an alternative controlling and steering system. In constructing that system you quite naturally have to adapt to the special circumstances in your kind of business and your company. In that context different kinds of technical devices will be useful: different types of key-indicators, ratios, graphs, etc. Modern companies already have myriads of operational, financial and physical measures. The problem is to choose a limited number of them — those measures which really show if the company and its different units are on the right track or not. The now popular concept of the “balanced scorecard” is a useful tool to help you clarify your thinking.

The important thing, however, is not to get so preoccupied by the different measures that you lose sight of the fundamental problems of your business and how to tackle them.

A metaphor might help to clarify my thinking.

An enterprise is like a ship navigating its way along a wide and mighty river, representing the total economy of which the company is a part. There are lots of other ships on the river and their captains and mates all try to move their ships as fast as possible down the river. The captains can see the other ships, but often their view is impaired by mist and fog and they have only vague ideas about how the other ships are being manoeuvred.

As captain you do not have any dependable chart of the river, but according to your experience there will be lots of shoals and rocks which you must avoid. Some stretches of the river are straight and easy to travel on, but other stretches are winding and the current is strong. There have been rapids and even cataracts where many ships have gone down. But what now lies ahead you do not know. Your job as captain is to make your people row as hard as they can to get ahead, of the other ships. At the same time as captain you must be prepared to make evasive manoeuvres to avoid the dangers that might turn up unexpectedly and find the way where the current will help you the most, without taking any improper risks.

How does traditional annual budgeting fit into this picture? According to conventional procedure, by observing the shore the crew will calculate every 12th hour how far they have proceeded since the last measurement, and will prepare a statement — the annual report.

But it is also their custom to sit down once 9 h have passed and to determine what courses they should steer after 3 h during the following 12 h. Exactly where they are when they calculate they do not know, because they are moving along the river all the time, but they try to make an estimate. After 12 h they will then start to steer by the new courses decided upon. All will be well if the river runs as they have assumed, and the other ships — their competitors — have not found better courses.

Naturally they will often find that the river does not flow as they have expected and that they will run ashore if they do not change their course. They will then have to put new assumptions into their navigation programme to get new courses and to send new orders to all the people who are involved in navigating the ship.

I do not think that a ship handled in this way will give their passengers much confidence. I think they would be much more interested in being on a ship where the captain does not spend so much time in calculating courses, but stresses instead the importance of having a good and constant look-out and continuous checking of the shore and of other ships in sight, to have an accurate idea of how fast the ship is moving along. He also has a man working the lead to see if it is getting shallow. In this ship the captain is on deck as much as he can be, trying to figure out how he can best avoid all the dangers that he comes across and how to use to his advantage all the opportunities that he encounters.

Of course you should not press a metaphor too far, but I think this one says something essential about my approach to management steering and control problems, and about the approach of people who look upon the yearly budget as management's central and indispensable instrument.

12. Special cases

There are cases where it is very difficult to avoid budgeting completely. This applies to organizations which get their income not from the market but in the form of appropriations. This applies to for a large part of the public sector as well as staff departments in private companies.

In these cases, however, you should try to imitate the conditions of a market economy as much as possible. For example, the staff departments should be faced with the necessity of "selling" their commodity to the rest of the organization, and in competition with outside suppliers if possible. You should try to apply the same principles to government bodies as far as practicable.

Many companies are organized along functional lines and are strictly centralised. The department of production and the department of sales are directly subordinate to the chief executive and have no direct connection with each other. In such a situation it might be tempting to work with budgets. Such a situation stresses the importance of good planning systems, but in reality there is no need for conventional budgeting.

In my opinion one of the great disadvantages of this type of organization is that it tempts you to use budget methods.

13. How to get rid of the budget

When a company starts to consider the possibilities of abandoning the budget system, the accounting and control department will in most cases react in a typical way. They will say that there is something in the criticism levelled against conventional budgeting. To meet that criticism they are now suggesting a number of modifications. If you proceed along that road you will get not a rational and effective steering system but a less than satisfactory compromise. You will still have much of the old budget system and on top of it a lot of new instruments.

My advice is to stop budgeting at once and start to think about your problems afresh. That is the only way to really wipe the blackboard clean and get better and more informative figures on it. You should brace yourself and kill the budget dragon with one blow. The dragon which Jack Welch has called “the bane of corporate America”.

However, the forces you will have to face — the budget bureaucratic complex — are very powerful. To overcome the resistance some Swedish companies have used the following tactic. Instructions are sent out that from now on no budget is requested. At the same time the managers of the different units in the company are told that if they want to continue with budgeting they are free to do so, but central management is not interested in seeing their budgets. The different units are requested at the same time to deliver the figures needed for the new steering and control system. They are told that their performance will be judged by those figures. After a couple of years all budgeting will have vanished from the company.

There is no risk in abolishing budgeting. People will go on working as before. Nothing will happen except that you will hear a deep sigh of relief from all those who can now really concentrate on their task, which is to produce and sell your product. You will also save a lot of money as people no longer have to spend hours and days filling out forms and sitting in meetings discussing the budget. The costs of the budgeting system are staggering as investigations show.