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Building the Professional Firm: McKinsey & Co.: 1939-1968[1]

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Abstract. Returns from investments made in a professional firm's capabilities and resources are not easily appropriable. Firm owners therefore tend to under invest in crucial intangible assets such as reputations and knowledge. This paper describes and analyzes how the founders of McKinsey & Co. overcame these problems to build one of the world's leading management consulting firms. McKinsey's success, I argue, derives from a system of professional norms, approach to serving clients, personnel policies, organization, governance and ownership which encourages firm members to identify with the long-term interests of the institution. Other firms cannot easily replicate this system because it incorporates difficult-to-codify trade-offs that have evolved through decades of trial and error and are now embedded in the firm's routines and tacit knowledge. The history and traditions of the firm have also inculcated values that encourage firm members to adhere to policies that they might, for short-term reasons, deviate from. The system's evolution is not however merely the result of a series of chance events. McKinsey's founders resorted to considerable trial and error, but it wasn't ad hoc; the experiments were intended to discover the best means to further a long-term vision and strategy. Moreover, their vision and strategy derived more from a priori faith and personal values than from scientific evidence or financial calculation.

Keywords: entrepreneurship, organizational development, leadership, professional service firms

1. Introduction

A firm's profits, according to the resource-based perspective (Wernerfelt, 1984), derive from strategic assets that rivals cannot easily obtain. For instance, a crucial asset – "organizational competence" – comprises many interrelated activities (Milgrom and Roberts (1990), Holmstrom and Milgrom (1994), Teece et. al. (1994)) and evolves slowly over time (Nelson and Winter (1982), Arrow (1974)). Firms that progress in the "wrong" direction cannot easily replicate the competence that successful rivals have developed through

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1. Except when otherwise stated, the data and quotes in this paper are drawn from two Harvard Business School teaching cases – McKinsey & Company (A): 1956 (Case No. 393-066) and McKinsey & Co. (B) (Case No. 393-067). The cases were based on the author's interviews with several active and former McKinsey partners, two partners' memoirs (privately published, for the exclusive use of the firm's personnel), firm archives from the 1940s and 1950s, and the author's experiences as an associate at McKinsey from 1980 to 1985. Several McKinsey partners reviewed the cases for accuracy but made no effort to influence tone or content. I wish to thank the firm for generously making their time, writings, and records available to me.

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years of trial and error (Henderson, 1994). These concepts offer a worthy complement to the traditional product market approach, but as may be expected with a new perspective, the details and empirical evidence are still patchy. For example, what makes a path-dependent competence difficult to imitate? What promotes or retards trial-and-error learning from diffusing across an industry? Why do some firms take the right path and not others? Is it simply a matter or chance or does purposive strategy play a role?

Prior empirical work on these questions has dealt mainly with industrial (and usually capital-intensive) companies. The subject of my study, McKinsey & Co., is a professional service firm that belongs to the increasingly important class of knowledge-based enterprises. In this setting, the challenge of building capabilities and resources comes with a twist: because the reputations, knowledge, and other intangible assets of a firm are closely tied to individual firm members, the firm's owners cannot fully capture the returns from their investment in such assets. For example, employees can leave with clients their firm had cultivated and the skills and training their firm had paid for. Even if the firm owners do control client relationships and expertise, they may avoid loss through defections, but they cannot fully realize the value of their investments through sale of the enterprise. As a result, they tend to underinvest in these crucial intangible assets.[2] Of the thousands of professional firms started every year, therefore, most represent little more than a convenient, often temporary banding of individuals. They invest little in organizational infrastructure, avoid opening many offices, and rely on the knowledge and training provided, as a public good, by universities and research institutions.

McKinsey provides an instructive counterexample. The firm's owners have shown an unusual willingness to invest in the organization's infrastructure, reputation, and capabilities. McKinsey has established (as of 2001) 83 offices located in 44 countries. It conducts pro-bono studies that bring its partners into contact with influential members of the community. It invests in building a reputation for management expertise by encouraging its staff to publish articles and books. In its research budgets, McKinsey matches top business schools. In 1993 McKinsey spent, according to its managing director, more than $50 million annually on knowledge building. Its training program described by *Business Week*, "comprehensive and constant" (Byrne (1993)) was also estimated to cost $50 million in 1993 (Milbank (1993)). Between 1993 and 1996, McKinsey more than doubled its investment in

2. The usual restriction of ownership to active firm members – because outside investors are especially vulnerable to opportunism by the employees – also discourages investment. As Fama and Jensen (1984) suggest, the inside shareholders who have much of their personal wealth tied up in the firm are apt to avoid risky investments. Moreover, ownership by many active firm members can make it difficult to decide which investments are worthwhile, especially in intangible assets such as reputation, Bhide (2000) and disagreement about the potential returns may preclude any investment.

knowledge giving up between 5% to 10% of estimated billings of about $1.8 billion. (Bartlett (1996)). In addition, the firm invests the valuable billable hours of senior professionals in evaluating and providing feedback to its members to improve their skills and build a reputation for quality work. A client impact committee oversees the evaluation of how much difference a consultant's work actually makes to a client and passes its findings on to the promotion and evaluation committees.

Just as the magnitude of McKinsey's investment in firm building is noteworthy, so is the firm's longevity. At many consulting firms, discord over what individuals or strategies to invest in and how to divide the returns have led to defections, sale, or dissolution.[3] In 1995 for instance, the partners of A.T. Kearney, a firm that shares the same ancestry as McKinsey, agreed to sell their firm to E.D.S. In 2001, the consulting arm of Anderson split up with the accounting arm, following many years of litigation between the partners of the two units. McKinsey, however, has continued to invest in itself while turning over more than three generations of partners in the last 60 years.

What makes McKinsey different from the typical professional services firm? How has it developed what might be called the "meta-capability" of investing in firm assets – the sina qua non for all other competencies and capabilities? I will argue that:

1.1. No single factor can explain McKinsey's success – the firm has developed a *system* to overcome investment disincentives whose every element is crucial. For example, the firm's ownership plan requires partners to sell their shares at book value (which in any successful professional firm is considerably lower than its true economic value) when they retire or leave the firm. Aspiring partners can thus look forward to buying stock at a cheap price and are dissuaded from leaving to start their own firms. But the ownership plan, of course, also has the potential to discourage older partners from making long-term investments. A partner close to retirement, for example, might oppose opening a new office or developing a practice in a new industry: the start-up costs would reduce the partnership's current profits, and the long-term increase in firm value would not be reflected in the share price the partner would receive upon retirement.

The disincentive has been neutralized by the other elements of the system, such as the firm's client strategy, personnel policies, governance, and management principles and values. McKinsey has realized the benefits of its ownership plan without paying a serious cost because the system recruits individuals who are predisposed to institution building and reinforces their innate preferences. Successful firm members earn attractive incomes that are

3. "Except for a few accounting and law firms," Marvin Bower, a founder of McKinsey & Co., has noted, "almost no professional firm dates back 50 years or more."

partly based on their contribution to firm building. The system also encourages individuals to make investments whose financial rewards they may not fully enjoy by providing intangible rewards such as membership in an elite meritocracy and a meaningful voice in its governance and management.

1.2. The development of the system involved a gradual process. Although the founders established the firm's basic goals and broad vision when they launched McKinsey in 1939, it took many decades (see Table 1) to conceive, test, and implement several important elements. The implementation of certain principles, such as giving all partners a voice in firm governance, evolved as the firm grew: initially, all the partners jointly determined all important decisions; later, as the number of partners increased, committees and task forces were used extensively to proposed and analyze new policies. The system also evolved in response to problems and opportunities the founders had not thought about in 1939. For example, the ownership plan was adopted in 1956 after the partners became concerned about maintaining adequate incentives for the next generation. Similarly, the founders had conceived of McKinsey as a national firm. Overseas expansion began in the late 1950s as a result of the increased overseas activity of the firm's clients.

Other policies were delayed because implementation was initially infeasible. For example, McKinsey only began recruiting at business schools in 1953, after it had achieved the requisite stature with clients for them to accept fresh graduates instead of consultants with previous industry experience. Similarly, during its European expansion in the 1960s, McKinsey initiated the policy of transferring existing staff to head up the new offices. Previously, when new offices had been added in the United States, McKinsey had brought in outsiders because it lacked sufficient internal talent now embedded in the firm's routines and tacit knowledge. The history and traditions of the firm have also inculcated values that encourage firm members to adhere to policies – for example, just serving top managers of large companies – that they might, for short-term reasons, deviate from.

1.3. The evolution of McKinsey's system owes much to the unusual qualities of its leaders, especially Marvin Bower, who co-founded the firm in 1939 and served as its managing partner between 1950 and 1967. Although luck (good and bad) certainly played a role in McKinsey's development, this is not a story of the selection of the fittest random mutations. Bower and his partners resorted to considerable trial and error, but it wasn't ad hoc; the experiments were intended to discover the best means to further a long-term vision and strategy. Moreover, the vision and strategy derived more from a priori faith and personal values than from scientific evidence or financial calculation. For example, Bower and his partners simply assumed that investments in training were worthwhile; they adopted policies (such as the ownership plan) that

Table 1: McKinsey "System" and its Evolution

Goals	
Build prestigious firm that will last in perpetuity	From inception in 1939
Client Strategy	
Serve large prestigious clients on top management problems	1939 goal; took about 10 years to implement
Charge premium fees	Fees raised as reputation and clientele improved
Focus exclusively on consulting	Avoided audit and accounting from the beginning, but maintained executive rccruiting until 1951
Wordwide clientele served through local offices	Initially East Coast only, national expansion after 1944, European entry in 1959
Investment in Knowledge Building and Dissemination	From inception; first seminars and publications in 1940
Emphasis on "Professionalism"	From inception; formal code established in 1974
Investment in Training	Firmwide daylong sessions from inception; longer specialized programs added later
Ownership Plan	
Ownership limited to active firm members	From inception
Corporation with stock bought and sold at book	Adopted in 1956
5% cap on individual ownership	25% cap introduced in 1056, later reduced to 5%
Selection and Recruitment	
Value intellectual abilities over experience	Initial aspirations stymied by personnel shortages in WWII
Recruit from top business schools	Started at Harvard Business School in 1953
Personal qualities of leadership, team-building as highly valed as intellectual abilities	Origins unknown, formally articulated in 1950s
Hire "partner" material only	??
Advancement and Terminations	
Partnership based on "economic self-sufficiency" and leadership ability	Formerly articulated in 1952
Promote from within	Rigorously applied in opening European offices after 1959
"Up and out" for junior personnel	First version adopted in 1954; subsequently modified
No "lifetime" partnership; typically "peak in their 40s"	First partner eased out in 1952
Compensation	
Compensate more than industry	1939 policy implemented as firm built clientele and increased billings
Performance-based partnership compensation with high variance	From inception; criteria and proceses first formalized in early 1950s
Considerable weight to "firm-building" activities	From inception; criteria and proceses first formalized in early 1950s
Firm Governance and Management	
Broadbased, consensual decision making	From inception; implemented through committees and task forces after early 1950s
"One firm policy"	Implemented and evolved as offices added
Fct-based and fair personnal decisions	Formal criteria and processes first adopted in the 1950s
Spirit of partnership	From inception
De-emphasis of hierarchy with "Responsibility for dissent"	Espoused from inception; traditions established over time
Multi-round secret ballots with "write-in" nominees to elect firm head	Adopted in 1968. Clee (1939-50) and Bower (1950-67) routinely re-elected previously

reflected Bower's dedication to the firm's longevity rather than financial self-interest. Arguably, few other professional firms took the McKinsey route because individuals with Bower's traits are so rare.

Understanding the sustainability and cohesion of the McKinsey system thus requires taking a closer look at the firm's development and its leadership. In the pages that follow, I describe how the formative experiences of the founders shaped their goals and assumptions about building a consulting firm. Next I describe developments from 1939 to 1968. We will see how over these decades McKinsey built its economic base in the United States, formulated and implemented the critical internal, or organizational, elements of its system, and then rapidly took advantage of opportunities to grow internationally. The overview of the firm's history then serves as a basis for the concluding section of the paper, which discusses the McKinsey system in greater detail, the difficulty of imitating the McKinsey formula, and the implications of the McKinsey story for other firms.

2. Marvin Bower: Formative Experiences

Marvin Bower and two co-founders started McKinsey & Co. in 1939, to take over the failing East Coast practice of McKinsey, Wellington & Co. McKinsey, Wellington had been formed in 1935 through a merger of James O. McKinsey & Company and Scovell, Wellington & Company. Many of the goals and policies that McKinsey's founders espoused in 1939, including its focus on consulting to top managers, its emphasis on professionalism and training, its client development approach, and its egalitarian, consensual culture were shaped by Bower's educational and family background, his experiences at McKinsey's two antecedent firms, and a brief legal career.

Bower had graduated from Brown University in 1925 and Harvard Law School in 1928, when he had first applied for a position at Jones, Day, one of the most prestigious firms in his hometown of Cleveland. Jones, Day turned Bower down because his law school grades weren't high enough. Bower then enrolled at Harvard Business School and finished the first year of the MBA program in the top 5% of students, enabling him to secure the position at Jones, Day he been turned down for.

At Jones, Day, Bower recalls that he "made it an immediate objective to learn why it had been so successful. From observation and analysis during my Jones, Day years began the formulation of the program that I later brought with me to McKinsey." Bower was impressed with the firm's professional approach, recruiting standards, and the prominence of its partners in Cleveland's charitable, social, and cultural organizations.

The Jones, Day experience also persuaded Bower of the opportunity to create a top-quality management consulting firm. During the Great

Depression, bondholders' committees gained control of Cleveland companies that defaulted on their bonds and asked Jones, Day for assistance. Thanks to Bower's business education, he became secretary of a number of committees; in that role, he studied the potential earning power of distressed companies and proposed recapitalization structures. Viewing his studies as "amateurish and superficial," he saw the need for a firm to handle these problems in the same professional manner in which Jones, Day handled legal problems. Bower was therefore pleased in 1933 when James O. McKinsey ("Mac"[4]), a certified public accountant and professor at the University of Chicago, asked him to join the New York office of James O. McKinsey & Company (JOM), a firm specializing in accounting and what was then known as "management engineering." Bower believed he could help develop JOM into the kind of firm he had envisioned.

James O. McKinsey had founded the firm bearing his name in 1926. Mac had seen an opportunity to advise managers during World War I, when he served in the Army Ordnance. Seeking a reputation as a management expert, Mac – who had already obtained bachelors degrees in pedagogy, law, and philosophy from three different colleges – became a certified public accountant and received a Master of Arts degree in 1919. In 1920, he was appointed assistant professor of accounting at the University of Chicago. Mac wrote books, lectured to business groups, and became a junior partner in a firm that provided organizational, accounting, and industrial management advice.

Mac's and Bower's backgrounds together shaped the firm that Bower would later launch in several ways. Apparently, Bower was always keen on associating with well-regarded institutions – Brown, Harvard, and Jones, Day – which likely contributed to his desire to build a prestigious firm. At the same time, he came from a Cleveland family of modest means, and Mac had been raised on a farm in Missouri, which probably fostered a pragmatic and meritocratic orientation – McKinsey would be prestigious but not genteel.

Both men also unquestioningly believed in investing in intellectual capital – no effort was made at JOM or later to measure the returns on such investments. Mac ran training meetings at JOM like the professor he still was. Mac's "text" was the General Survey Outline – a checklist that reflected JOM's "integrated" or "top-management" approach. The Outline forced a strategic approach to client studies by requiring consultants to analyze a firm's industry and competitive position before considering anything specific to the organization. The JOM tradition of codifying knowledge and training and the top management approach would later be continued at McKinsey & Co.

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4. I will use "Mac" to avoid confusion with the firm bearing his name. It is also noteworthy that, unlike the other professional firms of the era, the staff at James O. McKinsey and Company and its successor firms addressed each other by their first names (or abbreviations), regardless of their rank or status. The practice was intended to promote collegiality and a nonhierarchical culture.

The JOM experience also shaped Bower's views about what he would not want in his firm. For instance, Bower questioned JOM's policy of conducting an audit practice alongside its consulting practice. He felt that most people could not excel in both accounting and consulting. Bower was also troubled by the conflict of interest in a corporation retaining its auditors to provide management counsel. Bower also was concerned about potential clients' perceptions of JOM, which was often regarded as a firm of "efficiency experts," or worse, "business doctors," whose retention was an admission of "sickness." The perception did not sit well with Bower, who would later invest in building a more respectable image for consultants.

In 1934, JOM secured a prestigious study for Marshall Field and Company, the leading department store in the Middle West. Mac and Bower both worked on the study, and they submitted a report recommending concentration on the department store business and the divestiture or liquidation of most other businesses and assets, including the wholesale business, all 18 textile mills, and the Merchandise Mart (then the world's largest office building). The bold report, and the attention it generated, was a forerunner of the work that McKinsey now routinely undertakes. Later that year, the Marshall Field board offered Mac the job of chairman and chief executive, which he accepted.

Mac also decided at that time to merge his firm with Scovell, Wellington & Company, headed by C. Oliver Wellington. The firm had 11 accounting offices, but its management engineering or consulting staffs were confined to Boston, New York, and Springfield. Horace G. ("Guy") Crockett headed the New York consulting practice, and F. Richmomd ("Dick") Fletcher headed the Boston consulting staff. Oliver Wellington and Mac decided to create two partnerships: Scovell, Wellington & Company (SW), accountants, and McKinsey, Wellington & Company (MW), management engineers. Wellington would be managing partner of both firms. Bower was disappointed by the continued association of consulting and accounting practices but Mac "brushed [Bower's] views aside"; the MW partnership agreement was signed in November 1935.

Crockett, then 55, became manager of MW's New York office. Bower, 32, served as his deputy. Andrew Thomas ("Tom") Kearney, who had served as Mac's number 2 at JOM, became the manager of the Chicago office. Dick Fletcher continued as manager of the Boston consulting staff. At the time of the merger, the JOM office was located at 52 Wall Street and the SW office, at 115 Broadway. Bower proposed a separate office for MW to achieve at least a physical separation between the consultants and the accountants. Crockett agreed, and MW moved to a new building at Two Wall Street, taking on a lease that would later become a problem.

The merged firm inherited a major study from Scovell, Wellington for U.S. Steel. During this period, the standing of management engineers

improved, and Bower, who regarded "management engineers" as an inaccurate characterization, adopted the term "management consultants." He urged the staff to be sensitive to the need for eliminating the popular terms "efficiency expert" and "business doctor" and to take the time to discuss the nature of the firm's consulting process with insiders or outsiders who used those terms.

The partnerships did not merge harmoniously because the Chicago partners resented Oliver Wellington's autocratic management style. In 1937, Bower, who had adopted from his Jones, Day years the practice of "putting it down on paper" (a tradition that would continue at McKinsey), tried to get agreement on a memo he wrote on firm objectives, but found the Chicago partners indifferent to his efforts. Partner dissatisfactions were muted, however, because the Steel study and growth in Chicago resulted in satisfactory earnings.

In May 1937, Wellington announced that the Steel study, which accounted for about 55% of total MW billings, would soon terminate. In November, James O. McKinsey died unexpectedly, and Marshall Field executives, who harbored resentment against the outsider, helped generate considerable negative publicity for MW. The firm went into a loss position in 1938, when Chicago earnings could not offset New York and Boston losses. The Chicago partners now became alarmed about the Two Wall Street lease.

In April 1939, Bower proposed a reorganization that would separate MW from SW, keeping the New York and Chicago offices together as a single firm. Kearney and his Chicago partners, however, believed there was ample work locally and questioned the value of operating multiple offices. Bower then suggested to Crockett that they, along with Fletcher of Boston, form a new partnership that would take over the eastern practice of MW and assume the Two Wall Street lease. The Chicago partners would organize a firm of their own, and Wellington would return to SW.

Perhaps because of the personal relationship he had formed with Bower,[5] Crockett agreed to start a new firm with Bower rather than return to the security of SW. Kearney and the Chicago partners also favored Bower's plan because it shielded them from the Two Wall Street lease. Differences over the names of the two firms were resolved when Bower suggested McKinsey, Kearney & Company (MK) for the Chicago firm and McKinsey & Co. for the East Coast firm.

Guy Crockett became managing partner of the new East Coast firm and continued to serve as manager of the New York office. Bower, who functioned as deputy to Crockett in both roles, recalls that the two worked "as a team" with complementary strengths and interests. The older man was chiefly interested

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5. "After four years of working together," Marvin recalls, "Guy and I were very close." Commenting on MW's New York office move in 1935 to a new location, Marvin thought that Guy "welcomed a physical separation from Oliver."

in "day-to-day operating matters"; Bower's primary interests were "conceptual and long term."

In his 1937 memo on firm objectives, Bower had described a long-term vision. He had proposed that MW confine its activities to management consulting; place primary emphasis on solving major management problems; adhere to the highest standards of integrity, professional ethics, and technical excellence; select, train, and advance personnel so that the firm would be self-perpetuating; provide the work-interest, financial reward, and growth opportunities that would attract young men of outstanding qualifications; and continuously increase its stature and influence. The memo served as a starting point for the goals of the new firm.

Although Bower took the lead in defining the firm's long-term strategy, he also sought the endorsement of his partners. In 1940, he took responsibility for producing a booklet for prospective clients, entitled *Supplementing Successful Management,* that described the firm and its practice. It took nearly a year to produce the publication because Bower wanted his three partners to "agree with substantially every word," so that they would gain "genuine agreement" on the kind of firm they wanted to create. Apparently, Mac's dismissal of Bower's objections to the MW merger, Oliver Wellington's autocratic style, and conflicts with the Chicago partners had impressed on Bower the value of consensus building even at the expense of delay.

3. Building a National Practice: 1939-50

In the first decade or so, the McKinsey partners focused on building the economic base of the firm: They expanded and upgraded their client base, opened new offices, and raised fees, relying mainly on "doing good work" rather than on any innovative strategy. While Bower also tried to establish norms of professionalism and a spirit of partnership, many important developments on the "internal," or organizational, side of its system were deferred to the following decade, when the firm had attained a strong financial position and client base.

For the first few months, the practice taken over by the new firm continued to decline. To the partners' surprise, however, the firm made a profit of $57,000 in its first year. Billings for that year were $284,000, and compensation amounted to $10,000 for the partners and $7,500 for the principals.[6] Thereafter, billings and profits continued to grow. The first step in

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6. Principals were senior consultants who played a similar role as the partners in managing client engagements, but did not contribute to the firm's capital, assume responsibility for its debts, or have a claim on its profits.

the firm's national expansion was the opening in 1944 of an office in San Francisco. The office achieved its first profit in 1946.

After World War II, Bower thought it time to either reconsolidate the Kearney and McKinsey firms or sever the affiliation and open McKinsey's own Chicago office. He outlined a reconsolidation plan, but partners from both sides expressed reservations. As one McKinsey partner noted, although the two firms shared a common heritage, the different strategies they had followed after 1939 impeded reconsolidation. For example, Kearney had continued JOM's policy of recruiting individuals with many years of business experience for its staff. Bower and his partners thought it better to attract and train outstanding young people; experienced executives often could not adapt to a consulting role and McKinsey's distinctive culture. Moreover, after the 1939 reorganization, McKinsey had raised fees to a level that the Kearney partners feared could not be sustained in Chicago. Starting with a much smaller base, McKinsey billings and earnings were by 1946 more than twice as large as the Chicago firm's.

In 1946, Tom Kearney told Guy Crockett that the Kearney partners preferred to go it alone. The McKinsey partners decided to sever the affiliation with Kearney and open their own office in Chicago. Bower persuaded Tom Kearney to remove "McKinsey" from the Chicago firm's name by suggesting that Kearney call his firm "A.T. Kearney & Company" and allow Bower's partners buy the McKinsey name. In 1947, McKinsey opened its Chicago office. Two years later, it opened a Los Angeles office.

As McKinsey added offices, the partners sought to combine a high degree of local autonomy with what they called a "one-firm" policy. The manager of each office had broad operating responsibility and decision-making authority, but only within the confines of firm principles, strategy, and policies. Under the one-firm policy, all consultants were to be recruited and advanced by the firm rather than by an office; partners' profit shares were derived from a firm pool, not an office pool; and each client was to be treated as a client of the firm, not of a particular individual or office. Originally intended to prevent the interoffice discord experienced at MW, the policy also helped reassure clients of the uniform quality of McKinsey services, increased the mobility of professionals needed to open new offices, contributed to the solidarity among firm members, and prevented individuals from walking away with firm relationships.

As it expanded its geographic reach, the firm upgraded its clientele. Bower's 1937 memo on MW objectives and the 1940 booklet had espoused the goal of helping large, prestigious companies solve problems of major concern to their top-management executives. In its early years, however, when McKinsey was struggling to survive, the partners were willing to serve clients of any size and any reputation that was not actually negative. But by the mid-1940s, a reasonably high proportion of studies met McKinsey's strategic

objectives. The firm's New Engagement and Executive Relations Guide, issued in 1945, could realistically endorse a policy stating that every assignment the firm accepted should bring something more than income, such as prestige or experience.

McKinsey maintained the emphasis on training inspired by Mac, continued his top-down approach, and avoided narrow functional assignments. The firm did not seek to exploit a specialized management technique (as it might have done by building on Mac's field of budgetary control); rather, McKinsey positioned itself as a firm that would apply well-known techniques with superior judgment and diligence and thus insulated itself from changes in management technology.

McKinsey did, however, adopt some changes. The firm decided, for example, to place more emphasis on persuading clients to act on its recommendations. According to Bower, Mac had expected clients to carry out the recommendations in his reports largely on their own. Bower, however, came to believe that unless clients acted on recommendations, the firm's reputation might suffer. So in the early 1940s, McKinsey began working with client executives to implement recommendations; later in the decade, once it was in a position to do so, it used the client's willingness to act as a criteria for accepting assignments.

The firm also adopted what Bower called a "professional approach" to serving clients. His background as a Jones, Day lawyer had convinced Bower that consultants needed to improve their standing; consultants should emulate the older, or classical, professions by adopting and enforcing self-imposed standards of competence, ethics, responsibility, and independence. Bower's convictions apparently had had little impact at JOM and MW.[7] After the 1939 reorganization, however, Crockett and Bower decided to establish the "professional concept as a hallmark of McKinsey." As articulated by Bower, the professional approach had many facets: a consultant should put the interests of clients ahead of increasing firm revenues; preserve confidences; provide truthful, independent advice and not be afraid to challenge a client's opinion, even if it might lead to the termination of a study; and only perform work that was necessary and that McKinsey could perform well.

Following the example of leading law and accounting firms (and in contrast to many other consultants) McKinsey did not advertise or directly solicit clients; the firm did, however, adopt "an organized program of professional exposure to make the firm more widely and favorably known." For example, in 1940, the firm began organizing seminars, or "clinic dinners," that brought together 20 to 25 executives for dinner with firm members and a

7. According to Marvin, "although Mac had personally adhered to professional standards, he had never articulated them. It was not until MW broke up and we organized our own firm that we were able to do something about instilling professionalism."

guest of honor, whose brief talk provided background for the discussion. The same year, the firm started *Top Management Notes*, a newsletter sent to officers and directors of client companies.

By the end of its first decade, McKinsey had attained the stature, financial strength, and confidence to devote resources to organization building. In the years ahead, the firm would turn its attention to defining and establishing the key internal elements of its system.

4. 1950-1956: Organizational Innovation and Investment

During the early 1950s, McKinsey undertook significant initiatives to formalize and revamp policies in areas such as governance, recruitment and advancement policies, and ownership structure. These initiatives represented an investment that would facilitate future growth, including international expansion, and it is probably not a coincidence that they started with Bower's term as managing partner. Changes were gradual, however, as the firm's leadership sought to balance short- and long-term concerns and secure a consensus.

In 1950, Guy Crockett, now 60, stepped down as managing partner, and Bower was elected in his place. For the next six years, the firm made only modest changes in its external strategy. It opened a Washington, D.C. office in 1951 to serve government agencies and help corporate clients adapt to regulation. In 1953, it closed its Boston office, which had failed to build a satisfactory practice in New England. In December 1951, McKinsey withdrew from the executive recruiting field, which Bower believed was "out of character" for the firm: it could create ill will in the companies whose executives were lured away by McKinsey, and a potential conflict of interest could arise if, in the course of an organizational study, McKinsey recommended a new position and then offered to recruit candidates for it. Moreover, we may speculate, the firm was now in a position to give up the income that recruiting provided, for the sake of its reputation.

At the same time, the firm developed new practice areas that fit its strategy, often through the initiative of individual consultants. For example, in the early 1950s, a principal, Richard Neuschel, asked Bower whether he might take the lead in building an insurance practice. Bower agreed, even though he knew that a special development committee had concluded that no attractive opportunities existed for the firm in the field of insurance or banking. Neuschel began writing articles about insurance and getting to know industry executives. Eventually, the firm gained a prestigious insurance client, whose chief executive subsequently recommended McKinsey to other insurance companies.

The firm's intensified focus on internal development began in 1950, when the partners adopted written guidelines for sharing profits, promoting

consultants to principal, and electing new partners. Reflecting a concern that the firm was becoming too dependent on a few individuals to generate clients, the criteria stressed the importance of "economic self-sufficiency" in electing new partners: besides demonstrating the ability to direct client studies, candidates also had to demonstrate their ability to develop and maintain clients. Applying this standard could reduce firm earnings, compared with the alternative of promoting individuals who could direct studies others had generated. The policy reflected the belief that the longevity of the firm and the spirit of partnership would be better maintained with partners of similar talents held to the same standards of performance.[8]

In 1951, the firm established three committees. The profit-sharing committee was formed to expedite the allocation of profits to partners. The executive committee was established to act for all of the partners on matters that did not involve basic policy. The planning committee, comprising Bower and three other partners, was formed to discuss important management questions and to make recommendations to all the partners.

In 1952, the planning committee changed the system for the annual reallocation of partnership shares. The shares of the founding partners in 1939 had been divided through a negotiation on the basis of their "long-term" contribution (as demonstrated in the antecedent firms) and on capital contributed. The division was subsequently altered to reflect the retirements and additions of partners as well as through an annual reallocation of shares. The reallocation was intended to reflect relative contribution based on the following criteria: responsibility for producing the firm's income; contribution to the firm's reputation; contribution to the formulation of firm policies and program; contribution to the development of techniques for performing consulting engagements; training of firm personnel; responsibility assumed for firm administration; and leadership of firm personnel. The managing partner was responsible for preparing a schedule of suggested distribution of shares based on his appraisal of each partner's contribution. The planning committee found that there was little common understanding of the criteria used to allocate partnership shares. The committee developed new criteria and assigned values to each. Instead of the old practice of the managing partner appraising the others, the committee recommended a process by which each partner rated all the others but not himself.

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8. In the early years after 1939, the partners had divided the firm's meager profits more or less equally; subsequently, as the profits improved, the following arrangement evolved: half of profits were distributed to partners in proportion to the shares they owned; the other half was distributed as bonuses to all professionals. The amounts from this pool paid to associates was somewhat fixed as partners sought to insulate associates from fluctuations in firm profits and to compensate them on the basis of their individual performance. The partners then split the residual bonus pool according to their judgment of each others' contribution. In 1950, the partners formally codified the process and criteria for dividing their share of the bonus pool.

The use of committees to formulate and implement policies would become a hallmark of McKinsey's and Bower's management processes. Decisions were made more slowly but were more likely to be accepted by firm members than if the leadership had acted unilaterally. The firm was also able to reduce the confusion that often accompanies growth by applying formal policies instead of ad hoc decision making. Bower exercised considerable influence through the committees he formed, by selecting their members and by forcefully expressing his views in their meetings. He did not, however, impose his views; as we will see in the case of McKinsey's international strategy, Bower would wait for years while a committee (or the partnership group as a whole) reached a consensus. With a few exceptions (as in Neuschel's insurance practice development effort described earlier), Bower respected even those committee decisions he disagreed with.

In 1953, Bower persuaded his partners to start recruiting directly from graduate schools of business. Bower had long believed that to serve top-quality executives the firm should bring in young, relatively malleable individuals rather than the experienced recruits favored by JOM and MW. World War II had, however, forced McKinsey to hire older individuals, many of whom did not meet the firm's standards. After the war, according to partner Ev Smith, McKinsey "got rid of almost everybody" (McKinsey & Co. (1999) p. 11) and began to favor intellectual ability and other intrinsic qualities over experience.[9] But several partners doubted whether clients would accept a young person who might never have worked in a business before. By 1953, however, Bower had convinced his partners that McKinsey now had the stature to attract high-caliber graduates and a strong enough reputation with its clients to gain acceptability for young recruits. Bower further argued that the admissions standards of business schools provided a convenient pool of good candidates and that once the outstanding prospects had succeeded elsewhere, McKinsey would find it harder to recruit them. Although common practice at large law firms such as Jones, Day, the decision to recruit at graduate schools was pioneering in the consulting field. It was also contrary to Mac's belief that consultants should have had many years of business experience, with titles that would impress clients.

In 1954, McKinsey adopted an up-or-out policy for associates. Bower believed that, like law firms and universities, McKinsey should terminate individuals whom it did not promote, but it took him several years to build a consensus for that view. In 1950, the partners had begun exploring the advisability of a policy that an associate be separated as soon as his performance demonstrated that he did not have the qualities to become a

9. According to Marvin's analysis, the successful consultant was "a balanced person with an attractive appearance, a forceful personality, self-confidence, superior intellectual equipment, and a broad range of other human qualities."

principal; that all associates be reviewed annually against that standard; and that associates not elected principal by age 40 be separated. The proposal was extensively debated. There was little dispute about the desirability of terminating consultants who could not perform their current duties. McKinsey didn't promise great job security – in 1952, for example, 16 professionals (or about one-sixth of the total staff) left the firm; four of these departures were involuntary. But with high turnover and the difficulty of finding competent replacements, some partners were reluctant to terminate associates merely because they lacked the potential for election to the partnership. McKinsey, they claimed, should not eliminate "good consultants who can do good work under the direction of more brilliant firm members."

Bower argued that up-or-out reinforced the firm's recruiting policy: McKinsey sought to hire only exceptional people, and if they did not work out, they should work for organizations that could better use their exceptional talents. Consultants who were treated as "workhorses" or "second-class citizens" would damage morale. Moreover, as Bower complained in his annual report to the partners in 1952, the firm was "slow to eliminate associates whose lack of capacity [was] well recognized." Eventually, by 1954, the arguments for an up-or-out policy persuaded a predominant number of partners. The difficulties of implementation, however, led to second thoughts. In April 1956, the planning committee partners established a "senior consultant" status: an associate with special technical skills who was not advanced to principal by age 40 could be elected a senior consultant instead.[10] Four individuals were made senior consultants but they were quickly seen as second-class citizens, and their positions eventually were eliminated.

In 1956, after seven years of discussion and research, the McKinsey partnership turned itself into a private corporation. In 1949, the partners had first considered incorporating the firm to help build its capital. As a partnership, McKinsey had to pay out all its earnings to its partners every year. The partners paid personal income taxes on their earnings and put back after-tax money into the firm for its capital.[11] As a corporation, McKinsey could build its capital by retaining earnings after taxes levied at a lower corporate rate. The accumulated earnings would increase the value of the corporation's stock; when the partners eventually "cashed in" their share of retained earnings by selling their stock, they would face a relatively low capital gains tax.

10. The memos discussed were "Resolving the Status of the Technician," written by Bower, and "The Rationale Between Technique and Problem Solving in the Firm's Evolving Practice," written by a principal, Richard Neuschel. The memos suggested the senior consultant status in order to address the issue of associates emphasizing general problem solving to the exclusion of developing technical know-how.
11. The partners financed the firm through contributions to capital account, in proportion to their shares. New partners were not required to contribute their capital share immediately, but were usually eager to do so quickly because the firm paid an attractive 6% interest rate on capital contributions.

Incorporation had disadvantages, however. As a corporation, the earnings paid out to its stockholders would incur two levels of taxes – taxes on corporate profits and subsequently personal income taxes on dividends received. To avoid double taxation, the firm could try to retain most of its after-tax profits rather than pay them out as dividends. But if the Internal Revenue Service subsequently determined that the firm had retained earnings merely to avoid taxes, McKinsey would be liable for a penalty tax. Another argument against incorporation was that it might cause the organization to lose the trust and solidarity of a partnership. These reasons led the partners to maintain the status quo.

In 1951, a partner suggested incorporation in order to establish a tax-sheltered profit-sharing plan. Congress had passed legislation that allowed companies to set up profit-sharing or pension plans for employees to which they could make tax-deductible contributions of up to 15% of pretax profits. The McKinsey partners could not take advantage of such a plan because they weren't employees of the firm. Bower consulted an accounting firm, which recommended against incorporation. Besides raising the issue of penalties on the excessive retention of earnings, the accounting firm predicted that changes in the tax laws would soon permit the partners to make tax-deductible contributions to a pension plan. Bower and Crockett were predisposed to accept this advice because they feared that incorporation might change the firm's character. In 1955, after Congress had failed to change the tax laws, the partnership consulted a different accounting firm, whose recommendation was to incorporate. This time Bower and Crockett withdrew their opposition because they "became convinced that all the partners *would* make determined efforts to maintain the Firm's professional character and partnership style of managing."

Another reason for their change in attitude was concern over the growing retirement and death claims of the older partners. The 1935 MW contract had stipulated that on the death of any partner, his estate would receive a percentage of the earnings for three years. Payments made under that contract to the McKinsey estate after Mac's death had proven burdensome, and the retirement benefits due to Crockett and Fletcher had been one reason for the Kearney partners' willingness in 1939 to separate from the East Coast partners. These experiences had led McKinsey's partners to develop a contract with less burdensome death and retirement provisions; even so, Bower and Crockett felt that the claims of the longer-term partners had become substantial enough to be a disincentive for the younger partners. They hoped that incorporation and a fully funded profit-sharing retirement plan would wipe out the disincentive of the large partner claims and thus facilitate the transfer of ownership to incoming partners. Although book values considerably understated the true economic value of the shares, Bower felt that the alternative was the impasse

he had observed at other firms: the next generation of partners could not or would not buy shares at the price their seniors demanded.

By June 1956, incorporation documents had been prepared. They contained provisions intended to keep the ownership of all shares exclusively in the hands of active firm members: each shareholder had to sign a contract binding him and his estate to sell his shares only to another shareholder or the firm. Shareholders had to sell their stock at book value as they approached retirement. This arrangement, through which one generation gradually sold the firm to the next reflected, according to Bower, the partners' determination to maintain the firm in perpetuity. The incorporation documents replaced all existing retirement and death claims of the partners. In lieu of the extinguished benefits, the newly incorporated firm would pay the existing partners a fixed sum in equal installments over ten years. In the future, retiring shareholders would be entitled only to the amounts they had accumulated in their profit-sharing retirement plans and the book value of their shares.

Although the shares after incorporation could have been distributed in the same proportion as the partnership interests, the partners adopted new policies regarding shareholding. A compensation and special committee recommended that no one individual should hold more than 25% of the total available stock. It argued that because the firm's success depended on everyone's collective effort, it was "important for each partner or director to have sufficient shares to give them a major financial 'stake' in the enterprise." Also, in the future it would become increasingly important for control to be spread over as many individuals as possible.[12] After incorporation, partners were called directors, and Bower became managing director instead of managing partner. Principals who were not allocated shares in 1956 were allowed to buy stock some years later.

Together, the policies that emerged through these years of experimentation and debate solidified the firm's character and its operating norms, preparing it to now focus outward, on new and expanding global opportunities.

5. International Expansion: 1956-1966

Between 1956 and 1966, McKinsey committed resources chiefly to international expansion. During that decade, the firm added only one office in the United States while it opened offices in the United Kingdom, Switzerland,

12. Hitherto, although partners could vote their shares on a proportional basis, the norm was to resolve issues by consensus, and the partners had never actually conducted a vote by shares. The committee probably feared that in the future, with a larger number of partners, the concentration of shareholding might lead to a concentration of control. In fact, the firm continued the tradition of trying to give an equal voice to all directors; for example, in electing a managing director, each director had only one vote, regardless of his shareholding.

Holland, France, Germany, and Australia. Once started, the pace of office openings was rapid. Initially, however, many partners had resisted overseas expansion. McKinsey's strategy for overseas expansion entailed short-term costs: Opening new offices would slow the growth of the existing offices. Partners would have to give up their short-term earnings. As U.S. consultants were transferred overseas, they would lose their contacts in the cities they left behind. Through his patient but steadfast advocacy, Bower persuaded the partners to give a foreign office a try; the unexpected demand for McKinsey services overseas eventually won them over.

In 1953, Bower had suggested that the partners consider establishing a "beachhead" in London or Paris; in 1955 he again urged serious consideration of an overseas practice. One partner, Gilbert Clee, who had once served as a loan officer for the World Bank, was enthusiastic, but most of the partners favored continued concentration in the United States. Consequently, firm policy was to "move slowly." The partners did agree, however, to hire someone to help Clee explore opportunities overseas.

In February 1956, the Royal Dutch Shell group retained McKinsey to study their largest operating company, based in Venezuela. John Loudon, managing director of Shell, had indicated that the study was a "tryout" for an overall study of Shell's organizational structure. In April 1956, Clee presented a report on the options for developing an international practice. He recommended that the firm gradually develop a corps of consultants dedicated primarily to the international field who could serve clients at home or abroad without necessarily limiting the practice to specific countries. Clee's report suggested that the firm only undertake "diagnostic and general survey type of studies and let others take on thereafter if further studies in depth on more specific projects were required." The firm should emphasize assistance to domestic companies in expanding their international business and "move slowly in accepting assignments that involved substantial numbers of people going overseas for extended periods." Large assignments of indefinite length should be undertaken only under exceptional circumstances. The planning committee endorsed the gradual program.

The tryout study in Venezuela was well received by Shell. In 1957, Loudon became chairman of the Royal Dutch/Shell Group. On the day he took office, he cabled McKinsey about the overall study of Shell's organizational structure. Bower went to The Hague and negotiated terms. The study agreed upon required a large number of consultants to work in London and The Hague, where the joint headquarters offices of the Shell Group were located. The experience persuaded Bower and Clee that McKinsey should open overseas offices, using the Shell study as a bridge to a first office in London. But, according to Bower, "a significant number of directors were still reluctant." He noted that the McKinsey partners' attitude now was: "We have

all we can do in the United States. A move to Europe will slow our U.S. growth."

Indeed, by the mid-1950s, the U.S. practice was flourishing. "There's no denying that McKinsey is successful," *Business Week*'s cover story (Business Week (1955)) of its September 24, 1955, issue observed. Listing clients such as General Foods, General Electric, American Airlines, Corning Glass Works, and H.J. Heinz, the article stated that "most of McKinsey's business just walks in the door. So much of it has been walking in over the last few years that McKinsey has been refusing jobs because of the limits on its manpower." Overseas, however, McKinsey lagged. In its December 21, 1957, issue, *Business Week* (1957) described McKinsey as the one large "home based" U.S. firm that still operated abroad by sending consultants out from its U.S. offices.

Clee and Bower forced the issue in 1958. In March, Clee distributed a memorandum entitled "Proposed London Office." Extensive discussion ensued at the directors' April meeting. Some directors were still reluctant to open an overseas office but when one suggested further study, Bower decided that the problem had been studied long enough and asked for a show of hands on Clee's proposal. With some wavering, all hands were finally raised – the vote was unanimous. The directors further agreed that the firm would "conduct the same kind of practice overseas as at home – studies of top-management problems for major corporations; to charge the same fees, which we knew were several times above the European level; and to build a European staff of the same quality as our American staff. In short, we agreed to follow our U.S. philosophy and strategy – but with the added strategic factor that we would not (as we had in the United States) 'work our way up' in caliber of clients and problems."

The London office opened in April 1959. Clee, based in New York, served as the partner in charge. Hugh Parker, a graduate of Cambridge University who had joined McKinsey in 1951 and worked on the Shell studies since 1957, was the resident manager. Appointing Parker rather than a distinguished outsider represented, according to Bower, a "strategic policy of selecting leaders for new offices from experienced McKinsey people," which the firm subsequently followed in all its new locations. The policy, intended to provide a unity of purpose and cohesiveness among the far-flung staff, was regarded a crucial element of McKinsey's "one firm" philosophy.

In January 1959, the London office began an implementation study for Shell. In 1960, the London office became profitable. In July 1962, the firm gained Imperial Chemical Industries Limited (ICI), the United Kingdom's largest industrial enterprise, as a client. The ICI study added to McKinsey's stature in the U.K. and led to many British clients. To the firm's surprise, British clients dominated the London practice. Later in other countries as well, an unexpected demand for U.S. know-how would make local companies the mainstay of McKinsey's practice.

Building a U.K. staff proved more difficult than securing clients. Many U.S. consultants were skeptical about the prospects overseas and were reluctant to transfer. McKinsey also had difficulty recruiting British consultants of the same caliber as its U.S. staff. The firm sought honors graduates of Cambridge and Oxford, but could not attract them because the firm was not well known in Britain and consulting was not held in high regard. By 1962, however, a growing clientele and reputation reduced the unwillingness of the U.S. staff to move overseas and enabled McKinsey to attract British recruits who met the firm's standards.

London was followed by several offices in Europe: The first was in Geneva, in June 1961. McKinsey had already secured a study from DuPont of Europe, located in Geneva, and Geneva was the European headquarters for many U.S. companies. The office was profitable almost from its inception. Besides the ongoing work for DuPont, McKinsey immediately secured engagements from three other U.S. clients with European operations. The clients and consultants developed from Geneva served as a bridge to other offices in Europe. A high-profile study for KLM Airlines in Holland and the prior relationship with Shell led to the opening of an Amsterdam office in 1964. McKinsey opened two other offices that year – a Paris office in September and a Dusseldorf office in October. The French practice developed quickly. French executives apparently yearned for American management know-how, and favorable articles in the British and continental press had made them familiar with McKinsey.

Securing and serving German clients proved tougher. German executives were less exposed to consulting and to McKinsey, and they had concerns about confidentiality. As in the early years in the United States, there was no "magic bullet" for building a clientele. The German operation eventually succeeded according to Bower, "only because we did superior work under stringent conditions and focused on building a high-caliber staff." McKinsey overcame the suspicions of German executives by maintaining "high standards of care" and asking present clients to testify to prospective clients about the firm's trustworthiness.

In 1965, the Geneva office was closed. The circumstances, according to Bower, reflected the firm's dedication to nonhierarchical decision making. Two Swiss associates asked to see Bower when he visited Geneva in April 1965. They suggested that the Swiss office be moved to Zurich – – a location that would greatly reduce the extensive travel required by consultants to reach clients. Bower proposed that they write a report supporting their recommendations. Four months later, the firm's executive group, citing the report, announced a shift to Zurich.

Taking stock of the offices that had been opened, Bower acknowledged the short-term costs but emphasized the long-term opportunity:

> Opening a new office inevitably slows the growth of existing offices as leaders and clientele-building consultants are transferred to the new location. And it takes a while for our leaders to become well and favorably known to business and civic leaders of the area. And, of course, another part of the cost is the loss of personal contacts in the cities our people leave behind. Long-term, however, a properly located office with effective leadership will expand the total firm clientele and benefit us all.

6. The McKinsey System: a Closer Analysis

The long-term success of overseas expansion, of course, was not guaranteed. Why did the firm's partners give up short-term earnings, especially since the 1956 ownership plan precluded them from realizing the true long-term value of their shares? Why did capable individuals transfer to unfamiliar overseas locales, giving up existing client relationships (their personal human capital) and disrupting their lives? Similar questions may be asked about a variety of other investments. Why, for example, did the firm turn away clients instead of recruiting consultants more quickly? Why did it actually reduce the manpower available for studies with the up-or-out policy?

The answer lies in the complex system, developed by McKinsey over time, that encouraged investment in the firm's reputation and capabilities. At the system's core lie the *goals* that Bower and his two partners set for themselves in 1939. They had resolved "to build a firm that would continue in perpetuity. This goal required every individual to protect and build the firm's future and reputation so that each generation of partners would pass the firm along to the next generation stronger than they had found it." Undoubtedly, the partners hoped for individual financial success as well, but they did not express their objectives in terms of personal wealth maximization, and they wanted their successors to continue this tradition.

In *recruiting* consultants, therefore, the firm sought individuals with the disposition and ability needed to build the institution; every new associate was supposed to have, in addition to exceptional analytical skills, the potential to make the contribution necessary for election to partnership. When the desired combination of talents was difficult to attract (as in the early years of recruiting at HBS and in the U.K.), the partners were prepared to turn away work rather than modify their recruiting criteria. And the firm's policy was to separate consultants whose "basic qualities" had been mis-estimated during recruiting.

The system reinforced the innate preferences of its staff through the level and structure of its *financial incentives*. By the time McKinsey began its overseas expansion, it had developed the economic strength to pay its consultants more than what they could earn in industry.[13] In 1955, associates' incomes were estimated between $15,000 and $20,000, principals made between $25,000 and $40,000, and the typical partner over $100,000. So even

if consultants did not realize the "full" value of their shares and investment, they earned a handsome income. Current incomes and advancement were also tied to the investment the individual made in firm resources and capabilities: Promotion to principal required an associate to demonstrate long-term contribution to the firm through developing new clients, junior staff, or knowledge. At the partner level, the wide dispersion of compensation (in 1955, for active partners between about $55,000 and $200,000) was also largely based on contributions to firm building instead of, as was the case in many prestigious law firms, tenure.[14]

Attractive financial rewards were made possible by the firm's *client strategy*: to work on important studies that could justify premium fees for large companies that had the capacity to pay. Conversely, premium fees allowed the firm to attract the talent needed to serve prestigious clients on important projects. The client strategy was also congruent with several other policies that built a reputation for staffing studies with capable consultants who would provide superior value for fees paid. *Selective recruiting* from top business schools; extensive on-and-off the job *training*; rigorous advancement standards and an *up-or-out* policy for individuals who didn't fit; an *ownership plan* that encouraged capable employees to stay; compensation based on performance rather than tenure; investments in know-how ("advertised" through talks and publications); and the emphasis on professionalism all helped McKinsey secure the clients and studies it sought.

The system complemented financial incentives with *intangible or psychic rewards*.[15] Policies that gave McKinsey its economic strength also developed an esprit de corps and the pride of belonging to a special club. Serving the top executives of prestigious companies gave consultants the feeling of doing important and valuable work. Selective recruiting, up-or-out, and meritocratic compensation helped evoke a sense of specialness – it was a privilege to

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13. I do not have data for the rate of separation of consultants for the period discussed here and my personal experience at McKinsey suggests that that it is difficult to distinguish between voluntary and involuntary departures. According to contemporary accounts the overall departure rate is high: a brochure produced by McKinsey (1999 p.17) reports that 20% of recruits are elected to Principal after 5 or 6 years. Presumably the others leave the firm.
14. For example, in the 1,000 point scale developed by the planning committee in 1952 to allocate partnership shares, only 50 points were for the length of tenure. Rather, the scale emphasized a variety of difficult-to-quantify contributions to firm building: formulation of objectives and policies and development of firm philosophy and concepts (150 points); leadership and organization building (200 points); attracting firm members who made particular contributions (50 points); developing firm personnel (100 points); introducing clients (200 points); developing clients, especially prestige clients (125 points); and building firm reputation (125 points).
15. Bower's beliefs about the importance of intangible or psychic incentives are reflected in his observation that "once assured of an attractive income and financial security for himself and his family, the outstanding professional person responds mainly to nonfinancial rewards. Such rewards are typically more powerful motivators than more money would be in their absence."

belong to the firm and to contribute to its long-term well-being. These personnel policies (and the one-firm approach) also contributed to the cohesiveness of a staff of diverse national origins by promoting the homogeneity of character and personality traits and by serving as constraint on growth.

The emphasis on professionalism not only helped build McKinsey's reputation, it also fostered the belief within the organization that the firm had a higher mission. Bower insisted that McKinsey was a professional firm, not a business – its profits were a byproduct and not the purpose of the enterprise, which was to serve clients. Moreover, as a professional firm McKinsey was to control its rate of growth to permit proper recruiting and training of consultants.

The system encouraged individuals to identify with and internalize the long-term institutional interest by giving them a voice in the firm's *governance and management.* Their distaste for Oliver Wellington's controlling style of leadership at MW had led the founders of McKinsey in 1939 to adopt a management philosophy that gave "broad participation in the affairs of the firm to as many partners as possible." Accordingly, the firm did not concentrate decision-making power with the managing director or a small executive committee. Distinctions of rank or position among the partners were discouraged by rotating individuals in and out of managerial roles.

Consensual decision making was the norm – all the partners had to agree to all major new policies even if this practice resulted in considerable delays. The process adopted for the election of managing directors similarly valued inclusiveness over speed; in contrast, the partners of most large accounting firms usually vote on one candidate chosen (often after considerable lobbying by aspirants) by a governing council. (Berton (1994)) (Fortunately, in the consulting field, tardiness in making strategic moves or electing new leadership does not appear to carry great penalties.)

Although partners clearly had more influence, the firm tried to give all its staff some voice. Unlike some military or religious institutions that also promote loyalty, the McKinsey culture did not espouse unquestioning obedience. The firm's managing principles prescribed a "de-emphasis of hierarchy" and held that all firm members had "a responsibility to dissent" with any decision they could not agree with. A memo by two young associates could thus lead to the closing of the Geneva office; a principal could ignore (albeit with Bower's support) the recommendation of a partners' committee and develop an insurance practice. Protection against retribution by superiors was offered by the principle of "fact-based and fair personnel decisions" – compensation and advancement was to be based on performance rather than personal animus or politics.[16]

Together, these elements motivated McKinsey's professionals to leave a stronger firm for future generations, even if that meant reducing their own

personal wealth. An episode from the "go-go" years of the middle 1960s underscores the point: Several investment banks approached Bower to discuss the sale of McKinsey's shares to the public. Bower declined, without drawing any opposition from the other directors. Although their shares could have been sold for two or three times book value, the directors agreed with Bower that a public issue would weaken the firm in the long run. Among other drawbacks, younger members who would have to buy shares at a multiple of book value, would be encouraged to leave.

6.1. Barriers to Imitation

Some elements of the McKinsey approach have been widely adopted. Many consulting firms now recruit at business schools and have established publishing programs to disseminate ideas developed by their staff. The scale of McKinsey's efforts however continues to be distinctive. For example the firm claims that its consultants have written more articles for the Harvard Business Review than all the other major consulting firms combined. (McKinsey (1999)) Similarly, although McKinsey now competes with other firms for recruits from business schools, according to Ghoshal and Bartlett (1997), "the top graduates from the best business schools around the world consistently rank the firm as their first choice employer.

To a certain extent, other firms cannot easily replicate McKinsey's overall system because McKinsey enjoys what might be called an early-mover mystique. By definition, few organizations can attract staff or clients through their preeminence in their fields. McKinsey established an exclusive cachet on campuses and in boardrooms by pioneering the practice of recruiting consultants directly from business schools and by focusing on the problems of top managers. And "positive feedback" inherent in the system amplified early-mover advantages. By investing in a reputation for high-quality, top management consulting, McKinsey could recruit and assimilate capable business school graduates. These graduates could then enhance McKinsey's client reputation, enable it to charge high fees, and thus improve its recruiting capabilities, and so on. Other firms that have now adopted McKinsey's client and recruiting strategies face obvious disadvantages.

Another serious barrier to imitation lies in the tacit knowledge and skills required to keep the system in balance. The system has conflicting as well as mutually reinforcing elements.[17] McKinsey consultants likely value membership in an elite organization because it also amply satisfies their material wants; therefore, the firm must balance outlays on long-term

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16. According to Bower, McKinsey had developed such a strong aversion to politics that a number of "politicians" – including partners – had been forced out of the firm.

reputation building with the current earnings needed to pay attractive compensation.

Similarly, the system has to maintain loyalty and traditional values while an up-or-out policy abbreviates the tenure of its staff. The system must promote teamwork and investments in the firm's intellectual capital but also discourage the free riding that would undermine the spirit of partnership and mutual respect. Therefore, in addition to making a contribution to firm building, all candidates for election to director have to demonstrate "economic self-sufficiency." Moreover, McKinsey encourages directors who can no longer make a satisfactory economic contribution to leave.

Managing these tensions requires a great deal of judgment that took McKinsey many decades to develop. In contrast to other complex systems (such as flexible manufacturing) that have also evolved through trial and error but can now be acquired from software companies, the McKinsey system is difficult to codify and transfer. Although the firm has devoted resources to systematizing procedures and policies, finding the right balance between a partner's "selfless" contributions to the firm and "selfish" investment in developing his or her own clients remains a matter of judgment and experience. So does selecting candidates with the desired personal qualities and implementing up-or-out policies.

Imitation is further impeded by the need for firm members to believe deeply in the firm's goals and strategies. Maintaining the McKinsey system requires conviction. The up-or-out policy, for example, reduces the billable capacity of the firm; its "fact-based and fair" administration, needed to protect morale and avoid undue ill-will, consumes considerable partner time. Similarly, compensating and promoting consultants on the basis of subjective evaluations of their contribution to firm building clearly requires more time than, say, using a formula based on billings. And, whereas the costs are certain and immediate, the benefits of a more elite or cooperative organization are long term and cannot be estimated even after the fact. Adhering to these policies requires an almost blind faith in their efficacy that the partners of other firms may not easily develop.

Moreover, the temptation to stray from espoused policies can be great. It is difficult, for example, to serve only top executives and turn down other work. In 1955, well after McKinsey had established a prestigious clientele, *Business Week* reported that "some of McKinsey's competitors laugh at the 'top management approach.'... 'While they're talking to the president, we've moved into the sales promotion manager's office and gotten the order for a

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17. At the same time we should note that the consulting field does not overly penalize tardiness, as we saw in the example of McKinsey's late entry in Europe. Moreover, one could argue that a newer and therefore smaller firm should enjoy some advantages in establishing a spirit of solidarity among its partners that the larger, more far-flung McKinsey would find hard to maintain.

new marketing survey.' " McKinsey occasionally undertakes studies that do not fit its long-term policy but its steadfastness is reinforced by a long tradition and by the conditioning of firm members.

6.2. Luck or Leadership?

As this study shows, the history of McKinsey has been marked by many chance events: Bower's initial failure to find a job at Jones, Day, his employment by Mac, the Marshall Field study, JOM's merger with Wellington, Mac's unexpected death, Bower's close relationship with Crockett, the Shell Venezuela study, and so on. But the evolution of McKinsey & Co. cannot be attributed to mere chance, particularly after 1939. The partners chose to discard or modify initiatives and activities that fell outside the framework of the founders' long-term strategy and goals and to keep those that fit. For example, McKinsey initially served marginal clients and charged low fees, but as soon as it became feasible, stopped doing so. It abandoned a profitable executive recruiting practice after 12 years when the partners concluded it might compromise the objectivity of their consulting services. McKinsey adopted up-or-out as an integral part of its personnel policies when the partners were convinced it was consistent with the tenet of building a high-caliber staff. The Boston office was closed in 1953 because it had failed to build a quality clientele, whereas the firm quickly expanded in Europe in the 1960s when it found unexpectedly strong demand from prestigious local clients.

It would be difficult to overestimate the impact of Bower's talents on the firm's evolution. Bower's exceptional ability to secure and serve clients earned him respect and influence with the McKinsey partners, as evidenced by his ownership in 1956 of more than a third of the firm's shares. He played an important role in pivotal studies. He was Mac's deputy on the Marshall Field work in 1935. While serving as the firm's managing partner and director, Bower directed the Shell study in Venezuela, negotiated the subsequent organizational study in the Hague, and secured the ICI study in London.

Bower was also an innovator; he popularized the term *management consulting* and helped establish many of its basic practices. He did not have a well-tried organizational model to follow. Rather, he synthesized: he took the professional approach, recruiting, and up-or-out policies from Jones, Day; the emphasis on training and serving top management from Mac, and the multi-office strategy from his observation of clients. And he had the innovator's willingness to experiment and learn from mistakes. For example, he pushed for an up-or-out policy, then proposed the senior consultant alternative, which he ultimately repudiated.

Most of all, Bower was driven by his goal of building a firm that would last in perpetuity: to this end he was prepared to sell his shares at book value (unlike William Bain, founder of Bain & Company, for instance) and rejected offers to go public. Unlike many entrepreneurs, Bower put the long-term interests of the firm ahead of his ego. He did not insert his name in the firm he co-founded. “I had seen the problem that having your name on the door caused Mac,” Bower recalled. “A client would come in an say, ‘We assume Mr. McKinsey will be working on this study personally.’ I didn’t want anybody dictating to me how I was going to spend my time. So I had no interest in calling it Bower & Co., or even McKinsey-Bower.” (Huey (1993)) Whereas Mac might “brush aside” Bower’s objections to the MW merger, Bower’s convictions and power were tempered by a belief in the importance of building a consensus: he showed great patience, for example, in persuading his partners to expand in Europe and, despite his reservations, went along with incorporation.

The manner in which he stepped down from leadership also reflected a desire to build a lasting firm. Instead of anointing a successor, Bower established a process of electing new managing directors designed to minimize politicking and cliquish behavior, forming a committee to work out a plan for electing the next managing director. The committee created a plan under which directors would not offer themselves up for election. Rather, each would fill a blank ballot with the names of the directors he wished to nominate. The firm’s outside auditor would then rank each director by the number of nominations received and thus determine who would be voted on in the next round. Directors could take themselves out of the running at any stage. The field of candidates would be narrowed through successive rounds of secret voting until a winner emerged. Bower further worked with the management group to redefine the role of managing director.

After they agreed on the managing director’s role and qualifications, Bower proposed that the directors elect their new leader in June 1967, at their next annual meeting. After a few ballots, Clee was elected and took office in October 1967. Shortly after taking office, in February 1968, Clee was operated on for lung cancer, and many directors urged Bower to resume the position he had just stepped down from. Bower refused,[18] and Lee Walton, the manager of the Chicago office, was elected managing director in March 1968.

7. Conclusion

18. Bower had announced the previous year that he would withdraw from any role in firm management after Clee took office. He did, however, continue as a director until his seventieth birthday in 1974, under a special retirement policy which required his annual reelection by the other directors. And between 1974 and 1993, when he reached the age of 90, Bower continued to serve in a nearly full time, “of counsel” or consulting role to McKinsey, with an office in New York.

Studies that analyze the exceptional case often do not suggest useful solutions to the problems of the mainstream. Indeed, the McKinsey story provides little normative guidance for other professional firms. Existing or new firms cannot easily adopt the McKinsey system in its entirety, and adopting isolated elements likely would not work – an ownership plan that transfers shares at book value would produce excessive free riding unless it were balanced by tough individual accountability. Even at McKinsey, the imperative of growth (however controlled) will increasingly test the professionalism, solidarity, and willingness to make long-term investments for the good of the firm. A system that has stood the test of longevity may not ultimately attain the goal of "perpetuity."

At the same time, empirical studies of profitable, long-lived enterprises must necessarily include exceptions. In a market economy, a company like McKinsey has to be rare and its strategies difficult to imitate. Yet, reassuringly (at least to some!), the McKinsey case suggests that long-term success isn't like winning a lottery ticket: patient leadership, organizational skill, and a holistic approach matter. Effort invested in refining strategies and a vision can make a difference.

Finally, McKinsey's story highlights the challenge of building modern systems that combine pecuniary and non-pecuniary incentives, especially in fields that require difficult-to-alienate human capital. Professional standards used to play this role in medicine, the law, and other classical professions: high training and certification requirements restricted entry and provided attractive incomes; ethical standards and pride encouraged professionals to transcend their financial self-interest. Thus, doctors approaching retirement could be trusted to avoid opportunistic behavior even if this "investment" did not lead to a high "price" for the sale of their practice. Now, in the so-called knowledge-intensive age, we have to cope with a shift from solo-practice to firms as well as the lack of professional traditions. But, the McKinsey case shows, there is no simple model of incentives that can be used by the mainstream. And without such a paradigm it seems difficult to imagine how private investment on the scale that took place in the industrial revolution can be sustained in knowledge-based enterprises.

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