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The Budget (1922–2009)

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McKinsey institutionalized it.

Drucker overlooked it.

R.I.P. | **12**

The Budget (1922–2009)

DuPont created it, McKinsey institutionalized it, Drucker overlooked it. Now, the tale of the overdue death of an infamous control process.

BY JACK SWEENEY

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THE BUDGET IS DEAD. There is no doubt whatsoever about that. It is as dead as a doornail. This must be distinctly understood, or nothing wonderful can come of industry's 20th-century management model that seemingly grows more dysfunctional with every quarter.

We are of course referring to the corporate budget, not the personal budget or family budget or any other revered variety of that which generally refers to a planned list of revenues and expenses. And while some companies may find this obituary a bit premature, others will likely tell us that it's long overdue and that their budget has been dead these past 5 years. (One Swedish company claims that theirs died as far back as 1972.) Still, others may claim that we've been duped and have fallen victim to a persuasive activist lobby that stands to gain an inheritance from the budget's demise.

Nonetheless, we say that the budget is dead. At the ripe old age of 87, the budgetary concept took its last useful breath. Of course, there will be some who will argue with sound reason that the budget is much older, and, as you will read, we believe that there is some merit to this. However for the purposes of this article we would prefer to simply report: "Dead at 87" — a life that may have served all of management better had it been half as long.

In fact, accounting historians will likely someday remember the budget not only for what it brought to business, but also for how tightly it clung to it. This enduring grasp — a steely fingered clench — is something that few management concepts have ever achieved with such speed and reach. Thirty years after their inception, the dictums of budgetary control were being disseminated to every part of the world, reshaping organizations and tasking finance executives (or putting a bit in their mouths) for generations to come.

Just how strong budgeting's grasp remains on business might be better revealed by the number of companies that have recently reported a broad-based system failure in the area of corporate budgeting and control processes, and yet these companies have so far refused to part with their budgets. A recent survey conducted by *Business Finance* found that two out of three finance executives expected their 2009 budgets to be obsolete within the first 6 months of the year, while 28 percent of finance executives reported that their budgets were obsolete even before 2009 began. This widespread failure of budgetary controls, however, is only a subtext to a much larger management quandary.

THE LAST KEY TO DECENTRALIZATION

In the late 1950s, when management thinker Peter Drucker began writing about the shift from the command control organization (the organization of departments and divisions) to the information-based organization (the organization of knowledge specialists), the practices of budgetary control seem to have been altogether removed from his line of sight. Or at least his writings don't express much concern over how widely used budgetary practices and fixed-performance contracts could potentially undermine his vision of late 20th-century organizations.

So it was for many management thinkers, whose explorations seldom peered into the finance department and with only rare exception all but overlooked budgeting.

In his book *My Years with General Motors* (Doubleday & Company, Inc., 1963), General Motors chairman and CEO Alfred Sloan Jr. suggested that budgeting was designed not to centralize power, but to decentralize it. "It was on the financial side that the last necessary key to decentralization with coordinated control was found. That key, in principle, was the concept that if we had the means to review and judge the effectiveness of operations, we could safely leave the prosecution of these operations to those in charge of them," wrote Sloan, while reflecting on the accounting processes his company had adopted nearly 40 years earlier.

"If Sloanism was built on decentralization, it was controlled decentralization. Sloan created a powerful general office full of numbers men," wrote John Micklethwait and

Adrian Wooldridge in their book *The Company: A Short History of a Revolutionary Idea* (Modern Library Chronicles, 2003). Micklethwait and Wooldridge describe a ten-man executive committee headed by Sloan that handed down a centralized GM corporate strategy.

Jeremy Hope, an author of several management texts that explore alternatives to budgetary control, suggests that many management thinkers of the last century may not have fully appreciated the impact that budgetary control was having on organizations because most often they were not "finance people," and budgeting numbers may not have appeared relevant as management became more enamored with corporate culture. What's more, Hope points out that it took many years (perhaps 30) to convert budgeting from its original state into the barrage of fixed contracts and performance incentives that routinely corrupt the system. Today, traditional budgeting forces managers at all levels to commit to delivering specified outcomes, even though many variables underpinning those outcomes are beyond their control, Hope explains.

"If people are going to be recognized and rewarded based on meeting the budget, then it's very difficult to change anything else," explains Hope, who 10 years ago helped to establish the Beyond Budgeting Round Table, a not-for-profit collaborative that offers members shared research and a guiding framework designed to help companies abandon budgeting. (Steve Player, whose interviews appear regularly in *Business Finance*, is also a director with the BBRT.)

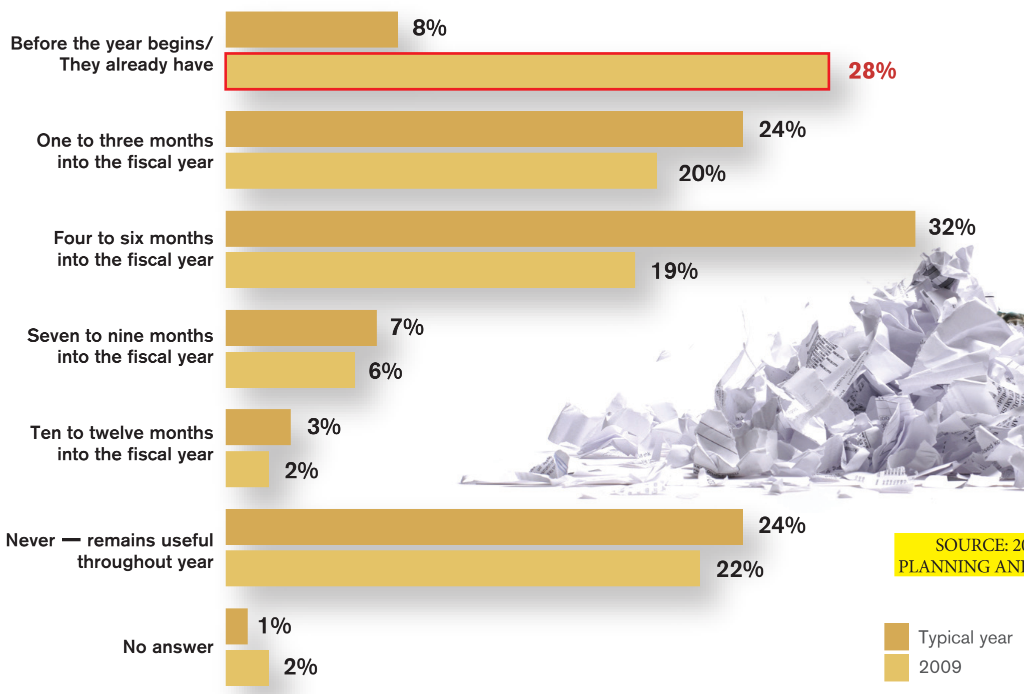
According to Hope, budgeting remains central to how nearly every large corporation is managed today. There is certainly a growing list of converts: Southwest Airlines, Toyota, American Express, Guardian. One company, Svenska Handelsbanken of Stockholm, Sweden, abandoned budgeting in the early 1970s. But all in all, the number of companies that have done away with budgeting remains relatively small.

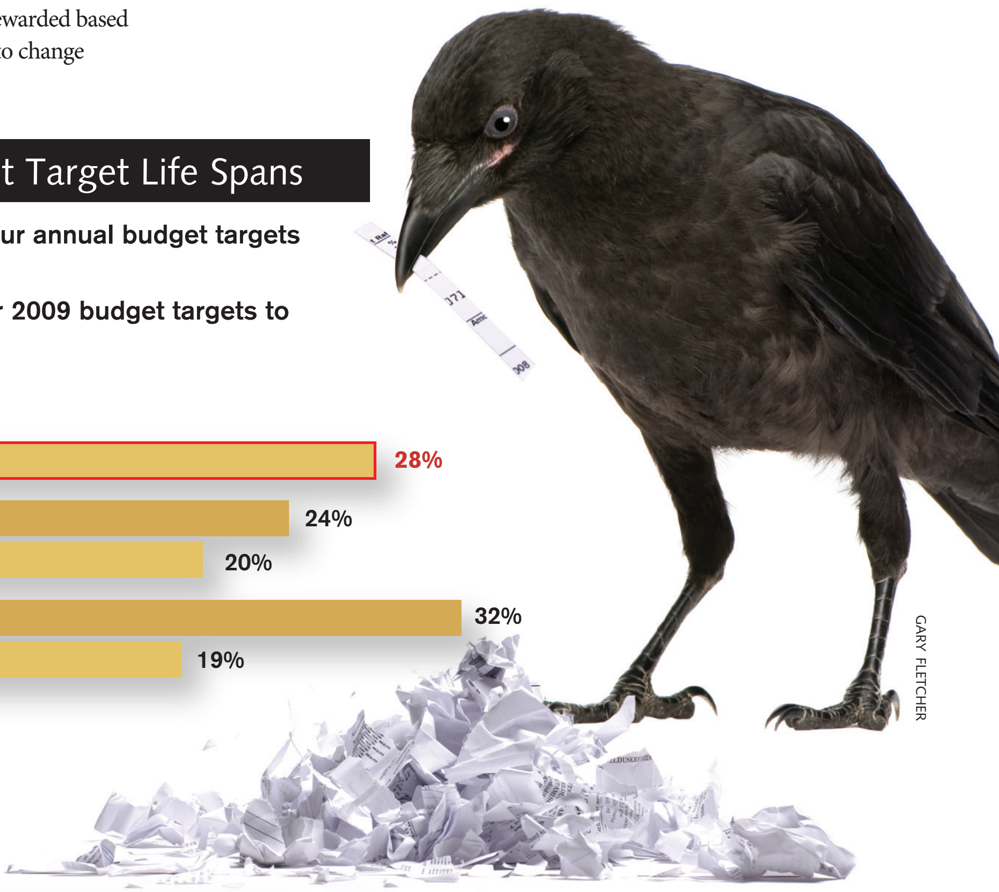
"We need to create organizations that are more agile, less bureaucratic, and lower-cost, with more accountability toward the front line rather than the corporate center. Budgeting just doesn't fit that organization. Budgeting is a constraining, controlling, and stifling system. It was never

DATA INSIGHT: Budget Target Life Spans

In a typical year, how soon do your annual budget targets become obsolete?

At what point do you expect your 2009 budget targets to become obsolete?





GARY FLETCHER

SOURCE: 2009 *BUSINESS FINANCE* RESEARCH STUDY: PLANNING AND FORECASTING IN TUMULTUOUS TIMES

THE BUDGET: From Whence It Came

Business and accounting historians have routinely traced the origins of modern budgeting to the 1920s, when companies such as DuPont, General Motors, ICI, and Siemens are all credited with having pioneered budgetary control. However, more than any one person, James O. McKinsey, an accounting professor at the University of Chicago and founder of McKinsey & Company, can arguably be credited with helping to institutionalize the processes of budgetary control.

Here's how McKinsey's impact on budgeting was recorded in the pages of history:

"The first general partner who joined Mr. Torbet and myself was James Oscar McKinsey, a Certified Public Accountant and member of the faculty of the University of Chicago, who became a junior partner in 1920. Mac had a strong bent toward budgets and management accounting. While in our New York office, he wrote a book on budgetary control, which pleased me because it followed outlines discussed in my seminar at the university in 1917 and 1918. The book was the first in its field and brought deserved recognition to Mr. McKinsey. ... McKinsey did valuable work in budget installations and left in 1927 to organize his own firm in management engineering — a firm that continues to be a leader in its field."

— *The First Forty Years: A History of Frazer & Torbet* by George Frazer

"Having grasped this unifying principle, he [McKinsey] had one intellectual advantage over the majority of his contemporaries in management who had been trained as engineers: His basic education in law and accountancy had taught him to look at a business as a whole. From this appreciation of every business as a unity, coupled with his practical experience as a management consultant, flowed his special contributions to management and thought and practice."

— *Golden Book of Management* (Neuman Neame Limited of London, 1956)

"James O. McKinsey was a faculty member of the School of Business from 1917 to 1935, except when he was a lecturer at Columbia in 1920–21. ... The modern era of management accounting dates from his book *Budgetary Control* (1922), which was the first attempt to put the concept of the budgetary control in useful terms."

— *The History of the School of Business of the University of Chicago* (1957)

> **"This book (Budgetary Control) was a major factor in shaping the firm's approach to problem-solving and in developing our early clientele. It was then the first definitive text on budgetary control, which was then in its early stages as a control technique. … Mac simplified the concept orally in this way: 'A budget is a statement of policy, expressed in terms of future accounts delegated to units of an organization.' This concept is the origin of our top-management approach."**
>
> — *Perspective on McKinsey* (McKinsey & Company, 1979) by Marvin Bower (McKinsey's modern founder)

> **"Contrary to most accounts, James McKinsey was an innovator not because of his particular skills in cost accounting, extensive as they were, but because he institutionalized his professional practices."**
>
> — *The World's Newest Profession* (Cambridge University Press, 2006)

designed to enable the front lines. It operates from the center," says Hope, who in passing adds that the Internet is today perhaps the greatest threat to traditional budgetary control, as it forces companies to finally rethink how they plan, hire, and motivate people.

When discussing the impact of the Internet on organizations, acclaimed management thinker Gary Hamel likes to use the analogy of muskets being introduced into late 17th-century warfare. Hamel points out that 17th-century battle formations were designed very deep and square — a configuration best suited for archers. "Eventually, these formations changed in size and scope to better reflect the capabilities of muskets. But it took 100 years for this to happen. Why? Because a couple of generations of generals had to die off before planners were able to use this new weapon in a productive way," Hamel recently commented.

To date, there have been three generations of executives that grew up in an age of budgetary control. The latest generation, or Internet generation, will be the last.

THE ORIGINS OF BUDGETARY CONTROL

When accounting historians seek to identify the origins of budgetary control, DuPont & Company and General Motors are frequently mentioned in the same sentence. While both companies can be counted among accounting innovators, it was the shared history between the two companies that has elevated their stature within the pages of accounting and budgeting history.

In 1921, shortly after Du Pont acquired 23 percent of GM's stock, Pierre S. Du Pont became president of GM and subsequently began staffing the company's finance department with DuPont's finance veterans. In the aforementioned *My Years with General Motors,* Alfred Sloan Jr. explained how most "specific forms of financial controls" were introduced by a finance executive by the name of Donaldson Brown, who arrived at GM from DuPont at the beginning of 1921.

Sloan writes of an incident in 1924 when he was taken to task by the company's finance committee for the overproduction of automobiles inside a certain number of GM's divisions. GM's response, according to Sloan, was to roll out an entire portfolio of pioneering financial controls, including a sophisticated forecasting system, flexible budgets to evaluate performance, and a stock-based incentive plan based on divisional performance. Brown would become the company's chief financial officer and later succeed Sloan as GM chairman. Said Sloan: "I cannot, or course, say for sure how much of my thought on management came from contacts with my associates. Ideas, I imagine, are seldom, if ever, wholly original. … I had not been much of a book reader."

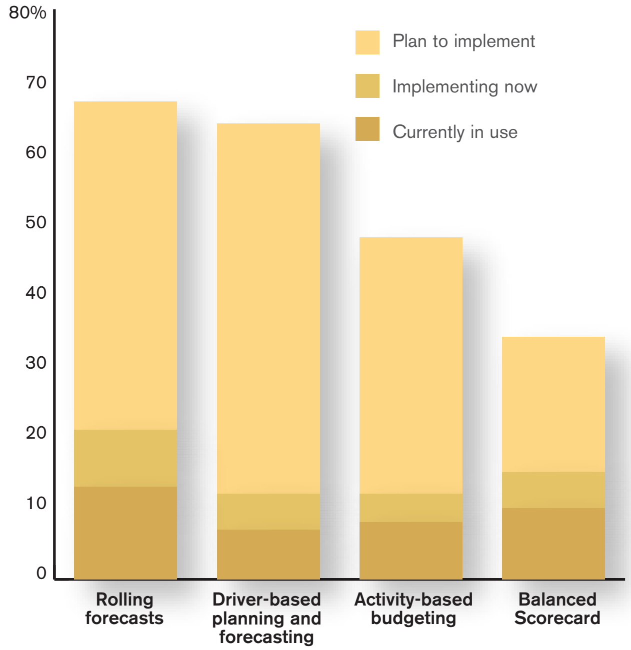
Perhaps GM's chief financial officer enjoyed books more than Sloan. If so, there was one book published shortly after his arrival at GM that would likely have resonated with the financially minded Brown.

James O. McKinsey was an assistant professor at the University of Chicago when he decided to take a stab at becoming the first academic to approach the subject of budgetary control as a whole, rather than zeroing in on particular aspects of budgeting and planning procedures. His book *Budgetary Control* (The Ronald Press Company, 1922) has been credited by business historians as being the first printed source that linked market forecasting, the feedback loop of plan, and outturn in an organic whole. It focused attention upon the importance of budgeting as major instrument of management.

"If effective control is to be exercised over current operations, it is necessary to plan these operations and to set up standards of performance for the separate units of the organization. This results in the preparation of departmental and subdepartmental budgets. … Budgets serve not only

DATA INSIGHT: Budgeting Techniques

Which of the following budgeting and forecasting techniques does your organization use?



SOURCE: 2009 *BUSINESS FINANCE* RESEARCH STUDY: PLANNING AND FORECASTING IN TUMULTUOUS TIMES

as standards by which to control current operations; they also serve as a means of coordinating the activities of several departments," McKinsey's book explained.

Yet McKinsey appears to have understood that the procedures he carefully detailed were far from perfect. In the preface to *Budgetary Control*, he characterized the book this way: "It is to be regarded as an effort to state clearly the problems involved, rather than to offer full solutions." What's more, he explains, "constructive criticism will be gladly received." It seems that McKinsey was intent on outfitting the budgeting procedures he evangelized with a warning label — a small insurance policy, perhaps, that might someday safeguard his text if and when such procedures fell out of favor.

More than 60 years later, professors H. Thomas Johnson and Robert S. Kaplan, in their business classic *Relevance Lost: The Rise and Fall of Management Accounting* (Harvard Business School Press, 1987), made no mention of James McKinsey or his books, but they did mention a moment in time that is significant to budgeting as well as to McKinsey's legacy.

They wrote: "By 1925, virtually all management accounting practices used today had been developed: cost accounts for labor, material, and overhead; budgets for cash, income, and capital; flexible budgets; sales forecasts; standard costs; variance analysis; performance measures. … At that point, the pace of innovation seemed to stop. Perhaps there was little incentive to continue to develop innovative management accounting procedures, since the corporate organizational forms developed by companies such as DuPont and General Motors proved to be the model for many corporations for the next half-century."

Christopher McKenna, University Lecturer in Strategy at the SAID Business School, University of Oxford, suggests that the "stagnation" of innovation in cost accounting was due in part to an alluring new professional incentive that began channeling resources elsewhere. "With a better understanding of consulting's true genealogy, we can see that cost accountants did not cease their investigations. They simply shifted their professional jurisdiction from monitoring costs as accountants to lowering costs as consultants," McKenna wrote in the *The World's Newest Profession: Management Consulting in the Twentieth Century* (Cambridge University Press, 2005).

BUDGETING: CONSULTING'S MEAT AND POTATO OFFERINGS

For his part, James McKinsey in 1926 would establish his own firm known as James O. McKinsey & Company (later just McKinsey & Company). In the latter half of the 20th century, as McKinsey & Company opened offices around the world, it became internationally recognized as management consulting's most elite firm.

Among McKinsey's early recruits was an attorney named Marvin Bower, who would eventually lead the firm for 17 years and become heralded as McKinsey & Company's modern founder. In his privately published *Perspective on McKinsey* (McKinsey & Company, 1979), Bower recalled how McKinsey — "Mac" — retained the firm's first client.

"In 1926, two other noteworthy events occurred: Mac achieved the rank of professor of business policies at the University of Chicago; the finance committee of Armour and Company, one of the country's largest meatpackers, decided that the company should establish budgetary control, and it authorized then-treasurer William P. Hemphill, who had read *Budgetary Control*, to retain Mac as a consultant. … So Armour became James O. McKinsey & Company's first client," Bower wrote.

Within the pages of *Perspective*, Bower frequently revealed his fondness for his one-time mentor, while at the same time underscoring how McKinsey's thinking around budgetary control helped to shape the firm's approach with its clients for years to come.

Bower wrote: "Mac simplified the concept orally in this way: 'A budget is a statement of policy, expressed in terms of future accounts delegated to units of an organization.' This concept is the origin of our top-management approach."

While professors Johnson and Kaplan tell us that the accounting and budgeting approaches at DuPont and General Motors became "the model for many corporations for the next 50 years," their text reveals little about how such a vast transfer of knowledge was able to occur. Somehow, the maxim "Build a better mouse trap and the world will beat a path to your door" didn't seem to apply when it came to complex accounting procedures — especially when Alfred Sloan Jr. was guarding the door. The point is important, because the size and scale of the challenge management today faces when it comes to uprooting budgetary controls can best be revealed by understanding how the origins of budgetary control were uniquely timed to become the "meat and potato" offerings of a young and hungry management consulting industry.

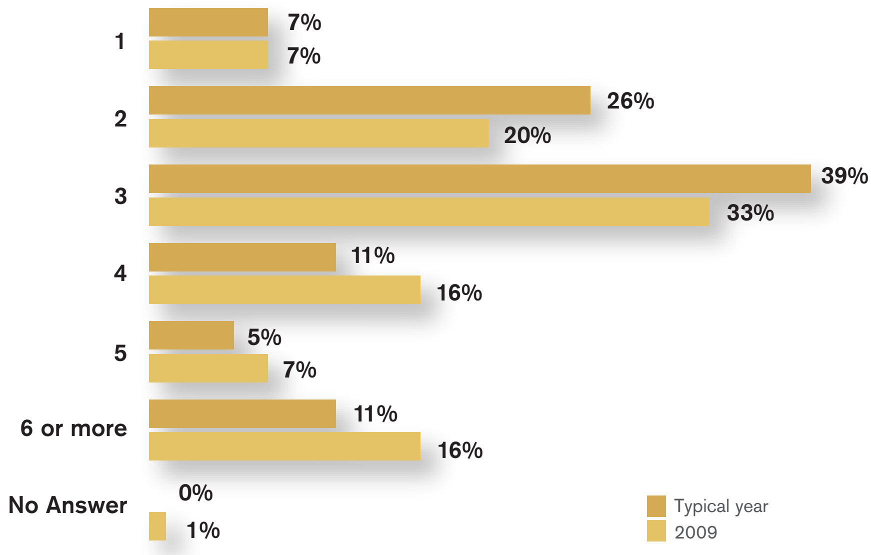
"Contrary to most accounts, James McKinsey was an innovator not because of his particular skills in cost accounting, extensive as they were, but because he institutionalized his professional practices," wrote McKenna. McKinsey was not alone. Booz Allen, Stevenson, Jordan and Harrison, George Fry, and many other early consulting firms systematized the process of conducting client surveys and deploying budgetary controls.

Just as the dissemination of budgeting control practices was in part fueled by the rise of management consulting in the 1920s, the adoption of budgeting practices in the 1930s would rapidly grow as New Deal legislation such as the Glass-Steagall Act forced commercial banks to give up internal management consulting, leaving it to the consulting firms, McKenna's book points out. "And when, in the 1950s, consulting firms expanded overseas, they disseminated these particularly American solutions for corporate governance among their international clients," wrote McKenna.

DATA INSIGHT: Budget Iterations

In a typical year, how many budget versions (iterations) are produced during the cycle before final approval?

How many versions (iterations) were produced before the final 2009 budget was approved?



SOURCE: 2009 *BUSINESS FINANCE* RESEARCH STUDY: PLANNING AND FORECASTING IN TUMULTUOUS TIMES

WALLANDER RETURNS THE LAST KEY

On April 29 of this year, Svenska Handelsbanken AB (Handels Bank) of Stockholm, Sweden, did something that few other banks worldwide can boast of doing within the first quarter of 2009. It posted a better-than-expected net profit — a 21 percent jump. Not bad, considering that more U.S. banks failed within the first 4 months of 2009 than in all of 2008.

Just how the Nordic bank managed to snare a profit without a government loan or handout, and meanwhile steer clear of mounting loan losses, is something banking analysts have lately been trying to explain.

"The way they are organized is very different from other banks — it's very decentralized, and they don't have a centralized committee like you find in other banks. The branches have a lot of operational freedom, but at the same time they are responsible for losses," says Fridtjof Berents, an analyst with Arctic Securities, who is quick to add that Handelsbanken was also the only Swedish bank to survive the Nordic banking crisis of the early 1990s without a handout from the government.

As Berents's comments reveal, Handelsbanken's recent profit is drawing renewed attention to its management philosophy — one that it likes to refer to as "radical decentralization," a management model designed to make organizations more agile by eliminating bureaucracy and pushing accountability out toward the company's front line.

Based on organizational thinking you might quickly attribute to Peter Drucker, the Handelsbenken's model parts with most 20th-century management thinkers, however, when it comes to the role that finance plays in decentralization.

Back in 1972, Handelsbanken CEO Jan Wallander ordered the bank's finance department to stop producing an annual budget — a practice he viewed as a wasting of time and one that he believed helped to stifle the bank's front lines. In fact, he's reported to have frequently referred to budgeting as an "unnecessary evil."

Nearly 50 years after Alfred Sloan claimed to have found the last key to decentralization, Wallander was handing it back. Budgeting, as far as Wallander was concerned, was dead. BF