PAGES MISSING WITHIN THE BOOK ONLY

(467TO502)

UNIVERSAL
LIBRARY

OU_160019

UNIVERSAL
LIBRARY

OSMANIA UNIVERSITY LIBRARY

Call No. 658 | T66 B Accession No. G. 16139

Author Towne, H. A., and others.

Title Business principles, organizatio. and management. 1958

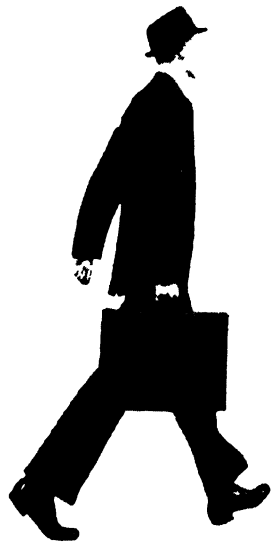
This book should be returned on or before the date last marked below.

The Authors

HERBERT A. TONNE *is a recognized authority in the field of business education. He is the author of several books and hundreds of articles in this field. In addition he has been the editor for many years of professional journals in business education, as well as an officer of many professional organizations. Dr. Tonne is Professor of Business Education at New York University.*

SIDNEY I. SIMON *is Associate Professor of Economics at Rutgers University. In addition to his Ph.D. degree from New York University, he also holds a J.D. degree and is a member of the Bar of the State of New York. He has taught courses in economics, business law, and accounting and has written numerous articles on accounting. He is co-author of two books on economics and insurance.*

ESBY C. McGILL *is Assistant to President and Director of Academic Affairs, Southern Oregon College, Ashland, Oregon. In addition to college teaching experience, Dr. McGill has also taught in elementary and high school. He has had practical business experience in retailing. He is the author of many articles in professional journals as well as of several books in the field of business education.*



BUSINESS PRINCIPLES, ORGANIZATION, and MANAGEMENT

HERBERT A. TONNE, Ph.D.
SIDNEY I. SIMON, Ph.D.
ESBY C. McGILL, Ed.D.

GREGG PUBLISHING DIVISION
McGraw-Hill Book Company, Inc.
New York · Chicago · San Francisco · Dallas · Toronto · London

BUSINESS PRINCIPLES, ORGANIZATION, AND MANAGEMENT

Copyright, © 1958, by McGraw-Hill Book Company, Inc. All rights reserved. This book, or parts thereof, may not be reproduced in any form without permission of the publishers. Nov., 1960–KP–3

Library of Congress Catalog No. 57–10230

64956

PUBLISHED BY GREGG PUBLISHING DIVISION
McGraw-Hill Book Company, Inc.
Printed in the United States of America

PREFACE

Business Principles, Organization, and Management was written in answer to requests from teachers for a "principles" book that is functional as well as factual. Why not, they said, start off the book with a young person who is going into business for himself; then, follow him along, step by step through the "growing pains" and expansion of his business—encountering all the problems a man starting in business is most likely to face—until at the end of the book he has become a successful executive in a large company?

This is the book—a book written to fill the needs of the modern classroom.

A Functional Book

Fred Kennedy, a young man who is working for a retail hardware store, wants very much to have his own business. He considers several types of business, the location, promoting, and financing of a new business, the various forms of business organization, and all other decisions to be made in a new business. Fred finally goes into the retail hardware business, where he faces the usual problems of buying merchandise and selling it at a profit, advertising and promoting the store, hiring and training employees, keeping financial records, and so on. Finally, his organization grows to such an extent that he decides to incorporate and to manufacture hardware products. Thus, it becomes a larger organization, facing those problems that are not unlike those faced by the modern corporation.

But this book is not really about Fred Kennedy and his associates. Fred Kennedy is used only as a "continuity thread" that ties business principles together and makes them come to life for the student. Sound business facts are presented throughout the book—facts that will apply to any business. Besides being a functional book, it is a complete book, a comprehensive book.

Organization

The organization of the book also is functional, inasmuch as topics are

covered in the sequence in which the events would probably happen in real life. The realistic setting allows for natural treatment and discussion, without special effort and contriving on the teacher's part.

Chapter Openings. Each of the twenty-seven chapters opens with a "Case Problem." This case concerns Fred Kennedy and his associates, posing questions that will be resolved as the student reads the chapter and discusses the content with the other members of the class. The "Case Problem" puts the student on his toes to the importance of the chapter's content, serving as a study guide in reading the chapter.

Contents. *Business Principles, Organization, and Management* provides the latest facts and figures, explores all aspects of business operation, and reflects the up-to-date trends in the policies and procedures of business management. But the authors know that it takes more than facts to make a successful businessman. The student needs to learn how to evaluate and apply those facts; consequently, the student is guided in the development of his own power of judgment. He is made aware that business is dynamic and that he must learn to be adaptable and to make his own rules and policies to meet new situations. The management problems that the student must meet and solve call for much more than "using the right facts in the right place." Any experienced manager will readily admit that business success also requires effectiveness in human relations, in order to lead and to work with people. Someone has said that "business is people"—and relations with people is a subject that is blended into every situation in the book.

End-of-Chapter Activities. The teacher will find an abundance of student activities at the end of each chapter. These activities are separated for convenience in making assignments:

For Review and Discussion. These questions are directly related to the text material. Some call for factual answers; others will provoke discussion in class.

Case-Problem Questions. These questions relate the content of the chapter to the familiar "story" of Fred Kennedy. Their purpose is to help the student apply his knowledge and understanding of the chapter material to a realistic situation—one with which he is intimately acquainted.

Applied Business Projects. These projects provide "doing" activities for the student, activities that often require planning, fact-finding, self-evaluation, and computation. They are designed, for the most part, to be completed on paper.

Community Projects. Many teachers feel that the student gets his most realistic experience by investigating local business services, practices,

conditions, and opportunities. These projects provide ample opportunity for experience in the student's own community.

Supplementary Activities. Special additional student activities are provided in the Supplementary Section at the end of the text. This material includes: (1) a glossary of business terms (Key Words), grouped according to the chapter in which they are used; and (2) a continuity case involving Bob Harlow, a young man who goes through a similar series of experiences as Fred Kennedy—but for a different type of business. These supplementary activities may be used for enrichment for the faster students or for regular end-of-chapter assignments for everyone.

Illustrations

The book contains numerous illustrations, such as photographs, graphs, tables, and summary charts. These illustrations are designed to *teach.* Accompanying many of the photographs and graphs are questions for the student to answer—questions that will cause him actually to study the illustration rather than simply "look at it."

Small Business vs. Large Business

This book cannot be called a book on small business. Nor can it be labeled a big-business text. It is neither—yet it is both. The authors believe that the basic principles of managing business are the same for any business, regardless of the type or size. Through the continuity provided by the Fred Kennedy story, the student receives experience in both small and large business, yet he does not get the impression that the principles of managing them are vastly different.

Acknowledgments

The authors are indebted to several people who read portions of the manuscript in its early stages and offered encouragement:

Enos C. Perry, Director of Business Education, Chicago Public Schools

Hunting Sherrill, Assistant in Business Education, New York State Department of Education, Albany

George DaVall, Supervisor of Business Education, Los Angeles Public Schools

William C. Gordon, Executive Vice-President, Bryant and Stratton Business Institute, Buffalo

To others—both teachers and students—who read the manuscript and gave helpful suggestions, the authors express deep appreciation.

CONTENTS

SECTION 1 • PRINCIPLES OF BUSINESS MANAGEMENT

1. Opportunities for Business in the American Economy 2
2. Single Proprietorship and Partnership 13
3. The Corporation 29
4. Principles of Management 46

SECTION 2 • MARKETING AND MERCHANDISING MANAGEMENT

5. Studying the Market 63
6. Channels of Distribution 78
7. Buying 94
8. Pricing 114
9. Selling 129
10. Promotion, Advertising, and Display 149
11. Delivery and Shipping 166

SECTION 3 • FINANCIAL MANAGEMENT

12. Financial Practices 183
13. Credit and Collection 206
14. Risks and Insurance 227

SECTION 4 • PRODUCTION MANAGEMENT

15. Production Planning 250
16. Factors of Production 263
17. Production Control 276

SECTION 5 • PERSONNEL AND HUMAN RELATIONS

18. Selecting and Hiring Employees 288
19. Employee Remuneration 304
20. Employer-Employee Relations 323
21. Management of the Office 339

SECTION 6 • INTERNAL FINANCIAL MANAGEMENT

22. Financial Accounting and the Determination of Profits 358
23. The Determination and Control of Costs 378
24. Budgets and Budgetary Control 393
25. Taxes and Their Impact on Business 408

SECTION 7 • BUSINESS MANAGEMENT AND THE GOVERNMENT

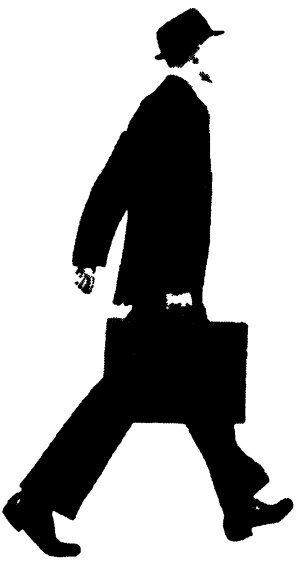
26. Regulation of Business 426
27. Planning a Career 451

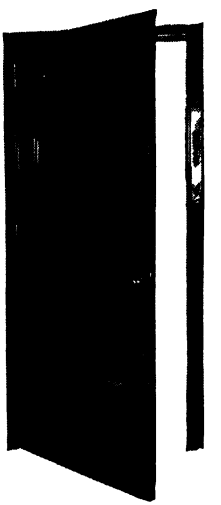
SUPPLEMENTARY ACTIVITIES 467

INDEX 496

Section One

Principles of Business Management







1

Opportunities for Business in the American Economy

CASE PROBLEM

Fred Kennedy, 29 years of age, has worked for the past ten years for various electrical-appliance and hardware firms in their service and sales departments.

Fred is thinking about giving up his job and going into business for himself in the electrical-appliances and hardware field. Naturally he is concerned with whether he can be sufficiently successful in his own business, so that it will be more profitable than continuing to work for others.

- What are the needs for small business in America? What are the opportunities?
- What are the points in favor of Fred's plan? What are the disadvantages?
- What type of business should he go into?
- What are the chances for success in his business, and what are some of the hazards to be avoided?

THE PLACE OF BUSINESS IN OUR ECONOMY

Most people are aware of the importance of business in the economic structure of our country, even though they may never have expressed themselves on the subject. *Business* exists to produce and distribute, for profit, the goods and services needed to satisfy human wants. Since human needs or desires are limitless and ever-expanding, there is always

an opportunity to form an enterprise to supply new goods or services. While the function of a business organization may be the production of goods and services to satisfy human needs, in our economic system the purpose of a business is to return a profit to its owners that will justify its existence. *Profit* is the amount by which the income of the business exceeds its expenses. The first problem in starting a business enterprise, then, is to choose a field that will satisfy enough people with its goods or services to bring in sufficient income to pay all expenses and leave a large enough profit to make the efforts of its owners worthwhile.

While the opportunity is always present, this requirement of making a profit as the basis for success and continued operation can make the formation and operation of a business enterprise, in our complicated society, a hazardous undertaking indeed. The enterpriser must choose merchandise or services to supply what the public wants and at a price the public is willing to pay. In doing so, he must generally compete with others who are attempting to supply the public with similar goods or services. In our present-day economy, he must operate usually in areas or industries that are dominated by large-scale enterprises, where each supplier is a specialist in his own field. Furthermore, he must conduct his business within the framework of government control and the ever-growing importance of consumer and employee opinion. What chance would Fred Kennedy, the young man in the case problem at the beginning of this chapter, have to organize and carry on, with his limited means and experience, a business of his own?

DETERMINING SIZE OF BUSINESS

Fred Kennedy would doubtless start a *small business.* This term usually means an enterprise with one or a few independent owners who actively manage its affairs; a local business whose owners, employees, and customers are mostly from the same general community; and a business whose finances have been supplied by the owners, either through their investment or borrowings. While small firms do only about 35 per cent of the dollar volume of the nation's business, nearly 85 per cent of all business enterprises are small ones. Accordingly, Fred still has the opportunity to start out small and make his business a success.

On the other hand, if Fred can obtain help from those with more capital and experience, he may be able to start on a larger scale. Such a venture would involve more help from others, a larger and more complicated form of organization, and greater risk. To balance these difficulties, if the larger venture is successful, the profit may be much greater than could be earned in a smaller business.



Ewing Galloway

America's Main Street. What types of business does this typical Main Street in a typical American town suggest to you?

Even in a small business, the opportunity for growth is limitless. Most larger enterprises have grown from modest beginnings. What is more, it is possible for Fred to obtain sufficient funds and start right off with a larger enterprise, if he has a really good idea for a service that the public will want and cannot get from other sources.

Nowhere but in America is there so much opportunity for a person with energy, enthusiasm, ability, and character to start his own business and make a success of it. In the American economic picture, there is "always room for one more"; equally pertinent, however, is the quotation that there is only "survival of the fittest"!

Owner of a Business—to Be or Not to Be? Having come to the conclusion that there is a place in the American economy for new business ventures, Fred Kennedy must now decide whether he wants to own his own business or continue as an employee. While the phrase "being your own boss" at first glance seems wonderful, it has many drawbacks that one should consider before deciding to stop working for someone else. Being an employee, with a good job with a substantial firm, also

has its advantages, most of which account for the disadvantages of owning your own business.

ADVANTAGES OF EMPLOYMENT

Perhaps the greatest advantage of being an employee with a good job in a good firm is that of *regular income.* The salaried employee gets his pay check every week or month, knows exactly what the amount will be, and can thus plan his standard of living accordingly. Even the hourly production worker knows his own speed of output and can estimate fairly closely what his income will be. But, more important, he at least knows there will be a check waiting for him at the end of the week. With the application of the guaranteed annual wage plans and governmental unemployment insurance, even the fear of lay-offs is no longer a major worry for many production workers.

The income of the owner of a small business, on the other hand, is dependent on the fluctuating sales and expenses of his business. It is the fortunate small-business enterpriser indeed who can accurately forecast what his income from period to period will be, when his income often depends so much on weather conditions, special sales by competitors, strikes in the industries of his suppliers, and many other emergencies and unusual events that arise. In fact, the income of a small enterpriser, particularly one not too successful, may be lower than the salary he could be making as an employee doing similar work.

Another advantage of regular employment with a good firm is that of the many fringe benefits, from the employer and the government, that go today with such jobs. Vacations with pay, sick leave, pensions, medical care, and other special services are commonplace for employees of substantial companies. The small-business owner enjoys no such benefits. To him, sickness is a calamity; vacations mean either closing the shop and having no business during that period, or just no vacation. Instead of receiving a pension, the aging enterpriser often finds his income from his business dropping off as his old age makes him less active. Consequently the value of his venture also drops, so that he cannot even sell it for a good price.

The employee has the advantage of regular working hours and overtime pay if he works more than those regular hours. The owner of a small business often works long hours, sometimes seven days a week, because he cannot afford help yet needs to keep the store open as long as possible so as not to lose any business. There is no overtime pay for him for such irregular hours.

An employee of a large firm often has tremendous opportunity for ad-

Advantages of Working for Others	Advantages of the Self-Employed Enterpriser
1. Regular income	1. Greater opportunity for financial gain
2. Fringe benefits	2. Freedom from fear of losing job
3. Regular working hours	3. Is his own boss
4. Opportunity for advancement	4. Personal dignity and prestige
5. Freedom from final responsibility	5. Opportunity for full use of his own ingenuity

vancement to better positions in the company, or even to a bigger job in another firm. The expansion of even a mildly successful business is often limited, however, by the owner's inability to raise sufficient capital or to delegate some of his supervisory work to others.

Finally, the employee enjoys a measure of freedom from responsibility. While every employee has duties for which he is responsible—some have very great responsibilities—it is a very different type of responsibility from that which burdens "the boss." The employee always has someone higher in the chain of command to whom he can look for decision, or at least for direction. The owner has no one to turn to; he must make all decisions himself. The employee never has the responsibility of meeting a payroll or of paying bills, no matter how bad business is. The employee generally can leave the cares of his job at the office when he goes home at night; few business owners can leave their worries behind.

Of course, most of these advantages of employment have contrasted a good job with a rather unsuccessful business. Conversely, many of the advantages of business ownership are good points only when comparing a healthy business with an unattractive job. In the comparison of a good job with an equally good business, or a poor job with a poor business, the advantages on either side may not be great. Like many things in life, the advantages and disadvantages are matters of degree, which must be weighed carefully against each other before Fred Kennedy of our case problem, or anyone else, can decide which course to take. Let us see what the arguments would be in favor of his giving up his job and striking out on his own.

ADVANTAGES OF THE BUSINESS ENTERPRISER

Perhaps the greatest advantage of owning one's own business is that of financial gain. If the business is successful, its profits all go to its owner, so that Fred Kennedy's earnings, rather than being limited to the amount of his salary, might be considerably greater than that. The

harder he works and the more successful his business becomes, the greater the return for him will be. This would not necessarily be true were he working as a salaried employee.

Another advantage of the business enterpriser is that of freedom from the fear of losing his job. The employee, no matter how well he is doing his work, can never be completely sure of retaining his job. Change in business conditions, administrative policy, or just change in the personnel of top management, sometimes may cause even the best employees to be let go, often with little notice. The employee may work hard for a higher position, only to see the promotion go to someone else. Although it is true of course that owning one's own business is risky, and the enterpriser often has to give up his enterprise because it failed to come up to expectations, the owner of a reasonably successful business has a sense of security never attained by the employee.

In addition to the possible financial incentives of operating his own business, the enterpriser may satisfy several important personal objectives, one of the most important of which is the pleasure that comes from being his own boss. It is a great satisfaction to many to be responsible only to oneself; not having to take orders or criticism from anyone. The enterpriser does not have to answer to anyone for what he does or fails to do. For some people this independence, alone, is often the main reason for striking out on their own.

Running one's own business often gives the enterpriser a sense of per-

TO BE OR NOT TO BE

To Work for Others	To Own Your Own Business
1. Regular pay check	1. Chance for great financial gain
2. Fringe benefits	2. No fear of losing job
3. Regular hours and paid overtime	3. Pleasure of being own boss
4. Advancement opportunities	4. Personal dignity and prestige
5. Freedom from responsibility	5. Reward for own ingenuity
BUT	**BUT**
1. Effort may not lead to more income or advancement	1. Risk of low income or failure of business
2. Ever-present risk of being discharged	2. No pensions, few vacations, etc.
3. Must take orders from others	3. Long working hours with no overtime pay
4. May never have chance to use, or get credit for, good ideas	4. All the worries that come with responsibility

sonal dignity and even prestige in the community not attained by any but the very highest ranks of employees. The successful merchant, for instance, is often on a slightly higher rung on the social ladder of the community than the salesman or other type of employee making a similar income. Even if he is not, he has a sense of pride that "whatever I have, I made myself," of which the employee cannot boast.

Lastly, the enterpriser has limitless opportunities for reward for his own ingenuity. If he is clever, skillful, and industrious, the chances for the growth and expansion of his business are limitless; and he reaps all the benefits of his ability. The employee, although he has chances to get ahead on the job, may nevertheless be somewhat hampered. His good ideas may be ignored or turned down by less imaginative supervisors. His ideas might be used without his receiving credit for them; or, even worse, he might see his idea used and his supervisor reap all the credit and gain for the bright thoughts of the employee.

Kinds of Businesses. If, after weighing the various advantages and disadvantages of being an enterpriser, Fred Kennedy still decides to go into his own business, he should next consider the various kinds of businesses and decide which would be best for him. Basically, there are five major types of commercial or industrial enterprises: (1) those that produce goods; (2) those that render services; (3) those that distribute goods; (4) those that render distribution assistance; and (5) those that render financial assistance.

In the modern American economy, many industries require such tremendous plants and organizations that they have become basically large-scale affairs; it is almost impossible for a small business to open and flourish in those fields. These include such areas as the heavy industries like automobiles, road and farm machinery, and the like; the extractive

Kinds of Business

Production	Service	Distribution	Marketing	Finance
Manufacturing for consumption Manufacturing for further production Mining Farming	Transportation truck rail air mail Utilities light heat power Communication	Retail Wholesale Importing Exporting	Advertising Warehousing Delivery	Banks Credit Investment Insurance

industries, like metals and oils; transportation and communications; the various utilities; and most financial fields. Areas in which the small business still has a good chance for success, despite keen competition from encroaching large-scale organizations, are personal and household services, retail and wholesale distribution, agriculture, and lighter forms of manufacturing.

To succeed, the prospective enterpriser must of course pick a field that is not too overcrowded, in which he has some training and experience and which will give him a chance for expansion. Many of our largest firms started as small ones. If a person has some new or unusual ideas for rendering a service or producing goods that the public will want, or doing so in a region where the goods at present are unobtainable, or producing the goods at a lower price than the present one—then he has the best prospects for success. Thus, Fred Kennedy would do best in the hardware and appliance field or in some type of such service with which he is familiar. He should try to think of a novel way of producing or distributing these items, or of a new location, or of an economic means of their production or distribution, so that he will offer something the public wants. The old adage, "Build a better mousetrap and the world will beat a path to your door," still applies.

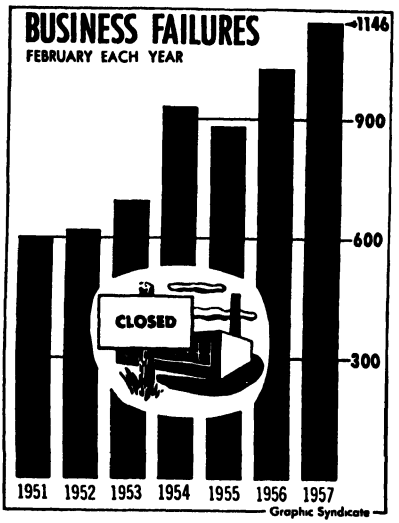
CHANCES FOR SUCCESS

Although everyone has an opportunity for success, and many new enterprises have indeed made the grade, the chances for the success of a new business are alarmingly slim. About one-seventh of all business organizations in the United States close their doors for good each year (but about a similar number of new ones open yearly). Over one-third of all new businesses fail or give up within their first year of operation, 15 per cent more die in their second year of operation, and about another 9 per cent close in their third year. Thus more than half of all new business enterprises in this country do not last for three years of operation! What is the cause of this staggering death rate?

CAUSES FOR FAILURE

The United States Department of Commerce made a study during the great depression of the 1930's in an effort to determine these causes. They discovered that the failures were not generally caused by the depression or by excessive competition, as the unsuccessful enterprisers had thought. Rather, the failures were due to poor management, such as keeping inadequate records, bad merchandise and inventory practices, and too loose credit and collection methods.

When a ship founders in a storm, the hurricane may have been the



Some Businesses Fail. About how many businesses failed in February of 1952? 1955? 1956? How many failed in 1957?

occasion that brought on the sinking, but the loss was actually caused by improper loading or overloading of cargo, improper ballasting, or faulty construction of the vessel. Other ships, properly built and loaded, survived the storm. The poor business conditions during the depression brought about the failures covered in the study, but the cause of these failures was bad management. Well-organized and carefully run enterprises survived the depression and overcame competition.

Questions to Ask Yourself in Determining Whether to Go into Business for Yourself

1. Can I get along with people and inspire confidence?
2. Am I willing to shoulder the responsibility of meeting a payroll and paying debts on time?
3. Do I like the business I expect to enter, so that I am willing to make personal sacrifices?
4. Do I understand that business is a speculation, and am I willing to take the risk involved?
5. Do I like to sell?
6. Can I make decisions and weather wrong ones?
7. Am I resourceful in emergencies?
8. Do I have the financial resources to overcome the probable losses of the early period of business?
9. Am I willing to work harder and for longer hours?
10. Am I a good organizer?

Because poor management is the prime reason for business failure, it is important for Fred Kennedy, and every other future businessman, to understand the principles and practices of good business management. Questions* that the prospective enterpriser should ask himself are given on page 10. They are all of consequence, but the last question is the most important of all, "Am I a good organizer?" The knowledge and application of proper business organization and management are not only essential to the successful operation of any business but represent a valuable tool toward advancement in the hands of every business employee or enterpriser.

► FOR REVIEW AND DISCUSSION

1. What is the purpose of business?
2. What is profit?
3. Why is competition a factor in starting a new business?
4. What proportion of all business is classed as small business? What per cent of the total dollar volume do these small businesses represent?
5. What are the advantages of working for others?
6. What are fringe benefits? Do employers have fringe benefits?
7. "An advantage of self-employment is that there is no fear of losing your job." Is that true?
8. Is the employee ever rewarded for ingenuity in his business activity?
9. What are the five major types of business?
10. What are the questions every prospective enterpriser should ask himself before he goes into business?
11. List some of the common causes of business failure. Are the causes the same for all types of business? What conditions caused businesses that you have known to fail?
12. Tell whether or not you expect to be in business for yourself. If not, should you still study the management of business? Why or why not?

► CASE-PROBLEM QUESTIONS

1. Do you think Fred Kennedy should give up his job to go into business for himself? Why?
2. What is the first problem Fred must consider in selecting a field in which to start a business?
3. Will Fred have to give consideration to government control? Give an example.

* Adapted from the pamphlet, "Starting Your Own Small Business in New York State," *Small Business Series 1*, N.Y. State Dept. of Commerce.

4. Under what conditions may Fred be able to start business on a larger scale?
5. Why might Fred want to be his own boss?
6. How certain is Fred to have greater financial gain if he goes into business for himself?
7. How can Fred increase his chances of success above the usual?
8. What questions should Fred ask himself and others about his personality before he undertakes a business enterprise?

► APPLIED BUSINESS PROJECTS

1. Fold a full page of paper (8½ x 11) down the middle. On the left side list the reasons favorable to owning your own business and on the right side those unfavorable.
2. In order to succeed in business, certain personal attributes are essential. List in one column those personal characteristics which you think are desirable for success in business. In another column list those characteristics which you think will interfere with success in business.

► COMMUNITY PROJECT

Assume that you have decided to start your own business in your town. You are very much concerned about what type of business you should enter. Check the classified section (yellow pages) of the telephone book, and list the number of firms in at least ten types of business such as: electrical supplies, hardware, restaurants, automobile accessories, plumbing supplies, laundromats, do-it-yourself shops, garages, garden supplies and equipment, fruits and vegetables.

As a committee project decide whether there are enough or too many businesses in each field. If possible, actually look over each business and check on the service either directly or by inquiry among customers. Decide whether there is room for a new enterprise in each business and report your opinion to the class. Is there sufficient service in total? not enough quality service? too much quality and not enough price line service?

SUPPLEMENTARY ACTIVITIES

At the end of this book you will find additional learning activities, including a glossary of business terms, called "Key Words," grouped according to the chapter in which they appear; and a second case study, involving Robert Harlow, whose experiences in getting started and prospering in the floor-covering business parallel somewhat those of Fred Kennedy.



2

Single Proprietorship and Partnership

CASE PROBLEM

Fred Kennedy, after much thought, considers an idea that he thinks might develop into a successful business. He has noticed that in New York City and other big cities there are many people who live in apartment hotels and rooming houses, who must eat all their meals in restaurants because their living quarters have no kitchen facilities. He has seen the success of many "do-it-yourself" stores in those areas —laundries, woodworking shops, and so on. Why not open "Cook-O-Mats"; that is, stores with stoves and cooking equipment where customers could bring their own raw foods and cook them themselves for an hourly charge for using the equipment, for seasoning and other ingredients, and for some advice from an expert cook.

An older friend, R. K. Ames, is a man of some means and has expressed an interest in participating in a business, either by lending Fred some money or by actually investing in the business himself. However, he is not at all assured that the Cook-O-Mat is one that will succeed.

Fred also knows a man who lives in the neighborhood, Ray Grebs, who has had retail hardware experience and who has indicated that he might be willing to work in the store or possibly go into business with Fred.

► Should Fred go into this venture by himself, borrowing money from Mr. Ames, or should he and Mr. Ames become partners?

- Should Fred hire Ray Grebs as an employee in the store, or should he go into partnership with him?
- Might it be advisable for Kennedy to go into business with both Ames and Grebs as co-partners?
- What factors should Kennedy consider before deciding on the form of organization he will use?

CHOOSING THE FORM OF BUSINESS ORGANIZATION

When a person has decided to go into business for himself, one of the first problems he must settle is the form of business organization that will be best suited for his purposes. Generally speaking, there are three major forms that a business can take: (1) the sole proprietorship; (2) the partnership; or (3) the corporation. The choice of one of these three forms of organization makes a big difference in the future management of the business, its financing, and the rights and liabilities of its owner or owners, whether the firm is large or small. In this chapter, the sole-proprietorship and partnership forms of organization will be discussed.

THE SOLE PROPRIETORSHIP

The simplest form of organization is the business that has only one owner, known as the *sole proprietorship* (sometimes called *single* or *individual* proprietorship). The proprietor of such a business takes all the risks, reaps all the profits, and makes all the decisions. He has to answer to himself and satisfy no one but himself; but, at the same time, he has no one with whom to share his problems. They are his alone.

If Fred Kennedy were to set up a business, for instance a hardware store, as a sole proprietorship, he might then borrow some money from Mr. Ames and perhaps hire Ray Grebs as an employee in the store. This means, of course, that if the store is successful, he would do very well, as he needs only to pay the loan plus interest and the agreed wages to Grebs. He would share the profits of the store with no one. Should the store do poorly, however, Mr. Ames is still entitled to receive his money plus interest; and Grebs, his wages; and there would be no one to share the burden of any losses with Fred.

Thus, it can be seen that a sole proprietorship has advantages and disadvantages as a form of business organization.

Advantages of the Sole Proprietorship. The sole proprietorship satisfies, perhaps best of all forms of business organization, the major incentives for a person to go into business for himself. It enables him to keep all profit from the business for himself and requires him to answer to no one but himself. All decisions made in the business are made by him

Advantages of a Sole Proprietorship

1.	Easy to organize	No "red tape" or complicated legal problems; little cost.
2.	Freedom of action	Not necessary to consult others in order to reach a decision.
3.	Profits not shared	Owner keeps all profits for himself.
4.	Low taxes	Taxes are not levied against the form of ownership itself.
5.	Personal pride of ownership	Owner has more incentive to work and gets more satisfaction from his work.

alone. While he may delegate some lesser decisions to employees working for him, these employees are responsible to him and can be replaced if their decisions do not satisfy him.

But the single proprietorship has other advantages, too. It is the simplest form of organization to set up. Aside from the possibility of having to obtain a license (for certain types of businesses such as a restaurant or barber shop), or of filing a certificate with the county or city authorities if the business is to be known by a trade name, such as "The Acme Hardware Store," no formalities are involved in starting a sole proprietorship. There are no complicated legal papers to be drawn up and lived up to. The proprietor simply begins his operations.

Furthermore, because it is a one-man business, the individual proprietorship has the advantage of close personal contact between the owner and his customers and between himself and his employees. He generally gets to know most of his customers personally and of course is well-acquainted with all his employees. And, if he is a likable, efficient person, this will be a stimulating factor to his business.

The very fact that the owner makes all decisions also means that such decisions can be made quickly where an emergency arises. If a chance comes to sign a favorable lease or to make a good, quick purchase or sale, he does not have to delay and possibly lose the opportunity while he attempts to get agreement from others.

The sole proprietorship, in some cases, also can have tax advantages over the corporation. For example, the proprietorship is not taxed as a form of organization as is the corporation. Before an individual makes a final decision as to the form of organization his business will take, he should be sure to discuss the problem of income tax and other taxes on himself and his business with competent tax authorities.

Disadvantages of the Sole Proprietorship. Just as it has a number of advantages, the one-man form of business organization has several dis-

advantages, some of them directly related to the very considerations that were listed among its advantages.

Thus, while it is an advantage that the proprietor need answer to no one and can quickly make all decisions himself, in some cases this very fact may be a disadvantage when it is realized that it limits the size of the business and also affects the decisions the proprietor would make. There are few people indeed who are gifted sufficiently to run, single-handed, a business of any great size. Not only are there too many problems coming up for one person to handle, but they are very often quite complex. Few people, furthermore, are good at everything—the Jack-of-all-trades usually being master of none—yet the sole proprietor must be a master of all the functions of his business. He may be a good salesman, or good at making shrewd purchases, or have a keen financial mind; but the truly successful individual proprietor must be good at all phases of his business, an all-round ability that few possess.

It was mentioned as an advantage of this type of organization that the proprietor receives all profits of his business and need share them with no one. In the Case Problem at the beginning of the chapter, it was pointed out that Fred Kennedy would need only to pay Mr. Ames the amount of the loan, plus interest, and give Mr. Grebs his wages—then Kennedy could keep all profits for himself. This may appear to be an advantage when speaking of profits. But what about losses? In the sole proprietorship form of organization, Fred Kennedy would have no one to help share any losses the business might have. No matter how poorly the business does, the expenses and obligations of the business must be paid.

What is even more serious, however, is that the sole proprietor's liability is unlimited. No matter how much the investment in the business may be, the proprietor is fully liable for all its debts. Suppose he has invested $5,000 in the business and, because it is an unsuccessful venture, Kennedy is forced to close it owing $9,000 to creditors. He would not only lose the $5,000 he put into it; but the creditors may seize his personal property, such as his automobile or jewelry, toward the payment of what is due them.

The fact that it is a one-man business will limit it in still other ways. If the business is successful and the proprietor wants additional money to expand it—or if he needs money just to keep it going—the amount of capital he can obtain in either case is limited by the extent of his personal credit. It would probably be considerably easier to secure additional funds if the business were not a one-man enterprise.

Then there is the problem of what is to become of the business in case the proprietor becomes ill or dies. Since the business depends entirely

Disadvantages of a Sole Proprietorship

1.	**Risk of loss**	**Owner stands alone in the risk of losing money; may also lose his personal goods if business debts cannot be paid.**
2.	**Limitation of size**	**Capital needs for expansion usually are beyond individual's ability to borrow.**
3.	**Problems of management**	**Owner cannot be a specialist in all fields of business operation; must be Jack-of-all-trades.**
4.	**Uncertain future**	**If the proprietor dies or is otherwise unable to continue, the business may have to be terminated.**

on him, his death or disability possibly also means the end of his business, even though it might have been a flourishing one.

THE PARTNERSHIP

Having weighed the advantages and disadvantages of going into the retail hardware business for himself, Fred Kennedy should next consider the good and bad points of forming a partnership with Mr. Ames or with Mr. Grebs, or with both of them. A *partnership* is an association of two or more persons to carry on, as co-owners, a business for profit and to share the profits or losses of the enterprise. It has several advantages over other forms of organization; it also has certain disadvantages.

Advantages of the Partnership. Since a partnership combines the brains, talents, and specialized abilities of more than one man, it is likely to be better run than the sole proprietorship. The individual owner of a business usually cannot be an expert in all functions of manufacturing, selling, buying, financing, and office work. In a partnership, however, it is possible for each partner to be a specialist in one particular field. For example, one partner could do the buying for the store; a second partner could take care of the displays and do most of the selling; a third partner could handle the records and accounts; each doing that for which he is best fitted. Furthermore, when important decisions must be made, all partners consider and discuss the matter together—each contributing his own judgment and experience—instead of leaving the decision to only one man.

If a partnership should need more money, it would be easier to obtain because the amount that can be raised is now based on the credit standing of all partners rather than limited to only one person's credit standing.

While the partnership form still allows the advantage of personal relations with customers and employees, it has the added advantage that the

Advantages of a Partnership

1. More capital available	Additional owners increase possibility of obtaining more money for expansion.
2. Better management	Combination of skills and ideas lead to better operating procedures. "Two heads are better than one."
3. More interest in the business	Each partner will have much keener interest in the success of the business than if he were only an employee.
4. Simple organization	Compared with the corporation, the partnership is relatively easy and inexpensive to organize—few state regulations.
5. Low taxes	Just as in the sole proprietorship, a partnership has tax advantages over a corporation. The form of ownership itself is not taxed as is a corporation.

partners, because they are financially involved in the firm, will normally take a much keener interest in their work than if they were employees. Should the firm train and develop an employee over the years who becomes essential to the organization, he can be rewarded by also being taken into the partnership.

Disadvantages of the Partnership. The partnership has a number of distinct disadvantages that make it in some ways a rather precarious form of organization. Many businessmen form partnerships without really understanding this form of organization or foreseeing all the difficulties that may lie ahead.

For one thing, the life of a partnership is very uncertain. Death, serious illness, insanity, bankruptcy, or even withdrawal of a partner, mean an end of the partnership no matter how successful the enterprise may have been. While the other partners may be able to buy out the share of the partner who is being eliminated, or even carry insurance on the partner's life for this purpose, very often they cannot raise the necessary funds to pay off his share; and dissolution of the firm is the only answer.

Each of the partners has an equal say in the running of the business. If the partners get along well, they may submit to the majority rule; but should any partner at any time refuse to go along with the others on a decision, he can withdraw and bring the partnership to an end. Even though the partners may have decided at the start that one will handle the buying, a second concentrate on the selling, and a third on the office

Disadvantages of a Partnership

1. Risk of dissolution	If a partner withdraws or is unable to continue because of illness or death, the partnership ends.
2. Possibility of disagreement	Partners may not agree on how the business should be run, causing friction, drawn-out decisions, and general inefficiency.
3. Unlimited liability	Each partner is individually liable for all debts of the firm. Each partner is "at the mercy" of the others in their individual activities that affect the business.
4. Limited in size	Limited in growth by the fact that it is owned by a few and the consequent difficulty of obtaining capital for expansion.
5. General agency	One partner's acts can bind all the others.

and records, they may later disagree so violently with a decision the first partner may have made with reference to buying policy that no other alternative remains but splitting up the firm.

Since each partner is a co-owner of the firm, he has the right to make contracts in the normal running of the business that will bind all partners. Thus, even though one partner is assigned to do all buying, another partner could buy a big supply of hardware, without the knowledge or consent of the other partners, and bind the other partners to the contract. Of course, one partner could not bind the partnership to a contract to buy something completely foreign to its line of business. For example, Kennedy could not be bound if Ames or Grebs bought a stock of ladies' dresses; but so long as one partner buys or sells something normal to the hardware business, the whole partnership is bound to the contract. Thus, it can be seen how important it is to know all partners well and to have implicit faith in them, because an act of one partner can cause the other partners considerable trouble.

LIABILITY OF PARTNERS

This leads to what is doubtless the most serious disadvantage of the partnership. Each partner is individually fully liable for all debts of the firm. This means not only that, like a sole proprietorship, a partner's own personal property can be seized by creditors to pay the debts of the firm, but that any one partner can be called upon to pay all debts of the firm himself. This is known as *unlimited liability* of the partners. Suppose, for example, the hardware business is unsuccessful and closes its

doors owing $18,000. Suppose also that the creditors can raise only $6,000 on the sale of the firm's property or assets. The creditors can then proceed against any or all of the partners personally to obtain the remaining $12,000. Since Mr. Ames is a man of means, he could be forced to pay the entire remaining $12,000 out of his own personal funds. While he would then have a right to insist that Kennedy and Grebs each give him his share of this loss, Ames would have to suffer the entire loss himself, if they have nothing to give. This can be seen to be a most serious weakness in the partnership form of organization—each partner is at the "mercy" of the other. But this is not all.

The growth of the partnership is limited by the fact that it is owned by just a few men. This not only makes management expansion difficult, but also limits the amount of funds obtainable to the amount the partners themselves can raise. Compared with the fund-raising possibilities of a corporation (discussed in the next chapter), this limitation can be quite restrictive. A partnership can, of course, raise funds by taking in more partners; but that only increases the number of partners that must agree, increases the number of persons who can bind the others in contracts, and makes the life of the enterprise even less secure.

A difficulty also arises if a partner wishes to sell his interest in the business. Not only must he find a buyer willing to purchase his share of the firm, but the other partners must unanimously agree to take him into what will now be a new partnership, in place of the retiring partner. If they do not agree, dissolution of the firm is again the only answer. Even if the buyer is accepted as a new partner, the retiring partner must take careful steps to assure that all creditors know he has left the firm, so that he cannot be held for future debts of the partnership.

ARTICLES OF PARTNERSHIP

The agreement between the parties in a partnership should be in writing. A written agreement, while not absolutely necessary, prevents misunderstandings about the responsibilities of the partners and "spells out" the operating procedures of the firm. The agreement, called *articles of partnership* or *co-partnership,* is usually made in a sufficient number of copies, so that each partner may have a copy; and a copy may be available for deposit in a safe place. It is not required that the agreement be placed on public record, though the parties are legally bound by the agreement when it is signed.

SHARING OF PROFITS AND LOSSES

Many problems arise in a partnership with regard to the sharing of profits or losses and the amounts partners may withdraw from profits.

ARTICLES OF COPARTNERSHIP

Date

Identity of Partners

This agreement made and entered into this tenth day of September, 19--, between Frederick R. Kennedy, New Rochelle, Westchester County, New York; Robert K. Ames, Rye, Westchester County, New York; and Raymond Grebs, Mount Vernon, Westchester County, New York.

Nature of Business

Name and Location

One. The above-named parties agree to form a copartnership for the purpose of engaging in and conducting a retail hardware and electrical-appliance business under the firm name of Kennedy & Co., at 336 Stetson Street, Mount Vernon, Westchester County, New York.

Duration of Partnership

Two. The partnership shall begin on the date that this agreement is executed and shall continue for a term of ten years thereafter.

Investments of Partners

Three. Each partner shall contribute to the capital of the partnership the sum of ten thousand ($10,000) dollars cash. These contributions shall be without interest.

Sharing of Profits and Losses

Four. All profits resulting from the business shall be divided equally between the partners, and all losses incurred by the business shall be borne equally by them.

Accounts of Business

Five. Proper books of account shall be kept of all transactions relating to the business of the partnership, and such books shall always be open to the inspection of the partners. At the end of each calendar year, a full inventory shall be prepared; a statement of the business made; the books closed; and the account of each partner credited or debited, as the case may be, with his proportionate share of the net profits or the net loss. A statement of the business may be made at such other time as the partners agree upon.

Partners' Drawings

Six. Each partner may draw from the business, for his own use, a sum not to exceed $100 a week, to be withdrawn at such times as he may choose. No partner is to withdraw an amount in excess of this weekly figure without the written consent of the other partners. At the end of each calendar year, the balance in each partner's drawing account will be closed out and charged to his capital account.

Duties of Partners

Seven. During the continuance of this partnership, each partner agrees to devote his entire time and attention to the business and to engage in no other business enterprise without the written consent of the others.

Restraints on Partners

Eight. No partner shall, without the written consent of the others, become surety or bondsman for anyone.

Termination of Partnership

Nine. At the termination of this partnership, a full inventory and balance sheet shall be prepared; the debts of the business shall be discharged; and all property then remaining shall be divided among the partners in the ratio of the capital invested at the time of dissolution.

IN WITNESS WHEREOF, the parties have hereunto set their hands and seals the day and year first above written.

Frederick R. Kennedy (seal)

Robert K. Ames (seal)

Raymond Grebs (seal)

A Partnership Agreement. (1) When does the partnership begin? end? (2) How much money is each partner to invest? (3) How are profits to be divided?

All these difficulties can be settled in advance by a carefully worded partnership agreement; but it is very hard to anticipate all the complex situations that may arise in this connection and to cover them in the articles of partnership.

The law provides that, where no other definite provision is made, partners share all profits and losses equally. But the partners may agree in advance to another method of sharing profits. For instance, Fred Kennedy might agree with his partners that he will receive 50 per cent of all profits and bear 50 per cent of any losses; that Ames and Grebs might each receive 25 per cent of the profits and assume 25 per cent of the loss. Such an arrangement might come about because Kennedy thought up the idea of the hardware store and actually set it up, or because he is to give more time to the enterprise, or because he has more experience in the hardware business, or because he has a greater clientele.

Sometimes, when all partners contribute the same amount of time but one has invested considerably more money than the others, it might be agreed to give the partners interest on their investment out of the profits before dividing the balance according to an agreed ratio. Thus, since Fred Kennedy has invested $5,000; Mr. Ames, $20,000; and Grebs, $2,000, they might perhaps have agreed to pay interest at 6 per cent on the investments out of the profits and then share the balance equally. A profit for the year of $4,500 would then be divided in this manner:

	Share for Kennedy	*Share for Ames*	*Share for Grebs*	TOTAL
Interest at 6 per cent on investment	$ 300	$1,200	$ 120	$1,620
Remainder shared equally	960	960	960	2,880
Distribution of profit	$1,260	$2,160	$1,080	$4,500

Occasionally, when the partners have contributed comparatively equal amounts, but some give more time to the business than others or have more experience, a share of the profits, if any, is first given to one or more of the partners as salary. The balance is then shared according to an agreed ratio. This salary, however, though recognized as such by the partners is legally classified as profit.

ALLOCATING PROFITS

Suppose that Kennedy, Ames, and Grebs have invested like amounts. Since Kennedy and Grebs are working full-time at the store while Ames comes in only occasionally, it is decided to pay Kennedy a salary of

$3,000; Grebs, a salary of $2,400; and Ames, a salary of $1,000, and to share any balance of the profits equally. A profit for the year of $8,500 would then be divided in this manner:

	Share for Kennedy	*Share for Ames*	*Share for Grebs*	TOTAL
Salaries	$3,000	$1,000	$2,400	$6,400
Remainder shared equally	700	700	700	2,100
Distribution of profit	$3,700	$1,700	$3,100	$8,500

It is important to note that the interest and salaries mentioned are actually only methods of sharing profits. They are not typical expenses of the business, such as interest to the bank and salaries for employees. The law says a partner can take from a partnership as income only his share of the profits, and these sharing plans are devised only for distributing the profits in what the partners consider a fair manner.

It is interesting to note how partners, under these arrangements, would share a loss. The interest or salary is first credited to each partner, which means that an even greater deficit must be shared in the equal profit and loss ratio. Thus, under the interest-on-investment plan mentioned, a loss for the year of $4,500 would be divided among the three partners in this manner:

	Share for Kennedy	*Share for Ames*	*Share for Grebs*	TOTAL
Interest at 6 per cent on investment	$ 300	$1,200	$ 120	$1,620
Deficit shared equally	*2,040*	*2,040*	*2,040*	*6,120*
Distribution of loss	$1,740	$ 840	$1,920	$4,500

It can be seen that under this arrangement the partner with the biggest investment receives the greatest share of the profit—yet he suffers the smallest share of any losses. This would not be true if the partners shared profits and losses at the rate of 50 per cent, 25 per cent, and 25 per cent. Under such an arrangement, the first would receive $2,250 of a $4,500 profit and suffer $2,250 of a $4,500 loss. But under the salary arrangement mentioned, the man who receives the least profit is the one who suffers the greatest loss. For example, under the aforementioned salary arrangement let us assume a loss for the year of $8,300. The loss would be distributed as follows:

	Share for Kennedy	*Share for Ames*	*Share for Grebs*	TOTAL
Salaries	$3,000	$1,000	$2,400	$6,400
Deficit shared equally	*4,900*	*4,900*	*4,900*	*14,700*
Distribution of loss	$1,900	$3,900	$2,500	$8,300

It is therefore most important that an understanding be reached as to the sharing of profits and losses before any agreement is signed, as it will otherwise be a source of dissatisfaction and possibly even dissolution of the firm later on.

THE USE OF DRAWING ACCOUNTS IN TAKING PROFITS

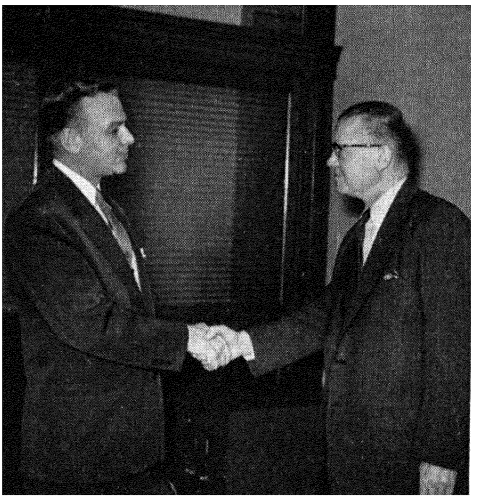
Another possible source of future trouble is the drawing account. Here, too, the partnership agreement must be most carefully drawn to avoid difficulties among the partners. By law, a partner's only income from his business is his share of the profits; but profits will not be ascertained until the business has been in operation for some time, usually a year at least. In the meantime, the partners will need money for their own personal expenses. It is usual for partners to draw weekly or monthly against their future profits, and such drawings must be agreed upon. The problem comes up as to what to do with the discrepancy between the total annual drawings and a partner's share of profits.

Let us suppose, for example, the partners agreed to withdraw $65 a week each, an annual total of $3,380 per partner; and that Kennedy's share of the profits comes to $3,700. What is to be done with the $320 difference? Is Kennedy to be permitted to draw the $320 at once in a lump sum? Is he to leave it in the firm, so that his investment will be $320 more? Or should he be permitted to draw an extra $6 a week more next year because of this amount that is due him? Suppose, again, that Kennedy drew $65 a week for a year ($3,380 in all), and his share of the profit is only $3,000. Is he now expected to return $380 to the firm? Is his investment in the firm to be reduced by $380? Or should he draw approximately $7 less per week all next year to make up for this deficit?

These situations are introduced to indicate the importance of settling these matters in advance—preferably through the articles of partnership.

SPECIAL TYPES OF PARTNERS

It sometimes happens that a person invests money in a partnership but does not wish to take an active part in the running of the firm. For example, Mr. Ames is a retired businessman; and, while he is willing to invest money in the business, he might not wish to become actively engaged



A Partnership Is Formed. Some partnership agreements are verbal only. This is not advisable, of course; but in many instances written evidence was not necessary.

in running it. He is then considered a *silent partner;* as such, he has no voice in the management of the firm but does share in its profits and assumes the usual partner's liability for the losses of the firm. His name may or may not appear in the firm name, in accordance with the wishes of the partners. Of course, the partners may decide among themselves in advance that Ames's share of the profits and losses may be less, because of his inactive association, in accordance with one of the previously mentioned methods of sharing profits.

If Ames wishes to invest in the business and share in the profits, but wants his liability limited only to the amount of his investment and thus not have to worry about firm creditors seeking to satisfy their claims out of his own personal assets, he may do so by becoming a *limited partner.* A limited partnership is allowed in most states, provided there is at least one general partner in the firm who has unlimited liability for the debts of the firm. The firm must file a certificate of limited partnership in the local office of public records stating who are the general and who are the limited partners. The limited partner may take no part whatever in the management of the firm, and his name must not appear in the name of the firm unless he is specifically designated therein as a limited partner. Because the limited partner has no say in the running of the firm, this form of business organization is not very popular.

OPERATING UNDER A TRADE NAME

Both individual proprietorships and partnerships may do business under an adopted business name, such as "The Coolidge Corner Hardware

Shop" or "Corner Bakery," provided they file a trade-name certificate at the local office of public records. This certificate lists the name or names and the addresses of the individual or partners operating under such a trade name.

In most states, a business cannot be called "and Company" unless there is a partner whose name does not appear in the firm name. In the case of the Kennedy firm, it may use the names "Kennedy & Company" or "Kennedy, Grebs, & Company." It may not use "Kennedy, Ames, Grebs & Company" because there is no one in the firm to be the "company" in the latter case. A partnership cannot use the term, "Inc.," "Corp.," or any other name indicating a corporation, unless the business is incorporated.

SUMMARY

If Kennedy should decide to be a sole proprietor and go into business for himself, he might borrow the money from Mr. Ames and hire Mr. Grebs as an employee. He would keep all profits and make all the basic decisions himself. He would suffer all losses and have no one to share the burdens of management with him; and his business would be limited to what capital he personally could raise.

With Ames and Grebs as partners, Kennedy could share the burdens of management with them, each doing what he is best fitted to do. The three probably could raise more capital than they could individually, so that the firm would have more chance for growth. On the other hand, the partnership could be broken up very easily; each partner would have unlimited liability for all claims against the firm; one partner's acts could bind all other partners; and a partnership agreement would have to be very carefully drawn if later difficulties are to be avoided.

Before making a final decision as to what form of organization the business should take, Kennedy should of course consider the corporation, which will be discussed in the next chapter. Because tax advantages, a complex problem, may be the deciding factor in choosing a form of organization, the lawyer and accountant should be consulted in making the decision.

► FOR REVIEW AND DISCUSSION

1. What are the major forms of business organization?
2. What are the advantages of a sole proprietorship? What are the disadvantages?
3. What is meant by the term "unlimited liability"?

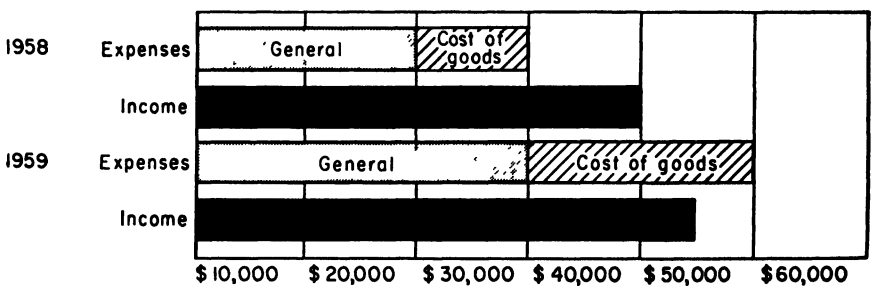
4. What are the advantages of limited liability?
5. Why is the partnership the less frequently used form of business organization as compared with the single proprietorship?
6. What are the advantages of a partnership? What are the disadvantages?
7. What are some of the things that should be covered in a partnership agreement?
8. How are losses shared, if there is no indication in the articles of copartnership explaining the method of sharing?
9. What alternate systems of profit sharing and loss sharing can be set up for a partnership?
10. What is the usual number of partners? Why?
11. What are the various types of partners other than general partner?
12. May a partnership operate under a trade name? If it may, what are the conditions under which the trade name may be used?

► CASE-PROBLEM QUESTIONS

1. Present all the evidence you can as to why Kennedy should undertake a single proprietorship.
2. Get together all the facts that would justify Kennedy and his associates in setting up a partnership.
3. What personal characteristics are of value in a partnership?
4. What system of profit sharing and loss sharing would you recommend for Kennedy and his partners? Why?
5. Should Kennedy consider allowing either of his two partners to become special types of partners? If so, why?
6. Do you think Kennedy and his associates should operate under a trade name? Why?
7. If there is a profit of $2,500, show how it would be distributed to Ames, Grebs, and Kennedy if they share profits equally; if they share profits on a capital-invested ratio and the partners have capital balances as follows: Ames, $12,500; Grebs, $10,000; Kennedy, $17,500. If there is a loss of $2,500, do you think it should be distributed in the same manner as profits?

► APPLIED BUSINESS PROJECT

Mr. Tarpin has the following income and expenses in 1958 and 1959.



Although Mr. Tarpin's income increased in 1959, his expenses increased much more rapidly and were larger than his income. Explain how this could have happened.

a. Why may his general expenses have gone up?
b. Why may merchandise costs have gone up?
c. Why may income have gone up?
d. Did income go up sufficiently?
e. What miscalculations may Mr. Tarpin have made?
f. What will happen if this trend continues?
g. What additional reasons may have caused expenses to go up? (Example —an accident, a theft.)
h. What could Mr. Tarpin do about such costs?
i. May income go higher in 1966?
j. Why?
k. Why not?

Answer each question in a brief sentence.

► COMMUNITY PROJECT

As committee projects (three persons serving on each committee), visit different partnerships in the community for the purpose of finding out about the points that are covered by the partnership agreements. After the visits have been made, each committee may select a representative to participate in a panel discussion to report findings to the class. The report should cover the following items:

1. Points of agreement covered in the partnership contract
2. Points omitted in the contracts that the partners now wish had been included



3

The Corporation

CASE PROBLEM

As was indicated in the first chapter Fred Kennedy has worked for several years as an employee in a retail hardware store. In addition to his dream about a chain of "Cook-O-Mat" stores, he has long considered opening a hardware store of his own. Sometime before Fred Kennedy got the idea of the "Cook-O-Mat," he had talked with some friends about opening a hardware store. Fred Kennedy has saved some money over the years, but not enough to finance a store of any size.

In his consideration of the hardware store, he would like to go into it as a co-owner with Mr. Ames and Mr. Grebs (mentioned in the case problem at the beginning of Chapter 2), but does not favor forming a partnership because of its unlimited liability, uncertain life, and because the acts of any partner can bind all the others.

In his consideration of the Cook-O-Mat chain, he is not only concerned with all the difficulties mentioned in the preceding paragraph, but also realizes that such a large-scale venture would need much more money than he or his friends could invest or borrow.

- What kind of business organization can the three men form that will give them most of the advantages of the partnership and yet eliminate most of its disadvantages?
- Would such a business form have disadvantages of its own, and what might they be?
- What kind of business organization could Fred Kennedy form that would be useful for a large-scale enterprise requiring a great deal of money invested in it?
- How would Fred go about the actual formation of these organizations?

OVERCOMING THE DISADVANTAGES OF THE PARTNERSHIP

It was seen in Chapter 2 that both the individual proprietorship and partnership forms of business organization have certain great disadvantages. These drawbacks plagued businessmen about two centuries ago and retarded business progress for many years. The size of the proprietorship and partnership was limited by the amount of money that could be raised by the owners by personal investment or borrowing. Both forms of organization, furthermore, had a very uncertain existence, being terminated by death, bankruptcy, or even just disagreement among its owners. More serious yet was the fact that the acts of one partner could bind all the others, whether or not they agreed to it; and one partner could be held personally liable for all the debts of the firm, no matter how little he had invested in it. Businessmen struggled to find a way, so that many people could invest in a venture without incurring the disadvantages of the proprietorship and partnership—such as the continued existence of the venture depending on the lives of the partners or owners, their solvency, and their ability to agree. Businessmen sought a form of organization where an investor was liable for no more than the amount he invested; where only the management, and not any owner, could bind the enterprise in contracts; and where an owner's share in the business could be easily transferred to someone else.

JOINT STOCK COMPANY

The idea of a joint stock company has been used extensively in England to meet this problem. The joint stock company arose out of a partnership. This type of company has gradually become more and more complicated in its structure. Shares are sold to the public when desirable, and only elected officers can bind the company to contract. The British West India Company and many others that aided in the colonization of the United States in the seventeenth and eighteenth centuries were joint stock companies. The joint stock company has never been very successful as a form of business enterprise in the United States. It is, however, the basis for the present limited-liability company, which is the characteristic large business form of organization used in Great Britain.

HISTORY OF INCORPORATION

Fortunately, when the expansion of the United States started right after the founding of the Republic under the Constitution, the American businessman did have a type of organization which served him very well. The British kings had provided for the incorporation of various cities

along the Atlantic seaboard. For example, the City of New York, Boston, Philadelphia, and two or three other cities were given special duties and privileges, as it was felt that the provincial legislators and royal governors did not know the detailed requirements of these cities sufficiently. These cities, therefore, were given rights by acts or grants of incorporation; that is, they legally were created as corporate bodies that could function as an individual. They were given the right to tax, to provide for a constabulary (police force), to pave streets, and the like.

In addition several colleges such as Harvard, Yale, King's College (now Columbia University), and William and Mary College in Virginia were given corporate rights. In order to set up a college, it was felt necessary to limit the liability of those who served as trustees. It was also felt necessary to give these colleges the right to borrow money, to spend it, and to charge fees. These college and city corporations were based on the forms of corporation used for municipalities in England for many years.

When in the early days of the United States it was found necessary to establish banks, build canals, road companies, and the like, they were set up as special private corporations. At first each of these corporations was set up by special acts of the state legislature or by the United States Congress. As business grew in the United States, the incorporation of new businesses became so frequent that state legislatures found it necessary to set up general laws to handle incorporations. Now, by following the forms required by the state governments or national government, a group of people may set up a corporation to undertake any form of legitimate business enterprise, provided they follow the specific requirements of the state laws.

RIGHTS OF A CORPORATION

A *corporation* is an organization formed for a definite purpose, under authority obtained from the state, and is treated at law as an artificial person, separate and apart from its owners. Thus it can own property, make contracts, borrow money, sue and be sued, all in its own name, without involving its unlimited number of owners in any more liability than the money they have invested in it. It has an indefinite life, not dependent on the continued existence or solvency of its owners. Its owners buy shares of stock, which are evidenced by stock certificates. These shares may be sold and transferred without the consent of the fellow owners—the other stockholders. Furthermore, only its duly elected officers have the ability to bind the corporation to contracts. Thus, a corporation overcomes all the disadvantages of the proprietorship and partnership. Although, as will be seen, it has a few disadvantages of its own,

these have not been enough to prevent the corporation from becoming the outstanding business form, which has permitted the tremendous expansion of business to its present colossal size.

Corporations are useful for nonprofit groups like charitable, fraternal, and social organizations, as well as for those formed to conduct a business for profit. The American Red Cross, The Daughters of the American Revolution, and school fraternities are examples. Although not a legal distinction, for they are both corporations in the eyes of the law, corporations may be classified from a practical standpoint into close and public corporations.

TYPES OF CORPORATIONS

The *close* or *family-type corporation* is one having few owners, whose stock is not normally open to general sale to the public. Its stockholders are all relatives, friends, or business associates who, but for its disadvantages, would use the partnership form of business. While this organization is a corporation in a legal sense, its owners conduct the enterprise much as they might a partnership.

The *public* corporation is one whose stock is for sale to the public on a large scale and thus has many owners or stockholders, nearly all of whom take no active part in its operations and have very little to say in its management. It is this type of organization that has made large-scale industry possible and has seen the growth of such gigantic corporations as The American Telephone and Telegraph Company, General Motors Corporation, Standard Oil Company of New Jersey, and others, which number their stockholders in the hundreds of thousands and even the millions.

OWNERSHIP AND MANAGEMENT

The *stockholders* are the owners of the corporation, the total ownership, or capital, of the corporation being represented by a designated number of shares of stock. The stockholders vote for the members of the board of directors, just as citizens of our country vote for legislators; however, instead of each person having only one vote, each stockholder has a vote for each share of stock he owns.

The *board of directors* may have any number of members but must have at least three; it makes the policies and broad decisions involved in the management of the corporation, somewhat as does the Congress in the United States Government. The board of directors in turn elects the officers, who carry out the policies of the board and actually conduct the day-to-day transactions of the business, somewhat as the President does for the United States.

TRANSFER OF STOCK OWNERSHIP

Shares of stock can be sold, bequeathed to heirs, or even given away, the new owner succeeding to all rights of the predecessor. The stockholder has no further liability for the debts or actions of the corporation after his stock has been paid for, as creditors can look only to the property of the corporation for payment of their claims. When the corporation has made a profit, the board of directors may, at their discretion, distribute as much of it as they feel the corporation can spare among the stockholders, in proportion to their stockholdings, retaining some in the corporation for future emergencies or expansion. This distribution of corporate earnings to the stockholders is known as declaring a *dividend.*

TYPES OF STOCK

Some corporations, especially large ones, have more than one class of stock, generally distinguishing between common and preferred stock. *Common stock,* the type that all corporations have, represents the final ownership of the company. Shareholders of common stock have the right to vote at stockholders' meetings, to elect directors, and to vote on a few other important matters involving important possible changes in the structure of the company. They receive in dividends as much of the corporation's earnings as the directors feel can be spared, no matter how much or how little this may be.



A Common Stock Certificate. How many shares of stock does this certificate represent?

Another class of stock issued by many corporations, both close and public, is *preferred stock.* Owners of this stock receive dividends at a fixed rate, if the directors feel they can be spared out of earnings, before any are given to the common stockholders. Thus they have first preference in dividends over the common stock. For this privilege, unlike the common stock, preferred stock is often limited as to the maximum dividends that can be declared for its stockholders in any one year; furthermore, its stockholders often do not have the right to vote at stockholders' meetings.

Par Value, Market Value, and Book Value. Stock certificates usually have printed on them a figure in dollars, known as the *par value.* This figure indicates the amount at which the firm was nominally financed; for example, if the corporation is capitalized at $10,000 and each share has a par value of $10, there will be one thousand shares. The founders of the corporation may have put that amount of cash into the corporation. However, they may also have put values such as real estate, merchandise, and the like into the corporation. The value of these properties cannot be decided exactly and may even be exaggerated by the founders of the corporation. Stock can be sold by a stockholder for any price; therefore par value is no indication whatever of actual value of the stock. In fact the term *par value* may even be deceptive to the unwary. For this reason some stocks are issued with *no par value* printed on them. This practice is now being discouraged by the need for a definite and formal value for taxation purposes.

The significant value of a stock is its *market value,* that value which buyers and sellers agree on as the selling price for the stock. This value may fluctuate from day to day, in accordance with changes in the supply of, and demand for, the stock. The market value cannot, of course, be printed on the certificate.

Book value indicates the value of the corporation according to the books of the corporation, kept according to standard accounting procedures. It also may be far from the actual value of the corporation. This is especially true if the actual appreciation or depreciation of fixed assets differ from the appreciation or depreciation as determined by accounting procedures. This topic will be treated in more detail in Chapter 22.

SEPARATION OF OWNERSHIP AND MANAGEMENT IN THE PUBLIC CORPORATION

A stockholder who finds it inconvenient to attend stockholders' meetings may authorize someone else to cast the votes on his stock for him at these meetings. This power of attorney is given by means of a simple paper known as a *proxy.* Because there are so many stockholders in a

large public corporation and because they are spread geographically all over the country, it is difficult for most of them to attend stockholders' meetings in person. By means of proxies, which directors obtain from stockholders, usually by enclosing proxy forms and stamped return-addressed envelopes right in with the notice of the stockholders' meeting, it is possible for the directors and officers to control a public corporation even though they themselves own very little stock. Of course, if the numerous small stockholders are dissatisfied with management, they can, and at times do, vote the old management out and replace it with directors more in agreement with their wishes.

FORMATION OF A CORPORATION

Corporations today are formed by the filing of a certificate of incorporation with a state government. This certificate must be signed by three or more persons, one of whom must be a citizen of that state. This certificate, together with the state laws authorizing and regulating the corporate form of organization in the state, comprise the *charter* of the corporation—its right to exist and do business. The essential parts of the certificate of incorporation are the following:

1. The *name* of the new company. Each corporation must have a name different from any other corporation doing business in the state. Furthermore, today every corporation must have "Corporation," "Corp.," "Incorporated," "Inc.," "Limited," or "Ltd." in its name to show it is a corporation. Corporations formed many years ago did not have that requirement, so that names like The American Telephone and Telegraph Company do not indicate the corporate form.

2. The *purposes* of the corporation. These must be stated because, except for some general powers permitted to all corporations, a corporation's powers are limited to those required to carry on its purposes. In order not to be too limited, it is common today to make the purposes of a corporation very broad, so as to encompass almost any type of business in the general field of its future operations.

3. The *life* of the corporation. This is usually perpetual and gives the company continued existence.

4. The *capital* that the corporation is authorized to have. This indicates the kinds of stock, their par value or that they will have no par value, and the number of shares the corporation is authorized to issue. Like the purposes, the authorized capital of the company may later be changed by a vote of the stockholders and the filing with the state government of a corrected or amended certificate of incorporation.

5. The names of three or more *incorporators,* the number of directors (at last three) to comprise the *board of directors,* and the names of the

first board of directors. There is no requirement that these lists of names of incorporators and directors be kept up to date, and since stock ownership can be transferred to anyone, the names of incorporators and directors of a corporation as listed in the certificate often bear little resemblance to those of its stockholders and directors after the company has been in operation for a while.

6. Finally, the *address.* The certificate of incorporation gives the address of the corporation in the state where a summons may be served on it.

GOVERNMENT TAXATION AND CONTROL

Since the corporation is a form of business that depends on state authorization for its right to exist, the corporation is in turn subject to considerable taxation and regulation by the state and Federal governments. In the first place, it must pay an organization tax or fee when it first files its certificate of incorporation with the state. Then it must usually pay a franchise tax to the state every year for the right to do business. Whereas partners in a partnership are owners and not employees, the officers of a corporation are considered employees; and the corporation must pay the required old-age, disability, and unemployment-insurance taxes on the salaries of its officers.

The heaviest tax on corporations, however, is the Federal income tax, as well as the state income tax in those states that impose such a tax. The income tax rates on corporations are usually high. Furthermore, the profits of a corporation are subject to a form of double taxation, for not only must the corporation pay an income tax on its profits, but the individual stockholder must pay an income tax as well on the share of corporate profits he receives as dividends. If the directors choose not to give out the profits in dividends, the government imposes an undistributed profits tax on any retained earnings above 30 per cent, unless the corporation can show good reason for such retention.

Corporations are also subject to a considerable number of regulations of various kinds. A corporation organized in one state, for instance, cannot do business in another state, where it is considered a "foreign corporation," unless it obtains a license from that latter state and pays a fee. Laws also regulate the issuance of corporate securities, the powers of the corporation, how it may merge with other companies, and the like.

BONDS

In addition to stocks, large corporations have another form of securities by which they can obtain money from the public. This is by the sale of *bonds,* which are formal promises to pay a certain sum of money at a



Courtesy Consolidated Edison Company

A Convertible Debenture. What is the face value of this bond? Some of the coupons have been detached. Do you know why?

definite date of maturity, and meanwhile to pay interest at a specified rate on the money borrowed. Bonds differ from stocks in that the bondholders are not owners of the corporation and cannot vote as stockholders do. Bonds have a definite date when they must be repaid, whereas stocks do not; and the interest on bonds is a fixed amount that must always be paid, whereas dividends on stocks are declared and paid out of profits only to the extent the directors feel the earnings are not needed for corporate growth or emergencies. Bonds are thus as a rule a safer investment than stocks, but the interest paid on a bond is usually smaller than the dividends a stockholder receives from a successful corporation.

Most bonds are *mortgage bonds,* which means that the corporation has pledged or mortgaged part or all of its property as security for the payment of the interest and principal of the bond. Some bonds, usually of very well established corporations, are not secured by a mortgage on any

property but depend solely on the company's good name and promise to repay. These are known as *debenture bonds.* When the name of the bondholder is written on the bond, as in stocks, the company maintains an up-to-date record of the names of bond owners and mails out interest payments by check; such bonds are known as *registered bonds.* In order to save the company the expense of maintaining records of bondholders and to make the bonds easily negotiable, so that they pass as freely from owner to owner as money does, some bonds are not registered but are made payable to the bearer instead. These are known as *coupon bonds,* because payment of interest is by means of little coupons attached to the bond, one of which the bondholder cuts off at each interest date and deposits in his bank as he would checks or currency.

CORPORATE EXPANSION

The major feature of the corporation in the American economy has been its possibilities for unlimited growth. The advantages of perpetual life, limited liability of investors, and ease of transfer of ownership, have served to attract idle funds for investment purposes from the general public, so that a corporation with good business prospects can grow to tremendous size. Even the close corporation can abandon its family-type organization, enter the public field by selling its securities to the public, and—if it is successful—can expand greatly.

A corporation first issues its securities to the public through *investment bankers,* large firms that specialize in the sale of corporate stocks and bonds. Investment brokers and *stock exchanges* serve as the means whereby a stockholder can sell his shares to others. These security transactions are regulated by state "blue-sky" laws, as they are called, and by the Federal Securities and Exchange Commission.

HOLDING COMPANIES

The laws of practically all states permit corporations to own stock in other corporations. This permits a form of expansion whereby corporations become *holding companies.* By owning substantial amounts of stock in other, generally smaller, *subsidiary* corporations, the holding companies direct the operations of the subsidiaries; and all work together as a family of corporations to obtain large-scale economies. Thus the New York Telephone Company is a subsidiary of the *parent company,* or holding company, The American Telephone and Telegraph Company.

Another form of corporate expansion is by *merger* or *consolidation,* where two or more companies combine to form one big one. Thus, for instance, two great New York City newspaper corporations, operating the "Evening Mail" and the "Evening Telegram," merged into one com-

pany operating one newspaper that was then called the "Evening Telegram." Later, that newspaper consolidated with the "Evening World" and the name was changed to "World-Telegram." Finally the New York "Sun" merged with the "World-Telegram," so that now the paper is known as "World-Telegram and Sun." Corporations are said to merge when they combine and the name of only one of them survives, as in the first illustration above; they consolidate when they combine and a new corporate name is used, either combining features of the old names, or an entirely new name. Thus the Studebaker and Packard Automobile companies consolidated into Studebaker-Packard Corp.; and Hudson, Nash, Kaiser, and Willys combined into American Motors, Inc.

ADVANTAGES OF THE CORPORATION

Returning to the problems of Fred Kennedy, it can be seen that the corporate form of organization might be useful to him whether he opens a small hardware store with his two associates, or opens a chain of "Cook-O-Mat" stores as a large-scale venture.

The hardware store idea of Fred Kennedy could be organized as a close corporation with Kennedy, Ames, and Grebs as the stockholders, directors, and officers. In this way each of the three would have his liabilities limited to the amount he invested in the company. As partners in a partnership, each would have been fully liable for all debts of the firm.

Another important advantage of the corporate form is that no general right to make binding contracts exists in a corporation as it does in a partnership. If Kennedy, Ames, and Grebs were partners, any one of the three could make a contract for the firm that would bind all three, even if the other two objected to it. As a corporation, however, only the officers can bind the corporation. If all three were officers—let us say, Kennedy as president, Ames as treasurer, and Grebs as secretary—the three of them at a stockholders' meeting can pass a by-law that all three officers must sign every contract before it is valid. Every corporation, furthermore, must have a corporate seal that is embossed on paper by an embossing device; and this *corporate seal* must be affixed to every important document the corporation signs. This seal could be kept in the possession of the president, Kennedy, so that no basic change in the corporation can be made without his knowledge because he has the seal.

Organizing the hardware store as a corporation, instead of a partnership, gives the advantage of continued existence as well. As a partnership, the death, insanity, or bankruptcy of anyone of the three partners might end the firm, no matter how prosperous it might be. Even more troublesome is the fact that if any partner disagreed with the actions of

Advantages of a Corporation

1. Limited liability	Each stockholder is liable only to the extent of his original purchase of stock.
2. Only designated officers can bind in contracts	No one owner can make a contract that will bind the company, as a partner can do.
3. Continued existence	The corporation life is not affected by death, disability, or disagreement of a stockholder.
4. Tremendous growth possibilities	The public corporation can grow large by selling securities to the general public.
5. Opportunity for expert management and large-scale economies	The large public corporation can afford to hire the most skilled personnel and save money by large-scale purchases and integrated operation.

the other two, he could have the firm dissolved. The life of the corporation, on the other hand, is not affected by the disabilities of its stockholders; and the minority owner cannot break up the company, but must either go along with the majority or sell his shares. Thus the form of a close corporation might be useful to Kennedy and his associates in running the hardware store.

Should Kennedy decide to open the Cook-O-Mats and try to start on a big scale, the corporate form offers even more advantages. As a public organization, Fred's enterprise still has the aforementioned good points of limited liability, binding acts only by designated officers, and continued existence. In addition to these, it has the advantage of tremendous possibilities for large-scale operation and growth. If Kennedy can interest good investment bankers in his idea, they may be able to sell considerable amounts of stock, and perhaps bonds as well, so that the company will have a sizable amount of capital available for large-scale operations and growth. By a wide-scale sale of stock to many people, and by obtaining proxies from them, Fred may be able to control and manage this great company with very little investment on his own part.

Corporations, furthermore, can thus grow large enough so that they can afford to hire the very best of managerial assistance and take full advantage of the economies of large-scale operation.

DISADVANTAGES OF THE CORPORATION

Just as there were two sides to the question of whether Fred should go into a partnership, so the corporate form presents bad as well as good factors for his consideration. The first of these certainly is that of the many taxes the corporation must pay, which is usually considerably more than that paid by the proprietorship or partnership.

Taxes and Fees. Fred and his associates as a corporation would have to pay fees for the formation of the corporation and a tax for the filing of its certificate of incorporation. Then there would be an annual state franchise tax and a license fee to each state in which the corporation conducts business. As a corporation, the salaries of Kennedy and the other officers would be subject to Social Security taxes, to which partners' drawings would not be subject. In all but the very high brackets, the income tax rates on a corporation are higher than they would be on individuals. As a corporation, the profits of the venture will be subject to double taxation, because the corporation will have to pay a tax on its profits; and when Kennedy receives his share of the profit as a dividend on the stock he owns, he will in turn have to pay an income tax on the dividends.

Regulations. The fact that the corporation is a creature of the state and is therefore subject to state regulation and supervision will be more annoying to Fred and his prospective public Cook-O-Mat corporation than it would to his close hardware corporation, but there are certain records that must be kept and reports submitted by either company. The corporation is subjected to considerable regulation by the Securities and Exchange Commission and other governmental bodies.

Credit. A disadvantage of the small, close corporation, like the hardware store, stems directly from the favorable factor of limited liability. A creditor of a corporation can look to its assets alone, and not to the private fortunes of the owners; therefore a creditor would be more willing to extend credit and a banker more willing to make a loan, to a partnership with its unlimited liability of owners, than to the small corporation. If the corporation has few assets, the banker or creditor may insist that Fred himself endorse the note and thus become personally liable on it, before the loan will be made or credit extended. If this is done, the advantage of limited liability is then completely lost.

MANAGEMENT

A disadvantage of the large public corporation, on the other hand, is that its very bigness may make it difficult and cumbersome to manage and lead to inefficiency and "red tape." Furthermore, the large number of stockholders leads to separation of ownership and management, a disadvantage to most stockholders. By obtaining a sufficient number of proxies, this might possibly work to Fred's advantage by keeping him in control with little investment; however, it is not good for stockholders generally to have officers with so little real control on their actions. Then again, it is always possible that some other stockholder can obtain more votes and proxies than Kennedy can and vote him out of office and control of what he considered his own company.

Disadvantages of a Corporation	
1. High taxes	The corporation pays many special kinds of taxes, and its income is subject to double taxation.
2. Government regulation	The state and Federal governments surround the corporation with many regulatory laws and supervisory bodies.
3. Credit depends on its assets alone	A small corporation may find it difficult to borrow money or obtain credit, since no owner is liable for its debts.
4. Possibility of inefficiency and red tape	The very large corporation may be difficult to manage.
5. Separation of ownership and management	Proxy voting can give the control of the corporation to those not looking out for best interests of the stockholders.

OTHER FORMS OF BUSINESS ORGANIZATION

While not especially pertinent to Fred Kennedy's problems, there are, however, two other forms of business organization that have some degree of popularity in certain areas of business activity. One is a co-operative, and the other is a mutual company.

Co-operatives. A *co-operative* is a special corporate form of organization operated to supply goods or services to its members, who are its owners. Unlike the ordinary corporation, however, the members of a co-operative receive only one vote regardless of how many shares they own. They elect a board of directors which selects a manager for the organization. The co-operative then purchases goods and supplies for its members, does their warehousing for them, or markets their crops for them. It has the advantage of giving the benefits of large-scale purchases or sales to small independent stores or producers.

Thus many independent retailers or wholesalers have banded together in co-operatives to buy on a large scale and compete with the supermarket. Growers of fruit and other agricultural products have formed co-operatives to give their individual small production the importance and advantage of large-scale distribution. Consumers' co-operatives have also been formed, particularly in rural areas, for the same reason of giving the independent consumer the benefits of large-scale purchasing.

The members of the co-operative receive interest on their investment and also a share in the earnings of the venture, over and above that needed for emergencies and expansion, in proportion to the amount of business each member does with the organization. These returns of

profit are considered as savings on the purchase price of articles bought or additions to the selling price of articles sold and are thus not taxable as income, as are the dividends of ordinary corporations.

Mutual Companies. *Mutual companies,* prominent in the savings-bank and insurance fields, are corporations owned by the people with whom they do business. Thus the depositors of the savings bank own the mutual savings bank, and the policyholders own the mutual insurance company. Management is by a board of trustees, which usually elects its own new members and is thus said to be self-perpetuating. Profits above business needs are divided among the depositors or policyholders in the form of dividends.

SUMMARY

The corporate form of organization is extremely important in the present-day American economy because it has been largely responsible for the growth of modern large-scale business. The close or family-type corporation affords its owners limited liability and an organization with continued existence. The public corporation allows for tremendous growth possibilities through the sale of its stocks and bonds to the general public. The corporation, however, is subject to comparatively heavy taxation and regulation; and the large size and widespread ownership of the public corporation leads to many difficult management problems.

► FOR REVIEW AND DISCUSSION

1. How does a joint stock company differ from a partnership?
2. Describe a corporation. How does it differ from a partnership?
3. What are the disadvantages of a corporation? What are the advantages?
4. Define close corporation, public corporation, stockholder, board of directors, dividend.
5. Distinguish between common stock and preferred stock.
6. What is the meaning of par value? market value? no-par value? book value?
7. How can a corporation be formed?
8. What control does government exercise over corporations?
9. Distinguish among mortgage bonds, coupon bonds, debenture bonds, and registered bonds.
10. Define holding company, subsidiary, parent company, and merger.
11. What is a co-operative? How does it differ from a corporation?
12. What are mutual companies?

► CASE-PROBLEM QUESTIONS

1. How can Fred decide whether he should open the "Cook-O-Mat" chain or the hardware store?
2. Which type of business will be most needed by people in small, medium, and large population centers?
3. How could Fred obtain the capital needed for opening his business if he formed a corporation? a partnership?
4. Will taxes on profits be higher in a corporation or a partnership if Fred operates on a limited scale? if he operates on a larger volume?
5. What type of business organization should Fred form in order to protect his personal property from claims against the business?
6. If a corporation is formed, how can Fred be sure to keep control of the management of the business?
7. How can Fred expand the corporate-type business structure to promote growth?

► APPLIED BUSINESS PROJECTS

1. Assume you are going into partnership with J. T. Harrison. He is putting $5,000 into the business and you are putting in $1,000. Mr. Harrison is to work at least ten hours a week for at least forty days a year without compensation. You are to work full time for at least forty-nine weeks a year and to receive $60 a week before profits are divided equally. The partnership is to last five years renewable by agreement of both parties. Mr. Harrison's life is to be insured for $5,000 and yours for $1,000 at the expense of the partnership.

Draw up the partnership agreement that you would want to sign and that Mr. Harrison will agree to. Supply any additional information you need to work up the articles of partnership that you find necessary. Make the agreement as complete as possible.

2. If the partnership of Ames, Baxter, and Cain has a profit of $25,000, show on an 8½ x 11 sheet of paper how the profit would be distributed:

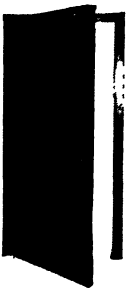
a. If they are to share equally after Cain receives an allowance of $4,000?
b. If they share profits after the partners have received 6 per cent interest on the following balances: Ames $10,000; Baxter $15,000; and Cain $25,000?
c. If they share equally after receiving interest at 6 per cent and after an allowance of $4,000 for Cain?
d. If the profit is $10,000 and they share equally after an allowance of $5,000 for Cain and interest as 6 per cent on investment?

► COMMUNITY PROJECT

There probably are several corporations in your community that have been established in recent years. In order to help the members of your class become better acquainted with the procedure in organizing a corporation, invite the president or general manager of one of these newly formed corporations to visit

your class to talk about the procedure followed in organizing the corporation. Ask him to tell about the problems faced and how they were overcome. He should describe details pertaining to capital organization, financial arrangements, stock plan, arrangements for obtaining the charter, and other details pertaining to establishing the corporation.

If you are unable to get a major officer of a recently formed corporation to talk to the class, perhaps arrangements can be made to get an attorney in your community to discuss the legal procedure involved in the formation of a corporation.



4

Principles of Management

CASE PROBLEM

Fred Kennedy is still not quite decided about whether to start one or more Cook-O-Mat shops or to open a hardware store. His two associates in a possible venture both feel much more assured about a hardware store, but Fred is still somewhat intrigued by his new idea. He faces a number of questions.

- While he was clever enough to think of the idea, is he a sufficiently competent organizer, administrator, and leader to carry it through to successful operation?
- How can he set up his organization to obtain maximum effectiveness of results?
- If a favorable decision is reached, should he start with one store, or begin on a grand scale in many locations at once?
- Would it be wiser to start with a full management setup, such as would be needed in a Cook-O-Mat, or with the more simple operation involved in a hardware store?

THE PROBLEMS OF PROMOTION

The old adage, "There's many a slip 'twixt the cup and the lip," certainly can be used to describe the vast area of problems and difficulties between "hatching" an idea for a business venture and the carrying out of that idea to the point where the enterprise is in successful operation. This process of developing a business from a mere idea to a going concern is known as *promotion.*

Usually, the promotion is done by those who will own or manage the "going concern." In some cases it is done by professional promoters who make their living by starting up new business ventures and then turning

them over to others. Regardless of who does it, good promotion is necessary to all business ventures. There are several steps in the general promotion of a business: (1) investigation and development of the idea; (2) the assembly of the men, materials, and money with which to carry on the business; and (3) the organization of the firm, so that it can operate smoothly and efficiently.

(1) INVESTIGATING THE IDEA

Before taking any definite steps toward getting the business started, those responsible for its promotion should investigate thoroughly the possible chances the venture will have for success. This will require fairly accurate answers to such questions as:

a. Is there sufficient demand for the product or the service, in the location or area selected, to give reasonable assurance of success?

b. Is the competition of firms supplying similar products or services in the area sufficiently limited, so as not to interfere with the success of the new venture?

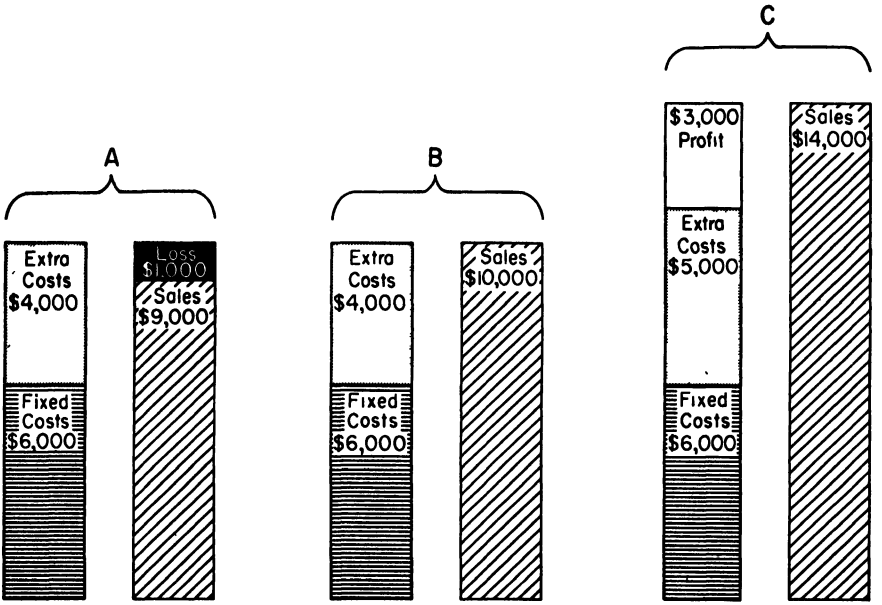
c. Will the income from the business be sufficiently greater than the expenses to justify continued operation?

d. How much capital investment will be required? Will the profit be sufficient to justify investing it in this venture?

e. Does the management of the business have the right kind of know-how, experience, and personality to operate it successfully?

The answers to these questions will, of course, be only estimates; but with a proper investigation, it is possible to come up with answers that might have a considerable degree of accuracy. The question of demand for the product or service can be estimated fairly accurately by a survey of the area—actually sampling the product by selling it in one typical location, or by obtaining contracts in advance from future customers.

Neighborhood Survey. Thus, in the case problem at the beginning of this chapter, Fred Kennedy might test the demand for the services he was thinking of rendering by finding out how many people were living in rooms and apartments without kitchen facilities in the area in which he is interested. He might then go into a hotel and a rooming house or two and, by talking to its residents in a door-to-door canvass, find out the number who might be interested in a Cook-O-Mat service. He will probably have to reduce this figure somewhat, because some people who show interest might never patronize his Cook-O-Mat after he opens it. On the other hand, others who showed no interest might later become customers; and he could count on a few of these. Also, a comparative study of the area could be made to estimate the amount of competition that his business will have to face.



The Break-even Point. Fred Kennedy finds that his fixed costs (such as rent, fuel, workers, and the like) will be $6,000 a month regardless of how little or much business he does. At first he estimates that he can make monthly sales of $9,000 on which his extra costs (such as additional help) will be $4,000. On this basis he would lose $1,000 a month. However, by careful recheck he estimates that he can have monthly sales of $10,000 with $4,000 added costs above his fixed costs. This estimate gives him his break-even point. He estimates that in a few months he can raise his sales to $14,000 a month at an increase of only $1,000 added costs (in total $5,000 a month). Thus his profit will be $3,000 a month.

Fred's problem is whether he can support himself or get sufficient funds to tide him over until he can make a profit to give him an income.

Of course, any estimate is a guess and can easily be upset by many things. If his estimate is wrong he may make more or less money and his break-even point may be higher or lower. Therefore most wise businessmen allow for a margin of safety in making estimates. They will assume costs are 10 per cent higher and sales 10 per cent lower than careful estimates. If charts then still show an adequate profit, the businessman may consider the venture a good risk.

Break-even Point. The question concerning the expected profits of the proposed business involves estimating its *break-even point.* This is done by multiplying the price the owner expects to charge for the goods or services by the number of sales, and "plotting" these figures on a graph. Next, the various expenses expected by the business are plotted on a graph or chart. The many fixed expenses—such as store rent, interest on money borrowed, wages, telephone service—will remain relatively the same no matter how much or how little business is done. Other

expenses will vary according to the number of products sold or customers served. For Fred Kennedy, these other expenses would include electricity and gas, repair service on the equipment, and so on. The graph will then give an estimate of just how many products must be sold, or customers serviced, for the business to make a profit. The point on the graph where the income of the venture exactly equals its expenses is known as the *break-even point.* On page 48 is a graph that illustrates this situation for Fred Kennedy.

Capital Requirements. The break-even-point graph can also help the promoter in deciding on the amount of capital needed to start the business. Naturally, he will need sufficient cash to make down payments on all equipment bought to furnish the store and for the deposit and first rentals on the lease of the store. In a business venture, such as Fred plans, he also will need cash for *working capital,* to pay the day-by-day expenses until sufficient sales are made to take care of these expenses—thus until the break-even point is reached. His charts, if accurately estimated, tell him how many customers he must service monthly, weekly, or even daily, to cover his estimated expenses. His survey of the neighborhood should give him some idea of how long it will take the people of the area to accept his scheme.

Thus his investigation and computations should give him an idea of whether the business will be successful and whether it will earn sufficient profits to make it worth while. He will know, to a fairly close degree, how much of his own money he will need to invest, as well as the money of his financial backers. Then he can see whether the expected profits will be sufficient to justify this investment. Finally, he will have to analyze his own abilities, to see whether he has the training and experience, the managerial competence, and a personality sufficiently pleasing to customers and employees to be able to run such a venture in a successful manner. He has then completed his investigation of the project. Now come the problems involved in its development.

PLANNING THE PROJECT

Having decided that the business idea has sufficient profit-making possibilities, the promoter must now answer some basic questions as to its development. For one thing, should the business start small, with one store and just a few products and hope to grow as it receives customer acceptance? Or would it be better to start right out as a big venture, with many stores and attempt to get citywide, statewide or nationwide coverage? Should he build or buy the plant, machinery or equipment needed, or should he rent them?

While Fred Kennedy in his hardware business would have no worries

about manufacturing and distribution of a product, many promoters of businesses in other lines will have. They must decide whether they will carry out all, or just some of these functions. Suppose someone invented an automatic eraser for pencils, requiring no rubbing—just touch the eraser to the paper and it erases. Shall he manufacture these erasers and try to get the pencil manufacturers to add them to their pencils, so that they actually sell them to the public? Or should he have another company manufacture them for him and do the selling himself? Or shall he do all the functions of manufacture and distribution himself?

Another decision that must be made by some new business ventures is whether to centralize or decentralize their operations. This involves the problem of whether to do all manufacturing at one large central factory (centralization) or have several smaller ones at various locations throughout the country (decentralization). Similarly, is there to be one centralized sales and administrative office, or many smaller branch offices?

It can be seen then that Fred Kennedy would have decisions of size, location, extent of service, and organization pattern to make. This last problem will be discussed under the third step in promotion, organization.

(2) ASSEMBLY

The promoter or enterpriser is now ready to take definite steps to make his idea a reality. He must obtain the money, materials, equipment, and manpower, which will transform his vision into an operating business. For Fred Kennedy this will first mean obtaining the money from his financial backers, either by borrowing from them, or by taking them into the business with him, or by selling them stock in a corporation he might form. Then he must lease the store or stores in which he will locate his hardware store or his Cook-O-Mats, and sign the contracts to obtain the store equipment and merchandise or the stoves, ranges, and ovens he will need for the cooking facilities he proposes to offer. These he may buy for cash or on a limited-time basis. He also may buy some of his equipment under a conditional-sale or installment-plan agreement, although he might possibly lease these from the manufacturers. He then must hire the employees he will need; and once he has set up his pattern of organization, the business will be ready to start.

(3) ORGANIZATION OF THE BUSINESS

The last step in the promotion of a commercial venture—organization—is one of the most important considerations that must be faced. Every organization, no matter what its size, must be properly set up or it will not run efficiently. Fred Kennedy must plan the organization of his Cook-O-Mat very carefully. He must decide, for instance, who is to take

care of each part of the work of the business. He will have to decide how each of these types of work will be co-ordinated with the others. *Organization,* then, is the pattern or structure for combining the men and materials of an enterprise to provide the most efficient and successful means for achieving objectives of the business. Planning organization involves deciding what work is to be done and deciding who is to do each type of work. Each person responsible for a particular type of work must know just where his work begins and ends, and he must know with whom he works to get the entire work of the business done.

ORGANIZATION CHARTS AND MANUALS

With the principles of organization in mind, the organization pattern of the business should then be devised and set down on paper by means of organization charts and, for large firms, by organization manuals as well. The organization chart, samples of which are given in the following paragraphs on types of organizations, shows graphically the assignment of authority and responsibility to the specific persons, the lines of supervision and promotion, and the channels of communication. Manuals, as opposed to mere charts, are full write-ups of the descriptions, duties, and responsibilities of each department and subdivision of the enterprise.

The pattern of organization of a new business should be thought out and placed on the chart and possibly written up in a full manual; in fact it is just as important for an existing enterprise, no matter how old and established it may be, to be analyzed and have its pattern of organization charted. This analysis and charting will often reveal faults in organization or prevent their commission, such as:

1. *Duplication of functions.* Each of the Cook-O-Mat store managers, for instance, may be buying his own supplies.
2. *Splitting up of functions.* Both the central office and the store managers, for example, may be hiring workers for the individual stores.
3. *Neglect of functions.* No one may be assigned the duty of handling the testing of supplies, offered to the store managers for purchase, to see which of the many brands is the best to use.
4. *Vagueness of responsibilities.* There may be no clear-cut assignment as to whether advertising is handled by the store managers or by the main office. Thus both or neither may try to do the job.
5. *Illogical assignments.* The assignment of unrelated duties to one person may show up in a chart; for instance, if the purchasing manager in the main office also is responsible for public relations—the maintenance of good will with the company's customers. The chart will indicate that this assignment may be undesirable.
6. *Overburdening assignments.* One official may be charged with entirely

too many different responsibilities or have too many people reporting directly to him.

TYPES OF ORGANIZATION

The organizational pattern should take the form, both on the chart and in actual practice, of either the line, functional, or line-and-staff type. In speaking of type of organization, reference is not made here to the form the business should take, such as whether it should be a sole proprietorship, partnership, or corporation, which problem was discussed in Chapters 2 and 3, but rather what the internal structure of the business should be. The type to be adopted will depend on the particular needs of the individual enterprise.

LINE ORGANIZATION

The line type of organization is one where the lines of authority are clearly drawn and each supervisor is in direct control of those immediately below him for everything they do. It is carried over from the old military rigid form of organization. A chart of a possible line organization for Fred Kennedy's Cook-O-Mat enterprise, with many stores throughout New York City, might look like this:

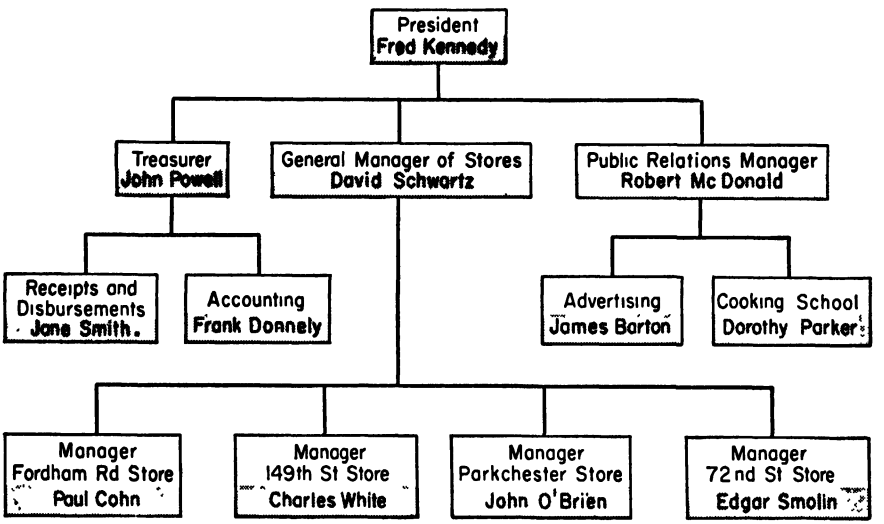


Chart of a Line Type of Organization

The principal advantages of the line type of organization are:

1. It is easy to understand; and lines of supervision, promotion, and communication are clearly defined.
2. It is very direct, in that everyone knows exactly to whom and for whom he is responsible.

3. It makes work function quickly and smoothly, because decisions are easily obtained and arrived at, each person having only one boss.

Its main disadvantage is that it makes little use of specialization. The store managers and their district supervisors cannot be experts in all fields, such as hiring and firing employees, keeping customers satisfied, keeping equipment in operable condition, and keeping premises attractive and neat. If a difficult problem comes up, there is no expert in any one field to whom one of them can turn. The supervisor is his only resort, who in turn has to know all fields and is thus no expert himself.

FUNCTIONAL ORGANIZATION

The very opposite of the supervision of the line type is that of the functional type of organization. Here each function of the business has a specialist who supervises all matters, and all subordinates, in relation to that specialty. Thus, if Fred Kennedy's Cook-O-Mats were organized under that type of structure, there would be no district managers of stores, to whom the local managers would look for all their orders in every field. Rather, there would be, for instance, a supervisor of purchases, who would supervise all local purchasing, an employment manager to oversee all personnel decisions, a maintenance manager who would give all the local store managers direction on repair and maintenance problems, and other specialized supervisors. Fred's organization chart, instead of showing district-store managers stemming out from the general manager of stores, would show these individual managers of special functions and might look like this:

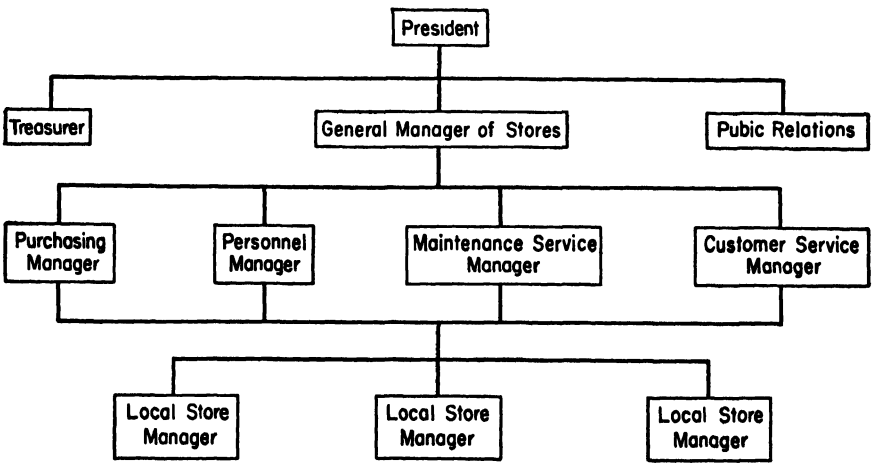


Chart of a Functional Type of Organization

The principal advantage of the functional type is that it allows for highly specialized supervisors who are experts in their fields to whom local store managers can apply for orders and advice instead of going to executives who are Jacks-of-all-trades. A look at the confusing lines on the chart, however, brings out at once the great disadvantage of the functional type; namely, each subordinate has so many bosses which results in confusion, overlapping authority, "passing the buck," and inability to fix responsibility for errors.

LINE-AND-STAFF ORGANIZATION

The disadvantages of both the line and the functional types of organization have led to the adoption by most business and military organizations of some form of the *line-and-staff* type of organization. This type combines the best features of each of the other types. The line setup of district managers would be retained, for instance, and they alone would be the direct bosses of the store managers subordinate to them. But the general store manager would also have a staff of experts in the specialized fields who would help the store managers by rendering service and advice to them. These specialized supervisors would not, however, have any direct authority over the local store managers, all orders to these managers still coming from their own superiors only, the district and general manager of stores. The organization chart of this type of organization for the Cook-O-Mats might look like this:

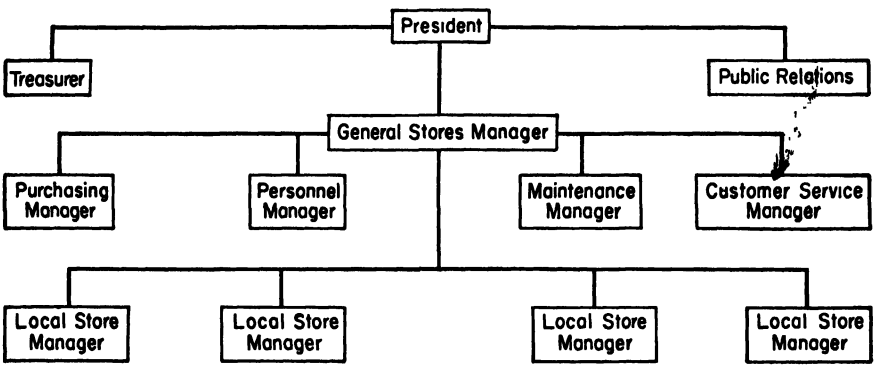


Chart of a Line-and-Staff Organization

Thus the line-and-staff type of organization includes the direct lines of authority and channels of communication of the line type, each store manager having only one boss. It also allows experts to supervise their own special functions, but only to aid and advise the store managers. All orders to the latter can come only from the district store manager and

Advantages and Disadvantages of Three Basic Types of Organization

Line

Advantages	*Disadvantages*
Easy to understand	Makes little use of specialized skill
Very direct	Too simple for a complex organization
Functions quickly and smoothly	

Functional

Advantage	*Disadvantage*
Specialized skill for each function or service need	Too many bosses, resulting in confusion in responsibilities

Line-and-Staff

Advantage	*Disadvantages*
Has the advantages of both line and functional organizations	Requires a great many supervisors
	Sometimes the dual lines of authority—line supervisors and staff supervisors—have conflicts of interests

general store manager, through whom the special function managers must operate. The disadvantage of this type of organization is that it generally requires a greater number of supervisors and, therefore, can usually be used only by comparatively large business enterprises.

SOME PRINCIPLES OF MANAGEMENT

In deciding the kind of organization desirable for his proposed business, Fred Kennedy should keep in mind certain basic principles of business organization. No business enterpriser can be successful merely by following principles of good business organization; however, unless he does follow a carefully chosen set of principles that are basic to all good business, he will fail regardless of his competency in selling people hardware, in repairing electrical goods, or in providing people with better means of cooking their meals. Here is a list of basic principles that Fred Kennedy will have to follow:

1. ***The objectives of the business control all activity.*** Fred Kennedy must keep in mind what he is proposing to do. Fred Kennedy wishes to render service to people by making it easier for them to cook the kinds of meals they want in the way they want. In so doing, Fred Kennedy hopes to make a profit. Unless, however, Fred Kennedy is rendering a real service to people they will not buy his services. He must, therefore,

always ask himself and get his co-workers to ask themselves in anything they do: "Is this particular task that I am doing making people more anxious to come to us to cook their meals and prepare their food?" If it does not, if the work does not lead ultimately to this objective, it is useless.

2. ***Human beings are different.*** Fred Kennedy's staff must realize that they cannot look upon people in the abstract. Some customers are easily satisfied. Some customers want to cook quantities of food and are indifferent to taste. Others are interested in a little food very well prepared. Some of Fred Kennedy's co-workers are excitable; some are even tempered. Fred Kennedy must recognize these differences and must allow for them. He must encourage his even-tempered co-workers to be enthusiastic about what the customers want. He must encourage his hot-tempered co-workers to realize that the customer is right so far as the business is concerned, even if the customer may at times be unreasonable.

Fred Kennedy must realize that no human being is perfect. Consequently, if a co-worker has failings in some respects but is very competent in other respects, Fred Kennedy must allow this worker to do the kinds of jobs for which he is especially fitted and find other people to do the work for which the worker is less well fitted. If this is not possible, then Fred Kennedy must, with the help of the worker, retrain him so that he is more competent in several different areas of work.

3. ***Specialization is desirable.*** Fred Kennedy must plan for each person to do a group of closely related jobs, so that the worker will do these few things well. If everybody does everything, no one does anything as well as it should be done. Fred Kennedy, therefore, must provide that some workers do the cleaning, others do the repair work, and others serve the customers. Consequently, each person knows what he is to do. Likewise, other people will know what that person is to do, and customers will find it easy to discover who is responsible for certain tasks in the Cook-O-Mat shops.

4. ***Control must be definite.*** Each person must have a definite group of responsibilities in which he can specialize. There must be an over-all control of what is done. Each person must be definitely responsible to some other person. While a superior must be understanding and considerate of those who work for him, there must be no question as to who is the responsible boss in each particular job. There must, in other words, be definite channels of supervision, so that each person is held responsible for what he does. If everybody is the boss, no one is the boss; and the firm will soon go to pieces. It is the job of a supervisor to see to it that each person knows what he is to do. The supervisor must be careful that there is no duplication of work on the one hand and neglect

of work on the other. Specialization is vital to a good business; however, unless there is real co-ordination of the work, there will be nothing more than a group of specialists performing their work without understanding of what the others are doing.

5. ***Flexibility is needed in every organization.*** An organization should not be so rigid that it cannot change with circumstances. A firm may have a personnel manager at the main office who hires the employees for all stores; however, if one store is located in a section of the city where Spanish is spoken almost exclusively, he may permit the manager of that store to hire all employees from among the people in that area.

There are many other principles of organization and even more important principles for getting along with people. For example, it is a good rule to give credit when due. It is also very important to let people know if possible in advance when they are going to be asked to do different things. Usually it is desirable to tell them why. These and other important principles of human relations in management will be taken up in more detail in later chapters.

THE NECESSITY OF GOOD MANAGEMENT

The principles of good management presented above are basic to all business. Fred needs to be careful to see that he follows them in his proposed business. The manager of a billion-dollar firm needs to be just as careful, if not more careful than Fred Kennedy that he is following these same principles. These same principles are also important to the management of the home and indeed are basic in one's personal life. It is important, for example, for each of us to know what his objectives are in life; to treat other people with consideration; to try to do one thing at a time rather than to do everything all at once. Each of us needs to co-ordinate all of his life into a total pattern for doing things, so that we can attain our objectives; and, finally, each of us must be able to adapt himself to changing conditions. Thus, the basic principles of organization that Fred Kennedy must practice in carrying on his proposed enterprise are important for the biggest business and important for us as individuals in getting the most out of our personal lives.

LEADERSHIP

Having grappled with the problems of promotion and organization brought up in the case problem at the beginning of this chapter, there now remains the question of whether Fred Kennedy is a sufficiently competent administrator and leader to carry his plans through and develop a successfully running business. The idea that a person is a "born leader" went out with the concept of the "divine right of kings." While

Qualifications of a Good Leader

- Has plenty of vitality and energy
- Is willing and anxious to assume responsibilities
- Has an appreciation of individual differences
- Enhances the self-respect of his subordinates
- Has a strong sense of loyalty to his superiors and toward his workers

some may develop the ability more naturally than others, many persons can be leaders if they will study and apply the principles of assuming responsibilities, making decisions, and handling people properly.

Leadership is the ability to get people to co-operate voluntarily with you toward a goal. In business, leadership involves dealing with people in such a way as to induce them to produce efficient results amid an atmosphere of business harmony. The leader of a business enterprise must not only understand the technical problems of his industry and of economic conditions generally, but he must also understand human relations and business psychology. While there are many kinds of leaders and no fixed pattern of how a business leader should operate, there are, however, some general principles of leadership that all competent business managers must adhere to and apply.

Qualifications for Leadership. A good business leader has first of all the vitality and energy to get things started and keep them moving. He must have the imagination needed to recognize and grapple with problems and the ability to meet with courage and decision any emergencies as they come up. Secondly, he must have the strength of character to assume the duties and responsibilities of his office without attempting to avoid them or trying to place the blame on others if things do not run well. This also involves the necessity for him to be consistent in his actions and to keep his word, so that others will know at all times where they stand, what they can and cannot do, and that this leader assumes full responsibility for his decisions and promises.

Since a business organization is actually a group of people, the manager must understand the feelings and needs of human beings. This means he must appreciate the individual differences among those working with and for him and allow for these differences in his association with them. Despite these essential variations among persons, everyone likes to feel important. The leader, therefore, treats those under him in such a way as to enhance their self-respect. He does not belittle his subordinates or show off or treat them with an air of superiority. He is always open to their suggestions and does not resent constructive criticism. Above all, he must

have faith in those to whom he delegates duties and authority and not feel that only he alone is competent to handle the details of a situation.

The successful leader has a strong sense of *loyalty*. Thus he does not ignore nor openly criticize the directions of his superiors, and he tries to aid and back up his subordinates whenever they need his help. He gives them credit for their aid and suggestions and generally assumes the blame himself for their shortcomings.

The successful leader has a general and thorough understanding of the problems of those working under him, although it is not usually necessary that his technical skill or physical prowess be greater than that of those whom he supervises. Thus, while Fred Kennedy must be completely familiar with the problems involved in putting over the Cook-O-Mat idea with the public, he need not himself be as good a salesman nor understand the techniques of the advertising profession as well as his public-relations manager. Fred has to be sufficiently well-rounded to see all problems of the business and fit each one into its proper place and not be lost in the individual details of one technical specialty.

SUMMARY

Starting a new business involves problems of investigating and developing the idea, assembling the component parts of the business, and organizing these parts into a working unit. In organizing a business enterprise, whether small or large, basic principles of organization should be followed; and a type or system of organization should be set up. What is more, the management that will run the enterprise must be versed in the principles of leadership and human relations. The business executive must remember that the venture must co-operate with, and in turn receive the co-operation of, its employees and their unions, as well as its customers and the government.

► FOR REVIEW AND DISCUSSION

1. What are three of the steps in the general promotion of a business?
2. How can the demand for a business or business service be tested?
3. What is meant by "break-even point"? Give examples of situations where a business fails to break even; breaks even; and exceeds the break-even point.
4. What does the term "organization" mean when applied to getting a new business started?

5. What are the five major types of businesses? Give examples of each type.
6. What is the nature of a line organization? What are its principal advantages?
7. What is the nature of a functional organization? What is its principal advantage?
8. What is the nature of a line-and-staff organization? What led to its development? Why is it usually desirable?
9. Describe each of the five basic principles of management.
10. What is meant by human relations? How does human relations influence business management?
11. Are the basic principles of management any more important to big business than to small business? Explain.
12. What are some of the outstanding qualities of a successful business leader?

► CASE-PROBLEM QUESTIONS

1. What are the various ways in which Fred Kennedy can raise the funds for buying the materials and equipment to set up the Cook-O-Mat?
2. What type of business-organization plan best fits Kennedy's business venture? Does it make any difference what type of organization plan should be developed for a single business or a chain? Explain.
3. What personal characteristics should Kennedy's employees possess in order to help make his business a success?
4. How can Kennedy develop the specialization and control needed for good management and still provide for the flexibility needed to assume successful operations of his business, even when certain vital employees have to be absent?

► APPLIED BUSINESS PROJECTS

1. The president of the Nobasco Engineering Company owns 20% of the stock. He is a competent engineer, knows important people in the business, and through good management earned a good dividend for the company for twenty years. In the past three years, however, earnings have dropped off.

Here are possible reasons:

a. The president is getting old and not keeping up with the times.
b. The president has given himself more salary, which has reduced profits available for dividends.
c. The need for engineering services has decreased in the locality.
d. Economic conditions have become poorer.
e. Competition is keener.
f. More capital is needed.

Give suggestions to the stockholders as to how they should meet each of the possible explanations above.

2. List the steps that you will have to go through to organize a corporation if the members of your class should decide to organize a corporation for selling shopmade products to raise money for a class trip.

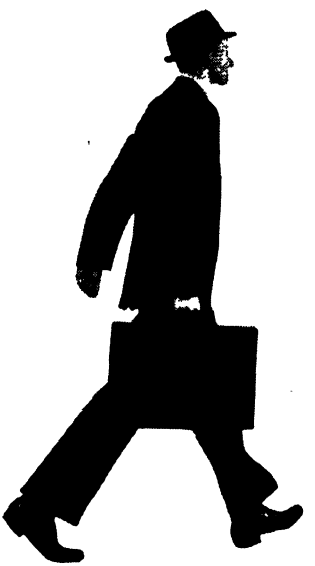
► COMMUNITY PROJECT

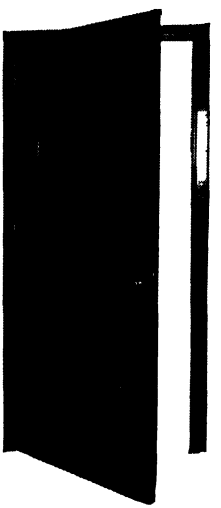
Every business has an origin somewhat in keeping with its environment, population groups to be served, competition, and many other factors.

Have each member of the class select a business in the community to find out just how it got started. The manager should be interviewed to find out who had the idea to start the business. Other considerations might be the original plan for financing the business, who were its first employees, and what were their responsibilities. Try to find out as much as you can about the factors that were considered preparatory to opening the business. If you will ask the manager, he can undoubtedly tell you much about early difficulties and how those difficulties were met. Should the first manager you interview not be acquainted with the origin of his business, try to locate another firm whose manager is well acquainted with the origin of his business.

Section Two

Marketing and Merchandising Management







5

Studying the Market

CASE PROBLEM

After discussing the problem thoroughly with his prospective partners, Fred Kennedy has decided to drop the proposed venture of opening Cook-O-Mats. They have convinced him that the idea is so new, untried, and unusual that it might not go over with the public at all. Furthermore, this would be essentially a service business, closely allied to a restaurant, fields in which none of them has had experience.

Fred therefore desires to go ahead with his alternative plan, that of opening a hardware and electrical-appliance store. Mr. Grebs and Mr. Ames, who might go in with him, have raised several questions: Is there a need for another such store in their city? Where should they locate their store to attract the most business? Just what type of merchandise would interest their future customers? What price ranges of merchandise should they carry? Kennedy recommends that a study of their market would give them answers to these and similar problems.

► How can they conduct a survey of their prospective market, in order to know best how to satisfy the needs and wants of their future customers?

THE FUNCTION OF MARKETING

The problem with which Fred Kennedy and his partners are now tussling—that of getting the right goods to the right customers at the right place and at the right price—is involved in the over-all business function known as marketing. *Marketing,* also known as *distribution,* involves all problems in getting the finished product from the factory to its ultimate use by the consumer. In other words, marketing concerns

itself with such processes as are involved in getting the toothbrush from the end of the factory assembly line to the bathroom shelf, and the orange from the orange-picker's basket to the kitchen refrigerator.

ACTIVITIES OF MARKETING

The function of marketing includes many activities. Let us take, for instance, a keg of nails that Fred might sell in his store. The marketing process begins as the nails come off the nail-making machines in the factory. The nails must be graded according to size, strength, and weight; and then they must be packed and stored. After a short time in storage, the nails are sold by the manufacturer to a wholesaler who buys them in large quantities. They are then shipped to the wholesaler's warehouse. The wholesaler must raise the money to pay for them and to carry them in stock until he, in turn, can sell them. The wholesaler's salesman, who calls on retailers, sells some of the nails to Fred. The nails must then be transported to Fred's store and carried in stock there. Fred must pay for them and bear the risk that the nails may not be what his customers want, so that he may not sell them. Fred calls the nails to the attention of his trade by advertising and displaying them. Soon the nails are sold to one of his customers, to whom they must be delivered. The sale may have been on credit, so that Fred will have to wait a while for payment.

THE IMPORTANCE OF MARKETING

That the marketing function is important to our economy is evidenced by the fact that, on the average, the costs of distributing an article are one-and-a-half times the costs of producing it. In other words, for an article for which you pay $2.50, the man who grew or made it gets only about $1, the other $1.50 going to those who transfer it from the producer to you. If a businessman wants to supply his customers with goods at a price that will be lower than that of his competitors, the savings must and should be made in the marketing costs. It is evident, therefore, how important it is that the enterpriser study the distribution problems that affect his own specific business, so that he can be sure he is handling them in the most efficient way. The proper solution to the processes of getting the correct goods to a customer who wants them, at the place where he needs them, and at the best price, may indeed be the difference between making the sale or losing it and between the success or failure of the entire business venture. Fred Kennedy, to make a go of his business, must indeed study the market factors that will influence sales in his future enterprise.

MARKET FACTORS INFLUENCING SALES

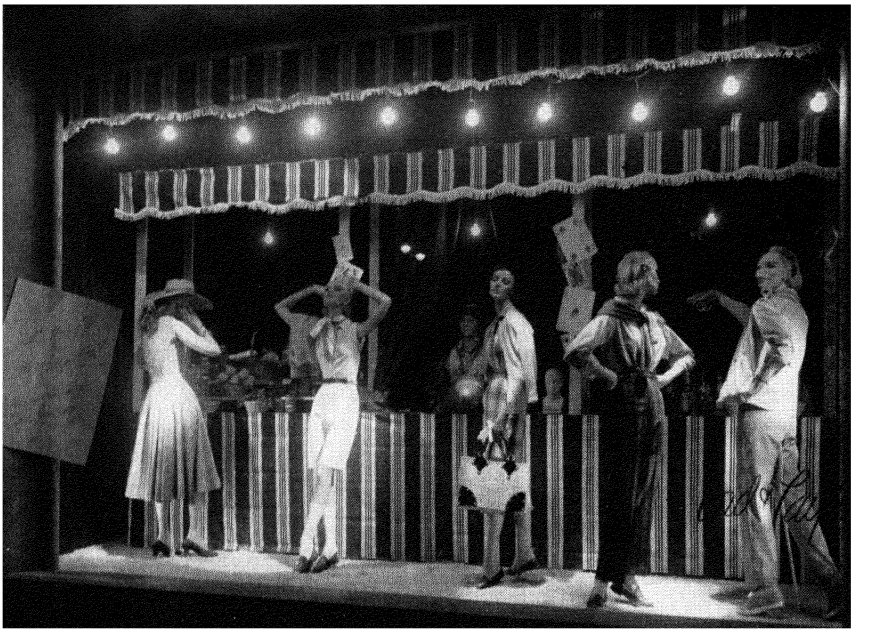
Types of Goods. Since marketing means first the choice of the right goods, we must examine what types of goods there are. Goods may first be broadly classified into industrial goods and consumer goods. It will be seen that this classification is significant because each class is distributed in a different way, with its own peculiar marketing problems.

Industrial goods are those used in producing other goods or in rendering services, rather than those to be sold to the ultimate consumer. They include raw materials, supplies, parts, and machinery and equipment used in commerce and industry. *Consumer goods,* on the other hand, are those used by the final consumer, the members of the public at large, for their day-to-day use. Consumer goods may, in turn, be broken down into three important classifications.

Convenience goods are those that the customer purchases frequently. He wants them readily accessible and obtainable with a minimum of effort on his part. These goods are generally of small size and unit value and are those for which the consumer will accept a substitute, rather than leave the store and go elsewhere to get a particular brand. Tobacco, candy, newspapers, and many grocery and hardware products are examples of this class of merchandise. Because convenience is the essential element in the sale of this type of goods, they are for sale in many stores and in all locations and neighborhoods, the customer usually patronizing the most accessible store. In the sale of such articles of his stock as nails, screws, nuts and bolts, Fred Kennedy would be dealing with convenience goods.

Convenience goods are sometimes subclassified into emergency, utility, and impulse goods. *Emergency goods* are those the customer suddenly needs on the spur of the moment as the result of some unusual occurrence and that he will buy at the nearest store carrying them. Umbrellas or rubber overshoes in a sudden rain, garters, or handkerchiefs, might be goods in this class in appropriate circumstances. *Utility goods* are those the customer purchases while shopping for other merchandise, but seldom goes out especially to buy. Soap, oil for an automobile, and boxes of matches are examples of this type of merchandise. *Impulse goods* are those the customer buys because he sees them and is attracted to them while buying something else. Originally he may have had no desire for them and did not go to the store with any intention to buy them. Cookies or candies, novelties, and kitchen gadgets are in this group.

Shopping goods are those which the customer selects carefully, taking time to compare prices, quality, and style in various stores. These



Courtesy Lord & Taylor

Customer Appeal. This window display of women's sportswear attracts many customers into the store. What is the type of goods displayed here?

goods are bought less frequently than convenience goods, and the customer considers them important enough to spend some time before making the final selection. For this reason, these items are sold by large stores located in the downtown shopping center, where other stores of the same type are located, instead of being carried by many small local, neighborhood stores. Women's clothing, furniture, and jewelry are items of this class.

Specialty goods are those for which a customer will go to considerable inconvenience to obtain, for which he will accept no substitutes, and for which there is some special attraction other than price. The buyer usually knows in advance what he wants, when he wants it, and where it is sold. The quality or reputation of the store or the brand of the merchandise are the major factors, many specialty goods being branded articles. Because the customer goes to some effort to obtain the particular item he wants, this type of merchandise may be sold in relatively few, especially selected stores; sometimes this merchandise is sold directly from the manufacturer to the consumer. Brand-name men's clothing,

CONSUMER GOODS

Type	Example
Convenience	candy, cigarettes, hardware, screens
Emergency	rubbers, umbrellas
Utility	matches, soap
Impulse	gadgets
Shopping	furniture, furs, jewelry
Specialty	automobiles, radio, television

automobiles, electrical, radio and television appliances and sets, and fancy groceries are in this category.

SERVICES

Some firms market services rather than any kind of merchandise. Either they supply labor of a physical or mental kind, or they temporarily rent out or loan something. Thus the barber, tailor, laundry, service station, and theater all supply some form of labor which the customer will use or enjoy. The typewriter-rental shop, hotel, garage, taxicab, and Fred Kennedy's dream of a Cook-O-Mat all sell the temporary use of some kind of equipment.

POPULATION TRENDS

Another major factor influencing the distribution of goods and services, besides the type of the merchandise itself, is that of *population trends.* The population of our country and of the world has increased tremendously in recent years, more than doubling in the past fifty years. This, of course, means that many more consumers will be seeking merchandise than formerly. In addition to the factor of population increase is that of the over-all movement of population. In our country, this has been a steady movement westward, so that the center of population is moving from its former position close to the East Coast to one where it is now close to the geographic center of the country. The western states of our country are experiencing a much greater rate of growth than any other sector and are thus more and more a factor to be considered in the distribution of goods.

Another population factor influencing the "right goods" and the right place where they are wanted is the trend away from a rural and farm population to a city and suburban population engaged more and more in commerce and industry. In 1920, about 50 per cent of the population of our country lived in rural areas. In 1950, only 40 per cent of our

people lived in rural areas, many of which may be classified as suburban rather than purely country areas. Naturally, this makes a difference in the type of goods to be sold and the place where they will be sold.

The factor of *average age of population* must also be considered; on the average, our population is growing older. This is due to two things: (1) a birth rate that for quite a few years was declining, and (2) an even greater decline in the death rate. The average life expectancy of the American today is close to seventy; not too many years ago it was in the thirties. The number of persons over 65 years of age in our country increased nearly 30 per cent in the ten years from 1940 to 1950. This, of course, means a greater volume of business for those articles wanted and used by older people.

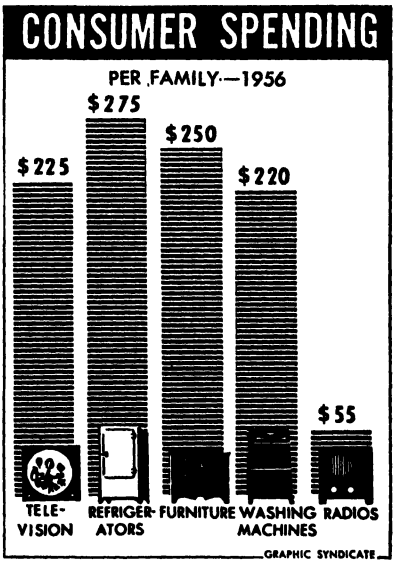
Conversely, the recent tremendous rise in the birth rate in this country means a similarly great rise in the consumption of babies' goods. As these babies grow older, an increase in the consumption of children's and then teen-age necessities and luxuries will, of course, follow.

The number of families in the population has been increasing. This trend has resulted in the demand for more homes and more apartments. The result has been a demand for less heavy furniture and for more carefully selected household accessories. The increase in the number of families has resulted in the need for more housing and household appliances. This trend will continue for at least ten years.

The great increase in the number of women who work in commerce and industry and the improvement in their political, social, as well as economic status has had a marked effect on marketing. Fewer women are tied down to the home; and those who are either do not have the time or do not want to take the time to do household tasks. This has led to a great increase in the demand for prepared foods, ready-made clothing, and household appliances and labor-saving devices. The income that women earn has helped to raise the standard of living generally and thus contributed to the increased demand for goods of all types. Their improved social status has tended to intensify the importance of women in the area of purchasing. Many of the items that are usually purchased by men, of which the automobile is an example, are now being designed to appeal to women, because producers and distributors are taking note of the influence women are exerting in the selection of such purchases.

INCOME AND ITS EFFECTS ON MARKETING

To understand fully the distribution problems of his business, the enterpriser must study the wealth and income levels of his customers. The wealthier the community in which his goods or services are marketed,



Spending for Furniture and Appliances. This graph represents average consumer spending, of course. Can you suggest how the ratios of expenditures might change from year to year?

the more stable and conservative his trade will be. They will be more interested in expensive items than the customers of a store in a poorer neighborhood and will be less affected by depressions and periods of economic stress. The taste of people of truly wealthy backgrounds, who have been rich for generations, is generally for very fine but also ultra-conservative merchandise. On the other hand, if the rich people of a neighborhood are mostly newly rich, self-made individuals—wealthy as the result of a sudden success—they are likely to desire the most expensive, flashy, and extreme merchandise. The old-line wealthy are slow payers for goods bought on credit, but are usually sure to pay up eventually. The high-income, newly-rich may pay up more quickly; but they are more of a credit risk, because they often live beyond their incomes or their businesses, which, suddenly successful, may fail as quickly.

A knowledge of the income level of the customers in a given area is helpful also for other reasons. The great majority of consumers are in the low-income groups, so that merchandise, to have mass appeal, must be inexpensively priced. The fewer people in high-income groups, however, spend as much money in total for goods as do the larger number of persons of low income. There is thus a considerable market for high-quality and expensive merchandise, if the distributor of them picks the right places and methods of sale.

Studies have shown that, as income increases, the proportion of the total income spent for food decreases; the proportion spent for rent, fuel, light and other housing expenses remains the same; while the proportion

spent for clothing, recreation (including automobiles), health and education increases. Thus the income level of his customers will be a clue to the businessman as to how much interest they will have in the items he is distributing. Furthermore, the changing income patterns of his trade over the years, due to prosperity and rise in income levels generally, or the falling incomes of depression periods, will indicate shifts in the demand for various types of products. A rise in the income level will mean an increase in the purchase of food, but nowhere near as much as an increase in the demand for fur coats and automobiles. Falling incomes among the population of the area will see some decrease in food purchases, but a much more radical decrease in the purchase of furs and autos.

THE EFFECTS OF LOCATION

The geographical location of the store or distribution outlet also affects considerably the marketing problems of the enterprise, although years ago the influence of geography was much greater. There was a time when country people wore different clothes and had radically dissimilar tastes in merchandise than city folks did. Nationwide advertising in magazines and on the radio and television has done much to eliminate this difference. Today the farmer's wife wears clothes that are just as stylish as those worn by the city-bred housewife; the urban boys and girls are now clad in the same blue jeans as farm children wear. Farmers once grew their own food, and their wives made clothing from cloth manufactured from yarn produced by the sheep raised on the farm. Specialization in agriculture today has done much to eliminate this distinction. The farmer buys from stores most of his family's food and about all of its clothing, just as the man in the city does; but geography, or location, still does have some considerable effects on distribution.

Climate makes a difference in the demands of customers. Fuel, heavy clothing, snow shovels and snow tires naturally sell more readily in cold areas. Bathing suits, soft drinks, and electric fans are, of course, more in continuous demand in warm ones. The changes in climate of New England make a considerable difference in the stock carried by a childrens' clothing store in Boston from that carried by a similar shop in San Diego.

The problems of wealth and income differences of people, mentioned above, are often, at least on the level of the retail store or small wholesale house, actually matters of location. Similarly, the small firm dealing with customers in only a limited area must deal with variations in tastes and desires of people due to religion and nationality backgrounds. Orthodox

Jewish people buy food only from stores selling kosher products; Catholics eat no meat on Fridays; Spanish, Italian, and Irish people are generally more interested in religious articles for the home and person than people of other national extractions, and so on. If a neighborhood is predominantly of one race, religion, or nationality, the stock carried by a storekeeper in that area must conform to the tastes, customs, and prejudices of that ethnical group.

Location or geographic situation of an enterprise is also strongly affected by what might be called traffic factors. The store emphasizing convenience goods locates in home neighborhoods. The wholesale distributor of men's hats generally locates in an area where other wholesalers of men's hats are situated, so buyers from hat stores will not have to go out of their way to visit his showroom. A store, such as a supermarket, whose customers come in cars in order to drive off with their purchases, must locate in an area where parking facilities can be made available. The number of people passing the store during the day or night makes a difference in the amount and type of business a store might do. Thus a location on a busy corner is important to the drugstore selling so many convenience articles. The extra rent for a corner store makes such a location inadvisable for the furniture store or automobile dealer selling high-priced shopping or specialty goods whose customers come in to shop or buy after careful thought.

BUYING MOTIVES AND HABITS

It is important for a retailer like Fred to know the reasons why people buy merchandise and services. What makes a person buy merchandise from a specific seller at a certain time and at a given price? The question of why he buys can often be answered from a study of his buying motives. How, when, and where he buys are indicated by his buying habits.

People sometimes buy merchandise because of the desire for pride of ownership or people often want to appear to be distinctive or different. On the other hand some people imitate others who are considered smart. Such reasons are called emotional reasons. Rational motives, on the other hand, might be the purchase of merchandise to save labor or because of its long-run economy or dependability.

Buying habits affect the time, place, and method of purchases. Fred Kennedy, for instance, should be very much concerned with the interests of his potential customers. Does the average customer, in the location where Fred plans to have his store, think out in advance what hardware he needs? Does he go around searching for the best buy? Does he buy those items on impulse, or as the need actually arises? Does the

purchaser of hardware items normally go to the hardware store for them, or does he buy them at a variety store, commonly known as a "5-and-10"?

STYLE AND FASHION

Fashion is also an important factor in motivating buying. A *style* is a characteristic mode of expression in art or design. It is more or less permanent. The three-button suit, the Queen Anne chair, or the page-boy hair-do, are examples of a major style or design that on the whole does not change. A *fashion* is a style that is generally acceptable or popular with the public at a given time. Fashions do change. The long skirt, for example, is the fashion at one time; the short, at another. A *fad* is a very short-run, extremely popular acceptance of a particular style.

The enterpriser who sells merchandise in styles that become popular and then go out of popularity is dealing in "styled" goods. A ladies' millinery shop deals in such goods. Fred Kennedy's hardware shop, for example, will deal mostly in unstyled, staple goods like nails, screw drivers, hinges, and so on. Nevertheless, there are also fashions, though in more limited degree in hard goods, when styled merchandise becomes the fashion. There are generally five periods in the sequence of growth and decline of a fashion. The first period is *innovation,* when styles are started by a few key people. The second is the period of *imitation,* when many people tend to follow the innovators. A third period is that of *conformity,* when most people feel the need for following a fashion. The fourth period is that of *acquiescence,* when almost everybody follows the fashion. Finally the fifth period is one of *clearance,* wherein the old fashion is going out and a new fashion may be coming in. It is important for a merchandiser of styled goods to realize, if possible, at what stage of the fashion cycle a particular style is. If he is to make wise decisions, he must do his purchasing accordingly and plan his sales program in terms of the probable interests of his customers.

MARKET RESEARCH

STUDYING MARKET TRENDS

Thus it can be seen that the alert enterpriser does not start a business by just stocking and trying to sell what he likes or feels he wants to handle. Instead, he makes a careful study of the market to see what his customers want and where he can best locate to supply them with it. This study or research of his future market should be as detailed and accurate as possible, commensurate with the amount of time, effort, and money he can afford to expend and the size of business he hopes to

open. The smaller venture can be initiated after a moderate study described below; the larger enterprise often can afford to hire specialized, trained market analysts to conduct this research for it.

MARKET STUDY BY THE SMALL BUSINESSMAN

What can a small businessman, like Fred Kennedy who hopes to open a hardware and electrical appliance store, do in the way of market research to aid him in solving his marketing problems? We have seen, in the discussion throughout this chapter, what some of these questions and problems are that Fred must face and solve if he is to operate in a suitable location and supply his customers with what they want. Let us see how he can set about, within his own limited scale of funds and abilities, to seek the possible solutions to his distribution difficulties.

First of all, the businessman's own experience and records of past sales by items will be of considerable value in indicating the wants of customers for his new enterprise. Fred has had experience working in the hardware and appliance field and should have a fairly good conception of demand in his line. Then he should take note of the merchandise being carried by stores that will be his competitors and by hardware shops in comparable locations in other parts of the city or similar cities. Trade journals and the advertising and literature of manufacturers in his line will also be helpful.

The public libraries in larger-size cities, chambers of commerce, and trade associations will be sources of business and statistical information that should aid in determining the size of population, number, and income level of families, and other data useful for determining the size and level of consumer demand in the area where the business will be located. Similarly, information can be obtained from these sources as to the specific neighborhoods where Fred, or any other prospective storekeeper, is contemplating locating his shop.

Items that Fred would want to know about, and should be able to obtain from his studies at the library, chamber of commerce, local hardware association, as well as from neighborhood banks and real estate offices, include:

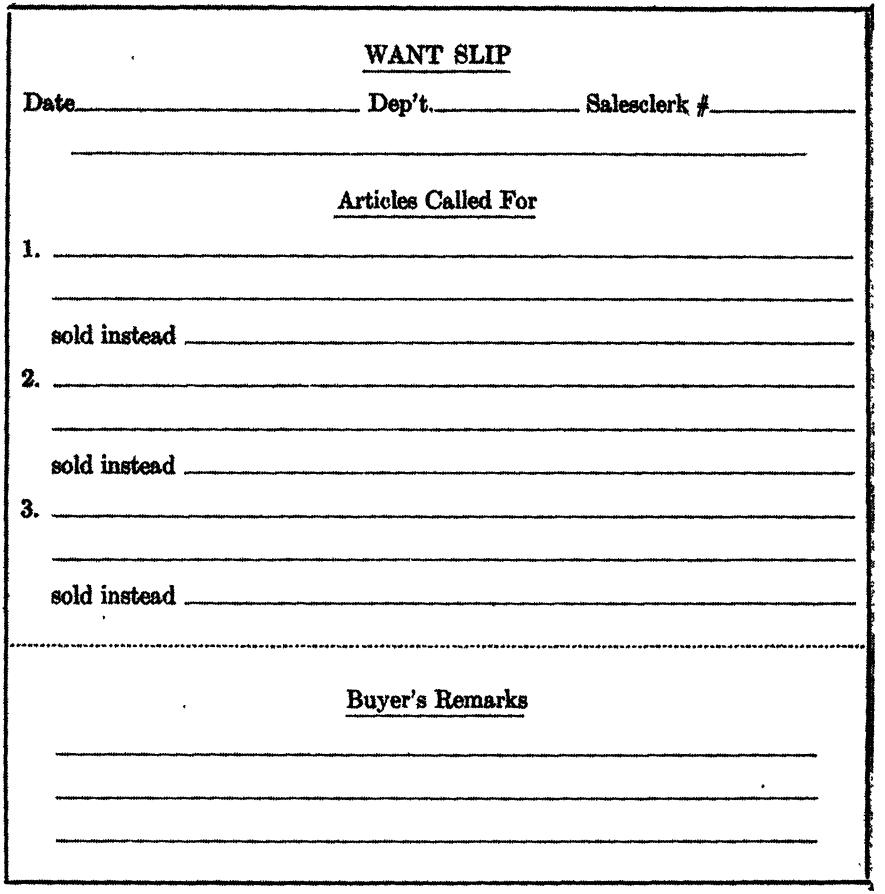
1. Population of the area, with reference to:
   a. Number of people
   b. Average age level
   c. Major vocational activities
   d. Number and size of families
   e. Major nationalities, races, and religions
   f. Average level of income and trend of income—rising or falling

   g. Trend of population growth or decline
   h. Percentage of home owners, apartment dwellers, rooming-house tenants, etc.
2. Physical characteristics of the area, with reference to:
   a. Climate
   b. Size of the trading area
   c. Transportation and highway facilities
   d. Amount of traffic congestion and available parking space
   e. Nature of surroundings
   f. Number and nearness of competitive stores
   g. Future of the area as a shopping center
   h. Nearness to residential areas
   i. Whether it is a "dormitory" area, where people live, but do their business elsewhere
3. Desirability of the precise location from standpoint of the specific business:
   a. Nature and number of customer traffic on different streets, each side of the street, at various hours of the day, and different days of the week
   b. General mood or state of mind of people passing the location—seeking amusement, going to and from work, out shopping, etc.
   c. Proximity, size, and efficiency of the nearest competitor
   d. Availability and rent of a desirable store
   e. Zoning or other restrictive laws or ordinances
   f. Availability of suitable banking and protection facilities

Want Slips. Once the business is under way, an alert enterpriser can soon discover precisely the type of merchandise his customers are seeking and make revisions in his stock accordingly. In a larger store than Fred Kennedy would start with, where the management does not itself have contact with its customers, sales personnel are often instructed to fill out a *want slip* to indicate items of merchandise that customers asked for which were not in stock. It does not mean, however, that because one or two customers ask for something, it is necessarily advisable for the store to stock the item; but the buyers often get good ideas from such requests to fill in good items not presently carried.

MARKET STUDY BY LARGE BUSINESSES

The problem of market research is the same for the big business enterprise as it is for the small one, except that it is on a larger scale. The large firms, however, can generally afford to hire specialists in market research to obtain this information for them. Some maintain their own staff of such experts to obtain data constantly and to evaluate and interpret particular business information. Others employ independent private firms that specialize in market research for their clients. Large as well



WANT SLIP

Date_____ Dep't._____ Saleselerk #_____

Articles Called For

1. _____

sold instead _____

2. _____

sold instead _____

3. _____

sold instead _____

Buyer's Remarks

A Want Slip. What use is made of this form?

as small firms make extensive use of information supplied by governmental agencies, trade associations, and chambers of commerce. Questionnaires, house-to-house canvasses, and questioning passers-by in the streets are also used.

SUMMARY

The marketing or distribution of goods or services presents an important area of problems that must be studied and effectively solved if the enterpriser is to run a successful business. Among the market factors that will strongly influence his sales are the type of goods he is selling, the population, income, and geographic factors of the locality in which

his enterprise will be located, and the buying motives and habits of his customers. It is essential that he obtain as much information as he can on this subject from all available sources and evaluate them carefully, so that he can make intelligent decisions on the proper distribution of the product or service he is offering for sale.

► FOR REVIEW AND DISCUSSION

1. What is marketing? Describe some of the activities of marketing.
2. Distinguish between consumer goods and industrial goods.
3. Identify the characteristics of convenience goods. Name and describe three general types.
4. Why are "shopping goods" so named?
5. What are specialty goods?
6. Describe the effects of population changes on the marketing of goods and services.
7. What is the relationship between the income of an individual and the amount of goods he purchases? Is this relationship the same for all income levels?
8. How do geographical factors influence people's buying habits? In what way have these influences changed during the past hundred years?
9. In what way do such factors as religion, nationality, and race influence the marketing process?
10. How do style, fashion, and fad influence what people buy?
11. Describe the stages in a fashion cycle.
12. What is meant by "researching the market"?
13. What are "want slips"?
14. What makes one particular business location better than other locations? Discuss the factors that must be considered in selecting a business location. Does it make a difference as to whether the business is located on the east side or the west side of the street? north or south side? Is it better to locate near competing businesses or as far away from them as possible?

► CASE-PROBLEM QUESTIONS

1. How can Fred and his associates accurately determine the need for a hardware business?
2. What factors should they consider in selecting a location?
3. Should they handle small household hardware goods, industrial hardware, farm hardware, or all these goods? What will location have to do with this decision?

4. If they locate their business on the main traffic artery near the edge of the city, should they handle the same type of merchandise as they would if they located in the center of town?
5. In surveying the market and the extent to which the market is now being served, what types of businesses, other than hardware, should Fred study?
6. Is volume of traffic on the street the most important factor to be considered in the study of population as related to location?
7. How can the chamber of commerce help Kennedy decide whether he should open a hardware business?

► APPLIED BUSINESS PROJECTS

1. There are many factors that cause people to buy. Construct a table like the following example. Give at least ten factors and make certain that at least five are favorable and five unfavorable.

Factors Influencing People to Buy or Not to Buy	*Will Factor Result in More or Less Buying? Either Result? If So, When?*
Climate	A warm winter may encourage people to buy less clothing. A cold winter would encourage more buying.

2. List five types of businesses that can usually operate successfully in a suburban shopping center; five that should be downtown in the center of the city; and five that can be located in rural areas.
3. On a map of your town or your community (obtainable from your City Hall, City Planning Commission, or commercial map seller in your community), locate the major market centers for industrial goods, convenience goods, shopping goods, consumer shopping goods, specialty goods, and services. Itemize in an accompanying chart.

► COMMUNITY PROJECT

Have each member of the class choose a type of product which he would like to sell to the public in your community. Select a business location where the product can be sold successfully. All of the following factors must be considered in selecting the location of the business:

1. Population
2. Traffic
3. Income of customers
4. Climate
5. Religion and nationality of customers
6. Convenience
7. Fixed operating costs
8. Competition
9. Others



6

Channels of Distribution

CASE PROBLEM

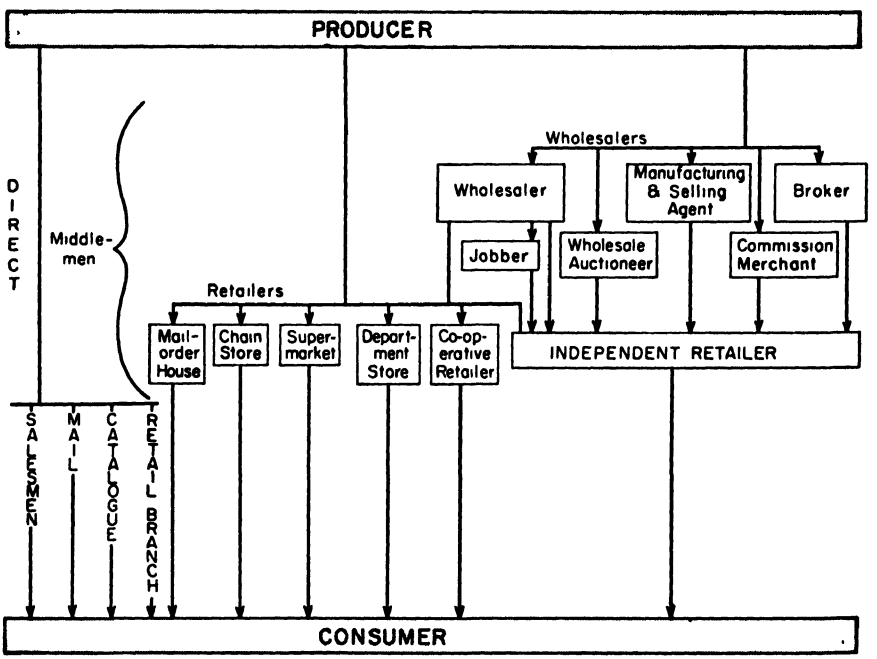
Fred Kennedy and his two partners have decided that an electrical-appliance and hardware business in their city should have a good chance of success. They have decided that they will be retailers because they do not have the clientele nor the experience to be good wholesalers. They think, moreover, that opportunity is better in the relatively quick turnover in sales in the hardware business. This rapid turnover, they hope, will give them adequate profit. They have found a neighborhood where they think there is need for a good hardware store, as none is there at present.

There are several good hardware wholesalers in the merchandising area of their community. With one of these Fred has been acquainted for a long time. Fred and his partners now face the problem of what to buy, when to buy, how much to buy, and from whom to buy. Then there arise such questions as these:

- What are the channels of distribution in the hardware and electrical industry?
- To what kinds of customers shall Kennedy try to sell?
- From whom shall he buy his goods—from manufacturers or from wholesalers and jobbers?
- Shall he buy from people whom he has known for a long time, or shall he buy from people in terms of a definitely stated list of qualifications?
- Should Fred seek to obtain exclusive rights to sell in his area the hardware items produced by one manufacturer?
- Should he plan to carry a balanced supply of merchandise of several manufacturers in competition with other distributors in his locality? Should he do a little of both?

CHANNELS OF DISTRIBUTION

In previous chapters, the problem of distributing factory products to the consumer was considered. Fred has made a study of the area in which he plans to set up his store, and he has some idea of the needs of his potential customers. Now his attention must be focused on the routes or channels that the products take in going from the producer to the consumer. Enterprisers who help in the transfer of merchandise and service from producer to consumer are called *middlemen* or *merchants.* Fred Kennedy, in other words, will be a middleman. The paths the merchandise might take in getting from the manufacturer to the consumer are referred to as *channels of distribution.* Some products are sold directly by the manufacturer to the ultimate consumer and require no middleman. Others require the intermediary step of being sold through one middleman, a *retailer,* before reaching the consumer. Still others pass through the hands of two or more middlemen on their way from manufacturer to user, generally being sold by the producer to a *wholesaler,* who sells them to a retailer, who in turn sells them to the consuming public.



Channels of Distribution

DISTRIBUTION WITHOUT MIDDLEMEN

The least complicated and oldest form of distribution is that directly from the producer to the consumer, with no merchant middlemen "in between." The simplest example of this is the farmer who sells his products directly to consumers either by means of a roadside stand, by home delivery, or by *huckstering*—selling from a truck or wagon in the streets. The amount of goods sold by such means is, of course, necessarily small.

Some manufacturers also use this direct trade channel in marketing their products. The producers of large, bulky articles—such as steamships, prefabricated buildings, railroad locomotives, and factory machinery—usually sell them directly to the industrial consumer who uses them in his own business. The manufacturer usually makes such sales through his salesman, and the products are usually sold by an order or contract before they have been made or built.

Some items are sold directly by the manufacturer to the ultimate consumer by means of house-to-house salesmen, called *canvassers,* often backed by an extensive advertising campaign. These are usually articles for women or for the home, such as vacuum cleaners, kitchen gadgets, brushes, ladies' hosiery, and cosmetics. Other articles, such as bakery or milk products, are sold by producers directly to consumers by means of delivery trucks and route salesmen who deliver them to the consumers' homes on a regular schedule.

Some producers use the mails as a means of selling directly to consumers, obtaining their customers either by sending out circular letters or advertising by radio and television, or in newspapers or popular "pulp" magazines. Articles most suitable for direct distribution by mail would be those that are (1) protected by a patent; (2) simple to use; (3) easy and inexpensive to ship; (4) not available in most retail stores; and (5) priced from $1 to $5. Some manufacturers mail out large catalogues describing the products they manufacture, and their sales are made directly to consumers; however, except for mail-order sales of machines and equipment to industrial consumers, most mail-order business through catalogues is done by large retail middlemen rather than by manufacturers.

Some manufacturers open their own retail sales branches in various localities as a means of selling their products directly to consumers. These are most successful where the producer makes a full line of products (such as paints) to justify maintaining a retail establishment to sell solely his own goods; or where, as in the case of some sewing machines, the store can demonstrate and teach the use of the product. *Manufacturers' retail branches,* as these are called, are difficult to manage, because the enterpriser must be familiar with the problems of both manufacturing



Courtesy Fuller Brush Company

The Canvasser at Work. The house-to-house salesman has a challenging job in keeping the buyer interested. One of his most effective sales methods is the demonstration. Can you think of some do's and don'ts for this type of selling?

and retailing and must be sure not to neglect or ignore one while solving those of the other.

Because the problems of selling to consumers are so intricate and diverse, the proportion of manufacturers who sell directly to consumers is comparatively small. Most producers prefer to concentrate on the manufacturing problems with which they are familiar and leave the difficulties of consumer distribution to middlemen specialists. Generally, distribution can be done more efficiently and inexpensively through these merchants than if the manufacturer attempts to eliminate them and market his products directly to the consumer himself.

SELLING DIRECT TO RETAILERS

A channel of distribution that is increasing in importance is that where the manufacturer sells directly to retailers, who in turn sell to the ultimate consumer. In this case, the retailer is the merchant middleman

who operates his store and deals primarily with the consuming public.

While more and more manufacturers are trying to eliminate further wholesale middlemen by dealing directly with retailers, this channel of manufacturer-to-retailer-to-consumer is best fitted to certain types of products. These would include those (1) where the unit price is so high that not many retail outlets handle the merchandise; (2) where the products require assembly or service, as in the case of automobiles or perhaps some of Fred Kennedy's electrical appliances; (3) where the goods are either perishable or extremely styled, so they must move quickly; or (4) where the manufacturer makes a whole family of products, such as Standard Brands or National Biscuit Company products, and can afford an organization large enough to distribute its wares to the many retail stores handling it.

TYPES OF RETAILERS

Fred Kennedy must not only decide at what level of distribution he wishes to operate (the pros and cons of which will be discussed later) but, if he decides that he and his partners should open a retail hardware establishment, they must also come to a decision as to what type of retail store it should be. The greatest number of retail stores are independent retailers, doing in total about 60 per cent of all retail-store sales. These are usually conveniently located, often family-run—or at least managed by the owners who actively participate in the operation of the store. These owners usually are not specialists, but they do the buying and selling, arrange for financing and advertising, hire and fire employees, and the like. They are generally independent proprietorships, partnerships, or small corporations.

Because they are usually small, the independent retailer has the advantages of the small business organization—better customer relations, personal attention of the owner, low rent and salaries, and little of the bureaucracy and "red tape" that plague larger establishments. On the other hand, they suffer because their owners must be Jacks-of-all-trades and thus masters of none. Buying is more expensive and less skillful; merchandising and pricing is haphazard, and the owners work long hours. The ease with which anyone can open an independent store and the mistaken belief that anyone can run it and that its operation takes no special skill or ability, make these stores vulnerable to quick failure.

Some independent stores are *single-line* stores, or *unit stores,* selling one line of merchandise, such as men's ties or perhaps only power saws. Others are *specialty shops,* selling a larger variety of a single type of merchandise. Examples of this would be a shoe store, selling men's, women's, and children's shoes; or in the case of Fred Kennedy, only hardware.

General stores sell many lines in the one store, operating as a unit rather than as separate departments. The old general stores sold just about everything their customers could want. The nearest thing to such stores today are the variety stores, which sell a tremendous assortment of items as one unit, usually for low unit prices. These are the former "5-and-10-cent stores," no longer so called because they do not limit themselves to those prices today. Drugstores that sell many items besides pharmaceuticals may be considered general-type stores.

Department stores are generally large stores carrying a wide variety of items and lines operating as separate departments. The department stores have the advantage of ease in customer shopping, because they carry nearly everything under one roof. They undertake large-scale purchasing and give their customers services, such as delivery and the privilege of taking back items that they do not want. Recently, many department stores have opened suburban stores in addition to their main downtown establishments, because so many of their customers have moved to the suburbs and like to shop where parking space is available.

A *specialty store,* as distinguished from specialty shops mentioned previously, is really in many respects a smaller department store that is limited to one general area of merchandise. There is no clear distinction between a small department store and a specialty store. The specialty store does not deal in all merchandise and therefore tries to be especially complete in those departments in which it does give service. Specialty stores are particularly popular in such fields as women's apparel.

The *supermarket* is a large departmentalized store on one floor, dealing in foods and household merchandise on a self-service and, usually, cash-and-carry basis. Except in a few congested city areas, most of them also offer adequate parking space. Supermarkets are able to sell at relatively low prices, because they buy large quantities, have a rapid turnover of their merchandise, and emphasize mainly well-known nationally advertised foods. They require few salespeople and have only a few stock clerks and cash-register checkers. The supermarket self-service idea has been spreading to variety and general stores. Fred Kennedy might indeed consider such a form for a retail hardware and appliance store, where merchandise would be sold on a cash-and-carry basis. Ample parking space would also have to be available.

Chain stores consist of several, usually four or more, centrally owned stores selling similar lines of merchandise. They combine the advantage of convenient location with that of large-scale economies, through central purchasing and warehousing. Many retail stores combine several of the retail classifications, as there are chains of department stores and supermarkets. While some retailers are *mail-order houses,* doing their selling



Courtesy Gertz & Company

Ready for Business. A clever display with a "political" flavor, featuring Father's Day—Vote for Pop June 17! What type of store is this?

by means of catalogues of thousands of items that they send by mail to customers who order through the mail, many mail-order houses maintain chains of department stores; and most department stores also do some of their business by mail.

SELLING THROUGH WHOLESALERS

Over 75 per cent of all merchandise sold in this country passes through the hands of wholesalers, by a channel of distribution that includes manufacturer to wholesaler to retailer to consumer.

The *wholesaler* is generally a merchant middleman who buys goods from the producer in large lots and carries stocks of this merchandise in his own place of business. He then sells the goods in smaller lots, by means of salesmen, to retailers, hotels, and institutions, extending credit and affording prompt delivery. *Jobbers* are smaller local wholesalers who buy goods from a large national or regional wholesaler in medium-size lots and sell them in even smaller quantities to independent retailers.

Some middlemen perform many of the functions of the wholesaler, in taking goods in large quantities from the producer and disposing of

them in smaller lots to retailers; but they themselves do not assume the ownership of the goods. Thus many of them act merely as *brokers,* making sales for the producers. Others are *commission merchants* who accept the goods in their own places of business purely on consignment and sell them to retailers there, but never at any time own the merchandise. These middlemen, usually in food and grocery lines, are compensated by a commission, or percentage of the selling price. *Wholesale auctioneers* maintain auction salesrooms to which the produce is brought and sold by the auctioneer to retailers for the producer. This method of distribution is commonest in the sale of tobacco, fresh fruit, and vegetables.

Manufacturers' agents and *selling agents* are men in business for themselves, who take several lines of merchandise from different manufacturers and sell them for commission, much as might a salesman actually employed by one of the producers. But by selling for different manufacturers of allied, but not identical products, these agents can offer a variety of items to their customers at the same call, thus selling them more economically than if each manufacturer had to have his own sales force. The chart on page 79 illustrates the various channels of distribution as they have been described in this chapter. Now let us observe the factors that Fred Kennedy must consider in deciding upon the place of his business in the distribution pattern.

CHOOSING THE CHANNEL OF DISTRIBUTION

The choice of the channel that Fred's hardware or appliances will take in passing from factory to consumer is to a great extent not one that Fred himself can make. Rather, it depends on the type of product being sold, the consumers who buy it, the size of the producers, and the customary pattern of distribution in that industry.

1. ***Peculiarities of the Product.*** The number of middlemen who will handle a product on its way from manufacturer to consumer is often governed by the peculiar properties of the product itself. Thus those that are very perishable, such as milk and bakery products, are sold in many instances by the producer directly to the consumer, or at most, along with several other food items, reach the ultimate user through only one middleman, the retail store. Products that require servicing, expensive handling equipment, or instructions before use also pass through few middlemen's hands. Thus automobiles, gasoline, and sewing machines are sold by the producer directly to the consumer or perhaps through just a retailer.

2. ***Number and Proximity of Consumers.*** Another important factor in the selection of a channel of distribution of a product is the type of con-

sumer it will have. Where the number of consumers is small, the manufacturer can employ his own salesmen to call on them himself and thus sell directly to consumers, or the retailers. This would be true for instance, in large, bulky, or very expensive items, such as power plants, boilers, or fine jewelry. If, on the other hand, there were many consumers for the product, as in the case of cigarettes, a manufacturer could not possibly hire or afford to maintain a staff of salesmen to sell them directly to the consumers, or even to the host of retail stores who carry cigarettes. Here the services of wholesalers are essential.

The proximity, or nearness, of the consumer to the manufacturer is also a factor. If all the consumers who will use his goods are in the same city, or nearby, a producer might distribute his product to them himself. But the more widespread and farther away his consumers are, the more need the manufacturer has for the aid of middlemen in the various regions and localities.

The question of credit enters into the picture too. Where there are numerous consumers buying the goods on credit, or many retailers needing *credit*—time within which to pay for their purchases—the producer again needs the aid of middlemen, as he would not normally be in a position himself to extend credit to so many customers.

3. *Size of the Producer.* The size and financial strength of the business firms involved have much to do with the trade channels in the sale of goods. If the producer is very large, particularly one who produces a great many, or "family" of products, he may be able to maintain his own sales force and various warehouses to keep stocks of his goods throughout the country. Similarly, he might be able to extend credit to many customers. Such a producer could then sell directly to retail stores, eliminating the wholesaler entirely, and in a few cases, possibly even sell directly to the consumer. Sometimes, a retail chain of stores becomes large enough to maintain a central purchasing office and warehouse in different parts of the country, so that it is the retailer who then eliminates the wholesaler.

4. *Customs of the Industry.* Often a producer must market his product as the rest of the industry is doing, if he is to meet competition. A druggist, for example, carries thousands of items on his shelves. He could not possibly have the time to confer with salesmen from the hundreds of manufacturers of these products and order from each of them individually. Instead, the wholesaler gathers these items together from the manufacturers in large lots and sends salesmen around to the retailers. The latter can thus order practically all their stock from the one firm. Drug manufacturers must therefore distribute their products through

wholesalers, unless they are selling to large drugstore chains who do their own wholesaling.

BY-PASSING THE WHOLESALER

As businesses have grown in size over the years, a movement has been steadily growing to eliminate the need for so many middlemen, especially the wholesaler. Manufacturers have become large enough to distribute directly to retailers, and retail chains have grown large enough to deal directly with manufacturers. Since a wholesaler must make a profit like any other businessman, it is generally felt that the product can be sold more cheaply if he is eliminated; or, at least, the large manufacturer or retailer can retain for himself the profits of the wholesaler.

The wholesaler does a necessary service, however, in (1) taking the goods off the manufacturers' hands in large lots; (2) assembling the products in stock in various regions where they can be quickly delivered; (3) selling them in smaller lots to numerous retailers or dealers in local neighborhoods; and (4) extending credit to these retail customers. Furthermore, the good wholesaler has become expert and efficient in performing these services, which have to be performed by someone. If the manufacturer or the large retailer can take care of these functions as carefully and thoroughly as the wholesale specialist, then they can indeed save his profits. But because they have their problems of manufacturing or retail selling to worry about, they often are not able to become as expert or efficient at the wholesale functions as the wholesaler himself would be, and instead of a saving, it might actually cost them more to carry out the wholesaling themselves than if they did their business through a wholesaler.

The by-passing-the-wholesaler movement and the efforts of wholesalers to combat it in order to save their businesses have led to some important business developments in many industries. In order to compete with retail chain stores, who obtain cheaper prices by buying in very large quantities and by doing their own wholesaling, some independent retailers band together and establish *co-operative warehouses,* which do the large-scale purchasing and assembling for these independents.

To maintain their existence, some wholesalers affiliate with a group of independent retailers and arrange to give them cheaper prices in return for the promise that these retailers will buy everything from the wholesaler. The selling worries and expenses of this voluntary group wholesaler are thus eliminated. Some wholesalers advertise and push their own private brand of goods, so that it will have a public demand; and retailers will have to buy from them.

WHERE TO LOCATE ON THE LADDER OF DISTRIBUTION

An enterpriser wishing to go into business must decide where to locate his activities on the ladder of distribution—whether to be a manufacturer, a wholesaler, or a retailer or possibly combine two or all three of those steps. The factors that affect his decision will be his own past experience or "know-how," the level of his former customers and friends in the business, the size and financial strength of the enterprise he intends to start, and the level at which he feels there is more room for another competitor.

1. ***Past Experience.*** One of the reasons for the large number of failures of retail stores in their first and second years of existence is the mistaken belief that it takes little ability to run a retail shop and that anyone can do it. This notion is false, not only for retail establishments, but for all levels of business endeavor. Success in business requires ability based on experience and know-how in the trade; therefore, in choosing the rung of the distribution ladder on which to place his enterprise, Fred Kennedy, or any other prospective businessman, should choose the level at which he has had previous experience and of which he has some personal knowledge. If, like Fred, he has worked only as a salesman in a retail hardware and appliance store, it would not normally be wise for him to attempt a hardware manufacturing or wholesale establishment, the problems of which will all be new to him.

2. ***Previous Customers.*** A prospective enterpriser is wise in choosing a phase of distribution in which he has friends; for example, if Fred Kennedy knew many retail hardware merchants, it might be wise to become a jobber or wholesaler. Since Fred is planning a retail establishment, the more people he knows in the neighborhood of his store, the better. Friends and acquaintances are excellent prospective customers.

3. ***Size and Financial Strength.*** Since, in most lines of business endeavor, it takes the most capital to be a manufacturer, somewhat less to be a wholesaler, and relatively the least capital to maintain a retail store, the size and financial strength of the new business might be a significant factor. A manufacturer not only needs a tremendous amount of know-how to succeed, he also usually requires a large investment because of the heavy machinery that must be purchased and the raw materials, labor, and overhead that must be paid for during the manufacturing process. A wholesaler, because he usually buys merchandise in large lots, requires a considerably large amount of storage space for the stock he must carry. Also, he generally extends liberal credit to his retailer customers. These functions require sizable financial backing. While there are some retailers who are larger than manufacturers or



Courtesy New York State Electric & Gas

America Shops. Busy marketing centers, such as this one, have sprung up all over the country in recent years. Can you account for the popularity of this type of shopping area?

wholesalers, the retail establishment can generally start on a smaller scale than can an enterprise on the other levels of distribution.

4. ***More Room for Further Competition.*** Finally, there is the factor as to which level presents the greatest opportunity for success; that is, which level is less overcrowded and has the most need for a new competitor in the line. There might perhaps be many retail hardware stores in an area, so that another such shop might have slim chance for success. Yet it might also be that there are no wholesalers of hardware in the area at all, the local retailers being required to buy from wholesalers remote in distance. Under such circumstances, it is possible this might be the deciding factor in favor of opening a business on the wholesale rather than the retail level.

SELECTING THE TYPE OF DISTRIBUTION

Another marketing problem that must be faced in the distribution of goods from the factory assembly line to the home of the consumer is that of choosing the type of distribution; that is, the number of outlets. The decision must be made whether the most sales will be made by having an article handled by every retail store in an area, or whether

more sales would result if only one or a very few shops in the area are given the exclusive agency to sell and therefore to push the product.

Intensive distribution takes place where one's goods are on sale everywhere, and the manufacturer trys to obtain every possible outlet for his product. While, at first glance, this may seem the way all manufacturers would want their goods to be sold, further thought will show that no seller will give a particular product much emphasis or push when all his competitors also carry the same merchandise. If, on the other hand, a product is one requiring much salesmanship to sell it, it is better to give a retailer an exclusive selling franchise in the area for the product, so that he will be willing to expend considerable time, effort, and money in advertising and selling it.

Goods most generally sold through intensive distribution are convenience articles and the lower-priced branded specialty goods. Cigarettes of all kinds, for instance, are sold in every store carrying tobacco items in the neighborhood. Items like nails, nuts and bolts, carried in a retail hardware store such as Fred Kennedy might open, would also be sold by every other hardware store in his locality.

Exclusive distribution involves the use of only a single outlet in a particular market area. Here the retailer or wholesaler enjoying this franchise, or exclusive privilege, has no direct competition with other distributors on that particular product and should be expected to give it considerable emphasis in his sales. Such exclusive agencies are generally granted for the distribution of a variety of special types of goods. These include:

1. Articles that are of high unit value, such as automobiles or expensive silverware. The manufacturer needs to have the distributor carry a full line of his products to show to customers; and because of the amount of money that must necessarily be tied up in carrying a full line of such expensive merchandise, he allows the retailer the advantage of being the only one to sell the product in the area.
2. Articles that require especially trained salesmen.
3. Articles that require installation or a stock of replacement parts.

   In these latter two instances again, the investment required of the distributor in obtaining the special salesmen, the installation crews and equipment, and the inventory of parts justifies the manufacturer in assuring the distributor (either on the wholesale or retail level, or both) that no one else in the locality will compete with him.
4. Articles that are part of a complete line of products. Where the manufacturer produces an entire line of goods, such as paints or fancy groceries, he may grant an exclusive agency to a distributor if the latter will in turn agree to handle no other lines of such goods. Thus, a manufacturer of electrical appliances might give Fred Kennedy's store the exclusive right to be the only one to sell its brand of appliances in

the entire city in which Fred's enterprise is located, provided in turn that Fred sells no other appliances except this manufacturer's brand.

Style goods that are often sold through exclusive shops; for example, only one store in an area might handle Gotham hosiery, or Kuppenheimer clothes, and the like.

Where an exclusive agency is given to a distributor, the manufacturer often requires the seller to agree to maintain a certain size of stock of the manufacturer's products, or to meet a certain quota of sales, or to spend an agreed amount of money advertising the product. Sometimes when a product is new and requires considerable salesmanship, exclusive distribution is used. Later, when the product becomes well known and established, the exclusive agencies are dropped and distribution becomes intensive.

In some lines, a compromise type known as *selective distribution* is used. Here competition among distributors takes place, but it is limited to only a few selected outlets in an area. This gives the manufacturer the advantages of having distributors who will have an incentive to push the sale of his products and, at the same time, will give him greater distribution than only one exclusive agency in an area would. Sometimes the manufacturer will grant an exclusive agency to a distributor in a remote area where the manufacturer's salesmen seldom call, while distributing his product intensively, or by selected outlets, in areas covered by his salesmen more frequently.

SUMMARY

The marketing of a product presents problems with reference to the channels of distribution. The question must be decided whether products should be sold directly by the manufacturer to the consumer; by the manufacturer to retailers and then to the consumer; or whether an additional middleman, the wholesaler, will be injected between the manufacturer, retailer, and the ultimate user of the goods. The promoter of a new enterprise must decide at which level of this distribution ladder he will place his business. It must also be decided whether distribution is to be intensive, selective, or exclusive.

► FOR REVIEW AND DISCUSSION

1. What type of goods are often sold directly to the consumer by the producer?

2. What are some of the advantages of operating as an independent retailer? disadvantages?
3. Distinguish between single-line stores and specialty shops; between general stores and department stores.
4. What types of products can best be sold through the supermarket type organization? Why?
5. What are the advantages of the chain-store type of organization?
6. How important is the wholesaler in the distribution of goods? Why is this type of organization essential in the marketing process?
7. Identify the following: jobber, broker, commission merchant, wholesale auctioneer, and manufacturer's agent.
8. What are the factors that determine the channel of distribution through which a product will be marketed? Discuss each factor.
9. What development has given rise to the establishment of co-operative warehouses; of voluntary group warehousing?
10. What types of merchandise can probably best be distributed by intensive methods?
11. Why do certain manufacturers enter into exclusive distribution agreements for the sale of their products? What types of products are often handled under exclusive agreements?
12. Explain what is meant by selective distribution.

► CASE-PROBLEM QUESTIONS

1. Can Fred be sure of his conclusion that the hardware business provides a quick turnover of merchandise?
2. How can Fred and his associates decide the kind of merchandise to buy for their opening stock?
3. What guides can Fred use to determine whether Kennedy and Company is buying at the best price available?
4. Should the new enterprisers try to direct their sales appeal to everyone in the neighborhood or primarily to certain types of customers?
5. Should Kennedy buy in large quantities, in order to obtain reduced prices, or buy smaller quantities at slightly higher prices?
6. Should Kennedy buy well-known name merchandise or unknown-name merchandise at a lower price?
7. What should Fred and his partners do with slow-moving merchandise?
8. Should Kennedy and Company plan frequent sales at special prices?

► APPLIED BUSINESS PROJECTS

1. Certain factors are important when deciding whether to enter the retail or wholesale field for selling goods. Among them are amount of capital available, knowledge of the market for the product, experience in management, and ability to expand the business operation.

What is the relationship of each of the above factors to the retailer and wholesaler? On an 8½ x 11 sheet of paper list the factors on the left-hand side

that are favorable and on the right-hand side those that are unfavorable. Answer the following questions:

a. Under what conditions is capital important?
Under what conditions is capital less important?
b. Why is knowledge of the market important?
Why is knowledge of the market not important?
c. When is experience in management important?
When is experience in management unimportant?
d. Why is ability to expand operation important?
When may it not be important?

2. List all services the manufacturer and wholesaler can expect the retailer to perform for them in the marketing of a product. In one or two sentences describe each service. Also place an asterisk (*) by those services which you consider as absolutely essential. On the left-hand side of an 8½ x 11 sheet of paper list at least seven services. On the right-hand side explain each service.

► COMMUNITY PROJECT

Use the classified section in your telephone directory to learn more about the channels of distribution represented by the businesses in your community. Classify the businesses under the following headings:

General stores	Chain stores	Department stores
Specialty stores	Single-line stores	Supermarkets
		Mail order

(If your town is large, the telephone directory should be divided into sections and a separate section assigned to different members of the class.)



7 Buying

CASE PROBLEM

One of the first problems that faces Fred Kennedy and his partners in starting their hardware store is that of buying the stock to be carried. Fred feels that this important function should not be handled haphazardly but that very definite policies, such as the following, should be set up in advance, so that buying merchandise and maintaining the stock of goods will be in accordance with a fixed routine.

- What kinds of merchandise should be bought?
- How much of each item should be bought?
- How much of each size of each item should be bought?
- When shall new merchandise be bought?
- Where shall the various items be bought?
- Are there any legal problems in buying the merchandise?
- What records of purchases need to be kept?
- How can control of the stock be kept, so that Fred knows when it is sold, when it may have been stolen, when it is time to buy new stock?
- Who should do the buying? all partners? one partner? Should one partner buy some items, another buy other items?

THE ELEMENTS OF BUYING

Few factors in the operation of a successful business are as important as proper buying of merchandise and the control of the stock. Regardless of whether the business is large or small, whether it is engaged in manufacturing, wholesaling, or retailing—in order to make good, the firm

must supply its customers with what they want, at the time, in the quantity, and at a favorable competitive price. If Fred and his partners are to make a go of their enterprise, they must know what to buy, how much to have on hand, and at what price to sell it.

The problems of purchasing and stock control, which the partners face, involve two important basic elements: (1) determining the demand for an article; and (2) determining the supply of it now on hand. From these facts, the type and precise quantity of the article needed may be decided. The problem then involves selecting reliable suppliers. A reliable supplier, for Fred's purposes, is one who will sell goods to Fred's firm that will retail at a fair profit. In the hardware business, the length of time a tool will last and how well it does its job are especially important. Placing the order in the right manner will help improve buying efficiency. Finally the merchandise must be received, inspected, marked, and placed in stock. Above all, an organizational pattern must be set up, so this can be handled in a routine manner as the business operates from day to day.

BUYING POLICIES

Before they are ready to set up these routines of buying and inventory control, Fred and his partners must decide on many important purchasing policies. They will need considerable information in order not only to make the actual purchases, but also to set up the policies according to which they will buy. They will need information about the needs of the business, with reference first to what and how much to buy. Once Fred and his partners have assembled the facts on these matters, they are ready to make important policy decisions.

What to Buy. Primary among these purchasing-policy decisions that must be made and one that is, of course, closely tied in with sales is that of what to buy. This involves choosing merchandise in qualities and styles that will suit the needs of their customers. The question is one of deciding whether Fred's store will emphasize higher-priced, better quality merchandise, or middle-priced, or inexpensive merchandise. The location of their business and the amount of competition in these various classes of merchandise will give direction to their decision. The problem is primarily a selling or merchandising one, based on consumer habits and motives; but their purchasing policy as to quality will have to be based on this decision.

Another aspect of the question of what to buy, also tied up directly with what they can sell, is how limited their line will be. Should Fred's firm, for instance, carry just hand tools; or should they carry power tools and farm implements as well? Should they carry a line of elec-

trical appliances only, or should they also carry a full assortment of radio and television sets including parts?

The merchandising problem of whether or not to carry branded goods also must be decided. Even more puzzling is the resulting question of how many brands of the same type of goods should be carried. In food lines, for instance, there are literally hundreds of brands of coffee on the market. How many should a grocer purchase and place in stock? Chain stores generally concentrate only on the best sellers, whereas independent stores often attempt to appeal to the special tastes of individual customers.

Package sizes must also be considered in many lines. Do their customers buy mainly large economy-size packages, or are they in an apartment area where small families and small kitchens encourage customers to buy smaller sizes?

These questions can only be answered by a thorough study of the customers at which the business will be aimed. Location, competition, and perhaps their own past experience in dealing only with a certain type of trade, will dictate their decisions as to what merchandise to manufacture or sell and, thus, their policies as to what to buy.

How Much to Buy. The question of what to buy is mostly a merchandising or selling problem, rather than one of purchasing. The question of how much to buy, however, while not unrelated to selling is much more a purchasing problem, because the buyer must try to make his purchases in quantities that will be of the greatest economic advantage to the company. Many factors will enter into this decision.

Primary of these, of course, will be the rate of sales or consumption of the article; in other words, how quickly the article is sold. This is known as *merchandise turnover.* If Fred's goods move quickly off the shelves, much less of the partners' investment need be tied up in inventories than if the stock is slow moving.

Time required from order to delivery is another factor in determining how much to buy at one time. In this modern age of fast communication and transportation, less merchandise may be bought at one time without fear of shortage. Here again this means less money tied up in inventories that may deteriorate or become obsolete. Many firms keep "resource cards" on each of the vendors from whom they buy, noting the length of time it takes an order to be completed from the date when it was placed to the date when the goods arrive at the firm's premises. Subsequent purchases are then affected by the results these cards indicate.

Savings resulting from transportation rates or quantity discounts may also affect the decision as to how much to buy at one time. Many

Average Number of Stock Turns for Various Businesses[1]

Kind of Business	Stock Turns Each Year
Alcoholic beverage stores	6.6
Bakery shops	13.8
Confectionery stores	10.8
Dairy and poultry-products stores	35.9
Grocery stores (stores handling groceries exclusively)	10.0
Grocery and meat stores	13.5
Meat markets	50.8
Restaurants and other eating places	25.9
Country general stores	3.9
Dry-goods and general-merchandise stores	2.0
Limited-price variety stores	2.8
Lingerie, hosiery, millinery and accessory stores	2.8
Men's furnishings stores	1.9
Shoe stores	1.8
Women's ready-to-wear shops	3.8
Automotive accessory and parts stores	3.0
Floor-covering stores	3.1
Furniture stores	2.7
Hardware stores	2.0
Lumber and building-material dealers	3.2
Drugstores	3.0
Jewelry stores	1.1
Sporting-goods dealers	3.1

[1] *Standard Ratios for Retailing*, Research and Statistical Division, Dun and Bradstreet, Inc.

distributors grant substantial discounts in price for purchases in larger quantities. Railroads charge considerably less for a carload-lot shipment than for small shipments in less-than-carload lots.

In addition to these factors, a safety margin is added to insure against unexpected delays in shipment due to strikes, breakdowns, or natural catastrophes. The purchaser for Fred's firm must be certain that the store will never be short of goods.

Finally, of course, the prediction of the future of the business cycle generally will affect the purchase commitments to be made. If Fred expects a prosperous business season, he will order considerably more goods than if he believes business will be slow in the near future. Mistakes in these predictions can be costly, not only in overloading the stock with items that later do not sell, but also in lost opportunities by "starving the stock"—having too little merchandise on hand when business is good and customers are anxious to buy. A short recession in 1949, which many businessmen mistakenly thought was the start of a

serious depression, caused them to underbuy; consequently, they unduly limited their profits when customers came out in droves to make Christmas purchases and found little on which to spend their money. The problem of predicting the future, as it affects purchasing, is not only one of how much to buy, but it is the underlying basis for the next problem—that of when to buy.

When to Buy. An important decision that must be made by the buyer with reference to his procurement (purchasing) problems is when it is the right time to buy. In this regard, it is necessary to decide whether to follow a policy of requirement, group, or scheduled buying. *Requirement purchasing* refers to buying items only as they are needed. Generally, this should be done for such items, like special electrical appliances, that are not regularly sold and are thus only occasionally purchased. Such an item is often ordered immediately after one has been sold. It is, however, more economical for Fred to anticipate future needs for small items such as hammers or nails, which the store sells frequently, and buy these in lots or quantities larger than needed to meet immediate requirements. Rather than place many orders for these items in small quantities, it is considerably less expensive to accumulate these small orders in advance and place one large order. This process is called *group purchasing.*

Where a large number of items are purchased by means of the same order or contract, arrangements may be made for their delivery in various installments and according to a regular schedule. This *scheduled* or *contract* purchasing gives the buyer most of the advantages of large-scale purchases, yet makes the carrying of a large inventory of these items unnecessary because of the weekly or other scheduled shipments in accordance with his requirements.

Still another type of procurement policy is that of *market purchasing.* Under this plan of operation the needed items are bought, not in accordance with needs, but in advance whenever the purchaser feels that the market prices are favorable and he can save some money on purchases at this time. The price trends of the market must be watched most carefully and advantage taken of lower prices.

In line with this policy, if Fred wishes to buy while prices are low and before what he believes will be a price rise, he anticipates requirements of the goods and engages in *forward buying.* If prices are high, but appear to be at their top, with the possibility looming that they may fall, the purchaser buys only the very minimum of goods needed to care for immediate needs. This is called *hand-to-mouth purchasing;* and while it tends to take advantage of possible lower prices in the near future, it loses much of the savings of large-scale buying.

As the price continues to fall, the purchaser buys in small lots, known as *downward average purchasing*, a form of hand-to-mouth buying that results in a lower average price for the entire lot of goods bought. When he feels rock-bottom prices have been reached, he may again anticipate a rise in prices by placing an immediate large order for future needs. If Fred feels that he has obtained an extremely low price and that prices may go up considerably, he may buy considerably more than the firm will need for its own stock, with the idea of selling this excess to other stores when prices have risen and thus make a profit for the firm on this fortunate purchase. This is known as *speculative purchasing*. Speculative purchasing is dangerous because, having bought more than his store actually needs, the buyer must dispose of the excess. If prices should not react in the way he expects and should go down, a severe loss, instead of a profit, can result from this speculation.*

Where to Buy. Another policy that Fred must establish in procurement is that of deciding where to buy. Shall he buy from one or two wholesalers, or from many? If he buys only from one or two vendors, Fred may find himself with no sources of supply should anything happen to them. If he buys from a great many sources, he will find he is not the favored customer when goods in tight supply are hard to get. If he buys from one or two sources, Fred has the advantage of large-scale economy; that is, Fred can buy a considerable amount of merchandise from one vendor and therefore possibly get a discount. By splitting a large order among many vendors, however, Fred is able to keep his contacts open with many sources of supply. He must balance price advantage with other considerations such as the reputation of the seller for service and quality. He must decide whether a local source of merchandise can give better delivery and more personal attention than a more distant source.

Fred Kennedy can do his buying either by ordering from traveling

* An important buying policy, although of little concern to Fred Kennedy, is *hedging*. Where the finished product of a manufacturer fluctuates in price in the same way as do the raw materials he purchases, and where the commodity he purchases has an organized futures market—such as cotton, corn, rubber—the manufacturer can remove all the speculation from his buying, so that he does not even have to worry about fluctuations in price in ordinary market purchasing. He does this by the process of hedging. A miller can buy exactly the amount of wheat he needs and at the same time sell a "futures" contract for the same amount of wheat to be delivered as flour. When he has milled flour from the wheat and sells the flour, he buys wheat to cover his sale of the futures contract. In this way, he makes profit only on manufacturing the flour. If the price of wheat and flour have gone up, he makes extra profit on the sale of his flour, but loses a similar amount on his wheat-futures contract. If the price of wheat and flour have gone down, what he loses on the flour contract he gains by covering or buying on his wheat futures for less than he sold it.

salesmen who call at his store; by going himself to the large markets for his type of merchandise; or by picking his merchandise from a catalogue and ordering by mail. He will probably order staple items like bolts, screws, key-blanks, and the like by mail but will buy his large items either from salesmen who call on him or on his own trips to market centers like New York or Chicago. Many small firms in outlying areas employ the services of buying offices in the market centers, who advise them or actually make many of their purchases for them.

A practice that is strongly condemned by purchasing agents, yet is still carried on considerably, is that of *reciprocal buying*. This refers to favoring the products of a customer and buying from him just because he is a customer. Thus Fred might buy all the gasoline he needs to run his delivery truck from a certain service station, if it, in turn, will buy its hardware needs from him. This results in a little more business for Kennedy's store; but if he pays very much extra for it or gets a poorer quality gasoline, it may indeed not be worth it.

The practice of buyers accepting gifts from sources of supply, given in an effort to have the purchasers favor them with business, is also considered poor buying ethics and is frowned upon. A buyer must be free to place orders with the supplier that gives the best quality, service, and price; and the acceptance of gifts from any vendor is bound to have a limiting effect on this freedom of choice of where to buy.

LEGAL PROBLEMS

There are many legal problems involved in buying. Sometimes Fred may find it necessary to cancel a purchase order. Some buyers even send back to the vendor merchandise that they have already received. When there is something wrong with the goods or when they are not delivered within the time specified, the purchaser may be justified in canceling the order or sending it back. When the buyer changes his mind about the goods ordered only because prices or styles have changed since he placed the order, he has no justifiable reason for cancellation. The buyer who cancels unjustifiably hurts his reputation in business and may have a law suit on his hands for damages for breach of contract.

In some states it is necessary to have a written statement for the sale of merchandise over a certain price, usually $50, to be enforceable (but this depends on the state). A sales slip or other such memorandum, however, is usually satisfactory. If a full or partial payment or delivery is made at the time of the sale, an oral agreement is usually sufficient.

Warranties. Warranties can cause retailers some serious legal problems. When a seller makes a statement about the goods he is selling,

he is giving a warranty; and he is bound by that statement. Thus assertions by Fred in selling goods that an item is 100 per cent copper or an electric fan can turn 600 revolutions per minute are statements which the buyer has the right to rely upon. The buyer is entitled to legal remedy if the statements are untrue.

This does not apply, however, to what are considered mere statements of opinion, generally known as "salesmen's puffing." Thus a statement by Fred that his electric fans "will last a lifetime," or "are the best quality you can buy," or "are the lowest price in town" need not be defended at law. The buyer is generally expected to recognize them as mere opinions and not actual facts. Nevertheless, it is unwise for Fred to practice unreasonable "sales puffing," even though it may be legal to do so. People discount the person who exaggerates the value of his merchandise.

Sometimes a buyer can hold a seller for "implied warranties." One such implied warranty is that articles sold as food are fit for human consumption. Another is that an article sold as designed for a certain purpose must fit that purpose; for example, an electric heater sold by Fred must actually heat, although there is no warranty as to how large an area the heater will keep warm. It is difficult to have an implied warranty of quality. A buyer is supposed to make a reasonable inspection of the goods, so as to ascertain if they are of satisfactory quality. Nevertheless, again, Fred must not hide behind legal rights. Buyers are ethically justified and certainly will do their future buying in terms of the kind of service an electric heater will actually give.

When goods sold do not conform to the warranty, either expressed or implied, a *breach of warranty* has taken place. The buyer can then refuse to take the goods and sue for damages. He can sue for the difference between the price agreed on in the contract and the additional amount he may pay to buy similar goods elsewhere. He may, if he wishes, accept the goods and pay the contract price less an amount for his damage, because the goods do not conform to what was represented. If he has already paid for the goods, he may even keep them and sue for his damages, because they are not what they should have been, or return them and sue for a return of his purchase price. Most possible law suits never come to court and quite wisely so. The buyer and the seller often compromise, or ask some third person to serve as an impartial arbitrator between the two. Law suits are expensive and usually not worth the price to either party, when the amounts involved are small. Nevertheless, some retailers go to court to prove that when necessary they will do so. They may do so even though the cost of a law suit may be much higher than the amount that they can possibly gain.

PURCHASING ORGANIZATION

Having decided on their general procurement policies, the next buying problem that the management of a firm must settle is the purchasing organization of the business. In Fred's firm, the partners must decide whether all three of them can buy everything; or whether, for instance, Fred can purchase all hardware items; Mr. Grebs, the electrical appliances; Mr. Ames, the store and office supplies; or whether all purchasing can only be done by Fred alone. This agreement would be valid only among themselves, because by law each partner has the ability to bind the firm in any purchase he makes, unless the seller actually knew he did not have that right.

Centralization. In a larger business than Fred's, a more serious buying problem arises as to whether it is best to have all purchasing of the company done by one department under a special purchasing specialist, or to have each activity buy its own merchandise and supplies. The question of centralized or decentralized storage of stock and supplies must also be decided. Centralization of purchasing has many factors in its favor: (1) One large centralized purchasing department would buy in much larger quantities and should, therefore, save money by getting better prices, discounts, and transportation rates. (2) Concentration of purchasing permits the hiring of specialists in that field to do the job, men who will know the right time and place to buy the goods. (3) Centralization will lead to more uniform policies, and responsibility for a good or bad job is easily placed. (4) Savings can be made by eliminating duplications of purchasing and stocking of the same items, and by eliminating unnecessary varieties through standardization of purchases.

Centralization can, however, be overdone and sometimes actually leads to inefficiency. For one thing, too many departments and too much separation between those buying the goods or supplies and those who must use or sell them often result in excessive paper work, red tape, and dissatisfaction with the articles bought. Secondly, local markets often offer advantages in services or special merchandise that a central purchasing agency might miss. Many firms compromise by having the purchasing department in the home office formulate the policies and buy major, important materials, while the lesser items are bought by local branch managers in accordance with those policies.

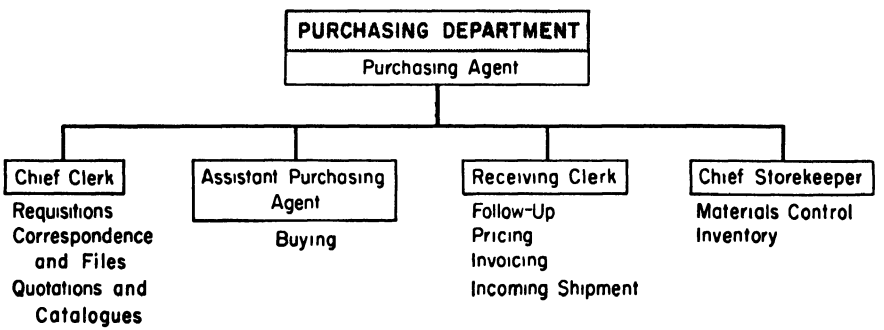
Place of the Department in the Organization. If centralized, or partially centralized purchasing is decided on, the next decision of the large company is the department's functional status. This depends generally on the nature of the firm's business. If the goods are merely pur-

chased for resale, such procurement is then done under the sales or merchandising department by specialists in the goods known as *buyers.* In such a firm, the purchasing department only buys supplies and equipment. In some firms, purchasing is merely a division of the manufacturing or production department, especially where the raw materials to be bought are relatively simple and easy to procure. Such a firm often also places the stock-keeping function under the production department.

In many organizations that are large enough to afford a separate, specialized department, purchasing and stores-keeping are either separate departments in themselves, or placed together under one department head. The head of such a department is usually called the *purchasing agent* and reports directly to the general manager or president, although some firms make him responsible to the treasurer. Very large firms may dignify him with the title of vice-president in charge of purchasing and give him an equal place with vice-presidents in charge of production, sales, personnel, and financial matters.

Purchasing Department Organization. The set-up of the divisions of the purchasing department would of course depend on the size of the firm and precisely what articles the department is assigned to procure. But whatever the size of the firm, and no matter whether it is a separate department or not, there are certain definite purchasing functions in every business, even in one as small as that of Kennedy's hardware store, that must be carried out. It is the task of management to see that they are done by someone and not neglected.

The following diagram illustrates the organization of the purchasing department of a fairly large firm. It is not necessarily typical or the best pattern, but it does cover the important functions. The department is



Organization of a Purchasing Department. Why is the receiving section a part of the Purchasing Department? the storekeeping section?

set up on a line basis; and in this particular case, stock-keeping is included within the purchasing department.

As the organization chart shows, the purchase office handles requests that come in from other departments asking that items be purchased. It keeps the records of sources of supply and prices and the general files of the department. The buying division places the actual orders, with each buyer purchasing on the basis of his own specialization. The receiving division checks invoices against the orders, follows up on deliveries, and checks the goods that come in against the invoices. The stores division keeps the goods until needed and maintains inventory records.

TERMS OF SALE

There are many common terms, and abbreviations for them, used by businessmen in selling goods, with which Fred Kennedy and all purchasers should be familiar. Many of these have to do with *dating,* the time within which the invoice for goods purchased must be paid.

An *invoice,* the bill for the merchandise bought, has a date on it, from which datings are computed. The terms of the sale will generally state the number of days within which the buyer is expected to pay for the goods. This is expressed as "net 10 days," "net 30 days," or whatever length of time is granted. Naturally the longer time the purchaser can get within which to make payment, the better he considers these terms, because he has time to manufacture or sell much of the goods before he must pay for them.

Sometimes purchasers obtain especially good terms from sellers eager to sell merchandise, in the form of extra or *advance dating.* Common among these is the end-of-month or "E.O.M." terms, which date all invoices from the end of the month in which the purchase is made. Thus a sale to Fred on August 12 on terms "net 30 E.O.M." would mean he would have 30 days from August 31, or until September 30, in which to pay.

In sales in some very seasonal lines, extreme advance dating is occasionally given to permit goods, shipped before the season began, to be paid for after the season. This is done by means of *extra dating.* Thus goods shipped October 16 on terms "net 30–60 extra," means the 30-day period does not begin to run for 60 days after October 16, or December 16, so that the invoice would not be due until January 16 (30 days are considered equal to one month).

When a buyer does not pay on the due date, his reputation for prompt payment is injured. The seller has the right to sue him at once for the purchase price, but in actual practice he usually does not do this until a considerable time after the due date has passed. Sometimes, however,

the buyer does charge interest at 6 per cent per year on the purchase price running from the date the invoice was due until the date it is paid.

Other common abbreviations for terms include *C.O.D.*, cash on delivery, which means payment must be made at the time the goods are delivered. *R.O.G.*, receipt of goods, means that the terms of the dating begin from the date the goods are received, rather than from the date of the invoice.

F.O.B. (free on board), however, has reference to who will pay the freight or shipping charges, for it really can be said to mean "seller will pay the freight or shipping charges, for the point designated." Thus, if the goods are sold to Fred F.O.B. shipping point, the seller only pays for delivering the goods to the railroad or express company at the place of shipment; the buyer, Fred, paying all further transportation charges. Where the goods are sold to him *F.O.B. destination,* the seller pays the freight charges all the way to the city of the destination of the goods, where Fred has his place of business.

Cash Discounts. In order to encourage prompt payment of bills, sellers often grant a flat discount of a small percentage for payment of an invoice in an earlier period than the full terms of the payment. Thus terms of "2/10, n/30" mean that Fred must pay within 30 days of the date of the invoice; but if he pays within 10 days of the date, he may deduct 2 per cent (a flat 2, not 2 per cent annually) of the invoice price. An invoice for $1,200 sold to Kennedy on March 17 on terms of "1/20, n/60 E.O.M." would be due on May 31, 60 days from the end of March, but Fred need pay only $1,188 (deducting 1 per cent, or $12 discount) if he pays before April 20, twenty days after the end of March.

Trade Discounts. In some lines of business, sellers quote a list or catalogue price, but for certain buyers they will permit deductions of a discount from the list price called a *trade discount.* Sometimes they even grant two or more discounts from the list price, called *chain discounts,* which the buyer deducts in turn from the list price. As an example illustrating all the above dating, cash and trade discounts, let us assume a list price of $4,000 on two dozen refrigerators sold to Fred Kennedy. They are sold with discounts of 25, 10, and 5 per cent, and are sold "1/10, n/30–60 extra R.O.G." The goods are purchased by Fred on July 12, and shipment is received by his store on July 25. The seller of the refrigerators would deduct 25 per cent from the list price of $4,000, leaving $3,000. He would then deduct 10 per cent from that to arrive at $2,700, and then a final 5 per cent to give the invoice price of $2,565. The terms would not begin to run until 60 days from the receipt of the goods on July 25 (60 days considered identical with 2 months), so that Fred would have 30 days after September 25 in which to make payment. If he pays in 10 days, or by October 5, he may deduct 1 per cent cash

discount and send a check for $2,539.35 ($2,565 less $25.65) in full payment.

PURCHASING DEPARTMENT PROCEDURES AND RECORDS

The purchasing department of a large firm needs many specialized forms and records to handle its duties in the most efficient manner. While the small business, like that of Fred Kennedy, may eliminate many of these interdepartment forms and some of the records, its management must make certain that none of the vital factors or facets of the purchasing function is neglected or overlooked.

Establishing the Need for the Material. The first step in purchasing in a large concern is the filling out of a form stating that certain material or equipment are desired. This *purchase requisition* is filled out by the head of the department or the foreman of the factory shop needing the material. If a stores inventory of the item is kept, the requisition is sent to the storekeeper, who fills the need from stock if he has it, and then makes up the purchase requisition for items low in stock. The requisition is a serially numbered form, especially designed for this firm, and requests the purchase department to buy a certain item, giving the name and description of the article, the number needed, and time and place of delivery.

Deciding on the Exact Type of Goods. Purchasing in large firms generally conforms to certain set specifications, made up by the engineering department, stating the exact size, grade, and composition of each type of article to be purchased. These are usually set up well in advance on a form known as a *specification* and are kept in a special specifications file. The specifications may simply list a brand or grade used in an industry, or they may be a complete description, a blueprint, or even a sample.

Selecting the Sources of Supply. Knowing exactly what is wanted, the purchasing department must decide where to obtain it. To this end, it keeps an accurate up-to-date list of all vendors in the field, known as the *sources of supply file,* and a file of their previous quotations or catalogues, known as the *prices-and-quotations file.* The purchaser then extends the purchasing process beyond the confines of his own office. In the case of certain large items infrequently purchased, he may request suppliers to make *sealed bids,* giving their offers in writing, the order going to the lowest bidder. On less formal or smaller purchases, he may ask several suppliers by means of a *letter of inquiry* what they would charge for the purchase; and in very small purchases, or purchases of goods bought regularly, he may just go ahead and place the order with one or more suppliers that he knows are satisfactory.

Ordering the Goods. While actual orders for goods often take the form of a letter, the large business uses a carefully drawn standard form, known as the *purchase order.* This is filled out with several carbon copies, often of different colors to tell at a glance where each copy should go. The original of the purchase order is sent to the vendor who will supply the goods. Copies of the order are sent to the department which requested the goods, to the accounting department, to the receiving clerk, to the follow-up section, and one to the purchaser's own file of purchase orders. The vendor generally acknowledges receipt of the order and, when the goods are shipped, sends a *shipping memorandum* or *bill of lading,* as well as an invoice or bill for the merchandise.

Follow-Up and Checking. The invoice is checked against the purchase order and requisition to make sure the right merchandise is on its way, and the prices and extensions of amounts are carefully checked to avoid errors. The follow-up section of the purchasing department keeps an *order tickler file,* composed of copies of the purchase orders arranged according to needed delivery dates, to follow up the shipment and make sure the vendor delivers the goods on the agreed date. The follow-up section keeps in touch with the vendor and the transportation company by mail, telephone, telegraph, or in person, to hurry the shipment and avoid any delays.

Receiving the Goods. When the goods are received, the receiving clerk carefully checks them as to quantity and quality against his copy of the purchase order before sending the goods on to stock and the order to the accounting department for payment. Some routines call for the receiving clerk to make out a *materials-received report* and send it on to the purchasing office to be checked against the original order, rather than having the receiving clerk do it. This is known as the *blind-check* system and, while it tends to make the receiving process a slower one, is more accurate because the receiving clerk does not know in advance what should be in the shipment and is therefore more accurate in his checking. If there are any discrepancies, the vendor is notified and adjustments are made. If any or all of the goods must be returned, a form known as a *debit memorandum* is sent to the vendor, with copies to all the recipients who received copies of the purchase order. The vendor acknowledges receipt of the returned merchandise by sending his own form called a *credit memorandum.*

STOCK CONTROL

Placing the Goods in Stock. After Fred Kennedy, or any other businessman, receives his merchandise from the manufacturers or vendors from whom he bought them, he must carry them in stock until he

sells them. This means they must be physically placed or stored on his premises. The manufacturer has three types of inventories to deal with—that of the *raw materials* that will be used in the merchandise he is making; *goods in process* that are on the machines, or in the process of being manufactured in his factory; and *finished goods* that are completed and awaiting sale. Fred, and other retailers, as well as wholesalers, are concerned only with finished goods. However, even the one type of inventory used by retailers presents several problems. This includes storing the goods in an orderly manner to make them easily available for sale when needed; keeping them clean and in a salable condition; and setting up some kind of a system, so that it can be recognized easily which are slow moving items and which items are running short and must be reordered.

In Fred's hardware store, some of the goods will, of course, be placed on display for sale; others must be stored in a stock room or the basement, so that they will not interfere with the attractive appearance of the store, and yet will be quickly and easily obtainable when needed. Care must be taken that the goods, whether on display or in stock rooms, are kept fresh-looking and in a salable condition. This requires that close attention be paid to cleaning, dusting or polishing the stock and making sure that the conditions of coolness or warmth, dryness or dampness, and light or darkness are suitable to the merchandise being stored. Care must further be taken to see that older stocks move first and that newer purchases are not placed on top of older ones in such a way that the newer items are sold and the older ones thus remain on the shelves gathering dust and becoming more and more unsalable.

Marking the Merchandise. It is the almost universal practice today among retail stores to mark the price, and often other information too, on all merchandise, either as it is placed in stock, or at least before it is placed on display in the store. This lets the customer know at once the price of the goods, saving the salesperson's time in answering questions and the possible embarrassment to the customer in having to ask the price. The storekeeper, furthermore, can mark, usually in code, other information on the goods, to aid him in the control of his stock and in taking inventory.

Prices can be placed on the goods in several ways. In many cases, they can be marked with a rubber stamp or crayon right on the wrappings of the goods themselves, as is done with groceries and other items in a supermarket. Gummed labels are used for many articles; pin tickets for others that will not be damaged by pins; some tickets are stitched on merchandise; and some are fastened by folding the tag around part of the goods. Still other types of goods have price tags attached to them with string.

Marking Codes. While the price is generally marked on the goods or tags in large, easily read figures, many merchants also mark on the price tags other information to aid them in their control of the goods. For example, the department or vendor and style number of the goods may be placed on the tags by means of numbers; the month and year of the receipt of the merchandise, by a code; and the cost of the goods, by another code. These designators are known as *cost marks.*

The code for the date when the merchandise was received could be based on any word or words, selected at random, which have twelve different letters, each letter representing a month of the year. Thus, for instance, if the code is

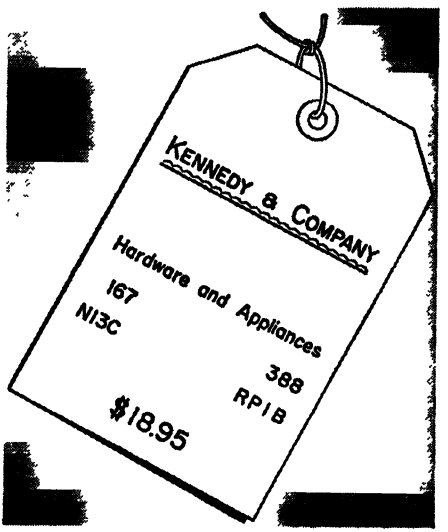
B	U	Y	S		O	N		C	R	E	D	I	T
1	2	3	4		5	6		7	8	9	10	11	12

then S/5 could be placed on the tag meaning the item was received in the store on April 5th; or D/24 could mean it was received on October 24th. If the stock is one that moves comparatively slowly, the code could be used for months and years, so that RC could mean the item was received in August of the year 1957, or goods received in March, 1958, could be marked YR.

A similar code device could be used for indicating the cost of the goods, using a word with eleven different letters, like this:

R	E	P	U	B	L	I	C	A	N	S
1	2	3	4	5	6	7	8	9	0	Repeat

Thus, goods costing $6.95 would be marked LAB; and goods costing $7 would be marked INS. A price tag might look like this:



A coded price tag

and would indicate to Fred that he bought it from the Ace Tool Supply Corp. (he has given that supplier the code number 167), that it is item or style number 388 in his inventory or stock control record, that he received it on June 13, 1957, and that it cost $13.75. The price to the customer, of course, is $18.95. Depending on what the merchandise is, this tag would probably be gummed and pasted on the tool.

Stock Control Systems. Every businessman, to be successful, wants a well-balanced, adequate stock of merchandise, which will enable him to do a maximum business with a minimum of money invested in inventory. He wants to be neither overstocked nor undersupplied. He must, therefore, develop some kind of a system of records that will help him in keeping his stock and his sales in a profitable relationship to each other.

Reminder or Tickler System. The simplest, and probably most effective, system is that of placing a card, or gummed label, or some other form of reminder or tickler at a certain place in each item of the stock. Thus, when sales have reduced the supply of that item to that point, the card or reminder will be reached; and the merchant knows he must reorder that item.

Dollar Control. Under this system of stock control, the inventory records are all kept in dollars, rather than number of units. The storekeeper classifies all the items of his store into departments, such as small hardware, hand tools, power tools, electrical fittings, electrical appliances, and so on. He then makes up a merchandise plan or buying formula, a kind of budget for each of these departments, wherein he sets down the normal or average inventory he should carry and the anticipated sales for each of these classifications. He then compares these figures with his records of actual goods on hand and already ordered for each department. The comparison will show what he is "open to buy" and in which classifications he is already sufficiently stocked or overstocked and thus "not open to buy."

Unit Control. The unit control system may be used instead of, or in addition to, the dollar control system. This method requires the keeping of records regarding stock by individual units, which may be classified by size, color, style, or combinations of these. It necessitates the recording by units of every item received in stock and deducting from this record every unit that is sold. This latter information is either obtained by the stub method or the salescheck method.

In the *stub method*, each price tag is divided into two parts separated by perforation, with the information as to color, size, style, etc., duplicated on both parts. As each item is sold, the stub is detached from the price ticket and retained by the store for entry in its stock-control records. Where the *salescheck method* is used, the salesperson makes out a sales slip for each purchase by a customer, putting on it all the information. A carbon copy of this salescheck is then used as a basis for the entry of the sale in the unit-stock records. The unit-stock record then shows exactly the number of items of each style, color, size, and so on, on hand. The record can also show the number desired to be on hand and the number at which the item should be reordered.

By placing dollar values, as well as merely the number of units, on the stock records, the system becomes a *perpetual-inventory* system, because the total of all the stock cards will show the amount of goods on hand—the merchandise inventory—at any time without actually having to count them. It is, however, advisable to take such a count, or *physical inventory*, at infrequent intervals, in order to check on and correct the records for errors, pilferage, and the like. Many manufacturers and wholesalers use the cost of the goods as the basis for the dollar values of the inventory on their records. Retailers generally find it more convenient, however, to use the sales price of the goods as shown on the price tags, known as the *retail-inventory* method in adding up their stock count. The retailer computes the value of his inventory at cost by reducing the total selling-price value by the average per cent above cost that he has marked up the goods for sale.

A problem comes up in the maintaining of stock records where identical items have been bought at different prices, as to which ones should be considered as sold when a sale is made. Thus, supposing Fred Kennedy bought 300 hammers at 12 cents each in March and an additional 500 in August paying 15 cents each at that time. He does not keep unit-, or perpetual-inventory stock cards, relying instead on a physical-inventory type of stock control, in that he takes an actual count at frequent intervals. He discovers he has 200 of the hammers still on hand. What is the cost of this inventory that he has in stock?

Some businesses say that the earliest hammers have all been sold (the first ones in being the first ones out), so that the hammers on hand cost 15 cents and are carried at $30 on his inventory records. This is the *first-in, first-out* or FIFO method of inventory valuation. Others say that as the new hammers were received, they were tossed on the top of the bin, and the hammers on hand are still some of the old ones. They believe in the *last-in, first-out* or LIFO inventory method, which would consider the 200 hammers Fred has in stock as costing $24. The decision to use the FIFO or LIFO method of determining inventory has a major influence on income in a large business. It probably would not be significant in Fred's business.

SUMMARY

The problem of buying and maintaining a satisfactory stock of merchandise is vital to the success of any business. Purchasing involves first of all the questions of what to buy, how much to buy, when to buy, and where to buy. Certain buying policies should be set up, and legal problems connected with purchasing also must be met. The question of who shall do the buying and whether purchasing should be centralized

also come up in many firms. Terms of sale, dating, and discounts are important factors that must be understood. Definite purchasing procedures and records, as well as stock-control systems, should be set up and properly carried out. All these factors of purchasing and inventory control are essential to the profitable operation of a business.

► FOR REVIEW AND DISCUSSION

1. How can a buyer determine what goods to buy within his merchandise line?
2. Explain the meaning of merchandise turnover. How does it affect profit?
3. Distinguish among requirement buying, group buying, and scheduled buying.
4. Contrast forward buying with hand-to-mouth purchasing.
5. What factors should be considered in selecting a wholesaler from whom to buy?
6. Describe some of the legal problems connected with the buying of goods.
7. What is an implied warranty? Give an example.
8. How do the purchasing functions differ when there is an organized purchasing department and when there is no organized purchasing department?
9. Explain the difference between cash discounts and trade discounts.
10. How does a purchase requisition originate? Where does it go?
11. Describe the proper procedure for receiving goods that have been ordered.
12. What is meant by stock control?
13. What are the problems commonly connected with the storage of goods?
14. What uses are made of marking codes?
15. Explain each of the following stock control systems: reminder on tickler system, dollar system, unit control, stub method, salescheck method.
16. How are the following inventory systems used in business: perpetual inventory, physical inventory, retail inventory, FIFO, LIFO?

► CASE-PROBLEM QUESTIONS

1. How can Fred determine the kinds of goods that should be bought?
2. How can Kennedy and his associates determine the quality and trade name of goods to purchase?
3. What types of purchase records should be kept?
4. What safeguards can the partners establish to prevent overbuying as well as running out of stock?
5. How can Kennedy and Company determine the best time of year to purchase various seasonal goods in order to obtain the best prices?
6. What can Fred and his associates do to protect exclusive franchises?
7. Should Fred attempt to buy special priced goods for seasonal sales or depend on standard qualities and prices?

► APPLIED BUSINESS PROJECTS

1. Here is a list of some of the more common terms on which goods are sold. Write a brief explanation of each.

F.O.B. Shipping Point; 2/10, n/30; C.O.D.; trade discounts of 5%, 5%; E.O.M.; Net 60–30 extra; R.O.G.; F.O.B. Destination

2. Johnson has a fine supply of carpets to sell, but we have never done business with him before. His price is lower by 5% than Smith's from whom we buy regularly. For which of the following reasons should we buy from Johnson:

a. Lower cost means lower selling price.
b. Different style helps sales.
c. Johnson allows 10 days less credit.
d. People like what they are used to.
e. Johnson's carpets are all viscose.
f. Smith will not extend credit beyond 30 days.
g. Johnson is a friend of the family.
h. Johnson is new in business.
i. Johnson has asked us to handle his line exclusively.
j. Smith has been in business a long time.

For each choice, state in one sentence why you selected it.

► COMMUNITY PROJECT

The duties connected with purchasing will vary considerably in different-sized businesses. Also the duties of the purchasing agent and the personnel involved will differ in various types of businesses. In order to help you become better acquainted with the organization of the purchasing department in businesses of different sizes and different types, each member of the class should select a business in the local community for study. By talking to the manager or the buyer, each can find out who is responsible for buying and the lines of authority. Using the chart on page 103 as an example, prepare purchasing-department organization charts for those businesses studied.



8

Pricing

CASE PROBLEM

Fred Kennedy and his partners are in the process of buying the stock for their hardware and appliance store, which is almost ready to open for business. At a conference of the three partners, Mr. Ames raises the important question of the range of prices they will charge their customers. Fred Kennedy goes further, insisting that before they can place prices on the goods, they must make some comparisons, and also decide on several price policies. He poses several queries for discussion by the three partners, the decisions on which might make all the difference between success and failure of the store. Among the questions that must be answered are these:

- Should they try to sell only high-quality products to a discriminating group of customers? or only lower-quality goods to a larger number of people? Or should they carry items priced to appeal to customers looking for either type of merchandise?
- Can they price their products so as to meet the prices charged by competitors and still be able to make a profit for themselves over their costs?
- Should they maintain one price for an item, or give certain customers discounts or different prices? Or should they add to the prices of popular items and reduce the prices of slow-moving goods?
- How shall they price their merchandise so as to reduce or eliminate interference from producers or regulation by the government with reference to the prices they seek to charge?

PRICING PROBLEMS

To stay in operation for any length of time, every business must make a profit. Whether or not the enterprise makes a profit is directly tied in with the prices it charges for the merchandise it sells. If a business charges too much for its merchandise, customers will not buy and it will make little or no profit. On the other hand, if the business charges too low a price, it may indeed have plenty of customers, but still might make little or no profit because it is not covering its costs. Thus the problem of pricing its wares is vital to any enterprise. This question of proper pricing may be broken down into three major subdivisions: *price determination; price policies; and price computation.*

PRICE DETERMINATION

There are generally four major factors in the determination of the price an enterprise will charge its customers. These are, roughly, that the price set should be:

1. More than enough to meet all costs
2. In line with what customers are willing to pay for the goods
3. Low enough to meet the prices of competitors
4. In line with the prices producers suggest or government regulations require

How important each of these factors are, will depend on the particular industry, or the level of distribution the enterprise is on, or even upon the size of the venture. Thus a manufacturer of a completely new, different, and very usable power tool might base his price almost entirely on the second factor, because the novelty and efficiency of the invention makes consumers willing to pay considerably more than what it cost to produce, and there are no competitors or government regulations on the price. A wholesaler of hand tools may find that he must base his prices primarily on the factor of covering his own costs. A retailer like Fred Kennedy, on the other hand, may find that, regardless of cost to him, he must price his goods to meet what his competitors are charging. He may be required to charge the price the manufacturer has set for a branded electric toaster even though his customers do not want to pay that much.

COVERING COSTS

In those businesses where the enterpriser is able to use some discretion of his own in setting a price, and is not too closely limited in pricing by the other three factors, he tries to charge enough to cover the cost of the

article; an amount to contribute to the overhead of the business; and to give him an adequate profit. *Cost* represents not only the price that he paid for the goods, but also any freight or insurance charges for the shipment. Thus, if Fred's store bought five gross of a small tack hammer at $28.50 per gross and had to pay $8.70 freight charges for the shipment, he would consider his cost per tool to be 21 cents figured in this way:

Invoice cost (5 × $28.50)	$142.50
Freight charges	8.70
Total cost	$151.20
Cost per tool (Total cost ÷ total number of tools [5 × 144])	.21

Margin. In addition to the cost, Fred must add a sufficient margin so as to give him a gross profit large enough to cover his overhead and leave him with a net profit. *Margin* is the name for the amount he charges per tool above its cost—the difference between cost and selling price per article. Thus if he sold the hammers in the above illustration for 35 cents each, his margin would be 14 cents per hammer. *Gross profit* is the difference between the cost and the selling price of all the goods sold in the store, or department of the store, for the period (a month, or a year, for instance).

This gross profit must be large enough to enable the partners to pay all their overhead and still have enough left for a reasonable net profit. *Overhead,* or *operating expenses,* are those expenditures made in the running of the business. These would include the cost for such items as rent, salaries of employees, payroll and other taxes, wrapping materials, light, heat, water, telephone service, delivery costs, advertising, insurance costs, interest on money borrowed, depreciation and repairs to the store fixtures, spoilage, breakage and theft, donations and all the other miscellaneous expenses that go into the operations of a business.

It is a difficult task to determine just how much margin to add to the cost of each hammer, and every other article in the store, so as to make a sufficient gross profit on all sales to cover the overhead and leave a satisfactory net profit. Since one cannot know in advance precisely what his total sales, or total operating expenses will be, the amount of margin to be added to cost can only be an estimate. How good the merchant is at making these estimates, is often, indeed, one of the tests of the successful businessman.

There is usually less profit on convenience goods than on shopping goods because there is so much more competition, and the customer is more familiar with competitors' prices on convenience goods. Thus Fred

may be able to make a comparatively high profit on some brands of lawn mowers or power drills, but may be limited to a low percentage on screwdrivers, hooks and such articles.

Another factor to be considered is the profit philosophy of the owners. In other words, will they try to make a large profit by charging a high price for their merchandise although they may sell less goods, or aim for a big profit by selling their goods at a low price, making little on each unit sold, but selling a tremendous amount of merchandise? Thus, a hardware store in a neighborhood, patronized by wealthy people, may charge high prices, justifying these prices on the basis of the exclusiveness of its clientele and the services it renders its customers, such as charge accounts and delivery. A hardware store in another neighborhood may be a "cut-rate, cash-and-carry" type of store, charging lower prices, having no charge accounts or delivery service, and hoping to make an adequate profit on the basis of a high volume or turnover, as it is called.

MERCHANDISE TURNOVER

Prices and profits are therefore very closely connected to the problem of the turnover of goods. Fred Kennedy, for instance, can make more profit from screwdrivers, which he buys for 20 cents and sells for 25 cents each, if the average screwdriver stays in his stock for three weeks, than he can from door-checks, which also cost 20 cents and may sell as high as 35 cents each, if the average door-check remains on his shelf for over eight months. Reducing the price of door-checks might perhaps increase their turnover, but the total profit from sale of door-checks might still be less, because it is not an item that people buy often. The best thing to do in such a case would be to carry a lesser supply of door-checks in stock than he does screwdrivers, so as not to have too much investment tied up in inventories.

A storekeeper usually computes his stock turnover by dividing his sales for the period by the average value of his inventory at retail prices. A similar result would be obtained from dividing the cost of goods sold by average inventory valued at cost, or, for individual items of merchandise, by dividing number of units sold by the average number of units kept in stock. For example, the more an enterpriser can turn over his inventory, the more profit he usually makes. The amount of investment tied up in an item, and the margin on it, are of course all tied in with turnover in computing total profit. Thus, on an item like an elaborate electric broiler with barbecue, Fred Kennedy must add a high mark-up to his cost because his investment in its cost will be high and its turnover very slow. Electric flashlight batteries, on the other hand, require only a small investment and are in constant demand. Since they would have a rapid

turnover, the mark-up on them can be small, and yet the profit over a year's time from the sale of these batteries may be greater than the annual profit on the sale of rotating electric broilers.

STYLE AND PERISHABILITY

An additional factor that a merchant must consider in pricing his goods is the element of loss through changes of style or the perishability of his product. He must mark up his prices sufficiently on the units he sells so that they will also cover the loss he will suffer from the cost of the last few units of the lot that he does not sell, due to the item going out of style, becoming stale, or spoiling. Thus a dealer in ladies' dresses must quickly sell all the garments in a lot, or be unable to sell the last few at all, or at least dispose of them at a sale for considerably less than cost. The dealer in fruit must sell his peaches at a price sufficiently high to cover the cost of the peaches that will go bad before they can be sold.

CONSUMER DEMAND

Another very important factor in the setting of prices is that they must be in line with what customers are willing to pay for the goods. Although two articles may cost the same, one may seem more desirable to purchasers than the other, due to attractive appearance, better design, color, or the like. The storekeeper may then be able to mark the popular item with a higher price than the unpopular one and still have it appeal to his trade.

The factor known as *elasticity of demand* also enters into the problems of price based on consumer preference. Fred Kennedy may, by running a special sale on electric fans and marking them at a lower price, greatly increase the number of fans sold. But no matter how much he marks down the price of doorknobs, he probably will not sell many more than he would at their original higher price. His fans have an elastic demand and their turnover is closely tied in with price. Doorknobs are only bought infrequently, usually to replace one that is broken. They, therefore, have an inelastic demand and their turnover is not very sensitive to price. Lowering the price of the doorknobs would then not increase Fred's sale of them, and would only lower his profit. Lowering the price of electric fans, however, might so greatly increase his sales that his total profit might become greater as a result.

The stages of the business cycle affect prices too. During good times, when everyone is working and has plenty of money to spend, Fred can mark his goods higher than he can during a period of depression. In the latter period, when people are out of work and money is scarce, Fred must keep his prices low if he is to do any business.

Consumer habits and customs must be considered in pricing also. If customers are used to paying 25 cents for light bulbs, they will not buy a bulb selling for 40 cents. On the other hand, the same customers might not buy the same bulbs if Fred were to mark them at 10 cents, because they would suspect they were inferior goods. This habitual price is known as the *customary price;* and when customers are used to paying such a price in practically any store, Fred has little choice but to mark it at that figure.

COMPETITION

In most lines of endeavor, a businessman, unless he sells a unique product, does not have complete freedom in marking his goods the way he wants to because he must consider the prices at which his competitors are selling similar goods. In some industries, dominated by a few very large companies, the merchant may have to follow the price leadership of these big competitors and set his prices to meet theirs. Generally, however, he has some freedom of choice, and must decide what his pricing policy will be in bucking competition.

Fred, for instance, must decide whether he will always try to have cheaper prices than his competitors; charge the same as his competition but undersell them on occasional sales of selected items; charge more than his competition but come down to their price if a customer complains; or always charge more and justify it by giving additional services like charge accounts and delivery.

Suggested Prices. Manufacturers of goods often aid, or even dictate to, the retailer in the prices he sets by suggested prices which they advertise nationally and expect him to charge. Often this is how a market price becomes established in the customers' minds. Thus some forms of the candy bar are sold generally for five or ten cents, and attempts to sell them for more, and even occasionally for less, are not successful. The price suggested by the manufacturer has become so ingrained for these bars that when the chocolate costs were very high, the manufacturers reduced the size of the bars rather than have their retailers change this long established suggested price. Eventually the habit is broken and the price of candies that cost five cents for many years now retail at six or seven cents.

PRICE LEGISLATION

Some states have laws which go even further in permitting a manufacturer to set a retail price for his branded, or trade-marked goods, and then giving him the protection of the law in enforcing the price and making all retailers charge only that price and no lower. These resale price

maintenance laws are more popularly known as "fair trade laws" and have been subject to considerable attack by consumer groups and retailers who wish to sell the manufacturers' goods at a discount from the set, or "fair-traded" price. The manufacturers have generally favored the laws because they stopped price cutting of their product and the price wars of competing retailers who, by constantly cutting prices of the goods, eventually hurt the popularity of the goods by cheapening them in the public eye. "Fair-trade" laws have recently been receiving an increasing number of blows in the courts because of their doubtful constitutionality.

Manufacturers, in turn, have their prices affected by the anti-price discrimination law, commonly known as the Robinson-Patman Act, after the congressional leaders who sponsored it. This law does not permit a manufacturer to charge one distributor more, for the goods he sells him, than he does all other distributors, unless the difference can be justified on the basis of the cost of the goods. In other words, the manufacturer cannot arbitrarily discriminate among his wholesale or retailer outlets, but can only charge different prices if his own costs differed.

During wartime, a merchant's prices may also be affected by price control legislation. These are laws which set a maximum price that may be charged for the goods he sells, in order to avoid an inflation, where all goods would go to the wealthy people who can afford to give the most for them and the storekeeper could charge tremendous prices for his wares.

PRICE POLICIES

In addition to the problems of determining what his mark-up ought to be in setting the price for goods he offers for sale, the merchant must also formulate and adhere to certain price policies which will affect his decision as to what he will charge for his various wares. First among these would be the decision as to whether he will follow a "one-price policy."

The One-Price Policy. The *one-price policy* is the sale of an item to all customers at the same price, rather than charging different purchasers varying amounts for identical merchandise. In most retail stores, the growth of the custom of marking goods with price tags, and the popularity of self-service, have made this policy a "must" for this type of outlet. This is not true in many parts of Europe and Asia, where the customer is expected to bargain with the storekeeper before a final price is arrived at. Even in some retail lines in this country, the one-price policy is not followed. Thus, while Fred Kennedy would adhere to such a policy in his hardware store and mark the goods plainly with prices that apply equally to all customers, a dealer in antiques might size up his cli-

entele as they come in the store and name prices for his goods in accordance with what he thinks the traffic will bear. The automobile dealer, while he may have a set list price on his cars, will vary the price by giving various trade-in values, even on identical autos, to different customers. The practice of manufacturers and wholesalers of charging various prices to their trade has led to the previously mentioned Robinson-Patman Act, which forbids discrimination in price among a manufacturer's customers unless such variation can be justified by difference in the cost of manufacturing and selling to that customer.

A policy that permits a merchant or manufacturer to maintain an apparent one-price arrangement, while actually varying prices among his customers, is that of granting discounts. Thus while Fred may place a price tag of 25 cents on a box of screws or bolts, he may give a *quantity discount* of let us say 10 per cent off on the price to any customer who buys five or more boxes at one purchase. Fred might also offer a *trade discount* of 20 per cent off on all prices, for instance, for all purchases made by carpenters, painters, or plumbers, who buy from his store the supplies they use in their trade.

Price-Lines. Many merchants set a few predetermined prices for all merchandise in their store, or in a department or section of the store, and carry all their merchandise at those figures. Thus, instead of carrying hand tools at many varying prices, Fred's store may sell tools, for instance, only at 35 cents, 65 cents, 95 cents, $1.95, and $3.95. Or he may carry appliances only at prices of $4.98, $8.98, $14.98, $18.98, $24.98 and $28.98. There are many reasons why such a procedure is a good one and also some reasons why it may not be a good policy. For one thing, the problems of selling are greatly simplified. Customers generally fall into three classes, those who want cheap goods, those desiring medium-priced merchandise, and those who prefer expensive goods. Instead of hundreds of varying prices, all Fred needs is a type of merchandise that will appeal to each level. In some lines of goods, the medium-class merchandise must be of two types. There is the item that will appeal to the customer who likes goods made of fine quality but will accept fewer frills and fancy trimmings in order to save money on his purchase of finer merchandise. Then there is, in the same price line, the item that is made of the cheaper grade of material but has all the frills and trimmings of the expensive models. Thus, in automobiles, for instance, the lowest-price Buick and highest-price Chevrolet might both sell for the same figure. By putting in perhaps just four models of an appliance, at three prices, Fred can satisfy just about all customers for that type of appliance. Thus he might carry an electric broiler at $8.98, one at $28.98, and two at $18.98, a cheaply made, elaborate one; and a simple, well-made model.

This will cut down on the amount of stock he needs to carry and should suit all customers.

Not only does this system reduce the size of his stock by eliminating all in-between items, not fitting any of his price lines, but it simplifies his advertising, makes it easier for his sales people to know the prices, and easier for customers to choose what they want. If Fred finds most of his customers fall into one of the three (or four) classes mentioned, he might carry a larger stock of that class than the others.

The disadvantages of price-lining are that it may be difficult to obtain merchandise that can be profitably sold at the predetermined prices; the prices selected for the lines may not be those that appeal to customers; and, once set, the prices may be difficult to change if economic conditions generally cause the need for a higher, or even lower, price. Thus, a men's clothing chain, which had a fixed price policy and had been advertising heavily that all their suits and coats sold for $22.50, found their good will of many years standing injured and customers resentful, when an increase in costs forced them to raise their prices into the thirty- and forty-dollar range.

Odd Prices. An interesting policy, followed by many stores, is to mark their goods with odd prices, such as 69 cents, 98 cents, $1.98, and $14.95 rather than 70 cents, $1, $2, and $15. This is done for several reasons. In the first place, there is the psychological effect of sounding more like a bargain. Somehow, $14.95 sounds considerably cheaper than $15. In addition to this, requiring the salesperson to make change and give the customer back two or five cents out of his dollar bills has two worthwhile effects. In the first place, it is a check on the honesty of salespeople. The need to make change practically forces them to use the cash register, so that there will be more of a chance that they actually will ring up the sale on the register, and not dishonestly drop the money from the sale in their own pockets without accounting for it on the register. More important than that, however, is the possibility that while the customer is waiting for the change, he will look around and perhaps see something else he might buy.

Loss Leaders. In an attempt to attract customers to their stores and give the impression that their prices are cheaper on all items carried, some merchants sell certain items at considerably less than their usual mark-up, or even at a loss. These *loss leader* goods are usually standard items, frequently bought by customers who know the customary prices, and are therefore aware of getting a bargain. It is hoped that this will cause the purchaser to think that all items in the store are equally bargain priced. Actually, however, the storekeeper generally marks up the prices of less well-known items so that he can make up for the loss he takes on



Costs and Markup. In this $50 man's suit, approximately how much is spent for the raw wool? What items are included under the heading "Retail Markup"?

the leaders. Some state legislatures have passed laws against selling items below cost, as loss leaders, and Federal laws prohibit selling merchandise below cost where the purpose of such sale is to eliminate competition.

Service Policies. Prices that a merchant charges for his goods are also affected by the amount of service he grants his trade. Customers expect to pay more at a store which delivers goods and permits them to run up charge accounts, than they do at a self-service, cash-and-carry market. These service policies, which will be more thoroughly discussed in the next chapter, are mentioned here because they too are factors that concern a businessman in the determination of his price.

PRICE COMPUTATION

Mark-up. The merchant adds to the cost of goods a margin that will give him a selling price sufficient to cover the cost of the item, its share of his total operating expenses or overhead, and a profit for himself. The percentage that he marks up the merchandise, in arriving at the selling price, is referred to as the *mark-up.* Mark-up may be based on selling price or on cost. Although basing it on cost makes computation easier, the retailer usually uses the selling price as the base for his mark-up. This is because the selling price is placed on price tags right on the goods, so that the selling price is the easier figure for inventory purposes and other comparisons.

Thus if Fred Kennedy has established a uniform 30 per cent mark-up on all hand tools, he will price them so that the invoice cost of the tools

Mark-up Table

Margin Percentage on Selling Price	Mark-up Percentage on Cost	Margin Percentage on Selling Price	Mark-up Percentage on Cost
4.8	5.0	25.0	33.3
5.0	5.3	26.0	35.0
6.0	6.4	27.0	37.0
7.0	7.5	27.3	37.5
8.0	8.7	28.0	39.0
9.0	10.0	28.5	40.0
10.0	11.1	29.0	40.9
10.7	12.0	30.0	42.9
11.0	12.4	31.0	45.0
11.1	12.5	32.0	47.1
12.0	13.6	33.3	50.0
12.5	14.3	34.0	51.5
13.0	15.0	35.0	53.9
14.0	16.3	35.5	55.0
15.0	17.7	36.0	56.3
16.0	19.1	37.0	58.8
16.7	20.0	37.5	60.0
17.0	20.5	38.0	61.3
17.5	21.2	39.0	64.0
18.0	22.0	39.5	65.5
18.5	22.7	40.0	66.7
19.0	23.5	41.0	70.0
20.0	25.0	42.0	72.4
21.0	26.6	42.8	75.0
22.0	28.2	44.4	80.0
22.5	29.0	46.1	85.0
23.0	29.9	47.5	90.0
23.1	30.0	48.7	95.0
24.0	31.6	50.0	100.0

Find your margin or gross profit percentage in the left-hand column. Multiply the cost of the article by the corresponding percentage in the right-hand, or mark-up, column. The result added to the cost gives the correct selling price.

represents 70 per cent of the selling price. If he has bought a certain type of pliers at $34 a gross, he would compute their selling price as follows:

$34 ÷ 144 = $.2361 cost per tool
$.2361 cost is 70% of what selling price?
(since he uses a 30% mark-up based on selling price)
$.2361 ÷ .70 = $.337 each

which means he should mark them either at a selling price of 34 cents, or, to fit in with his price lines, at 35 cents each. Similarly, if he uses a 35 per cent mark-up (on selling price) for appliances, an appliance which cost him $15.75 each, would be marked up as follows:

$15.75 is 65% of what selling price?
$15.75 ÷ .65 = $24.23

He could, therefore, mark it at $24.25, at $23.98 if he wishes to adhere to an odd-price policy, or perhaps $24.98 if he is fitting it into price lines as previously suggested.

Some businesses, particularly manufacturers, base their mark-up on cost. Thus a 30 per cent mark-up based on cost, on an item costing $15.75, would be computed as follows:

$15.75 × .30 = $4.73; thus $15.75 + $4.73 = $20.48 selling price

The article could then be sold at $20.48, $20.50, $19.98 or $20.98 whichever the merchant felt would best satisfy his price policies. (A merchant who adheres to price lines as suggested for Fred above would either sell this at $18.98, which would not give him the mark-up he needs but might be sold as a leader, or at $24.98, which would be above what competitors sold it for. (Perhaps he would not carry this item at all, substituting either a better appliance properly sold at $24.98, or a cheaper one that he can afford to sell at $18.98.)

It can be seen that mark-ups based on cost are smaller than mark-ups based on selling price, because the latter base is larger. Thus a mark-up of 25 per cent on cost is equal to a 20 per cent mark-up on selling price, 33⅓ per cent on cost equals 25 per cent on selling price, and 50 per cent on cost equals 33⅓ per cent on selling price. Because most business figures are based on sales, the mark-up percentage on selling price is the commoner base used by most business firms.

Markdowns. When goods do not sell at the original price, storekeepers often mark down the prices of these goods to encourage their sale. This is particularly true if the goods are going out of style, out of season, becoming shopworn or stale, or if the merchant has too many of them in stock or his price is higher than that of competitors. In retail stores these markdowns are again percentages of the next selling price. Thus if an item which cost $20 was marked up 20 per cent and was originally priced at $25 (the 20 per cent was based on the selling price), a 10 per cent markdown would not be $2.50 (10 per cent of $25), since $25 is no longer the selling price. Rather the computation is:

$25 is 110% of what?
$25 ÷ 1.10 = $22.70

Mark-down Ranges and Averages*

	High	Average	Low
Drugs and toilet goods	4.5%	4.0%	3.2%
Silverware and jewelry	6.5	5.4	3.5
Ladies' underwear	6.3	5.0	4.3
Handkerchiefs	5.4	4.4	3.1
Woolen dress goods	6.9	5.8	5.2
Silks and velvets	7.7	7.2	6.5
Linens	5.1	4.7	4.2
Laces, trimmings, embroideries	8.9	7.4	5.1
Leather goods	7.9	6.4	4.3
Men's clothing	8.2	7.1	6.1
Women's suits and coats	15.5	12.6	8.9
Women's dresses	18.1	15.6	11.0
Blouses and skirts	11.3	9.3	6.5
Gloves	8.2	6.2	4.4
Women's shoes	10.0	8.3	7.3

* *Pricing Merchandise Properly*, National Cash Register Co., p. 21.

Of course, for price line or odd-price reasons, the merchant might change the price to $22.98, $22.75, or $22.50.

When first marking up his merchandise to his original selling price, the merchant must remember that his *maintained* mark-up (the actual sales price less the cost) may not be as great as the *purchase* mark-up (the original retail price less the cost) because some of the goods had to be marked down. He should, therefore, set his original or purchase mark-up of an item large enough so that it will cover not only cost and its share of overhead and profit, but also some of the overhead and profit lost in marking down slow-selling goods.

Figuring Mark-up. Let us see how Fred Kennedy might compute what mark-up he should use, assuming that he will use a flat mark-up for all items in the store. First he would have to estimate the amount of sales per year a hardware and accessory store should achieve in his location. Then he estimates the amount his store's operating expenses, or overhead, should amount to in a year, and finally what he believes the annual profit, based on total investment, industry, and location should be. Thus, if he estimates annual sales of $150,000, operating expenses of $30,000 and that the store should make a profit of $15,000, he would compute mark-up as follows:

Estimated overhead	$30,000
Desired profit	$15,000
Gross profit or margin	$45,000

Margin ÷ total sales = mark-up; thus $45,000 ÷ $150,000 = 30%

To cover possible markdowns, however, it might be best for Fred to set a purchase mark-up of 33⅓ per cent, so he can mark down some goods and still achieve a maintained mark-up of 30 per cent on selling price. If he feels a flat mark-up is unsatisfactory, he might mark some goods up 40 per cent and others only 25 per cent, provided he maintains an average mark-up on all his sales of approximately the 30 per cent he seeks.

SUMMARY

The setting of proper prices on the goods he sells is vital to an enterpriser because it is an important factor in the amount of business he does and the profits he makes, which keep him in operation. The problems of pricing involve price determination, pricing policies, and price computation. The merchant must set prices that will cover all costs of doing business and allow him a net return. They must be in line with what customers are willing to pay for the goods and meet competition. Furthermore, they usually must comply with manufacturers' suggestions on prices. Price policies must then be formulated as to whether there will be one price for all customers, whether discounts will be allowed, and whether the store will follow price lines, or use odd prices and loss leaders. Mark-ups must be carefuly computed, taking into consideration maintained mark-ups as the result of some markdowns. All these factors must be carefully combined to arrive at prices that will allow for satisfied customers and a profitable business.

► FOR REVIEW AND DISCUSSION

1. What are the four basic factors in price determination?
2. Explain the terms: margin, gross profit, overhead, cost, mark-up, turnover.
3. How is turnover computed?
4. How do style and perishability of goods influence pricing policies?
5. How does competition influence pricing policies?
6. What types of legislation directly affect prices?
7. What is meant by a "one-price" policy? What types of business operations especially lend themselves to the one-price policy?
8. Why should a business carry different price lines of merchandise?
9. Why do some business operators price their goods on an odd-price system, such as 69 cents, 98 cents, $1.97?
10. How do service and credit policies affect the price of goods sold by retailers?

11. Show how mark-up based on cost and on selling price is computed. Give examples.
12. What conditions force a markdown on prices? Should the probability of markdowns be taken into consideration in setting the first price on goods?
13. Discuss the influences the consumer can exert on pricing policies.

► CASE-PROBLEM QUESTIONS

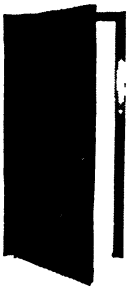
1. How can Kennedy and Company determine the per cent of profit they should make?
2. How can they determine whether they should handle high-quality goods or various grades of merchandise?
3. Should Kennedy and his partners make special prices to customers who buy in quantity?
4. Should they price all merchandise by the same mark-up rate?
5. What legal problems will Fred and his associates meet in pricing nationally advertised goods?
6. Can Fred change the pricing policies if they should prove to be wrong?
7. Should goods ever be sold at a price that is below cost?

► APPLIED BUSINESS PROJECTS

1. John Devers has a turnover of 300 per cent and a net profit of 15 per cent on his sales. Frank Evans has a turnover of 200 per cent and a net profit of 20 per cent on his sales. Assume each has an average inventory of $5,000. Who is better off? Draw a bar graph showing the inventory as compared to turnover and to profit for each.
2. Compute mark-up under the following conditions:
   (*a*) A small grocery will have $200,000 annual sales with operating costs of $20,000. The owner wants to make a profit of $10,000 a year.
   (*b*) A furniture store has an annual sales volume of $180,000 and operating costs of $45,000. The owner wants to make a net profit of $15,000.

► COMMUNITY PROJECT

In order to learn more about actual turnover of stock in businesses in your community, you should study representative businesses. Each member of your class should select three businesses and interview the managers to find out the amount of their annual sales and their average inventory. Each can then compute turnover. To avoid contacting the same businesses, a plan should be developed so that each class member selects the business firms he expects to study. This will insure a representative sampling of the various types of businesses. A consolidated report can be formulated to show the range in turnover for all businesses as well as for each particular type of business.



9 Selling

CASE PROBLEM

Fred Kennedy and his partners have now opened their hardware store and are anxious to do business. They know that an enterprise can only grow and be successful if it can earn a good reputation and foster the loyalty of satisfied customers. Fred emphasizes that they must set up store policies in their relations with their clientele that will assure customer satisfaction.

- What guides of selling and general conduct toward customers should the store establish in its contacts with them in the store, over the telephone, and through correspondence?
- What policies should the store pursue with reference to customer complaints, the return of merchandise, delivery, wrapping, extension of credit and other services?
- What methods should be used to induce customers to come to this store to do their business?

It used to be thought, many years ago, that selling was a matter of taking as much advantage as possible of the buyer and that the best salesman was the one who sold his wares for the most money and gave his customers as little as possible. But businessmen realize today that selling is actually a two-way proposition and that a truly good sale is one from which both parties profit. The only really satisfactory selling is that which will result in repeat sales, because the seller has profited not only by disposing of merchandise for more than he paid for it, but by obtaining a customer who is well pleased with his purchase. The customer too must gain from the sale. He profits by obtaining a good piece of mer-

chandise at a fair and reasonable price from a seller whose statements and judgment, as well as his goods, can be trusted.

SELLING APPEALS

It is now generally agreed that an enterprise can only be successful if it can build up a clientele of satisfied customers, who will return to it whenever they need more of the same type of goods. What, then, causes a customer to patronize a certain store rather than buying his needs from a competitor?

There are several ways in which a merchant can make his store and merchandise more attractive to purchasers than those of his competitors. The first one that comes to mind is naturally that of price. The price appeal is, of course, an important one and if his prices are lower than those of his competition, the storekeeper has a powerful weapon against them.

Cheaper prices alone are, however, not sufficient because the customer also compares quality. The average consumer is usually well aware that goods are not necessarily sold at a bargain because the price is cheap—the merchandise might be of such inferior grade that they are actually, economically, much more expensive. Some business enterprises even appeal to customers solely on the basis of the fine quality of their wares and make no effort to offer them at comparatively low prices.

A third appeal to customers is on the basis of originality or variation of style or design of the goods. Thus a ladies' millinery shop may stress, not the cheap prices nor even the exceptional quality of its hats, but rather that every piece of millinery is an exclusive original creation and different from hats the customer could buy elsewhere.

To Fred Kennedy in the retail hardware and appliance business, the appeals of price and quality, while they cannot be ignored and will indeed play some part, are not usually, in themselves, sufficient to develop a steady clientele for his store. Kennedy's shop sells standard items like nails, wrenches, and electric toasters. His prices and the quality of his wares must be good and comparable to those of his competitors, but being so standard they cannot be too different from other hardware stores; nor can his appeal be on the basis of originality of style or the design of his merchandise. No, if Fred's store is to develop a loyal clientele of repeat customers, it must be on the basis of sales appeals that are more difficult to achieve, those of the pleasantness of his salespeople and their selling methods, his service to customers, and the good reputation of the store for honesty and fair dealing. These appeals do not normally grow up by themselves. They must be developed as the result of constant effort on the part of the enterpriser. If Fred's store is to build up a trade

on the basis of its good reputation, its service and pleasant salesmanship, definite policies must be set up to guide Fred, his partners, and their employees in their dealings with the public. The store personnel must be trained in their use, and action must be taken to see that the policies set up are observed.

SELLING POLICIES

Since the business of the enterprise will be done over the counters in the store, by means of the telephone, and through the mails, Fred must make sure that his store personnel understand exactly how the management of the store wants its customers to be handled and treated under any and all situations. These are selling policies, which should be guides of action to employees in their contacts with the public. Thus, for instance, John Wanamaker insisted that sales people in his department store politely show goods to customers, but make no attempt to "push" them or talk the customers into buying the goods by high-pressure salesmanship. He further made it a policy, at a time when these ideas were new and not practiced by other stores, that the prices be plainly marked on all goods, and that customers could return all unused merchandise. Fred's store wants the policies that will guide the personnel of his store, in their relations with customers, to be in accordance with the most modern ideas on salesmanship and obtaining customer satisfaction. Let us see what these should be.

ATTITUDES OF SALESPERSONS

The first point that Fred must bring out with his salespeople is that they are the personal representatives of the store with the public. The first and often the only contact a customer has with a business house is through the salesperson who waits on him. In a store such as Fred's, good will is its greatest asset; and the attitude of salespersons does much toward building up, or destroying, the customer's goodwill. Fred must, therefore, not only hire the right type of sales personnel; but the salespeople must constantly reflect a personality that will attract business and make friends for the store.

A salesperson must first of all like his job and be anxious to do his best. If the employee is unhappy or lacks enthusiasm in his work, he does himself and the enterprise an injustice, for he will never make good on the job; and the firm will, similarly, not make good with its customers.

A salesperson must present a healthy, neat, clean, and attractive appearance at all times. Dress should be appropriate and should be such as will inspire in the customer the feeling that this salesman is business-



The Salesman Is Important. To the customer the salesman *is* the company. His attitude, his friendliness, his dependability—all affect the immediate sale and the future of the retail business.

like and a person in whom complete confidence can be placed. Fred and others who serve customers should not try to be fashion plates; in an expensive dress shop, the latest fashions would be in order.

The salesperson must be loyal to the store. This means having an enthusiastic desire to further the interests of the store, and to protect, display and sell its merchandise. If he does not believe in the store, the merchandise it sells, or his own ability to get ahead there, the salesman cannot do justice to his important position as personal representative of the store to the public.

The salesman must like people. The good salesperson gets along with everyone and has a smile and cheerful word for all with whom he has contact. He is anxious to be helpful to everyone. Thus the first requirement is for all salespeople to have an enthusiastic, pleasant, business-getting attitude.

Knowledge of Merchandise. While true of any business, it is especially important in a store like Fred's, where much intricate and technical equipment is sold, that the employees have a thorough knowledge of the merchandise for sale. First, of course, this means knowing what the store carries in stock. Equally important is knowing the location of each item in the store, so that the customer is not detained by long delays. The customer loses confidence in the salesperson who cannot find what the customer is seeking. But most essential of all is knowing the facts about the goods for sale.

The customer expects the salesman to be able to give expert advice on the goods that will best fit the needs of the customer. To talk intelligently with him and answer his questions while displaying the merchandise, the salesperson must have full information about the goods. If a customer is looking for a saw, Fred's salesman must know the materials and construction of the various saws in stock, their sizes, and the way they cut. He must know what each type of saw is best used for, and what it is unsuited for. He must know how it should be cared for and all its special features. Some of Fred's customers may be experts at handling tools and will pose some very technical questions when making purchases. Others will come in with little more knowledge than that they are looking for a saw. The salesman must be able to satisfy either type of customer and leave each with a feeling that the salesman knows his business and has sold the customer exactly what he needs.

The salesperson can only obtain this knowledge through careful study. He should thoroughly examine the goods in stock, and where possible, use them himself. He should carefully read the literature on the item put out by its manufacturer and discuss it with the salesman who sells the article to the store. Catalogues, technical magazines, and books, as well as advertisements in newspapers, magazines, and trade journals are also helpful. The salesman should also be on the alert for tips from other salesmen or customers who have used the product.

Understanding the Customer. In addition to knowing his merchandise, the good salesman also knows his customer. He knows that the man or woman who comes into the store is a person like himself, and the golden rule, to "do unto others as you would have them do unto you," certainly applies. This means of course that the customer must be treated with attention, courtesy, and tact. When the customer comes

The Successful Salesperson

Has a businesslike attitude

- Likes his job
- Presents a healthy, clean, and attractive appearance
- Is loyal to his employer
- Likes people

Knows his merchandise

- Knows what the store has in stock
- Knows the location of the articles in stock
- Knows the construction, materials, uses, limitations, and care of the goods
- Knows how to obtain information on the merchandise

Understands his customers

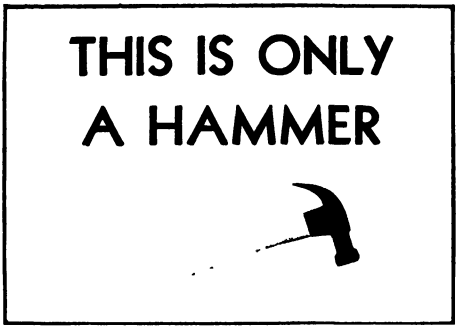
- Treats them with attention, courtesy, and tact
- Approaches them with a pleasant greeting
- Is friendly but not too familiar
- Tries to determine the customer's buying motive
- Tries to follow the customer's leads

Uses effective selling methods

- Uses a merchandise approach
- Shows the middle-range goods first
- Displays several items
- Treats the goods with respect
- Gives a short demonstration
- Handles objections with patience and initiative
- Closes the sale tactfully but without pressure
- Suggests other merchandise for sale
- Thanks the customer for his business

in, he is approached with a courteous greeting. In a friendly, but not too-familiar manner, the salesperson tries to put the customer at ease, and shows an active interest in the customer's need. A skillful salesman sizes up the customer, tries to determine what the buying motive of this particular customer is, and tries to follow every lead the customer gives him.

Using Effective Selling Methods. It is in the area of the actual methods of sale that Fred can formulate the most useful policies to guide his salespeople. He should choose personnel who have wholesome sales at-



Merchandise Knowledge Is Important. The same hammer will appear more desirable to a customer when he learns all its advantages.

Courtesy Macy's New York

titudes and know their merchandise and their customers, and he can train his staff to develop these traits. But effective selling methods can much more definitely be instigated and supervised by Fred and his partners because they are more concrete.

A policy which might be effective in the first step in the sale, the showing of the goods, might, for instance, be the suggested preference for the so-called "merchandise approach." Under this method, when the customer comes in and asks for a saw, the salesman does not immediately ply the customer with questions as to size, cut, price, etc., of the saw desired. Instead he takes the customer over to the part of the store where saws are displayed and, picking one up, hands it to the customer calling attention to its fine quality, or the well cut teeth, or other good points in general about the saw. Then, with the customer actually getting the feel of the saw in his own hands, he follows the lead of the customer as to the type he wants.

Another policy might deal with price lines. It is usually best for the salesman, when the customer does not indicate his preference, to show the goods first which are in the middle price range. This makes it easier to move up or down slightly to the more expensive or cheaper merchandise in tactfully following the customer's lead.

It is good policy to show several saws to the customer, even though

the salesman may believe the first one is what he needs. This will enable the customer to make comparisons and see for himself that the first choice was correct. Judgment must be used, however, so that the customer is not confused with too many articles from which to choose.

In the case of appliances and some tools, a short demonstration, with some participation by the customer himself, may be a general policy for encouraging sales. Fred may instruct his clerks that wherever possible the customer should get a chance to feel as well as see the goods. In line with this, the salespeople should be admonished to handle the goods themselves with respect and appreciation, as if it really meant something to them. This in turn causes the customer to look upon the goods as something fine and of value.

Fred probably will need to instruct his staff on the proper handling of objections. It is natural for a customer to question the worth to him of the goods being shown him. This usually shows that he actually has an interest in the goods, and gives a lead to the salesman as to what he has not covered in his demonstration of the goods. Where there is any merit to the customer's objection, it should be admitted, but a compensating advantage pointed out. Should the customer point out that the saw is too heavy, the clerk might point out that its weight is the very factor that insures a better cut or gives longer wear. Objections as to price can be met with emphasis on the fine quality. Quality objections, in turn, can often be met by stressing the bargain price.

Closing the sale may also present some difficulty. Very often the customer needs someone to give him the final push or inducement to action. There is no exact moment when all customers finally decide to buy; with each sale it may come at a different time, or even several times, during the demonstration. The salesman must never use high-pressure methods in trying to consummate the sale, but a tactful remark, properly placed, like "Do you want this in a box or will a bag be sufficient?" or "Will you take it with you or shall we deliver it?" might lead to the closing of the sale.

Suggestion Selling. An important part of salesmanship comes at the end of a sale in the form of suggestion selling. This takes the form of suggesting to the customer the possibility that he might also be interested in buying something else allied to what he just purchased. This is especially true in a store like Fred's, where, if a customer buys nails, he might also need a hammer, or if he buys a file, he might need a file-card. Fred could tell his staff that it does not consist of just asking the indefinite question "Is there anything else?" That leads the customer to nothing. Rather there should be a suggestion of a definite article related to the one just purchased. The suggestion might also be of some article on spe-

cial sale, or buying a larger economy size of the article he has just purchased. A clever use of suggestion selling not only increases sales but is actually of service to the customer in saving him trips to the store or in saving him money.

Finally, of course, Fred can insist that the sales personnel thank the customer for his business at the conclusion of their little interview. Even if no sale is made, the salesman should show appreciation for the customer's time and interest. The customer should be made to feel that he is always welcome at Fred's store whether or not he makes any purchases.

Telephone Selling. A store like Fred Kennedy's, which sells so many staples and branded items, will usually do a considerable amount of its business over the telephone. Salespeople should be trained in the store's policies on how such sales should be handled.

For one thing, the salesman on the telephone must have a thorough knowledge of the stock. The customer dislikes waiting while the salesman tries to see what he has in stock. This is especially true in areas where the customer is paying telephone toll charges for the time used on the call. Furthermore, the salesman must be able to describe an article and talk convincingly about it, because the customer cannot see it.

The salesman must develop good telephone diction and hearing. The telephone company's familiar adage emphasizes that "the voice with the smile wins." Customers become annoyed when they cannot hear or understand the salesman. They are equally perturbed when they must repeat what they say several times. Good telephone hearing is largely a matter of paying close attention to what is being said. Naturally, the salesman has a pencil and paper, or an order pad, and is writing down the customer's requests. Although no one likes to repeat what he says over the telephone, that does not apply to repeating the order back to the customer at the conclusion. Unless the caller makes it clear he is in a hurry, such repetition is a wise precaution, which the customer will understand and appreciate.

Lastly, suggestive selling is generally possible in telephone selling too. Just a sentence calling attention to a special sale on some article, or suggesting a related item that might have been forgotten, is often helpful. The telephone conversation must not, however, be unduly long, but should be businesslike and to the point throughout.

ATTITUDE OF CORRESPONDENCE

As Fred Kennedy's business gets larger, some of his sales will be made by correspondence with his customers. But whether the letters are written to prospective purchasers, or merchandise creditors, or banks, or any other type of addressee, every business should set up policies as to the

attitudes of those who write its letters. Fred, then, should lay down some rules with reference to his business communications that go out through the mails.

In the first place, every letter the business receives, no matter what its subject or who it is from (with the exception of circulars and strictly advertising matter), deserves an answer. The answer, furthermore, should be prompt. Failure to reply with dispatch to a letter can do much to injure the good will of a firm.

Every letter should be written in a firm, businesslike manner. This means it should be courteous and to the point, as well as couched in a dignified and not too-familiar tone. A business letter should be concise and easily understood and should not be too informal, since a certain amount of formality is expected in a business letter.

As much as possible, a letter should stress the reader's point of view in approaching any discussion. The usual correspondent is not especially interested in the writer's difficulties and problems; he is concerned with his own. If a letter is to make any point successfully, it must try to present the arguments as they affect the reader. Finally, a good general idea, although not an iron-bound rule, is that it is usually better to give good news early in a letter and present less pleasant information in the middle of the letter.

CUSTOMER-RELATIONS POLICIES

In addition to training his staff in the way he wants customers and others treated over the telephone, by mail, or when they come into the store, there are other important contacts, difficulties, and problems that Fred's firm will run into in its relations with its clientele, and which Fred and his partners should prepare their personnel to handle properly. What shall they do with the customer who buys a saw and two weeks later returns and says he is not satisfied with the way it cuts? How shall they handle the person who says he received an electric toaster from one of their customers for Christmas and wants them to take it back because he already has a toaster? Shall Fred and his associates sell an electric shaver to a man who wants it delivered to his home six miles outside the city limits? Shall they permit a customer to purchase an electric range on credit, or shall they insist on cash?

Questions like these, and many others, are bound to come up almost daily in the business. The salesmen cannot treat each customer differently, or have every employee turn such problems over to Fred or a partner for decision, or even have the problem decided each time in accordance with the whim of Fred at that moment. These difficulties must be

anticipated and policies of adjustments, returns, delivery, credit, and the like, established in advance. In this way every customer will receive the same treatment; and the employee can handle the situation himself, in the way the management wants it done and without bothering one of the busy partners.

ADJUSTMENTS

Every store will have complaints from its customers. It is part of human nature for employees to make mistakes occasionally, or for customers to be dissatisfied once in a while even with perfectly good merchandise. Fred and all other businessmen must therefore have their stores organized so that there is a routine for handling such problems. When stores are small, the proprietor can personally take care of all complaints. Larger stores often require that such complaints be turned over to a section manager for action, while some very large ones have a special adjustment bureau for handling these matters. Because a customer prefers dealing with the salesman who waited on him in selling the goods, the best method, even in large stores, is to give the salesperson authority to handle complaints, unless he feels the customer is clearly in the wrong. When a clerk feels the customer is in error, he probably would turn the problem over to the adjustment bureau, if there is one, or a section manager, or, in a store like Fred's, to one of the partners.

Customers should be treated with dispatch, with utmost courtesy and tact. Adjustments, when made, should be cheerfully and not grudgingly given. Generally customers' complaints will center around these situations:

1. Failure to receive merchandise ordered
2. Receiving the wrong goods
3. Shortage in merchandise received
4. Damaged or defective goods
5. Goods unsatisfactory for purpose customer wanted them
6. Customers have changed their minds and arbitrarily no longer want the goods

Some customers will be right in their complaints. Their difficulties must be cleared up at once, and the store must do everything it can to make up to the customer for the inconvenience or expense caused him. Some customers will be wrong in their complaint, but will genuinely believe themselves to be right. Here the store should try to convince the customer as tactfully as possible of the injustice of his claim; but if he is adamant and still thinks he is correct in his complaint, it is better for the good will of the store to give in to him and make the adjustment. Still other customers will make complaints or demand exchanges or their

money back, although they probably realize that they are in the wrong. Here the store people should be less lenient in their treatment of the complaint. If the adjustment the customer wants does not injure the store too greatly, the adjustment should be made even where the customer is wrong. This adjustment should be made after some investigation to discourage making a practice of complaining, and yet avoid the loss of possible future business the customer may give the store. Adjustments will take the form, in most cases, either of getting the correct goods to the customer at once or, in the case of a return, of giving the customer other merchandise in exchange, or a credit slip which the customer can use at a later date to purchase other merchandise, or refunding the purchase price.

RETURNED-GOODS PRIVILEGE

In some retail lines, it is the practice not to take back any merchandise. This is particularly true for certain types of wearing apparel for health reasons, or for articles like books, which the customer might read and then attempt to return. But custom and competition have made it a requirement in most lines of goods that the store take back any merchandise that is unused and undamaged. This can become a very expensive proposition for the store, even if the customer receives only a credit slip and not a cash refund, because the goods have to be resold, rewrapped, redelivered and rebilled. Such activities take time and cost money, and the goods themselves depreciate or deteriorate from age and handling.

Returned goods can run anywhere from 5 to as high as 30 per cent of sales. A businessman should carefully investigate the causes of high-return sales. Generally they will come from three main sources: (1) the wrong merchandise has been sold, because care was not taken to see that the right size or right item was provided; (2) the salesman was too aggressive and the customer bought an article he did not want just to get away from the salesman; (3) a lack of business ethics on the part of some customers who just change their minds, or buy several types of articles with the intention, from the beginning, of actually keeping only one, or even none.

It can be seen that the expense of excessive returns can be cut down considerably by attacking each of these three difficulties. In the first place, the salesman should make sure that the merchandise will fit the customer's needs before he makes the sale. Whoever wraps the goods should check, incidentally, to see that all pieces and parts of the merchandise are present and placed in the package before he packs it. The second type of return can be combated by discouraging high-pressure methods among salespeople. The salesman should make sure that "he sells the goods, and not the customer." For the third type of situation,

it may be lessened by being a little firmer in extending the returned-goods privilege to the constant abuser of it.

WRAPPING GOODS AND RECEIVING CASH

In a store like Fred Kennedy's, the question of wrapping goods and receiving payment presents no problem because all packages are wrapped and change made by the salesclerk in the customer's presence. In large stores, however, it is sometimes better to have central wrapping stations in various areas of the store, with specialized packers, just as it is often the practice to have a central cashier's office to which all receipts are sent, with sales slips, by pneumatic tube, and the change sent back by this means to the salesperson. This system of central wrapping and cash receiving allows for a better control of these two functions and frees the clerk for the next customer, as well as allowing more space on the counters for selling and display. On the other hand, customers often do not like the delays and errors that sometimes creep into the central wrap and cashier system. It is not good, furthermore, for the clerk to lose contact with the customer during the time he is waiting for the goods or change. Probably the best system in a large store is to have one convenient wrapping station and cash register for each department or section to which the salesclerk himself can go and do the job for all goods the customer is taking. For goods being sent to the customer, the large store might have a large bag near each clerk's station in which he places the articles to be shipped, thus releasing his time for other customers. This bag is emptied several times a day, and the merchandise is taken to a wrapping and shipping room.

The correct and economical use of packages and wrapping materials is also important to Fred, and other businessmen, because these items can run into a good deal of money. The way an article is wrapped makes an important difference in the appearance and condition of the article when it reaches the customer's home. Care should be used in choosing sizes of rolls of wrapping paper, as well as the paper's weight and consistency. Thought should be given as to whether cord, string, gummed or cellophane tape will be best for tying and sealing the packages. A decision should be made as to whether to use special gift wrapping in holiday seasons. But above all, employees should be trained and supervised to see that they use effective methods of wrapping goods without waste of wrapping materials.

DELIVERY SERVICE

A decision must also be made by Fred and his partners as to whether they will deliver merchandise for their customers, how they will go about these deliveries, and what geographical limits they will place on such

deliveries. Delivery is a great expense to any store, but in most lines of business it is essential. In recent years, cash-and-carry has become popular, especially in "cut-rate" stores with cheaper prices. Thus Fred's firm must decide whether it will extend delivery service to customers, since this is not universal in its line of business. (The question of just how to ship and deliver merchandise is of sufficient importance as to be considered separately in Chapter 11.)

EXTENSION OF CREDIT

Another customer service that requires an early policy decision by Fred and his partners is the problem of extending credit. (This will also be treated more fully in a separate chapter.) Allowing customers to buy on credit and pay at a later date is essential in the manufacturing and wholesale fields. In retail stores the extension of credit is a matter of store policy.

Cash or Credit. Some retailers feel that credit increases trade, because customers buy more than they would if they had to pay cash. Furthermore, credit may even out the peaks and valleys of business in the intervals between paydays. Thus a strictly cash business does better near the paydays in its community than it does between paydays. A business that extends credit would find its customers making purchases at any time, without regard to proximity to payday. Other retailers feel that the great expense of carrying customers' accounts, of trying to collect from delinquents, and customers who never do pay, does not justify selling on credit.

More enters into the question than just the attitude of the storekeeper, however; for the businessman must meet competition and must generally do, in this regard, what his competitors do. It is largely a matter of the character of his neighborhood, the class of his clientele, and the line of goods he is selling. In neighborhoods with a buying clientele of high-quality merchandise in the high-price ranges, credit extension by means of charge accounts is essential. In areas where customers seek less expensive grades and lower-priced merchandise, business may be done solely for cash. In recent years, especially in fields like Fred's, selling appliances on the installment plan has become a very important way of doing business. Fred and his partners would thus have to decide whether to have charge accounts, whether to sell appliances on installments, or whether their store will sell solely for cash.

Other Services. There are other types of services that Fred's firm might decide to extend to its customers, which require policy decisions in advance. These might include whether to offer customers free parking space, whether to sell C.O.D., and whether to use a "lay-away" plan,

where customers can order something to be kept for them until paid for. Some businesses must decide whether or not they will guarantee the products they sell against certain forms of damage or for certain uses, such as a ladies' hosiery firm guaranteeing its stockings against runs. Some large business firms have a minimum-order policy, under which they refuse, because of the shipping and bookkeeping expense, to accept orders for less than a dollar or some other figure.

OBTAINING CUSTOMERS

One of the most important problems which every business must face is that of developing a clientele—getting customers to trade with it. This is true not only of the new enterprise, but also of the well established one, for new customers are always a requirement of any business, to replace those it loses for various reasons, and to permit expansion. In general, possible customers, referred to as prospects, are obtained by one or several of these methods:

1. By personal solicitation of friends of the owners or of its sales personnel
2. By recommendation of satisfied customers
3. By mail solicitation
4. By advertising
5. By appealing to passers-by
   a. Through attractive window displays
   b. Through special sales

PERSONAL SOLICITATION

In many lines of commerce, an enterprise's customers are mainly obtained from among the friends or business contacts of its owners. One of the great assets which an enterpriser can contribute to a firm, in addition to his knowledge of the business, is a clientele of prospective purchasers who have dealt with him in the past and who like him and have confidence in him. Other customers are brought to a firm through the hiring of salesmen who have a "following"; that is, a group of customers who would buy their needs in that line from him, no matter which firm he is working for. Other enterprises, particularly manufacturers and wholesalers, send salesmen out to visit all the retailers in their field to show their line, and thus hope to do business by developing trade from such personal solicitation. Of course, once some business has been done, an enterprise is always glad to get customers through recommendations of others who have been satisfied in their relations with it. While that is the way professional people, like doctors and lawyers, obtain much of their business, it is not usually sufficient in itself for most enterprises.

DIRECT-MAIL SOLICITATION

Many business firms solicit customers by writing letters to all those in the area who might be potential prospects. There are firms who specialize in preparing mailing lists of various kinds and will sell their lists for such use. These lists are made up of names and addresses, for instance, of all those in the area whose income is above a certain figure, or who are in business for themselves, or who own television sets, or have certain special interests. Fred Kennedy could buy a list of names and addresses of those in his area he feels would be interested in electrical appliances (this might indeed be all those in his locality who are customers of the electric light and power company) and send a letter to each of these prospects telling of his store and what it offers for sale, in an effort to interest them in coming in and buying from him. Lists of certain types in an area can be taken from the city directories or the classified telephone directory without charge. Thus if Fred wants to write to every dentist in his locality about some appliance he is selling that might be of special use to dentists, or to every contractor, independent carpenter or painter, he could easily obtain their names and addresses from the yellow pages of the local telephone book.

Some prospects can even be obtained from an alert watching of news items in the newspapers. Announcements of engagements serve as a good prospect list for the firm selling bridal outfits; birth announcements for those selling baby products; lists of construction permits granted might serve as a source of prospects for building suppliers.

ADVERTISING

An effective means of obtaining customers in most lines of endeavor is through advertising. One such form of advertising is by the direct-mail solicitation mentioned above. Others might be by advertisements in newspapers or periodicals, on the radio or television, by car cards or billboards, or even by "sandwich-men" who walk the streets with placards hanging in front and behind them. The matter of advertising as a business problem is so important that it is discussed as part of the following chapter.

ATTRACTING PASSERS-BY

For a retail business, the very location of the store is a fruitful source of customers, its convenience being the magnet that brings them in. But to attract greater attention from those who pass the store, to gain as prospects those who might not normally notice the shop, or to attract trade away from competitors, the retail merchant depends largely on attrac-

tive window displays and on special sales. Like advertising, the problems of window display are discussed in the next chapter.

SPECIAL SALES

The special sale as a device for obtaining customers must be treated by the enterpriser with considerable caution. Selling goods at a lower price at a sale, rather than increasing profits, may lower them if the sale does not succeed in greatly increasing the turnover. More serious than that, however, is the fact that the sales may give the business a reputation as a cheap store. Customers looking for quality items may no longer patronize it; and other customers will only buy the sale items, ignoring the regular merchandise on which a normal profit is made. Rather than developing a steady clientele, these sales may serve solely to encourage the purchases of those seeking bargains at sales, so that only the special sale merchandise is sold.

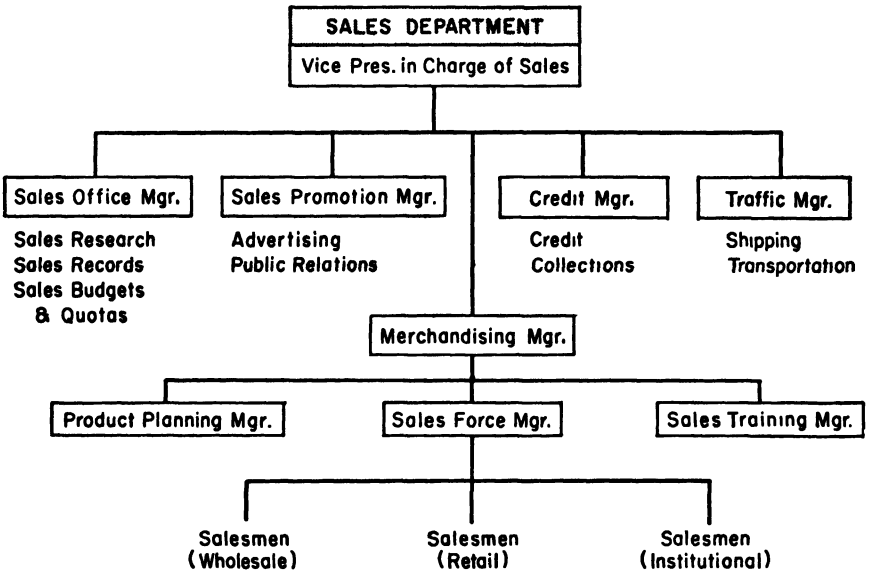
But special sales with a definite purpose may occasionally be worthwhile. Those which introduce a new product, or tie in with a large manufacturer's special advertising campaign, or close out last season's remnants, or celebrate some special occasion such as an anniversary of the store, or a "January white sale," the traditional time for putting cottons and linens on sale, may have the effect of stimulating business without giving the store a cheap reputation. Thus Fred Kennedy may run a special sale to introduce a new electric shaver, or he may give considerable publicity and attractive display to the fact that "April Is Garden Tool Month" and run a special sale on such items during that time.

SALES ORGANIZATION

THE SALES DEPARTMENT

While of no special concern to Fred Kennedy in his retail hardware store, a problem requiring considerable decision and policy-making for the large business, especially one in the manufacturing or wholesaling field, is that of the organization of the selling department of the firm. Some enterprises give the executive in charge of sales the responsibility for many other allied functions, while others limit his supervision to selling only.

Thus in many large firms, the sales executive is not only in charge of the salesmen, but also supervises what is known as *merchandising*. This refers to the internal problems of distribution—the selecting of models and styles, pricing of the goods to be sold, designing the packaging, and determining when items should be placed on special sale. In many enterprises, the sales executive is also in charge of advertising, while other



Sales Department Organization Chart

concerns consider this a function important enough to have a separate department head who reports directly to the president. The matter of extending credit and collecting customers' accounts is also placed under the sales manager in the organization of some firms; whereas in others, credits and collections are placed under the supervision of a financial executive like the treasurer. The shipping of outgoing orders is also often assigned to the sales executive.

The organization of the selling staff itself presents a problem to the large enterprise. Many sales forces are organized on a *geographical* basis, with salesmen selling all the goods to all the customers of the company in a certain designated area. Some salesmen, however, are divided on a *product* basis, so that the salesman who sells meat in an area for a large meat packer is not the same one who sells in that area the tennis-racquet gut the firm also distributes. Still other firms organize their sales staffs on a *functional* basis, one salesman calling on the wholesalers and jobbers in an area, another calling on retailers, and still another on hotels and institutions. It is possible, in the very large business, for a combination of two or even all three of the above bases to be used in organizing the sales force.

The above diagram illustrates the organization of the sales department of a fairly large firm. It is not necessarily typical of all firms, nor is it suggested as the best pattern, but it does show all the important functions and how one firm has set them up. The department is organ-

ized on a line basis under the leadership of a vice-president in charge of sales.

SUMMARY

It is essential that a business develop a satisfied clientele if it is to be successful. To make certain that customers will be properly treated by its personnel, the enterprise should set up policies for guiding its staff in their dealings with the public. These include policies as to selling in the store, over the telephone, and by mail.

As the organization chart shows, the sales planning division handles the sales records and figures, and the sales promotion division the advertising and publicity. Shipping, credits and collections, in this firm, are also divisions of the sales department under the supervision of the sales executive. The merchandising manager is in charge of pricing and planning the introduction of products; the training of the sales force and, through the sales manager, of the sales personnel in the field. In this firm, the salesmen are organized on a geographical basis within the framework of a functional organization, with different salesmen, in each area, calling on wholesale customers and on the retail and institutional trade.

Customer services, such as the handling of adjustments, returned goods, deliveries, and credit must also be given attention. The enterprisers should give thought as well to the methods they employ to obtain and develop prospects into customers. Finally, the large organization must give attention to the problem of proper organization of its sales department.

► FOR REVIEW AND DISCUSSION

1. Describe the basic appeals that attract customers to a place to buy goods.
2. What is meant by customer good will? How can it be developed and maintained?
3. How does the personal appearance and personality of sales personnel influence the customer's attitude?
4. Why does the salesperson need to have a technical knowledge of the merchandise he sells? Of stocking and stock location?
5. Describe methods in making the customer approach.
6. Describe effective techniques for closing a sale.
7. How can suggestion selling render a valuable service to both the customer and the store operator?
8. What are the essential sales factors in conducting telephone selling?
9. What basic rules should be followed in handling correspondence with customers?

10. What are the common reasons for having to make adjustments in merchandise sold? Describe the basic principles that should be followed in handling adjustments.
11. What are some of the problems that should be considered in establishing merchandise delivery policies?
12. What are some of the factors that influence credit policy?
13. What are the various ways in which retail stores attract new customers?
14. What is merchandising? Who is usually responsible for carrying out the merchandising function?

► CASE-PROBLEM QUESTIONS

1. How can Fred determine when a sale has really produced a satisfied customer?
2. What policy do you think Fred and his partners should adopt about providing special wrappings for gift and holiday merchandise?
3. Where can Fred get factual information about the goods to be sold, so that he can pass such information on to the customer?
4. Discuss the policy of service to credit customers compared to the service given those who buy for cash.
5. How can Fred and his associates be sure that they have developed the right sales policies?
6. Does Fred "sell a customer" or does the customer "buy"?
7. How can Kennedy and Company be sure they are using the most desirable means of attracting customers to their business?
8. How can they determine the amount of money to be spent on advertising?

► APPLIED BUSINESS PROJECTS

1. Set up a big letter T on a full page of paper and title it "Closing the Sale." List the proper techniques for closing a sale on the left side of the "T" and the improper or poor techniques on the right side.

2. (*a*) Suggestion selling arouses the suppressed desires of the customer. List in question form as many techniques as you can which exemplify suggestion selling. (*b*) Should suggestion selling be restricted to goods related to those already purchased or examined?

► COMMUNITY PROJECT

Several methods of obtaining new customers are listed on page 143 of this chapter. In order to help you become better acquainted with the practical application of these methods, observe efforts being made in your community to get new customers. Sources of information are newspapers, radio and television, store windows, direct mail, handbills and posters, contests and prizes.

List as many examples of different techniques as you can locate by observation of efforts of business firms in your community to get new customers. Classify them under the categories listed in your text.



10

Promotion, Advertising, and Display

CASE PROBLEM

Kennedy & Company, the retail hardware and electrical appliance store that Fred and his partners have opened, has been in operation for a few weeks, but Fred feels that it is not doing as much business as it should. He believes that not enough people in the locality know of the existence of the store or of the wares it has to offer. He insists that more attention should be paid to, and greater emphasis placed on, advertising, window and interior display, and the entire area of sales promotion.

- Are there any sales promotional ideas that the store might try in an effort to stimulate sales?
- What type of advertising should the Kennedy & Company store do; where should it advertise; and how should it go about placing its advertisements?
- What kind of window display should Fred's store feature, and how often should such displays be changed?
- How should the merchandise be displayed in the store itself so as to stimulate sales?

SALES PROMOTION

In this modern era of keen competition in business, it is not enough that an enterprise sells good merchandise at low prices, nor even that its salespeople are competent and pleasant. A business today, in the struggle of competing with other similar enterprises, must use every means it can to stimulate trade and encourage potential customers to buy from it. These efforts at customer stimulation are known by the general name of



Courtesy Gertz & Company

Eye-catching Display. This very effective window display capitalizes on Father's Day and dad's interest in golf. In this case, however, the store is selling men's clothing—not golf clubs.

sales promotion. Generally, they take three major forms: (1) special campaigns, ideas, or features to promote business (some business people consider only this one area as sales promotion, excluding the remaining two); (2) advertising; and (3) display of merchandise, both in the window and in the store itself.

Special Campaigns. The sales promotion that Kennedy might attempt, in addition to advertising and display, might in itself take three forms. First would be *special campaigns or ideas,* usually tied in with a special sale. Thus we saw in the last chapter the possibility of featuring a promotion based on the idea "April Is Garden Tool Month." The store might also push a "Do It Yourself" sale or "Make It An Appliance Christmas" campaign. A *tie-in* promotion is also good with a special display or sale on an article at the same time as its manufacturer is conducting a major advertising campaign featuring the product. Occasionally a tie-in with a motion picture showing at local theaters might stir sales. Thus if a picture like "Mr. Blanding Builds His Dream House" were showing at the theater in Kennedy's neighborhood, he might tie



Courtesy National Business Show

The Business Show. A special type of promotion in many cities is the annual business show. This little clown is attracting interest in a display of office calculators.

this in with a sale of tools and show still pictures in his store window from the movie depicting Mr. Blanding using similar tools. The theater manager will usually be glad to co-operate because of the publicity Kennedy's windows would give to his movie. Perhaps he might even give Fred some free passes, which Fred could give as prizes for some kind of contest he could run during the promotion.

Contests are in themselves valuable as sales-promotion schemes, as are the giving of premiums or samples. Thus Fred might give away an extra blade with every jig saw he sells during a certain period, or give a free sample of metal polish with every chromium appliance he sells. These are definite stimulants to business.

Demonstrations and Exhibits. Another form of sales promotion is that of special exhibits and demonstrations. Fred may be able to arrange for a demonstrator, an employee of the manufacturer, to be in his store for three days demonstrating some new electrical appliance or tool; and he could advertise this so that interested persons could come to see the demonstration, in addition of course, to customers who happen to be in

the store. Kennedy & Company might also lease a booth and set up an exhibit at the local state or county fair, at a home-and-garden show, a do-it-yourself show, or any similar exhibition which might bring his store and its wares to the attention of the public.

Institutional Promotion. A third form of promotion might be what is known as *institutional promotion* or simply *public relations.* This method attempts to bring the name of the store before the attention of the public and heighten its popularity, without specifically pushing any of its products. Here Fred's store might sponsor a bowling, basketball, or Little League baseball team, by paying for their uniforms and equipment in exchange for the team calling themselves "Kennedy's." Placing a float in public parades, or taking an active part in charitable or civil defense campaigns are other public-relations features the store would find profitable. Activity by Fred himself in organizations like the Junior Chamber of Commerce, service clubs like the Rotary and Lions, and veterans and civic groups like the American Legion and YMCA, might help Kennedy & Company in their business, as well, of course, as being of value to the community.

ADVERTISING

By far the most important form of sales promotion is that of advertising. This paid form of publicity is used not only to create a demand for a product and stimulate business, but also as an informative and educational force that aids the consumer in making judgments and adds to his standard of living. For in addition to *commodity* advertising, which attempts to sell specific products, there is an important type known as *institutional* advertising, which is of a general nature and brings to the attention of the public the entire store and its policies, or in some cases even an entire industry. Where Fred advertises a special sale on electric toasters, he is using commodity advertising, but where he advertises that the store now accepts charge accounts, or can give free parking facilities to his customers, or will stay open Thursday nights until 9 P.M., he is using a form of institutional advertising.

The Value of Advertising. American business spends over six billion dollars every year on advertising. What are the reasons why such a colossal sum is spent annually for this service? Is advertising always of benefit to the enterpriser or does it too have its bad side? Let us give this some thought.

ADVERTISING BY THE MANUFACTURER

Advantages. Looking at the problem first from the standpoint of the manufacturer, advertising has many great advantages to him. First of

all, of course, it stimulates and sustains demand for his product, by calling the public's attention to it. Fred Kennedy needs to say little to his customers to sell, let us say, a Remington electric shaver, because they have seen the product advertised extensively on television and in magazines and newspapers and know it well. The manufacturer builds up goodwill for all his products, so that a satisfied customer who has used and liked a General Electric toaster believes in and has confidence in an advertisement lauding the merits of a G.E. hot plate. Furthermore, advertising aids in controlling the distribution of the manufacturer's product. The extensive advertising of his merchandise not only increases sales, but makes distributors co-operate in carrying out the manufacturer's policies on prices, service, and the like. But most important of all, effective advertising cuts down on costs and decreases the price of goods. Advertising is expensive; but if it results in making many sales, the increased volume will usually lead to lowered total costs and therefore a less expensive price to the customer.

Disadvantages. But, like everything else in life, advertising too has its disadvantages, which a manufacturer must consider before embarking upon an expensive campaign. In the first place, of course, there is the fact just mentioned that advertising is costly and is only justified if it is effective and actually does succeed in selling the product sufficiently to pay for itself. More than that, however, once a product is heavily advertised, the campaign must always be continued. A product cannot rest on its laurels—that is, upon its past advertising. Many well-known products have disappeared when advertising them has ceased. It is only by constantly keeping a well-advertised item before the public that extensive sales of it continue. Then again, the advertiser makes representations and statements to the public that must be carried out or lived up to. A mistake or misrepresentation can be very damaging to the good will of the manufacturer and to the sales of the product. Advertisements come to the attention of so many people that they must be very carefully and skillfully created.

ADVERTISING BY THE RETAILER

Advantages. Just as it has good, and a few bad, features to the manufacturer, so advertising is of great value (and has some disadvantages) to the wholesale or retail distributor such as Kennedy & Company. For one thing, advertising makes the problems of the distributor much simpler, especially if the goods he sells are widely advertised by the manufacturers. Certainly it cuts down considerably on his selling effort. It was previously brought out that Fred needs to do considerably less on his part to sell a Remington shaver, General Electric toaster, or Simonds saw than he would if these products were unknown to the public. He need

not test such goods to make sure they are suitable for his trade, nor indeed will the usual customer blame his store if one of these branded, advertised articles should be defective. In many cases, he does not even have the problem of setting a price on the goods because the manufacturer's advertising has set it. He should have less returns of advertised goods, because the customer knows what the merchandise is and what it can do before he makes his purchase at Fred's store. Of course, Kennedy's own advertising, if effectively done, in addition to that of manufacturers, will bring more business to his store.

Disadvantages. Advertising has its disadvantages to the distributor too, however, in addition to its cost, which makes it only advantageous if well done. Selling goods which are heavily advertised by their manufacturer takes away much of the independence of the distributor and the individual appeal of his store. It is difficult for Fred's store to have any special appeal to the public if he sells the identical branded, advertised appliances his competitors sell, and even at the same prices that they do. Furthermore, where a manufacturer spends a considerable amount advertising his product, he expects that to be the main factor in its sale, and thus allows the distributor only a small margin between the cost of the article to the latter and the price at which he must sell it to the public.

ADVERTISING AND THE CONSUMER

Advantages. Advertising has advantages and disadvantages to the consumer too. For one thing, advertising on a national, and even worldwide scale, has so standardized products that the consumer can buy the same products, which he likes and has faith in, anywhere he may go. No matter where his travels may take him and how strange he may otherwise feel, he can still purchase his favorite cigar or toothpaste and know that it is the same product, guaranteed by the manufacturer to be satisfactory. Advertising as an educational device has done much to raise the standards of living of the entire nation, and of the world as a whole. The Michigan lumberjack or Iowa farm family know and want the same style of clothes that men and women are wearing on Park Avenue or Michigan Boulevard. Having read the advertisements, they are saved effort and expense in making purchases, because they go into the store with a good idea of what they want. They know what various manufacturers and distributors have on the market and have some idea of how these wares compare in price and utility.

Disadvantages. Just as it is costly to the manufacturer and distributor, ineffective advertising adds to the cost of some of the merchandise the consumer buys. Advertising raises the standard of living by causing us to want and to buy the nice things we see displayed in the advertisements;

but it also causes us to buy things we do not need, or that we cannot afford. Occasionally we are even taken in by deceitful or exaggerated claims made in advertising. Furthermore, because of the expense involved in advertising, manufacturers tend to standardize items and cut down somewhat on the variety or design of products, which might otherwise have been available to consumers.

Thus Fred Kennedy is doubtless correct in his assertion that carrying nationally advertised lines and carrying out an advertising campaign of his own will produce considerably more business for the store. But what form should this advertising take? Let us see what are the various types of advertising media and for what each is most or least useful.

TYPES OF ADVERTISING MEDIA

An *advertising medium* is the way or method by which the message of the advertiser reaches the public. These include, in descending order of general importance, newspapers, direct mail, magazines and trade papers, television and radio, billboards, and other methods.

Forty-one per cent of all advertising in this country is by means of the newspaper. This is a very flexible and current medium which can be completely changed daily to meet the up-to-the-minute needs of advertisers. Newspapers usually reach a very large audience in a normally limited local area and are thus best adapted for use by local merchants such as Kennedy & Company. Large metropolitan papers have a much larger circulation than small local newspapers, but charge considerably more for their advertising. Newspapers are read by nearly everyone, so that if one wishes to appeal to a small selective group like fishermen or bowling enthusiasts, he might be wasting much of the expense of his advertisement by inserting it in such an unselective medium as a daily newspaper. Some degree of specialization of readers is obtained, of course, in certain daily papers such as foreign language newspapers, or trade papers like *Women's Wear Daily* or the *Wall Street Journal.* Newspapers have an advantage over some advertising media in that the advertisement can be read again and again, and even clipped out and carried by an interested prospective customer.

The second most important form, accounting for 18 per cent of all money spent on advertising, is that done by direct mail. This includes advertising by letters, postcards, pamphlets and folders, booklets and catalogues. As was mentioned in the previous chapter, the effectiveness of this method depends on the address list used in sending out the advertising literature; and, depending on the extensiveness of the list, it can be used by any size of advertiser. It too is fairly current and can be reread and carried by the interested customer. On the other hand, adver-

tising letters can be easily recognized by the recipient and often are discarded unread.

Next in importance, amounting to 17 per cent of all advertising expenditures, are magazines and trade publications. Most magazines, rather than being local, have a national circulation and are a comparatively expensive medium. Thus, while some manufacturers whose products Fred sells might find it very useful to advertise these items in national magazines, the cost and exceedingly wide coverage make such a medium unsatisfactory for the limited purposes of Kennedy & Company. Except for a few national magazines of wide, general-reader interest, most magazines and all trade publications are of interest to a limited, selective audience. Thus the manufacturer of a fishing lure might get better results by advertisements in fishing, sporting, or even men's adventure magazines than by any other media. Magazines and trade journals (except trade daily newspapers) are not very current or flexible, however, and are often made up considerably in advance of their circulation date. It is therefore difficult to change any copy in a magazine advertisement because of some very recent occurrence. When a magazine appears on newsstands with a cover and lead story on "Why Stalin Will Never Die" several days after the death of the former Russian dictator, it certainly cannot carry up-to-date and easily changed advertising copy. Thus its advertisements must be restricted to general messages calling attention to branded goods and lauding their quality and satisfaction. Magazine advertisements may also be re-read or clipped and retained.

Two media which may be discussed together are television, representing 12 per cent of all advertising expenditures, and radio, its older but now less important sister, which accounts for 9 per cent of advertising. These methods can be national or local depending on the coverage the advertiser desires. Thus the "U.S. Steel Hour" and other such programs are heard or seen on large networks across the country. Fred Kennedy, however, can effectively use radio, and possibly even television, for a "spot" announcement between programs on the local radio or TV station. Radio and television are not especially selective as to the type of people they appeal to, although some degree of choosing an audience can be effected by the kind of program used to advertise the product. Thus the manufacturer of breakfast food sponsors a Western movie around 5 p.m., while the manufacturer of mops or floor polish might choose to sponsor a "soap opera" love story serial presented around 11 a.m. or 2 p.m. Radio and television advertising can be changed almost as quickly as that in newspapers, so it is more current and can stress special sales and prices. But unlike all previously mentioned media, these methods over the air

cannot be re-read or retained. Once they are shown and seen or heard their appeal is finished; they cannot be clipped out nor shown by the housewife to her husband when he comes home at night.

Outdoor advertising, mainly in the form of billboards, accounts for most of the remaining 3 per cent of advertising. These are local, because of their geographical location along highways, railroads, and on tops of low buildings, but are used extensively by national advertisers. Since they are passed quickly in a fast moving auto or train, their message must necessarily be brief, generally only calling attention to the product or the trade mark; and they are not too current, because they are not changed very often.

Other advertising takes many forms, such as car-cards in buses and trains, which are very much like billboards in their effect, although they may contain considerably more reading matter because the passenger has more time to look at them. Advertising on screens of motion picture houses, "sandwich-men" walking the streets carrying advertisements on their fronts and backs, sky-writing airplanes, and other novelty media are also used at times to good effect. Stores like Kennedy & Company often use "throw-aways" to good advantage. These are handbills similar to newspaper advertisements and are printed on pieces of paper. They are then inserted in every package wrapped at Kennedy's store. Fred might also hire boys to place them under the doors or in the mail boxes of all homes in the neighborhood of his store. He might also find it to his advantage to place an advertisement in the classified telephone directory under "hardware stores" and "appliance dealers," to call attention to his store.

ADVERTISING TECHNIQUE

Thus, in advertising, Fred and his partners must first decide on what media they will use. We have seen that questions of the local or national character of the medium, the selectivity or general character of its audience, the timeliness or ability to respond to change, the length or brevity of the message to be put across, and of course the relative cost of the medium will all enter into the choice of the advertising vehicle or method to be used.

Timing. Another factor is that of frequency or number of times, or length of time, that advertising will appear. Advertising has a cumulative effect and the more your name and products are called to the attention of the public, the more effective all your advertising is. Then comes the question of timing in advertising. A local business like Kennedy's should concentrate its advertising either on or just before the paydays of most of its potential customers, or on the day before all stores in

town stay open until 9 or 10 o'clock at night. Special sales and times of the year like Christmas or gardening time may also require emphasis and concentration in advertising. Bargain days, devised by the mayor or chamber of commerce of the city for all merchants, may also call for extra advertising.

Thus Kennedy & Company, and all business enterprises, should carefully devise some preplanned advertising program and carry it out with wisdom and some degree of flexibility. A decision should be made in advance of approximately how much will be budgeted for advertising, and a careful attempt should be made to stay close to that figure. Hardware stores, for instance, spend about 1½ per cent of their total income from sales, or about 5 per cent of their gross profit, on advertising; so that Fred could use this average figure as an estimate on which to base his advertising plans. As his business grows larger, he can let an advertising agency take care of his advertising problems for him. This is a firm of advertising specialists who devise and place his advertising. They receive their compensation in the form of commissions (usually about 15 per cent) from the media with which the advertising is placed. Large businesses have their own staff of advertising specialists, but many of them make use of the experienced services of advertising agencies as well.

EFFECTIVENESS OF ADVERTISING

It is important in advertising that some way be devised to test the effectiveness of advertising because, as was mentioned, advertising is expensive—it only saves money and justifies its cost if it actually stimulates sales. Although large advertisers are in a better position to make reliable tests of the effectiveness of their advertisements, some of these measures are also open to Kennedy & Company.

Inquiry Test. One such method is the inquiry test, where the public is asked to send in coupons, box tops, or post cards, in order to receive some literature, a sample, or even to purchase an article by check or money order. Where the advertisement has appeared in several media, or over several radio or television programs, or at different times of the day, or in different newspapers or magazines, the effectiveness of each of these can be checked by providing a slightly different address in each. Thus if Fred is wondering whether a morning or an evening spot radio announcement is better for advertising his store, he might offer a free sample of some product he sells (or for 10 cents or 25 cents to "cover mailing and handling charges"). Listeners to the morning announcements, for instance, are told to address their letters to Department A, Kennedy & Company, whereas listeners to the evening spots during the

trial period are told to address their replies to Department B, Kennedy & Company. A comparison of the number of letters addressed to Department A to those sent to Department B, will give the desired information.

Sales Test. Of course care must be taken to see that the advertising actually results in doing what the company wants—increasing sales—rather than merely stimulating the sending in of coupons to obtain free or inexpensive samples. To guard against this, large firms use a sales test, by picking two cities of similar size and type and running the advertising campaign in one city and not in the other, and then comparing the differences in sales in the cities. Other large advertisers test the effectiveness of their advertisements by hiring agencies which make inquiries by telephone and in person among consumers to learn what radio program they listen to, whether they can recognize a product solely by its trademark or advertising slogan, and the like.

ESSENTIALS OF ADVERTISING COPY

A final question that Fred and his partners must decide in their consideration of the problem of advertising is what advertisements should say. A generalization on this subject is very difficult because the kind of advertising that is most suitable for one firm might not be satisfactory at all for another. The type of advertisement that a business like Tiffany or the Singer Sewing Machine Company might use would be most unsuitable for Kennedy's hardware store. But there are certain requirements applicable to every ad, in that it should:

1. Attract attention
2. Arouse interest
3. Create belief or conviction
4. Instill desire
5. Compel prompt action

Thus the advertisement should be worth the time the reader spends on it and should be something he will remember and want to do something about. Above all, it should be sincere and inspire confidence. It is in this last factor that many advertisements have been found wanting, the question of truth in advertisements having become a major criticism of advertising.

Everyone expects salesmen to "puff" or exaggerate a bit about their product. Advertising, being a form of selling, can also be excused for doing this. But actual misrepresentation, false claims, misleading wording and misstatements of facts are completely objectionable. To guard against untruthfulness in advertising, most of the media have voluntarily set up standards for all advertisements which they will publish. In addi-

tion, many industries have set up codes, under the leadership of the Federal Trade Commission, which establish what is considered good and bad advertising in their field. Better Business Bureaus keep a close watch on ads in their local areas. Many states have passed the "*Printers' Ink* Model Statute," designed by the advertising trade publication and aimed at fraudulent advertising, and the Federal Trade Commission and Pure Food and Drug Administration police and prosecute offenders who use false advertising.

WINDOW DISPLAY

Of vital importance to the sales promotion of many firms, and indeed the only advertising of many small retail stores, are the displays they place in their show windows and the way they display the merchandise in their stores. The window display is the first thing a person sees on approaching the store, and, it has been asserted, half the sales of many retail stores are brought about through their window displays. The window is therefore the most valuable selling space in the store; in many cases, it is its only or most effective means of advertising. Thus the window display deserves considerable attention and thought. While many stores have their windows dressed by professionals who make a business of setting up window displays, a small enterprise like Kennedy & Company might handle its own window dressing and can do it attractively, if it pays attention to the basic principles of the art.

TYPES OF WINDOW DISPLAYS

Just as advertising is broadly classified into commodity and institutional, so store window displays may be similarly broken down into selling and prestige-building displays. The selling displays, like commodity advertising, have as their objective the sale of the merchandise sold in the store. Prestige-building displays, like institutional advertising, attempt to build up the reputation of the store rather than to sell goods directly. Window displays should be planned with either of these two basic objectives in mind and the display should be varied accordingly.

PRINCIPLES OF WINDOW DISPLAY

1. ***Displays Should Be Preplanned and Controlled.*** The design of a window display should not be thought up in the last minute, just before it is put in, but should be designed well in advance in accordance with a long-range plan. The plan should be drawn in a tentative way at least three to six months in advance, with final plans for displays decided upon two weeks to a month in advance of when they are placed in the win-

dow. Plans should include removal of a holiday or seasonal window immediately after that event has passed, so that the store is not displaying St. Valentine's Day items after February 14 nor Christmas items after December 25. As a measure of control and future guide, it is wise to keep a record of the theme of each window for each week and the principal articles on display. These can be compared with actual sales to determine the effectiveness of the type and theme of the displays.

2. ***The Display Should Be Built Around a Central Appropriate Theme.*** Every window display should have a central idea as the basis for its design. Generally such ideas should be tied in with some event to make them timely and appropriate. Thus, the display might emphasize school opening, football, winter sports, Christmas, St. Valentine's Day, graduation, weddings, beach activities, and other seasonal or holiday occurrences. Institutional windows might emphasize Armed Forces Day, the Red Cross, polio drives, national safety campaigns, and the like. Other window displays might tie in with manufacturers' national advertising campaigns, or with special bargain sales in the store. The window planning should consider all these features and tie-ins in setting up the long-range plan, subject to last-minute changes should an important or unusual tie-in come up.

3. ***The Criteria of Attention, Interest, Conviction, Desire and Action Should Be Satisfied.*** The essentials of advertising copy are also the basic objectives of window display. The window should be arranged with the aim of attracting the attention of the passer-by and stimulating his interest in its contents. It should instill in him a degree of confidence and belief in the message the store is trying to put across and a desire for the items on display. Except for a few purely prestige-building displays, it should set in motion some action on the part of the viewer as well. Thus, the whole arrangement of the display must be designed with those objectives in mind, and principles of window display are formulated to emphasize these essentials.

4. ***The Window Lighting Should Attract Attention.*** Windows should be brilliantly lit, with the most prominent lighting concentrated on the main features of the display. Concealed lighting and well placed spotlights should be used to reduce glare and the annoyance of exposed lights or bright reflections. A judicious use of colored light adds to the warmth of the array and aids in eliminating shadows and dull areas. Windows should be kept lighted all day and even after the store has closed. Time clocks may be used to turn off the lights late at night when the streets are deserted and there will be few passers-by.

5. ***Window Backgrounds Should Harmonize with the Display.*** Except in those businesses where the whole store is more or less on display

and the windows have no backgrounds, as in automobile showrooms and supermarkets, the window background should be arranged or covered in such a way as to blend in with the display and make the featured articles stand out. The background should lend cohesion and harmony to the entire window, instead of clashing with it or calling attention to itself rather than to the display. The background can often be used to set the tone or theme of the whole window, such as a snow background for a winter-clothing window, or a green landscape window for Kennedy & Company's "garden tool month" window.

6. ***Displays Should Be Appropriate to the Merchandise and to the Windows.*** In designing his display, the window dresser must pay attention to the type of merchandise being displayed and the size and shape of the window. Large items like furniture quite naturally look best in large deep windows, whereas small items like hosiery and neckware look best in smaller windows. Windows that are too large can be sectionalized by partitions, so that more than one kind of display can be placed in the same window. Where the feature of the window is a bargain sale, the display can be crowded with many items all prominently displaying



Courtesy Rich's, Inc.

Display for Fall. This window features men's hats and also suggests the suits and accessories with which to wear them.

price tags. A high-class jewelry store, on the other hand, might display only one or two very fine pieces in the entire window, without a price tag, against a background of rich velvet to emphasize the dignity and character of the jewels.

7. ***Displays Should Present a Simple Harmonious Appearance.*** Since the window display is a work of art, the principles of design for any artistic endeavor should be applied. This means that a harmonious balance or unity should pervade the entire window. Judicious use should be made of appropriate colors, and articles should not be cluttered all over the window. Related items should be grouped in one area and not scattered about. The entire picture should be one of simplicity and grace, highlighted by a little contrast to make the effect an interesting one.

8. ***Windows Should Be Kept Clean.*** Since a display should show off the store's merchandise to its best advantage and inspire confidence in the store and its wares, the windows and the displays should be kept spotlessly clean. A dirty window containing dusty merchandise or a collection of dead flies certainly does not impress a passer-by with the efficiency of the store management or the worth of its product.

9. ***Windows Should Be Changed Often.*** Since it is important for window displays to be timely, and since a major function of the window is to attract attention and create interest, it is important that the display be changed often. Frequent changes aid in keeping the window clean and keep the merchandise on display from becoming faded or shopworn and losing its fresh, attractive appearance.

10. ***The Name of the Store Should Appear in the Window.*** Despite the fact that the name of the store may appear on a large sign over the window, it is important that the store name appear in the window, where it will not clash with the over-all design of the display. A passer-by may, for example, walk by Fred's store and idly be attracted by a lawn sprinkler he sees in the window. Not being especially interested at the time, he probably will not look above the window to learn the name of the store. Perhaps a week later, the man may decide he needs a sprinkler and will remember the attractive one he saw in the window. If the name of the store also appeared in the window, his subconscious mind will remind him of the display as a whole and that it was in Kennedy & Company's window he saw it.

INTERIOR DISPLAY

Like the window, the store itself should be laid out in such a way as to display the goods to best advantage. The store should be well lighted; and counters, tables, and stands should be low enough to give the cus-

tomer a view of the entire store. The modern store does not place merchandise on shelves along the walls with counters separating it from the customers. The goods, instead, are placed on island tables and floor stands along aisles in the middle of the store, so that the customers can see them, handle them, and read the price tags easily. Except for items which might be damaged, or very easily removed by shoplifters, all merchandise is kept within easy reach of the customer in the modern store arrangement.

The store layout generally is such that the customer is encouraged to move about the store and must pass the "impulse" items to get to the staple goods. Fred, thus, might keep his hammers and pliers to the rear of the store, so that the customer must pass the latest gadget-type can opener or lawn sprinkler. Although the customer comes into the store for a conventional tool or appliance, it is hoped that he will become interested enough in passing the "impulse goods" to want to buy one or more of them.

SUMMARY

Competition is keen in all lines in today's business. An enterprise must therefore make use of every means for attracting customers. Sales-promotion ideas are most helpful in encouraging sales and stimulating business. These include public-relations activities, effective advertising, attractive window displays, and proper display of the merchandise in the interior of the store itself.

► FOR REVIEW AND DISCUSSION

1. What is meant by the term "sales promotion"? What are the major forms of sales promotion?
2. How can public relations be considered as sales promotion?
3. What is the difference in commodity advertising and institutional advertising? Is one more important than the other?
4. What are some of the advantages and disadvantages of advertising to the manufacturer? to the distributor of goods? to the retailer? to the consumer?
5. What is meant by advertising media? What are the common advertising media available to business?
6. Describe the various forms of direct-mail advertising.

7. Why should a business operator consider placing his advertising business with an agency?
8. How can a business owner tell if his advertising is getting the desired results?
9. What are the characteristics of good advertising copy?
10. What are the functions of window displays? What are the basic types of window displays?
11. What basic criteria should be satisfied in every window display?
12. How can the time for changing a window be determined?
13. What is the major function of interior displays?

► CASE-PROBLEM QUESTIONS

1. What can Kennedy & Company do to promote sales?
2. How can Kennedy & Company reach all the families in the neighborhood they seek to serve?
3. Where can they get ideas about improving window and store displays?
4. What can they do to get people into the habit of watching their windows?
5. Should windows ever be used for local service displays?
6. What guides can Kennedy & Company develop concerning the length of time a window display should be set up?
7. Can Fred and his associates develop local promotion ideas that render community service?

► APPLIED BUSINESS PROJECTS

1. The first page of this chapter gives three classifications of sales-promotion ideas. List all promotion ideas you can think of and classify them under the three forms referred to in this chapter.

2. Advertising should be of value to both the buyer and the seller of goods. Using the familiar "T" form, list the values of advertising to the seller on the left side, and the value to the buyer on the right side.

► COMMUNITY PROJECT

In order to make a more practical application of the information on window displays, select two or three windows in local businesses and evaluate them on a check sheet based on the standards given on pages 160–163. Be sure that you recognize the poor as well as the good qualities of each window evaluated.



11

Delivery and Shipping

CASE PROBLEM

Kennedy & Company's retail hardware and appliance store has been in operation for some time now and has been doing well. The partners notice that they are receiving orders and selling a good deal of merchandise to customers who live or do business a considerable distance from the Kennedy store. The firm also receives shipments of goods from manufacturers and vendors quite distant from the store. Fred therefore asserts that more consideration be given by the partners to the problems of transportation, so that money may be saved in delivery and shipping expenses.

- What are the means available to them for the transportation of their incoming shipments and outgoing deliveries?
- Which of the various methods of transportation is best suited for the shipping of merchandise which they must deliver to customers?
- Which of the means of shipment is most efficient and economical to them for those of their purchases for which they must pay the transportation charges?
- If the firm should increase in size, what provision should be made in its organization to assure that incoming and outgoing shipments will be properly handled?

DELIVERY AND SHIPPING SERVICES

Under the competitive conditions in which business operates today, the enterpriser has to meet the prices of his competitors; therefore his

prices cannot be high and his gross margin must necessarily also be slim. Since he cannot do much about his prices, the merchant who conducts a profitable business is the one who can keep his expenses down, so that the slim gross mark-up will still result in a satisfactory net profit. One area of expense, for a service which is necessary to most businesses, where a little thought, planning, and care might save many dollars for the enterpriser, is that of shipping charges. This includes both the delivery of merchandise sold to customers and, in situations where the buyer pays the freight, the charges on shipments of incoming goods. Shipping and delivery charges are expensive, so that the firm that can make use of the most efficient and least costly transportation for the movement of its goods will find that this may make a considerable difference in its net profit figures.

As was pointed out in Chapter 9, the question of whether or not to provide delivery service is a matter of business policy that must be decided at the outset. The cost of delivering merchandise is high, so that the business that can eliminate such an expense can afford to charge considerably lower prices for its goods. The lack of delivery service is generally combined with a similar lack of extending credit to customers, known as "cash-and-carry" policy, and is usually applied only in stores selling at bargain or "cut-rate" prices. Customers have come to desire and expect delivery service in most lines of retail business and from practically all wholesalers and manufacturers, so that few enterprises can operate on complete cash-and-carry plans. To get around this difficulty, some retail firms sell goods on a cash-and-carry basis but will deliver goods if the customer purchases over a certain amount at one time or pays a slight fee of around 25 cents for the delivery privilege. Some manufacturing and wholesaling industries have established the custom of selling under terms of "F. O. B. factory" or "F. O. B. shipping point." As explained in Chapter 7, this means that the buyer pays the freight charges. A few retail items, such as automobiles are also sold that way.

REASONS FOR DELIVERY SERVICE

In the great majority of cases, however, the seller pays delivery expenses. He takes on this added expense for one of several reasons.

1. In many cases, the very nature of the article sold requires that the seller deliver the goods to the customer. It would be practically impossible, for instance, for the average consumer to purchase household furniture on a cash-and-carry basis. Likewise, the business firm buying a large safe for its books, records, and valuables, would certainly not purchase it from a company that would not deliver it.

2. Much business is done today by telephone or even through the mail, so that the customer, not coming into the store at all, naturally cannot carry his purchases off with him and expects them to be delivered. Lack of delivery service would eliminate completely the possibility of doing business by telephone or mail.

3. Even though the goods may not be of such nature as to require it, many enterprises deliver their merchandise merely as an added inducement to encourage customers to do business with them.

4. Finally, many firms maintain delivery service only to keep up with their competitors. People have learned to expect delivery service in most lines and would resent the firm that does not give it; they might consequently take their trade to the store that does deliver.

If a manager should decide that the firm will make deliveries, the next question would be how to go about the process of making deliveries in the most efficient and least costly manner. This problem involves the total amount of goods that must be delivered; the size of the individual items or shipments; and the distance they must be transported. In the case of Kennedy & Company, for instance, if their problems involve merely the occasional delivery of a bag containing a few items or a boxed electric broiler or toaster to a house in the neighborhood, Mr. Ames's son or a local high school boy might be hired to carry the packages on foot or by bicycle each day after school. Where the business, however, involves the shipment of large hardware orders or heavy power tools or garden equipment to customers thirty-five miles out in the country, or in wholesale quantities to a building contractor in an up-state town, the matter of delivery becomes more complicated. Shipping then becomes a question of delivery by the store's own delivery truck or an independently owned delivery service, by parcel post, express, trucking company, railroad, airplane, or in some cases by ship or by pipe line.

METHODS OF DELIVERY AND SHIPPING

Private Delivery. The great majority of retail stores, and a large percentage of manufacturers and wholesalers, deliver by means of their own truck, or fleet of trucks, manned by drivers in their employ. While expensive and requiring a large investment, this method has several advantages. First of all, where required in special cases, customers may be given the convenience of immediate delivery by a special trip. Then too, courteous and properly trained deliverymen, being employees of the business, can do much in cementing the good will of the store and aid in handling complaints and adjustments. In the case of the small firm, the deliveryman can also handle other duties when deliveries are slack;

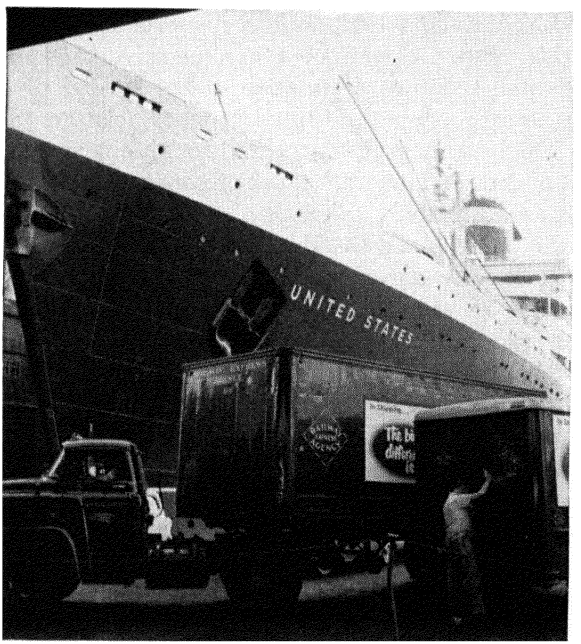
furthermore, the truck itself, traveling about the area, may be used as a form of advertising for the store, merely by carrying the firm name or posters on its sides. Some enterprises have cut down on the investment required in purchasing and maintaining trucks by leasing their delivery equipment. Others save considerably on delivery costs by combining with other local stores to run a co-operative delivery service. Still others hire an independent private delivery service, by contract, to do all their delivering for them. Both of these latter methods cut down on the cost and administrative burden in the operation of a delivery system. By making deliveries in an area for several stores, the cost to each store is obviously lowered. On the other hand, the advantages of individualized emergency service, the personal interest of your own employees in the customers' problems, and the advertising value of the trucks, are lost. In the case of the privately owned delivery service, however, the store knows in advance exactly what its delivery costs will be, as the charge is set by contract; and the delivery firm assumes the liability for damages caused by accidents in which the equipment is involved or for damage to the merchandise in delivery.

Parcel Post. The United States Post Office Department maintains a shipping and delivery service for use by the public known as *parcel post.* Here packages of limited size and weight may be shipped relatively inexpensively to all parts of the world, the charges being determined by weight of the parcel and the zone, based on the distance to which it is being sent. While this method of shipment has the advantage of inexpensive cost and unlimited scope of destination, it has several disadvantages. Federal laws, as set forth in the United States *Official Postal Guide,* limit the size and weight of packages accepted for shipment and also prohibit the shipment of certain dangerous types of goods. Although packages are usually delivered directly to the door of the addressee, this service does not pick up the parcels; and the shipper must take them to the post office. The service is comparatively slow; and the post office is not responsible for the safety of valuable packages, unless, for an additional charge, the parcels are insured and additional postage is paid for special care and speedier delivery.

Express. A relatively fast method of shipping packages with no limitation on size, not only within the United States but also between the United States and most of the free nations of the world, is that of railway express, run by the Railway Express Agency, a private company. This service affords the advantage of pick-up and delivery of the articles and is fully liable for loss or damage in transit. The shipments are made by truck and by special cars, attached to fast passenger trains, and with

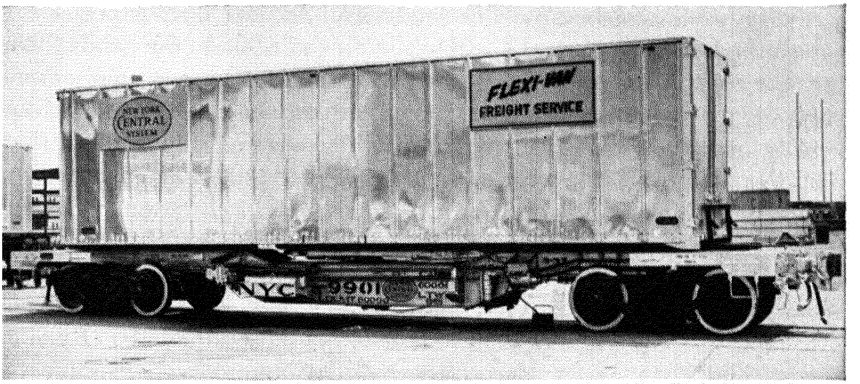
safes for the protection of valuable items. The charges are based on weight, distance shipped, and value of the contents and are relatively expensive compared with other domestic forms of transportation. Foreign shipments are taken to fast passenger ships for shipment abroad. In the foreign country, the shipments are loaded on Railway Express Agency trucks, placed on trains, and shipped to their destination. All this is done on a single shipping document with single through charges either prepaid or collect.

Trucks. A method of shipment that has grown tremendously in popularity in recent years is that of transportation by private truck lines; and for many areas this is the only method by which large shipments can be made. Trucks of various sizes are used, many with specialized bodies to handle liquid, refrigerated, or other unusual types of cargo; and shipments can be made in crates or packages, in bulk, or loose and unpacked. The trucks pick up the shipment at the door of the sender and deliver it to the door of the receiver and can of course go to any destination by means of public roads and highways. They are fast and, where the shipment is large enough for a full truck, can be sent at a time convenient to the shipper or consignee rather than having to wait for a scheduled run. Trucks are of course subject to the disadvantages of traffic tie-ups and accidents, bad weather, and breakdowns of the equip-



Delivery Everywhere! A Railway Express Agency tractor-trailer unit and delivery truck has brought its load to the SS "United States" for shipment to Europe.

Courtesy Railway Express Agency



Courtesy New York Central System

And Away We Go! This new Flexi-Van rides "piggy-back" on a flat car of the railroad. What are the advantages of this type of van?

ment. Trucks must be emptied immediately upon arrival at destination in order not to tie up the driver and his equipment, but this disadvantage has been eliminated by using trailer bodies, separate and apart from the tractor or engine of the truck, so that the trailer can be detached and left at the destination while it is being emptied. For very long hauls, the truck is usually not as economical as shipment by railroad.

Railroad Freight. Although it has suffered considerably in recent years from the competition of trucks and planes, the shipment of goods as freight over the railroads still comprises the major form of transportation, and incidentally, is the greatest source of railway revenue. The merchandise is shipped in freight-train cars, many of which are especially constructed for the type of cargo being carried. While all but these special bulk shipments must be carefully packed or crated, the cars move freely from railroad to railroad, so that once placed aboard, full carloads of goods can remain on them until the ultimate destination is reached. Door-to-door pick-up and delivery can be arranged for small freight shipments, but in large systems this can be accomplished only if the shipper, or *consignor,* and the receiver, or *consignee,* have railroad sidings leading to their places of business, so that the cars can be brought there and loaded or unloaded by the employees of the business firms involved. Those who do not own sidings of their own must haul the merchandise by truck to a railroad freight terminal or public siding.

Freight rates depend, first, on whether the shipment is in carload lots (C.L.) or less-than-carload lots (L.C.L.). A full freight car that is loaded with goods from one shipper is a carload lot, for which a fixed cheaper rate for the use of the entire car is paid. Less-than-carload lots

are more expensive because the contents of the car do not necessarily have one place of origin and one destination and because the goods themselves may have to be unloaded from one car and placed in another as it proceeds to its destination. Freight forwarding companies make a business of assembling less-than-carload lots from various shippers and shipping them as the cheaper carload lots. Railroads today have attempted to combine the advantages of truck and train transportation by having "piggy-back" cars on which loaded truck trailers can be driven and carried on the railroads for long distances, and then driven off by trucks again near the destination.

Freight Rates. While truck rates are computed on the basis of weight carried and distance traveled, often modified by some bargaining between shipper and trucker, railroad rates are based on a standard, but complicated, structure. These rates are classified in three ways: by territory, by commodity, and by certain preferences. The rates differ according to the region in which the shipment is being made and are cheaper in areas of greater population density and railroad competition. Then rates are set within the areas according to commodity classification, based on bulk, value, and weight, with minute breakdowns covering many thousands of different articles. Although distance between points does enter into the rate charges, exact mileage does not; so that two railroads between the same points can compete on an even basis even though one covers a considerably longer route in getting to the second point than does the other railroad. The shorter route, while charging the same, will, however, mean faster service. Finally, certain special types of merchandise receive preferential treatment, or, in other words, lower rates than other commodities, because the railroads are trying to encourage shipment of those articles.

Railroad freight rates are standardized and appear in printed books, the *Railway Freight Classification Manual* and the *Railway Freight Rate Book,* but computation of the rates is a difficult and complicated task. There are questions of territory, of commodity classification, and whether in carload or L.C.L. lots. Another consideration is whether the goods are shipped assembled or set up (S.U.), or unassembled or "knocked down" (K.D.); the latter, in furniture for instance, being cheaper. The final question is that of the distance between the two points. This rate is then multiplied by the weight to arrive at the amount to be paid. It can thus be seen that the shipper has a considerable problem in determining the rate for his shipment. Furthermore, where several routes of travel are available, the shipper must choose the route to be used; and this choice may make a considerable difference in time and expense.

Air Express and Freight. Another important factor in the transportation industry of late has been the growth of express and freight sent by plane. Air express, operated by the Railway Express Agency and the commercial airlines, as well as a few private companies, will give very speedy service for shipments by plane, with door-to-door service by truck or special messenger. Because of the expense involved, however, the service has been used mainly for the transportation of valuables, perishables, and emergency parts for important machinery. Many regular and private airlines are also operating planes for the transportation of ordinary freight by air. They charge in accordance with the commodity, distance, and weight; and like the railroads, they have cheaper rates for a full plane load than for less than such a load.

Other Methods. For large shipments where speed is no factor, the cheapest mode of transportation is by ship or barge, on the oceans, lakes, and rivers. The ships have no expensive rights of way to maintain, nor do



Courtesy United Air Lines

Quicker but Costlier. Shipping by air is the fastest method of transporting merchandise; but, of course, it is also much more expensive. What types of merchandise would be shipped most often by air?

they pay heavy taxes; so that their operating costs, and thus their rates, are low. For many large bulk products—such as iron ore, coal, or oil—it is often cheaper to haul by train to the nearest waterway, by boat to near the destination and then back on a train again than it would be to send them exclusively by rail. Gasoline, oil, and gas are very often transported by being pumped through long-distance pipe lines, which run directly from the source of the oil to the retailer.

CHOICE OF METHODS

For small, local deliveries, the owner of a business has to decide how they can be accomplished best and most economically. Fred and his partners, for instance, would have to decide whether they should rent or buy a truck or trucks, either method requiring the hiring of drivers for the equipment. Fred might possibly arrange for several other storekeepers in his locality to pool their deliveries with his and run a co-operative delivery service. While cutting down on the costs to each store, this system adds administrative problems of trucks, employees, and routes, because it is difficult for these various independent storekeepers to run a co-operative venture such as this to the satisfaction of all. Questions such as what share of the total investment and operating expenses each firm should contribute; management; amount of truck space allotted to each store on each delivery trip; and use of the truck for special emergency deliveries by any one store are all vexing and can be possible sources of dissension and disagreement. Kennedy & Company must weigh the advantages of a contract with a private delivery service firm as against the cost of a co-operative service and the inconvenience of not having deliveries under their own direct control.

A further problem under any of the above systems is how to deliver a package to an out-of-town customer. This involves the question of just how far the geographic limits of Fred's delivery service should be extended. Here again it is a matter of balancing service against cost. Sending the package by truck is quick and convenient for the customer, but it is costly for the store and may delay local deliveries. Parcel post or express, depending on the size of the package and the speed of delivery, may be the answer, being cheaper than delivery service if the number of such out-of-town packages is small.

When a business deals in large shipments to distant places, a decision must be made whether to ship by trucking companies, railroad freight, or air freight. A comparison of these alternatives is shown in the table on the facing page, with the advantages of each emphasized.

Comparison of Shipping Methods

	TRUCK	RAILROAD	AIRPLANE
Rates	Lowest rates on short haul	Lowest rates on long haul. Standardized rates.	High rates
Speed	Faster for short distances and small shipments than railroad.	Faster than truck for long distances.	Fastest service of all for long distance shipment.
Schedule	Usually follows no regular schedule, but handles emergency or rush-hour shipments.	Definite regularly scheduled trips. Not dependent on good weather or road conditions.	Frequent service, but highly dependent on weather conditions.
Service	Door-to-door service and flexible routes.	Rail service to factory sidings.	Airports usually far from commercial centers, which usually delays delivery to door.
Packing	Packing and crating costs reduced.	Requires packing, but C.L. lots move over all railroads without changing cars.	Less expense in packing but must be removed from plane before delivery. Smaller load needed to accumulate a full plane load.
Expense	Less handling, therefore less loss or damage.	Better terminal facilities. Cars need not be unloaded at once.	Quick deliveries cuts down on inventory and warehouse costs.

In making a choice as to which means of transportation to use, there are many factors to be considered. As the table brings out, these include cost, speed, dependability, convenience in pick-up and delivery, packing and crating requirements, and the speed required in loading or unloading the shipment. Over all, as a determinant in the choice of transportation, is the factor of the size of the shipment. A small package can go by parcel post; a larger one might best go by express or air; larger shipments by truck or rail freight; and very large ones can often be best forwarded by barge or ship. Comparisons of the cost of shipments between any two points by parcel post, express or rail freight may be obtained from a shipping book known as *Leonard's Guide*.

TERMS AND FORMS USED IN SHIPPING

There are certain words or terms used in the shipping of merchandise, as well as several forms involved, with which the businessman should be familiar. As was previously mentioned, the shipper is often referred to as the *consignor;* and the receiver is called the *consignee.* When Fred buys merchandise from a manufacturer *F.O.B. destination,* it means the seller will pay the freight charges. If he buys the goods *F.O.B. shipping point,* however, then Kennedy & Company must pay the charges for the shipment. Where goods are bought *C.A.F.,* the quoted purchase price includes the cost of the merchandise and the freight to the destination. *C.I.F.* means that the quoted price includes the merchandise cost, insurance covering the shipment en route, as well as the freight charges.

Shipments are usually sent *prepaid,* the transportation charges being paid at the time of the acceptance of the goods by the shipping company for delivery. Freight and express may, however, be sent *collect,* in which case the transportation company collects the freight charges from the consignee at the time the shipment is delivered. *C.O.D.* shipments, where the shipping company collects the cost of the merchandise for the shipper as well as the delivery charges, when it delivers the shipment, are handled by all forms of transportation, although an extra fee is generally charged the consignee for such service. By exception, parcel-post packages can only be sent collect if they are also being sent C.O.D., the postman collecting from the receiver of the package the purchase price of the goods (which he sends on to the shipper), the postage and the C.O.D. fee. While some freight is sent C.O.D. in similar manner to such shipments by post or express, much C.O.D. freight travels by means of an order bill of lading with draft attached.

When shipment is by carload, the consignee is notified that the car has arrived and he is given a certain length of time, usually 48 hours in addition to Sundays and holidays, to unload the goods and free the car for other use. When the consignee takes more than this designated time to get the car unloaded, he is charged a small fee, called *demurrage,* for each day he retains the car over the allotted time. Demurrage may also be charged if the consignor takes too long to load the car; and in case of less-than-carload lots, storage is charged if the goods are not called for within a designated time after notice of arrival.

When goods are delivered to a railroad for shipment, a *bill of lading* is issued by the freight office. The bill of lading contains on its face a receipt for the merchandise and indicates where it is to be shipped. On the back are the stipulations of the contract between the transportation company and the consignor. Bills of lading today are all uniform in size

and in the stipulations and wording of the form. When the goods are accepted for shipment, three copies of the bill of lading are made out. The original bill, or *shipper's copy,* is signed by the consignor and the agent for the transportation company, and is sent on to the consignee so that he may use it to claim the merchandise on arrival. The first carbon copy, the *shipping order,* is signed by the consignor and retained by the transportation company as its evidence of the transaction. The third copy, also a carbon copy, is called the *shipping memorandum* and is signed by the consignor and the shipping company agent and retained by the consignor.

When payment for the goods is not involved, either because they have been prepaid or purchased on long-term credit, a *straight bill of lading* is used. This directs the transportation company to deliver the goods only to the consignee and no one else, for the bill is nonnegotiable. An *order bill of lading* is negotiable, for it directs the shipping company to deliver the goods to the consignee, or anyone the latter may designate, who presents the original bill to the freight agent at destination, properly endorsed just as a check might be endorsed.

Order bills of lading are usually used where the consignee is to pay for the goods upon receipt, a form of C.O.D. shipment. Under this method, an order bill of lading is sent to a bank in the consignee's area, with a draft attached to it. This draft calls upon the consignee to pay for the goods to the bank. If it is a *sight draft,* the consignee pays the bank for the goods and receives the original bill of lading from the bank entitling it to pick up the merchandise. Occasionally the seller has agreed to allow the buyer a length of time to pay for the goods. He might then attach a *time draft* to the bill of lading he sends to the bank, which orders the consignee to pay for the goods after the designated time. The bank surrenders the original bill of lading to the consignee when he accepts the draft (making it similar to a promissory note). The consignee presents the original bill of lading to the freight agent and gets the goods, paying the freight charges if the goods were sent collect. When the bank gets the money in payment of the draft, it sends it on to the consignor, less a small fee for its services.

When the shipping charges have been paid, a *freight bill,* which itemizes the charges for the shipment, is given by the railroad. If the charges were prepaid, this freight bill might be attached to the original bill of lading. Accompanying the goods in transit is a form called the *waybill.* It includes the names of consignor and consignee, a description of the shipment, and the freight charges. It gives the point of origin and destination and, in addition, gives instructions as to the route the merchandise is to take in going from the one to the other. This form may

be made up by the agent of the railroad or by the shipper himself. When the goods have reached the freight terminal or siding at the destination, a *notice of arrival* is sent by the transportation company to the consignee (or the bank holding the draft and bill of lading).

THE TRAFFIC MANAGER

To the concern that ships a large quantity of merchandise, proper attention to transportation can mean a considerable difference in expenses and eventual profits. Large businesses therefore employ a traffic manager, a specialist in transportation, to handle their shipping problems. His duties primarily involve the areas of routing, auditing, tracing, and the handling of claims. Smaller firms, which cannot afford an expert, assign someone familiar with these problems to handle them.

Routing. Proper routing of shipments can save a shipper a tremendous amount of money. The traffic specialist, using his knowledge of the various means of transportation and their rates, knows which of the various methods to use in each instance and prepares the waybill in such a way that the goods travel over the most expeditious or least costly route. Proper routing of shipments means savings not only in the freight charges but also in the money tied up in inventories, for the traffic manager can assure the arrival of goods at the factory just before they are needed on the machines or work benches.

Auditing. Because more than one freight classification may apply to the same type of goods, the traffic manager can effect further savings by a careful auditing or checking of freight bills the company is called upon to pay. Since these charges are complicated and involved, errors are often made; and improper classifications are not infrequent. Mistakes in computation also occasionally arise. The time thus spent by the specialist in checking these bills can often pay dividends in the form of big savings on transportation costs.

Tracing. The traffic manager keeps close tabs on a shipment en route, so that if it is unreasonably delayed, he can have it traced by the shipper in an effort to locate it and speed its delivery. The shipping company starts from the point of origin and makes inquiries over the various stopping or transfer points along the line in an effort to locate the goods. Less-than-carload lots, because they must be moved from car to car at transfer points, are often misplaced or overlooked, with resulting delays until the tracer locates them and expedites them on their way.

Claims. Another duty of the traffic manager is to file and prosecute claims for lost or damaged shipments. With certain exceptions, all common carriers—the railroads, trucking companies, express companies, air and marine transport concerns—are liable for any loss or damage to the goods they carry. They are not liable for damage caused by

floods, earthquakes, tornadoes, lightning, and other so-called "acts of God"; for damage caused by the enemy in wartime; for damage caused by the fault of the shipper himself or by the inherent nature of the goods, or for example, through decay of perishables, evaporation of liquids, or natural death of animals. In the case of freight shipments, the freight charge includes insurance of the goods. Express companies charge an extra fee for goods above a nominal valuation. The shipper of a parcel-post package must request insurance and pay a fee for it or his shipment will not be insured.

When a shipment is lost or damaged, a claim must be filed with the shipping company by the owner of the goods. Included with the claim should be the bill of lading, freight bill, an invoice showing the value of the goods, and an affidavit signed by the consignee attesting to the non-delivery or to the amount of the loss or damage.

SUMMARY

The shipping and delivery of merchandise to customers, and in some instances the shipment of purchased goods, can mean a great deal in their effect on the profit margin of a business. They are therefore worthy of considerable attention by management. Primarily it is a question of choosing the most efficient and inexpensive transportation medium for the amount of shipping to be done. For Kennedy & Company this means a threefold choice: operating its delivery system; co-operating with neighboring stores in a joint delivery system; or contracting with an independent outfit to handle its deliveries. Shipment may also be made by parcel post, express, truck, railroad, or air. Comparison must be made on the basis of cost, speed, convenience, packing required, dependability, and size of shipment.

In large firms, a specialist is hired as traffic manager to take care of the shipping function, which includes routing and tracing shipments, auditing freight bills, and handling claims for loss or damage. The small business, too, must have someone with a knowledge of the subject to take care of delivery and shipping problems, so that this expense can be effectively controlled.

► FOR REVIEW AND DISCUSSION

1. How may the owner of a business eliminate or reduce delivery expenses?
2. What are some of the problems that need to be settled in determining the extent and type of delivery service provided?
3. What types of carriers may be employed in making delivery service?

4. On what basis should the owner decide whether to operate his own delivery equipment, lease equipment, participate in a co-operative project, or employ a private delivery service?
5. What are the advantages and disadvantages of shipping by truck?
6. Describe the method employed in computing railroad freight rates. Where can one find information about railroad freight rates?
7. What decisions need to be made by the shipper in choosing the routes of shipment and conditions of shipment?
8. Define the following terms: consignee; consignor; F.O.B. destination; C.I.F.; C.O.D.; demurrage; F.O.B. shipping point; C.A.F.; and bill of lading.
9. What is the difference between a straight bill of lading and an order bill of lading?
10. What is a sight draft; a time draft?
11. What are the duties and responsibilities of a traffic manager? What is the need for such an individual in various types of businesses of various sizes? When can a traffic manager be profitably employed?
12. To what extent are carriers responsible for damages or losses to goods shipped on their conveyances?

► CASE-PROBLEM QUESTIONS

1. What criteria can Kennedy & Company use to decide how far from their business they should provide merchandise delivery?
2. What factors should help Kennedy & Company determine whether they should ship from nearby or distantly located supply points?
3. How can Kennedy & Company decide whether they need a separate shipping department and a separate receiving department or a joint department?
4. How can Kennedy & Company decide the best form of shipping to use in making customer deliveries?
5. Where can Fred and his associates get information about delivery charges? Give five specific sources.
6. How can normal shipping costs be reduced when they are found to be too high? Give five specific examples.

► APPLIED BUSINESS PROJECTS

1. Using the chart of truck, railroad, and plane characteristics on page 175, indicate which type of service should be used for each of the following shipments. Give reasons for your selection.

a. Small lots; speed of delivery unimportant; inexpensive goods
b. Small lots; speed urgent; inexpensive goods
c. Large lots; speed unimportant; expensive goods
d. Large lots; speed of some importance; inexpensive goods
e. Medium lots; speed unimportant, but must be on time; inexpensive goods
f. Medium lots; speed of some importance; expensive goods

2. Refer to a map of the United States showing the following twenty major cities. Route the shipments of goods between the following points:

a. New York to San Francisco
b. Chicago to New Orleans
c. Portland (Oregon) to Los Angeles (California)
d. Boston to Miami
e. Minneapolis to Atlanta
f. Denver to Philadelphia
g. Kansas City to Cleveland
h. St. Louis to Seattle
i. Albany to Rochester
j. Milwaukee to Houston

State your reason in one sentence for selecting one of the following types of transportation: (1) railroad; (2) motor truck; (3) air service.

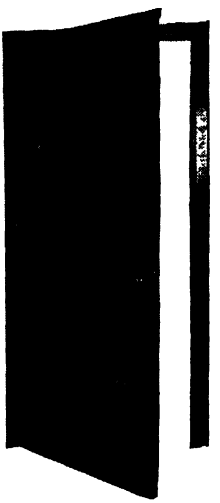
► COMMUNITY PROJECT

Use the classified section of your telephone directory, or consult a city directory to survey the various transportation agencies in your community. Make a list of the transportation services offered by each of these agencies. This will probably necessitate a visit to the agency office. In studying the services of each agency, be sure to consider such factors as the size of shipments, nature of goods, and perishability of goods. Should the list of transportation agencies become lengthy, the project may be divided and assigned to class committees with each committee studying a particular type of transportation agency.

Section Three

Financial Management







12 Financial Practices

CASE PROBLEM

Because of rapid growth and the possibilities for further expansion, Fred and his partners feel that continuing the business as a partnership might limit its eventual size and the future scope of its activities. They, therefore, incorporate the business with themselves as its stockholders and directors. Fred Kennedy is elected president of the corporation, now known as Kennedy & Company, Inc., and Mr. Ames is elected treasurer.

The board of directors—that is, the former partners—feel that the business could grow even further in size, sales, and profits if they had more money to spend on expanding the size of the store, offering more merchandise for sale, hiring more salesmen, and doing more advertising. But these ex-partners, the stockholder owners of the firm, have no further personal capital to spare other than that which they have already invested in the business. They request Mr. Ames, the treasurer, to explore the means open to the corporation for obtaining funds to finance the expansion which they feel will be so beneficial and a major contribution to the continued success of the enterprise. The question also arises as to what to do with this extra cash during any slack seasons which may arise in their business.

- What are Mr. Ames's duties as treasurer of the corporation?
- What means of obtaining more money are available to the firm?
- How would Kennedy & Company, Inc., go about raising funds for financing future expansion?
- Conversely, how can the corporation profitably employ any cash reserves, which it may build up over the years, during slack seasons in its own business?

One of the functions vital to the life of any business enterprise is the handling of its finances, for money is of course the life blood of any commercial endeavor. Not only is the firm's cash a magnet for the possible manipulations of dishonest employees, but even more serious is the effect that unwise use of funds by its owners or management may have on the success of a business. Too little cash might limit its operations or even cause the death of the enterprise through failure to pay its debts as they become due. Too much cash might lead to excessive speculation or imprudent moves that might prove equally harmful to the business. Most firms of any size therefore have an official, usually called the *treasurer*, who devotes his time to the handling of the business funds. Large concerns have an entire department—the finance department—generally headed by the treasurer, to handle this important function.

DUTIES OF THE TREASURER

As head of the financial department of the corporation, the treasurer is assigned the responsibility for the organization's funds. His precise duties would vary with the needs of the organization and the abilities of the individual, but generally the treasurer has five main functions to perform.

1. He or his assistants physically handle all receipts and disbursements of the firm's cash, including that which is on hand or deposited in the bank. In the case of Kennedy & Company, Inc., as in many businesses, much of the cash is collected from customers over the counter by the salespeople and placed by them in cash registers. In such a system, Mr. Ames, the treasurer, would make the daily collections and check the tapes of the cash registers. In large organizations, the receipt and disbursement of the firm's cash is handled by a subordinate of the treasurer called the *cashier*.

2. The duties of the treasurer include arranging for the raising of additional funds for the business. While the actual decision to borrow more money, or to raise it by inviting further investment, might be up to the officers as a group—that is, the board of directors—or even the stockholders at a meeting, the actual details of obtaining the additional funds are generally handled by the treasurer. As will be seen shortly, this normally involves either short-term borrowing or long-term financing.

3. The treasurer also makes recommendations to the management, in this case the board of directors, as to the best use to be made of any profits or excess funds the company may acquire. A share of the profits is usually distributed to the stockholders in the form of dividends. The balance of the profits is generally left in the firm, to be used as a cushion against any future emergencies or losses or to finance expansion without the need to resort to borrowing. Leaving a good portion of the profits

in the firm, instead of distributing it as dividends to the owners, is known as "plowing back the profits," or reserving the seeds, so to speak, so that the growth financed thereby will result in even greater profits in the future. When, as occasionally happens, the firm has more cash on hand than it can effectively or profitably use for its own business purposes, the treasurer has the duty of investing these surplus funds in such a way as to have them earn some income for the company and yet be readily available when the business needs them.

4. Since most enterprises must extend credit to their customers, it is often the treasurer's responsibility to check on the extension of such credit—that is, the ability and willingness of the individual customers to pay their charge accounts and to supervise the collection of these outstanding accounts. Many firms employ a specialist in this field, the *credit manager,* to handle this charge-account extension and collection function. The credit manager would then serve under the treasurer's supervision, although in some organizations he is responsible instead to the head of the sales department, or might even be a department head himself.

5. Finally, the treasurer is assigned the responsibility for providing for the conservation of the firm's assets by means of insurance. It is up to him to decide what needs to be insured and to what extent and then to obtain suitable insurance policies.

THE CONTROL OF CASH

The first function of the treasurer, or of his assistant, the cashier, is the control of the receipt and disbursement of cash. Cash, to the businessman, involves more than coins and currency. Cash includes checks and money orders, as well as all moneys deposited by the firm in bank accounts. For both practical and psychological reasons, the strict control of, and accountability for, cash assumes an importance far above the value of the money involved.

In the first place, cash is handled daily and almost continuously by most firms, either in the cash register or through a checking account, and is therefore a fruitful source of errors. Furthermore, it is of course the most desirable and generally the easiest business asset for the petty thief or even the grand larcenist to steal. In addition to the cruder methods of pilfering from the cash drawer or failing to ring up a cash sale and pocketing the amount, there are many more intricate and clever schemes for embezzling cash, which have cost some individual business firms hundreds of thousands of dollars.

Control of cash is important, however, not only as protection of the cash itself from theft. Because cash from a cash register or petty-cash



National Cash Register Company

And Here's Your Change. The modern cash register is essentially a bookkeeping machine and makes the salesperson's work easier and more accurate. What information does this machine provide?

box is comparatively easy to take, a strict and tight control system is a strong psychological deterrent to the prospective thief against stealing merchandise or any other asset of the firm. If he can see that the system is so rigid that he cannot get away with as much as ten cents from the cash drawer, he will feel that it would be impossible for him to pilfer merchandise or other valuables of the firm because their system of watching such assets must be equally tight. (This assumption is frequently erroneous, but the employee is afraid to test his assumption.) Thus strict control of cash not only prevents theft of the firm's money but has a psychological effect in the protection of all the firm's valuables.

METHODS OF CASH CONTROL

Most methods that attempt to safeguard cash and at the same time assure an accurate accounting of it are based on the following over-all principles. The individual system is then adjusted to fit in with these

principles and to conform with the size and organization of the particular company. These principles are:

1. Separate the duties of cashier and bookkeeper, so that the same person is not in charge of the cash receipts and the disbursement and recording of cash.
2. All cash receipts should be carefully collected by a responsible official and deposited in the bank each day.
3. All major disbursements must be made by check and only on written authority from a responsible officer.
4. Minor, or petty cash, disbursements may be made only on written authority and from a fund for which one employee is always responsible.
5. Cash should be checked carefully by daily proofs of cash and by monthly bank reconciliations.

The first principle—separation of the receiver of cash from the person who has charge of the account books—prevents a common form of theft known as *lapping*. This is a procedure whereby the dishonest cashier-bookkeeper receives a cash payment on account from a charge-account customer; instead of crediting the account, he makes no entry and keeps the cash for himself, perhaps using it for a bet on a horse race. Later, when another customer makes a payment on account, he credits the account of the first customer rather than that of the second customer who actually paid the money. This procedure is continued, always crediting the account of the previous customer with the payment of a later one, until he finally wins on the horses and restores the amount originally stolen and credits the account of the last customer. Sad experience, however, shows that the embezzler is usually a poor selector of winning horses; and he is finally caught. All this could have been prevented, or, at least, the thief hindered in his scheme, had he been required to accept the cash and give the customer a receipt, turning over cash and carbon copies of all receipts to the treasurer. (The latter gives the receipt copies to the bookkeeper for entry in the accounts.) Thus, not having access to the charge-account records, the cashier cannot know how much each customer owes, nor can he juggle the accounts.

When cash is received over the counter from customers, as it would be in Kennedy's, the clerk rings it up on the cash register, which should print a receipt for that customer. The complete register tape of the day's receipts should be locked in the machine. At the end of the day, a responsible official such as the store manager, the cashier, or, in Kennedy's case, Mr. Ames, the treasurer, opens the cash register tape compartment (to which he alone has the key) and in the employee's presence checks the employee's cash against the tape. The tapes are then turned over to the bookkeeper who records the totals in his records.

Except for a small amount which will be retained for making change the next day, all cash taken in is then deposited by Mr. Ames, or the cashier, in the firm's bank account. A duplicate deposit slip, authenticated by the bank, is retained by the treasurer or cashier to be used in making up his daily proof of cash, to be explained later.

Thus, by this procedure, the clerk receiving the money does not deposit the cash nor make book entries of it. The employee who deposits the cash must deposit all that was received as shown by the totals of the cash-register tapes, and his duplicate deposit slips will be checked against the cash account in the firm's books by means of the daily proof of cash. The bookkeeper, meanwhile, enters the receipts on the books from the carbon-copy receipts or cash-register tapes without ever seeing the cash. Schematically determined theft can never be completely eliminated, but a system such as this would require the collusion of three individuals, as, for example, the store manager, cashier, and treasurer. The opportunities for theft would be rare.

CASH SHORT AND OVER

When many customers make cash purchases or payments daily and much change is given, errors in counting or making change are frequent. These errors are discovered when more or less cash (in addition to the sum placed in the register for making change) is in the cash register at the end of the day than is indicated on the register tape of sales.

It has generally been found a better practice not to hold the employee responsible personally for shortages, if they are not too large in amount, and of course not to permit the employee to retain overages. Forcing the clerk to make up daily minor shortages out of his own funds causes resentment on the part of the employee and may lead to his shortchanging customers in order to make sure he will not end up the day with a cash shortage. Such a practice, of course, does not add to the good will or prestige of the store. Rather, most stores generally accept such minor shortages or overages as incidental to the quick handling of large amounts of cash and charge or credit the difference to an account called "Cash Short and Over," which should balance out over the long run. Of course, if an employee's register habitually shows shortages, or even a few large shortages, it might be best to investigate and possibly discharge him on the basis of incompetency, if not actual dishonesty.

CASH DISBURSEMENTS

Another principle of proper cash control is the daily depositing of all receipts of any kind in the firm's bank account. Disbursements must also be made from the bank account by check, with the exception of

small expenditures or refunds, which can be made from a petty-cash fund set up for that purpose. Just as it is important to set up a system for the receipt of cash so that theft is difficult, so it is equally essential that payments of cash, by check, or out of the petty-cash fund, be completely systematized. Wherever possible in an organization that is large enough, the disbursing cashier handling the checkbooks, the receiving cashier, the petty-funds cashier, and the bookkeeper should all be different individuals.

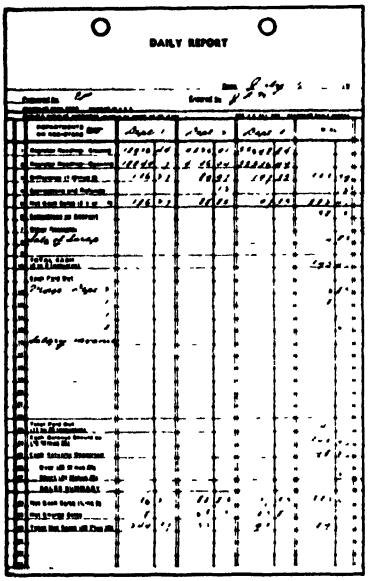
In firms of almost any size, persons responsible for ordering and receiving goods or services should not be the same as those responsible for the approval of payment and the signing of the checks. Payment by check or out of petty cash for supplies or services never received is a dishonest practice against which a business must be constantly on guard. Thus, if Kennedy's treasurer, Mr. Ames, is given the responsibility of signing checks, he must always be certain that the goods or services for which he is paying were actually received or performed. A careful organization always makes sure that the person who orders and gives receipts for merchandise or services does not himself have the authority to sign checks for them. Although this may be unnecessary in Kennedy's, since the officers are also the owners of the firm and not employees, it would, nevertheless, be better practice for Mr. Grebs to check all incoming shipments and initial the invoices, and for Mr. Ames to sign the checks in payment of the bills.

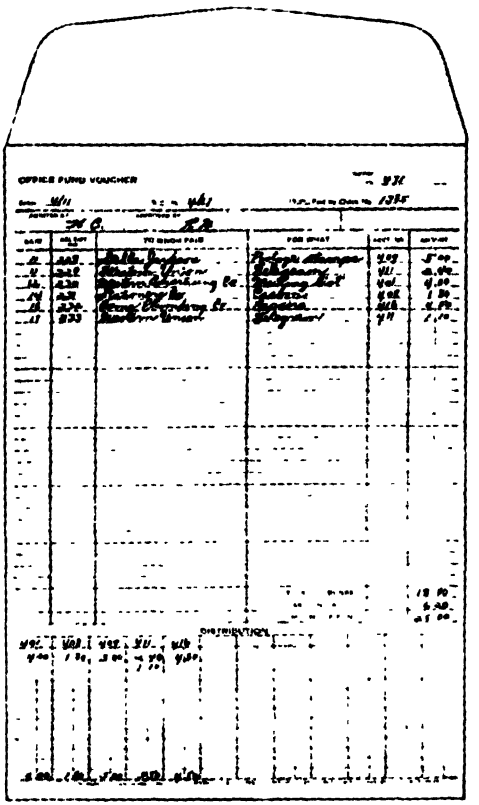
THE PETTY-CASH FUND

As previously stated, small disbursements should be made from a petty-cash fund which, since it is normally the easiest to pilfer, must be carefully controlled. This is best accomplished by means of the "imprest petty-cash" system. An employee is appointed petty cashier, usually some one like a receptionist or switchboard operator, but one who can be trusted and who has some sense of responsibility. An amount is then chosen, usually $25, $50, or $100, as the amount of cash needed to take care of the small payments made at the store or office from time to time. A check for that amount is then drawn on the regular bank account and given to the petty cashier who obtains coins and currency for it and deposits it in a locked box or drawer to which only she has the key, although it might be advisable to keep a duplicate key in a sealed envelope in the office safe. The petty cashier makes payments out of her fund only upon receiving a voucher or receipt giving the date, amount, and purpose of the petty cash required, the signature of the person receiving the money, and the initials of an official authorizing the payment.

The petty cashier places the vouchers in the petty-cash drawer or box in place of the money she has paid out. She must always be ready to

Important Forms. Typical daily-report and petty-cash voucher forms





show, at any inspection by the treasurer or regular cashier, currency, coins, and petty-cash vouchers or receipts which together total the full amount of the fund. When the fund becomes low, she turns over the vouchers to the treasurer, receiving a check for the amount of the vouchers, which she cashes and replenishes the money in her drawer, giving her once again the full amount of the fund.

PROVING AND RECONCILING THE CASH

As a final check on cash, the bookkeeper and the cashier (or the treasurer) make up a daily *proof of cash*. Separate statements are made by each of them. The bookkeeper shows, according to his records, the balance of the cash account as of the beginning of the day, the receipts and disbursements during the day as shown on his books, and, therefore, what the cash balance should be at the end of the day. The cashier, meanwhile, makes up a statement showing the balance in the bank account and on hand in the cash register at the beginning of the day, his

deposits and checks during the day as shown by his checkbook, the balance in the cash registers or the store safe at the end of the day, and, thus, the amount of money on hand and in the bank at the day's end. The bookkeeper's and the cashier's figures, although coming from different records and sources, should of course be the same. If they are not, both must check their figures until the error is located.

Similarly, at the end of the month the bank will send the firm a statement showing the deposits to, and the checks drawn against, the bank account during the month and the balance in the account. The cashier (or the treasurer) then makes up a *bank reconciliation statement* to show that his checkbook and the bank statement agree. Since he may have sent out checks which have not yet come into the bank, and the bank may have made some service charges, he must reconcile his figures and the bank's to arrive at what should be the actual amount of cash still available in the bank.

Bank Reconciliation Statement, June 30, 19__

Balance on Bank Statement		$750.99
Plus June 29 Deposit		37.95
		$788.94
Less: Checks Outstanding:		
#21	$125.00	
#23	5.10	
Total Checks Outstanding		130.10
Corrected Bank Balance		$658.84
Checkbook Balance		$673.89
Less: Bank Service Charge	$ 2.75	
Dishonored Check (RI)*	12.30	
Total Deductions		15.05
Corrected Checkbook Balance		$658.84

RI means returned item

RAISING ADDITIONAL BUSINESS FUNDS

Every business endeavor has at some time in its life, and usually at many times, had need of additional money. Often these funds are required to finance expansion. At other times they may be needed to purchase additional merchandise during a season of exceptionally good business. Sometimes cash is needed to keep the enterprise going and pay its day-to-day expenses during a period of distress when business is unusually slack. Occasionally such funds are supplied by additional investment, either by the present owners or by new owners who are taken into the firm. But more often the money is obtained through borrowing.

It is no disgrace, nor an indication of weakness or stress, for a business enterprise to borrow money. In fact, operating on partially borrowed



Courtesy Dupont "Better Living"

Banking and Business. The local banker is often the counselor and friend of the young businessman. In order to appraise the risk involved in lending money, the banker often needs to know the most minute details of the business and how it is conducted.

funds is common in business; management might even be considered inefficient that did not borrow money to take advantage of the extra business available during a very good season. Although many business firms are able to finance expansion through their own funds, often by using profits which have been plowed back or retained in the business, borrowing money is nevertheless a normal and expected occurrence in a perfectly healthy, successful venture.

TRADING ON THE EQUITY

Doing business with borrowed money, often referred to by businessmen as "trading on the equity," can be advantageous to a firm, and also dangerous. Let us take, for instance, an enterprise that has been able to make about 10 per cent net profit on its capital every year. The enterprisers have $100,000 of their own money invested in the business and therefore make about $10,000 every year. They borrow an additional $50,000 at 6 per cent interest and with that purchase additional facilities and merchandise. If they can continue to clear 10 per cent on the money put into the venture, they would make $15,000 on the $150,000. Deducting $3,000 for interest at 6 per cent on the borrowed funds, they end up with $12,000 profit for themselves, thus increasing the net return to them by $2,000 because they borrowed money and did additional business. But using borrowed money—trading on the equity—in slack seasons can be harmful. Let us suppose the next year is not as good as most years in the past, and the venture only earns 3 per cent on its investment. Without borrowing any money, they would have cleared $3,000 in net profit. Had they borrowed $50,000 at 6 per cent interest and were still able to earn 3 per cent on their funds, they would have made $4,500 on the $150,000, less $3,000 interest on the borrowed money, so that they would clear for themselves only $1,500. If times were so bad that they had a loss, rather than a profit, the loss would be magnified by the interest on the borrowed money, which is a fixed charge and must be paid.

SHORT- AND LONG-TERM FUNDS

When a business is in need of additional money, and before a decision is made as to the sources from which it should be obtained, it is important that the distinction between short-term and long-term funds is understood. When the enterprise needs additional cash in order to take care of its day-to-day expenses—such as salaries, utility bills, and rent—during a slack business season when little money is coming in from sales; or when funds are required because a great deal of merchandise has been sold to charge-account customers who have not yet paid their bills and the

enterprise finds it difficult to meet its own expenses; or when it needs extra funds to purchase additional merchandise to take care of the Christmas rush or a special sale—such cash is needed for only a short time, about two to six months. This money, to finance current expenditures, is known as *working capital* or *short-term funds.* But, when, on the other hand, the cash is needed to finance a new front on the store, or a branch store, or the purchase of a warehouse, these are more permanent needs to obtain additional fixed assets and are considered *long-term funds.*

The business management, particularly the treasurer, must distinguish between short- and long-term needs for additional funds because the sources for these should be different. It would be imprudent for the firm to borrow money on a long-term basis, let us say for ten years, when the additional cash is needed for a few months to finance extra Christmas-season business. The business would then be paying interest on money it is not using and which is earning nothing, during quieter seasons of the year. Conversely, if the company needs money to purchase and install new showcases throughout the store, it would be imprudent to borrow this for just a few months, when it will take the store many years to earn the additional money from the extra business the new fixtures might attract. Not only would such short-term funds have to be paid back soon, and thus probably reborrowed, but the interest is higher on short-term funds than on long-term borrowing. The management, therefore, must recognize the difference between its short-term and long-term financial needs and obtain these funds from the appropriate sources.

TRADE CREDIT

In some situations, of course, when additional money is needed by the business for a short time, the extra cash is loaned to it temporarily by one of the owners or a friend or relative of his. In most business situations, however, the proprietors have already obtained as much of that kind of financial aid as they can or want to use. Generally, when additional short-term funds are needed, they turn to commercial sources. Perhaps the commonest of these is known as *trade credit,* that is, purchase of the firm's merchandise from its suppliers on credit. Here the creditor does not actually lend money; but by selling goods which do not have to be paid for immediately he does, in effect, advance funds, because money that comes in from the sale of the goods or money that should have been expended in paying the creditor may instead be used to pay off current expenses. Not until such time as his credit terms expire, must his bill be paid. We will examine the problems of trade credit more

thoroughly in the next chapter, although our approach will be from the standpoint of the credit an enterprise extends to its customers.

THE COMMERCIAL BANK

By far the greatest source of short-term funds is the commercial bank, the bank where the business keeps its checking account and to which it often turns to borrow money for working capital. Because the commercial bank is of such importance to the average business concern and renders it so many services, we shall take some time at this point to examine this institution and see the various ways in which it is useful to the average business firm.

Checking Accounts. The most frequent contact the businessman has with the commercial bank is as a depository for most of his cash, against which he can draw by means of checks. The importance of the checking account is attested by the fact that over 90 per cent of all business transactions are paid by check. At one time, banks paid interest on checking accounts but they are no longer permitted to do this. Instead, they provide the checking service free of charge if a rather large minimum balance is maintained; otherwise there is a slight monthly service charge plus a very small fee for each check issued.

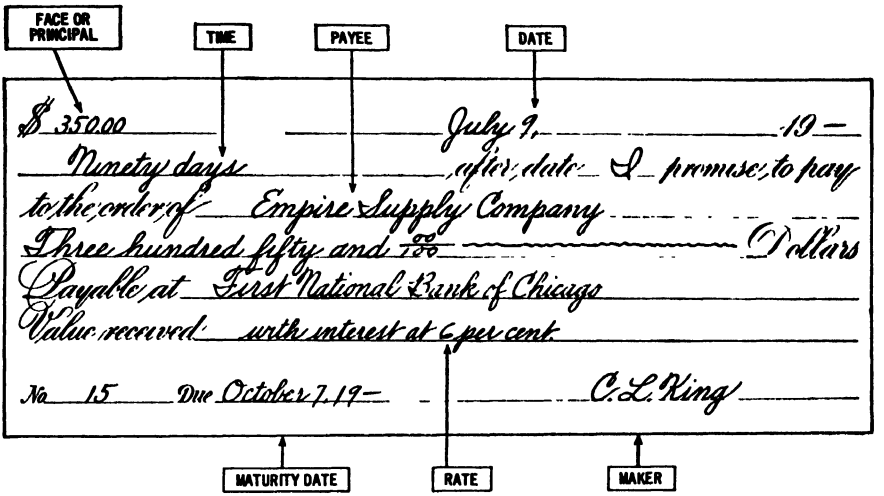
The convenience of a checking account is so important to the ordinary business as to be practically a necessity, for it would be almost impossible to engage in commercial transactions today if every payment had to be made in cash. Arrangements can be made with the bank, so that only a certain designated officer, or officers, of the company may sign checks, thereby insuring a careful control of disbursements. If desired, the bank will usually print the name and address of the firm on the checks, and will supply them in the form of *voucher checks* which have stubs on the left-hand side for recording to whom and for what the check is issued. It is important, of course, that the depositor keep an accurate record of deposits and checks in the stub section of the checkbook.

There was a time when it was necessary to use great care in choosing a bank in which to open an account, because a poorly operated bank might fail and the depositor would lose most of his money. Today, however, practically all banks are members of the Federal Deposit Insurance Corporation, a government agency that provides 100 per cent insurance on all deposit accounts up to $10,000 and partial coverage on larger balances. A business firm now chooses the bank in which to make its deposits mainly on the basis of convenience of location, the friendliness and co-operation of the bank's officers and employees, and its ability to render the firm whatever banking services it may require.

The commercial bank usually has a special-interest department where deposits will draw interest. These accounts, which compete with the savings banks where all accounts draw interest, cannot be used for checking purposes, since withdrawals must be made at the bank upon presentation of the passbook; and the bank has the right, almost never exercised, of requiring 30 days' notice of any withdrawal. Most commercial banks also have safety-deposit vaults where boxes can be rented for the safekeeping of important papers and valuables.

Negotiable Instruments. A service the commercial bank renders that can be of considerable importance to the business firm is in the collection of *negotiable instruments*. These are promissory notes, drafts, bills of exchange, and bond coupons. The promissory note is a written promise by one person to pay another a specified sum of money, either on demand or at a definite future date. *Drafts* are written orders by one person upon another to pay himself or a third person a specified sum of money, either on demand or at a definite future date. *Bills of exchange* are simply drafts drawn on persons in another state or foreign country. These business instruments which, like checks (also negotiable instruments), can pass from one person to another by endorsement of the payee's name on the back, may be interest-bearing or noninterest-bearing. Interest-bearing notes or drafts call not only for the payment of a specified sum of money, but also interest, usually at 6 per cent or lower, on that amount for the exact number of days between the date of issue and date of payment. All checks are noninterest-bearing. *Bond coupons*, as brought out in Chapter 3, are a means of paying the interest on bonds, the bond owner cutting off the coupon on the date it becomes due and depositing it in his bank to be credited to his account, just as is done with a check, note, draft, or bill of exchange he deposits. The bank usually collects on checks and bond coupons free of charge, but deducts a slight fee for the collection of notes, drafts, and bills of exchange.

Furthermore, the bank will lend money to the depositor on a promissory note or draft made out to him, collecting it back when the note or draft is paid at its maturity date. This is known as *discounting*, because the bank deducts interest in advance—the discount—as its fee. Thus if Kennedy & Company owes Ace Hardware Corp. $1,000, it may give the latter its promissory note for the $1,000, due, let us say, in two months without interest. The supply company can then take the note to its bank, endorse it on the back, and receive from the bank $990 at once, being the $1,000 due on the note less two months' discount in advance at 6 per cent on the $1,000, or $10. When the note matures two months later, the bank collects the full $1,000 from Kennedy & Company. Dis-



A Promissory Note

counting of notes has the advantage of obtaining for a creditor immediate payment of his account, the bank waiting until the maturity date and taking the discount as payment for its services.

Other Services of Commercial Banks. A function of the commercial bank which is important in some lines of business is the aid it gives in foreign trade. Banks have connections with other banks in many parts of the world, known as *correspondent banks*, and through them will help a local firm collect money owed to it by a debtor in almost any other place on earth. Furthermore, for a fee of course, banks will arrange to exchange money into, or from, any foreign currency. For those who travel great distances, or in foreign countries, the bank is also of great help. The traveler deposits a sum with the local bank before leaving on his trip; he is then given either a *letter of credit* on correspondent banks in the area to which he is going, directing them to give him money up to the amount he has deposited with his bank (less a fee), or he obtains *travelers checks* which may be quickly cashed in many parts of the world.

Banks also give financial advice; they act as brokers in certain business transactions; and serve as trustees, taking care of the money and investments of those who want someone reliable to handle their finances for them. But the most important service of the commercial bank, so far as the treasurer of the business firm is concerned, is that of granting short-term loans, a major source of the bank's income.

SHORT-TERM LOANS

Bank loans are generally of three kinds—unsecured, unsecured with an accommodation endorsement, and collateral loans. Banks will often lend money for short periods, at interest, with no security of any kind for its repayment and backed solely by the signature of the borrower on a promissory note. Such loans are only made to reliable business people or firms in whose character and ability to repay the loan the bank has great confidence. Thus, after Fred's firm has been in business for a time and operated successfully, the local bank may be willing to lend Kennedy & Company about $3,000 for two months at 6 per cent interest to enable them to buy more appliances to carry in stock during the Christmas season. They might lend this money without requiring Kennedy to put up any security to back the loan, and asking only that the firm give a promissory note signed by its officers in the name of the corporation.

Since a primary source of the funds a bank lends is the money of its depositors, it must exercise great care to whom it lends, so that it can be reasonably sure of being repaid. The bank, therefore, may want more than just the promise of the borrower to pay back the loan. It may require that a responsible person of reputation and property agree that he will pay the loan if the borrower does not. Thus, if the bank insisted upon this requirement before making a loan to Kennedy & Company, Fred might have to ask his wealthy father-in-law to help him out, either by being a *co-maker* and signing the note himself along with the corporation, or an *accommodation endorser,* by signing his name on the back. In either case, the law will then make the father-in-law liable to pay the loan and interest if the corporation does not do so at its maturity date. Since the accommodation endorser gets nothing for this possible, or contingent, liability that he assumes, but does it only as a favor for the borrower, it is usually difficult to find someone who will be a co-maker or accommodation endorser.

Most bank loans, however, are made with some kind of *collateral,* or security, which is put up, or *pledged,* with the bank by the borrower. This collateral takes the form of some kind of property, usually worth considerably more than the amount of the loan, which the bank can sell and thus obtain its money if the borrower fails to repay the loan. Since these loans are more sure of payment, collateral loans are usually either for longer periods of time, or at lower interest rates, than unsecured loans. The lender does not ordinarily turn over the pledged property itself to the bank but legal documents that evidence the fact that the bank

can sell the security on default of payment of the loan. These documents, called *liens,* may take the form of a *chattel mortgage* on movable property, such as a mortgage on the Kennedy delivery truck, or its showcases; a *trust receipt* showing that Kennedy & Company holds its inventory of merchandise in trust for the repayment of the loan to the bank; a *warehouse receipt* for merchandise that Kennedy's has stored in a public warehouse; or an *assignment* of certain of its outstanding customers' accounts. Other types of security might be stocks and bonds the company owns; valuable furs or jewelry Mr. Ames's wife owns and may be willing to pledge; the cash surrender value on the insurance policy on Fred's life that has been in force for several years; or, while this is usually more often used to secure long-term loans, a mortgage on real estate which the corporation, or one of its officers owns.

But whether the bank makes its loan on the company's signature alone, with an accommodation endorser or backed by collateral, before it is willing to lend the money it makes a thorough investigation of the lender and decides the maximum amount it will lend to that borrower, known as a *line of credit.* It will want copies of the latest financial statements of the borrower, references from other business people who have dealt with the borrower, information as to what the money is to be used for, and how the borrower expects to be able to pay back. If the borrower does not repay the loan, the bank *forecloses* on the collateral by a legal proceeding which results in a sale of the pledged assets and repayment to the bank from the proceeds.

ACCOUNTS-RECEIVABLE DISCOUNT HOUSES AND FACTORS

When Kennedy's, or any other prospective borrower, has difficulty getting the bank to lend it money, it may turn to another source of short-term funds, the accounts-receivable discount house. This is a firm that lends money to business houses by taking an assignment (as the bank also might occasionally do) on the borrower's best outstanding customers' accounts. Thus if Kennedy & Company needs money and is unable to get the bank to supply it, perhaps because the latter does not consider the firm a sufficiently good risk, Mr. Ames might go to an accounts-receivable discount house with his books of account. They will select the charge accounts of those customers which past experience has shown to be good payers and will lend Kennedy's about 50 to 60 per cent of the amount of those accounts. Kennedy & Company then signs a paper called an *assignment,* which provides that all money received from those accounts will be turned over to the lender until the entire loan, plus the fee or discount, which is higher than bank interest, are paid. In some

cases, a *notification plan* is used; and the customers are notified that they must make all payments to the discount house. Usually, however, the *nonnotification plan* is used, so that the customers continue to pay the borrower unaware that their accounts have been assigned; and the borrower turns the money over to the lender.

In some industries, business firms assign all their accounts receivable, that is, their customers' accounts, to a discount house which gives the firm the amount the customer owes immediately, less a discount or fee, and then collects directly from the customer. This type of discount house is known as a *factor.* The factor usually puts up the money for all customers' accounts, instead of choosing the best ones, as does the accounts-receivable discount lender. When a firm uses the services of a factor, however, the factor has the final say on whether or not the firm may sell to the customer on credit. If the factor does not approve of the customer as a credit risk, then sales must be on a cash basis. Factoring is common in certain industries, for instance, in some textile lines; but in many others it is not used at all.

OTHER SHORT-TERM MONEY SOURCES

When a business cannot obtain the money it needs from a bank, or has no customers' accounts to pledge, it may be able to borrow on a life-insurance policy of one of its owners from the insurance company itself. The amount that can be borrowed depends on the size of the policy and how long it has been in force. The insured turns over the policy to the company and receives a loan, which he can pay back when he can afford to do so. If he dies before it is repaid, the insurance company deducts the amount of the loan and interest from the amount it pays the beneficiary named on the policy.

Small firms can even borrow money from a *personal-loan company,* which generally lends comparatively small amounts of money at high interest rates to individuals, rather than business concerns. Like a bank loan, these may be made on the borrower's signature alone, with an accommodation endorser, or backed by collateral. Finally, the small firm might even put up some valuable asset, or a possession of one of its owners, and borrow money on it from a pawnbroker.

LONG-TERM FUNDS

Sometimes the treasurer of a business concern is faced with the problem of obtaining additional funds to finance a more permanent expansion, which will take a great deal of money and a long time to pay off. These long-term funds are generally obtained in a different way than are short-term borrowings.

ADDITIONAL INVESTMENT

One way to obtain money for long-term use, other than borrowing, is to get people to invest additional money in the firm. In a partnership, this means that one of the partners puts in more money, or the firm takes in additional partners who put up the additional cash the firm needs. In a closed or family-type corporation, additional stock is sold to one of the present owners or to someone else who is willing to become a part owner of the business. In the case of a large public corporation, stock is sold to the general public, usually through a class of stockbrokers who specialize in handling new issues. These brokers are known as *investment bankers* or *underwriters*. Obtaining money through additional investment has the advantage that it has no maturity date and thus does not have to be paid back; nor does any interest or share in the profits have to be paid unless it is earned, because these investors become co-owners and co-enterprisers with all the risks that ownership entails. On the other hand, the profits of the enterprise, including all the fruits of the expansion brought about by this additional money, must be shared with them as co-owners, instead of merely paying them a set rate of interest on their money and keeping the rest for the original owners of the business.

MORTGAGE LOANS

Money is seldom borrowed for long periods of time without security. Usually the loan is backed by a *mortgage*. This is a legal paper that includes a "bond" or promise to pay back the money borrowed with interest, and the mortgage itself, which is really a deed or transfer of ownership of real estate owned by the borrower to the lender, subject to cancellation if the borrower pays the principal and interest on the loan when they are due. A great deal of long-term borrowing by business firms, as well as individuals, is done by means of a mortgage, the lender generally being a commercial or savings bank, an organized loan company, or an insurance company, although mortgage loans may occasionally be made by wealthy individuals. Very large corporations have recently been able to borrow huge sums of money from insurance companies for medium-term loans of from five to ten years by means of unsecured promissory notes; but almost all long-term obligations, for fifteen or more years, are backed by mortgages.

BONDS

The large public corporation often borrows by means of a mortgage, but instead of obtaining the money from one lender, issues the mortgage

to a trustee, generally a bank, which holds the mortgage for many lenders whose combined loans are backed by the mortgage. The corporation then divides the loan into many small promises to pay, in denominations of $1,000, to $500, or $100, called *bonds,* and sells them to the public, generally also through the investment bankers. As was brought out in Chapter 3, some corporations borrow by means of *debenture bonds,* which are unsecured promises to pay, like promissory notes, issued to the general public.

Bonds and mortgages bear fixed rates of interest that must be paid at every interest period (usually semi-annual) whether the borrower has made money or not. Interest rates are fairly low, at least compared to what the owner expects to make on his investment, so that in good times, the interest on the borrowed money can be paid and still leave a considerable extra return on the additional capital as further profit for the enterprisers. As was previously pointed out, however, during periods of poor business, this fixed interest charge can cut very seriously into the borrower's profit and often even change it into a net loss for him.

INVESTING IDLE FUNDS

Occasionally, rather than needing to borrow money, a business finds itself during its own slack season with considerable cash in its bank accounts, much more than is needed for the normal operations of its day-to-day business during that slow season. It then becomes the problem of the treasurer to find some temporary use for the extra cash, so that it can earn money for the firm and not just remain idle until it is needed again for the regular business needs. This temporary use must take the form of some kind of investment that will pay interest or some other return to the company, and yet be safe enough so that the principal sum invested can be obtained again in full when the company needs the cash for its own use.

One form of such temporary investment is to take the extra cash (over and above that needed for the day-to-day operations of the business itself) out of the checking account and put it in a savings bank or in a special-interest account in the commercial bank where the firm maintains its checking account. Bank accounts are only insured by the Government up to $10,000 in each account. If the amount to be invested is larger than this, it would be better to place $10,000 or less in each of several banks.

When the amount is large, corporation treasurers generally invest the money in government bonds, which can be sold or cashed, according to the type of bond, when the principal amount is again needed. Another popular investment for temporary corporate funds is in securities of state

and municipal governments, mainly because by law the interest on them is exempt from Federal income taxes. In other words, if Kennedy & Company invested some extra cash in a bond of their state, they would not have to include the interest on such bond among the items of income on which they must pay income taxes to the Federal government. But the rates of interest on all municipal, state, and Federal government bonds are rather low. Furthermore, it is always possible that when Kennedy & Company again needs the cash and sells the bond, it might be selling the bond for less than it paid for it, especially since brokerage fees must be paid for buying and selling many of these securities, and the company would not get back all it had invested.

Buying bonds, or even stocks, of other corporations, is another way of investing extra cash. Although such securities may perhaps yield a higher rate of return, there is the possibility, since market prices of stocks and bonds fluctuate so much, that the stock or bond may meanwhile have gone down in value, resulting in a considerable loss in principal between the time the security was purchased and when it is sold.

SUMMARY

The handling of the finances of the business is a most important function in any enterprise. In a corporation, this is generally done by the treasurer. He must make sure that there is an efficient control system of the company's cash, in order to avoid errors or pilferage in the daily inflow and outgo of this important asset. Since it is normal for the ordinary business venture to make occasional use of borrowed funds, the treasurer must obtain this additional capital in the best and most economical manner. Current needs should be financed by short-term borrowing; fixed or long-term needs should be financed through loans with distant maturity dates. Short-term funds are generally obtained by buying goods on credit or borrowing from the commercial bank, although the accounts-receivable discount house and factor are also occasional sources. Long-term funds are obtained by additional investment, or by means of selling stock, borrowing on mortgages, or selling bonds. The treasurer is also called upon to find a safe investment for the corporation's idle funds, until the money is again needed by the firm.

► FOR REVIEW AND DISCUSSION

1. What dangers may grow out of holding large amounts of unused cash in the treasury of a business?

2. Describe the five main duties of a corporation treasurer.
3. What are the basic elements of an effective cash control system?
4. What method should be used in handling cash "over" or "short"?
5. What is the best method for making cash disbursements?
6. Describe the method of operating a petty-cash fund.
7. How is a daily proof of cash made?
8. Give the steps in reconciling the cash balance with the bank balance at the end of the month.
9. Describe the difference in arrangements that are made for short-term and long-term borrowing.
10. Describe the discounting process.
11. Describe each of the three types of short-term loans usually made by banks.
12. How is a "line of credit" developed?
13. How can funds needed on a long-term basis be obtained without borrowing money?
14. How do bonds differ from mortgages?
15. How can a firm invest its idle funds safely?

► CASE-PROBLEM QUESTIONS

1. Where can Kennedy and his partners obtain information that will help them decide whether they should continue as a partnership or change to a corporate type organization?
2. Where can Kennedy find out about the duties of officers of a corporation?
3. How can Kennedy and Company decide whether they should carry enough cash for round-the-year operation or borrow money during peak demands?
4. How can they decide how the profits should be reinvested and the amount to be distributed to stockholders?
5. What factors should be considered in deciding how much cash should be kept in the firm's bank accounts and in the Kennedy and Company cash registers and safe?

► APPLIED BUSINESS PROJECTS

1. The J. R. Wilson Company's bank statement from the First National Bank on November 30 showed a bank balance of $4,371.68 and included a bank service charge of $6.14, a collection fee of $1.50 on a note, and a charge-back of $75 for an uncollectible check deposited during the month. The treasurer's books did not show the charge for the note collection, the nonsufficient funds check, nor the bank service charge. Also, the following checks had been written but were not among the canceled checks returned by the bank: #786 for $106.15; #794 for $210.65; #796 for $16.51; #797 for $3.84; and #801 for $278.93. The deposit for $1,269.15 for November 30 had not been recorded by the bank. The treasurer's cash balance before adjustments was $5,107.39.

2. J. C. Dime and Company need to borrow $3,000 for six months to buy a special order of spring merchandise. There are several ways they can borrow the money. (*a*) The First National Bank will lend at 5 per cent. (*b*) They can borrow on Mr. Dime's insurance policy at 5¼ per cent interest. (*c*) They can assign $5,000 worth of accounts receivable and borrow the money at 6 per cent from a private loan company. By assigning the accounts receivable, they will not have collections available for paying current bills in time to take discounts. This would probably cause them to lose a 1 per cent discount on $1,000 worth of accounts. Which plan would you advise Dime and Company to use? Explain in a brief paragraph with arithmetic proof.

► COMMUNITY PROJECT

Prepare a list of firms or organizations in your community from which short-term loans can be obtained. Determine by investigation the interest rate charged by each firm for the various types of loans and the collateral, if any, which would be needed to obtain a loan.



13

Credit and Collection

CASE PROBLEM

As the business of Kennedy & Company has been increasing, a growing number of customers have charged purchases to their accounts instead of paying cash immediately. This has been particularly true of the local businessmen—contractors, painters, carpenters, etc., who have been purchasing their supplies from Kennedy's. In view of the volume of credit sales, Fred has become concerned about the possibility of a sizable loss from uncollectible accounts. He therefore asks the treasurer, Mr. Ames, to consider the matter of investigating the credit standing of customers before extending charge accounts to them and of the proper methods to encourage prompt payment and enforce the collection of overdue accounts.

- Should the firm sell merchandise on credit, or do business solely on a cash basis?
- If they do sell on credit, what measures should they take to assure, so far as possible, that charge-account privileges will only be extended to good credit risks?
- What procedures should they establish to encourage slow-paying customers to settle their accounts, without losing the good will of these patrons of the store?
- What steps can be taken to enforce payment of hopelessly delinquent accounts?

As was mentioned in Chapter 9, an important policy decision, which must be made when a firm first opens for business and one which will make a considerable difference in its approach to many other problems, is that of whether or not to extend credit to customers.

In most lines of endeavor, unless the management intends to develop a reputation for being a low-priced cash-and-carry store, the extension of credit is almost inevitable. This is especially true on the manufacturing and wholesale levels, but most retailers must also extend the privileges of charge accounts to their customers.

Many business firms extend credit to their clientele because it is the custom in their industry and they have little choice in the matter. Their competitors encourage sales by means of charge accounts, or on the installment plan, and to meet competition and stay in business they must also do so. But whether they are thus forced into it, or do it voluntarily, the granting of credit is of considerable value to the seller of merchandise.

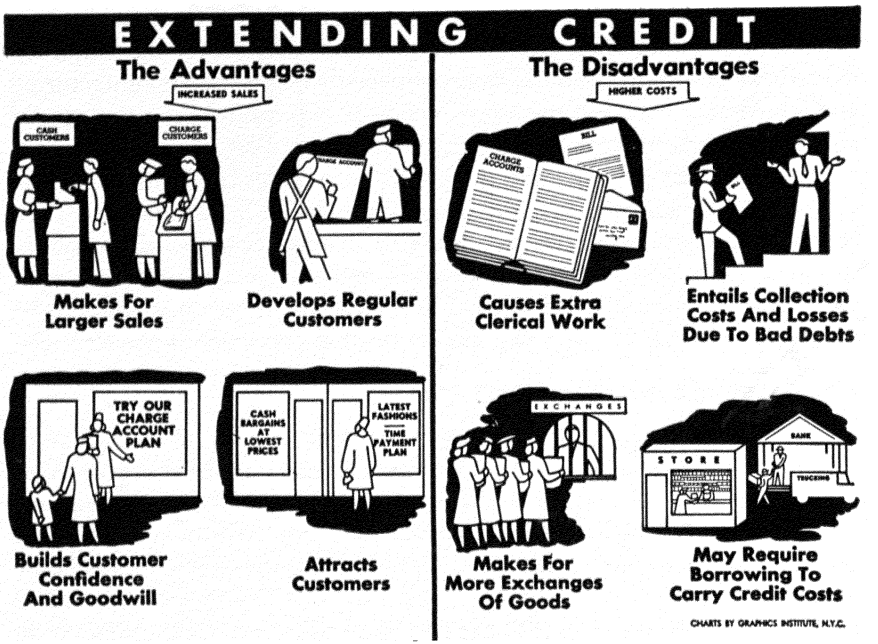
ADVANTAGES OF GRANTING CREDIT

Giving credit to customers usually permits a firm to do a larger volume of business. This is true for several reasons. In the first place, it taps the market for those purchasers who do not like to do business for cash and will only buy merchandise on credit. In many cases, they are the wealthier class of clientele, because the customer who buys only for cash is often one who is looking for low-priced bargains, from which the firm usually can make little profit. More than that, the normal credit purchase is a comparatively large one in which the customer stocks up on his present and future needs, since he does not have to pay for them at the time of purchase. In contrast, the average cash sale is made more frequently and for smaller amounts, therefore costing more in salesman's time, wrapping, and delivery expense. Furthermore, granting credit encourages the growth of mail and telephone orders.

Permitting customers to charge their purchases, or to buy on time, tends to eliminate rush and slack days, since buying is not concentrated immediately after payday. The knowledge that he can pay for the goods at his own convenience permits a customer to buy at any time and thus evens out and regularizes his buying. More important, perhaps, is the fact that a customer develops a sense of loyalty toward, and confidence in, a store where he has a charge account, so that extension of credit creates a permanent trade, rather than the ebb and flow of the more occasional impulse customer. Salespeople know the purchasers by name, which is always flattering to the customer and a big factor in building up good will. Furthermore, it gives the enterprise an excellent mailing list of people interested in the firm's advertising letters.

DISADVANTAGES OF CREDIT EXTENSION

The granting of credit has, like so many other things in business and life, its disadvantages too. Charge accounts require a good deal of record keeping and the collection of the accounts consumes time and effort,



Advantages and Disadvantages of Extending Credit

all of which add to the expenses of the business. Some investigation must be made before a customer is given a charge account, books must be kept, bills must be sent out and followed up to see that they are paid, and in some cases considerable effort must be expended in the collection of a delinquent account—all of which costs money. In addition, despite all precautions, some accounts will never be paid, and these bad debts cut down on profits. Unless the store does a very large volume of business, it usually therefore has to charge higher prices in order to pay for the expenses of credit extension than if it sold strictly for cash.

This means, of course, that it will lose some customers because of high prices, particularly those who prefer to do business for cash and do not want to pay higher prices for a service they do not use.

The experience of businesses extending credit shows that there is a greater tendency for customers to return or exchange items bought on credit than those bought for cash. The latter transactions, having been paid for, are considered more final by the customer than one for which he has not yet paid.

Finally, the extension of credit drains some of the business working capital and often forces it to borrow money, upon which it must pay

interest. When Kennedy & Company sells for cash, it receives the money immediately and provides the funds with which to pay for its daily needs. But when sales are made on credit, Fred's firm must pay its rent, salaries, utilities, and other expenses as they come due, and yet does not obtain cash until the customers pay their accounts some time later. Thus the firm may have to borrow money, at interest, to carry it until it starts to collect on its outstanding accounts. Fred must also pay the manufacturers and wholesalers for the merchandise sold to the customers; but since Kennedy's in turn receives credit for its purchases, and often for longer periods than that granted the retail trade, these particular debts are normally not a contributing factor to this problem.

CHECKING CREDITS

Not everyone can be trusted, because some people are less honest or less reliable than others; businesses therefore cannot extend credit indiscriminately. By careful investigation, however, of those customers who wish to buy on credit, and by evaluating their honesty, ability, and willingness to pay their obligations, the firm can do much to cut down on its eventual losses from bad debts.

Checking credits is the process of investigating the credit standing of persons who wish to have charge accounts with a firm and determining whether such persons are worth the risk. In a large firm it is handled by a specialist known as the *credit manager,* or just the "credit man," who is occasionally a department head in his own right but usually is a subordinate of the treasurer or the sales manager. In a firm like Kennedy & Company, which is still too small to afford a special man to devote his full time to the investigation and collection of accounts, this important task of checking credits must be handled by someone else, probably the treasurer, Mr. Ames.

DETERMINING CREDIT STANDING

When a customer wishes to open a charge account, he is usually asked to fill out an application form, giving information as to his financial standing. Questions cover such items as his employment and salary, his bank account, automobile ownership, whether he is a tenant or owner of his home, and many other queries from which his standing as a credit risk can be judged. The credit manager has, of course, many other sources of information in addition to this form, but this serves as a starting point for the investigation.

In determining whether to extend credit to a customer, the credit manager, or the official carrying out this function, ordinarily applies three standards, commonly called the "three C's of credit": character, capacity,

and capital. The most important of these is *character,* which in this case means that the customer realizes the responsibilities of his financial obligations and has a record of meeting his debts promptly. *Capacity* refers to income, whether the customer has the wherewithal to pay his obligation. The third test, that of *capital,* is the least important of the three, yet in some instances, is the sole determinant upon which credit may be extended. This refers to the wealth of the applicant, the property or assets that he owns. It can be seen that no one would care to extend credit to an individual who has a poor reputation for honesty or who ignores or neglects his debts. Others may have good intentions but just do not have the earning power to pay for a debt of any considerable size. On the other hand, if they possess property which can be put up as security for the indebtedness, their income and integrity are of lesser importance. But if a man has a reputation for paying his obligations and earns good money, it does not matter that he is not possessed of much wealth. The credit manager must weigh the information he obtains on the prospect, try to determine his character, capacity, and capital and their relative importance, and then decide how much credit, if any, the firm can afford to risk extending to this customer.

SOURCES OF CREDIT INFORMATION

To make a meaningful decision as to whether or not to extend charge-account privileges to an applicant, the credit man must have reliable information on the customer's background. This can be obtained from several sources. In the case of a retail store, like Kennedy's, Mr. Ames can check the credit rating of the customer from (1) information obtained from the application the latter has filled out or from questions Mr. Ames asks at their interview. (2) He may then make inquiries from the customer's employer, bank, and other references furnished on his application. (3) Other local merchants may supply Ames with details about their experiences with the applicant as a credit risk. (4) Most of such investigations today are usually done for the retailer, however, by a local credit agency or bureau, which supplies such information for a fee, of which Kennedy's can become a member, paying an annual charge and a small fee for each investigation made.

Over 1,450 credit bureaus in the more populated areas throughout the United States are affiliated through the National Retail Credit Association and have obtained, and are constantly enlarging through interchange of experience among their members, information on the credit standing of over sixty million people. By means of letter, telephone, teletype, or telegraph, a member can obtain prompt information on practically any one who applies for a charge account. In the case of the

Kennedy firm, Mr. Ames would be saved the expense and annoyance of making a complete investigation of each applicant, so that the fees for membership and the information on customers are well worth the money the firm would have to spend. In return, of course, Mr. Ames would have to supply the bureau with confidential information on the experience Kennedy & Company has had with its charge customers.

Where a business firm applies to wholesalers or manufacturers for credit on purchases, the latter have even more sources of credit information. Among them are the following:

Retail Credit Information. 1. The customer furnishes the prospective creditor with his latest financial statements. These would include the firm's balance sheet, or statement of financial position, showing assets and debts, and the income statement, showing income, expenses, and net profit for the previous year.

2. As in the case of the retail customer, the firm applying for wholesale credit supplies the creditor with the name of its bank, the names of other creditors, from whom the creditor may learn how good a credit risk the retail firm will be.

3. There are many private credit agencies and trade associations in various industries which investigate retail firms and assemble the credit experiences of the various members with retail houses in order to report to other members that seek such information on a prospective customer.

4. The National Association of Credit Men maintains a central office in St. Louis and nearly sixty bureaus throughout the United States. The association collects data on credit risks from about 10,000 participating members and makes this information available to its members.

Wholesale Credit Information. The most important source of credit information on the wholesale level are the mercantile agencies, of which Dun & Bradstreet, Inc., is by far the largest. These agencies provide credit appraisals, collect and distribute information on the financial standing of almost every business and professional individual in the country, whether manufacturer, wholesaler, retailer, or service industry. The data are published in credit rating books issued quarterly, and sent to business firms that subscribe to the service by paying a fee. In addition, subscribers are furnished special reports on specific firms upon request.

The content of the credit rating book is arranged in two classifications: geographical, and alphabetical: business firms are classified by three codes. The first code number shows the type of business or profession the firm or individual listed is engaged in. The second code shows the financial strength of the firm or individual, in other words, its net worth after payment of all obligations. The third code shows the composite credit rating of the person or business listed. This represents

IOWA

GROVETOWN 2,331 Ash 52

1st NAT BK OF GROVETOWN ... $220M
W I Walters Pr T H Smith Cas
GROVETOWN STATE BK $163M
S D Slater Pr T L George Cas

23 37 Adams Mfg Co WnSuitsCoats 3 D 2
59 83 Anderson W P R2 FuelOil E 2½
54 12 Atwood Dan & Mary (Mrs Dan) Gr 8 G 3½
C 59 HA Benson Gift Shop ..... 2 F 3
(Also Henderson)
43 11 Bradford Coach Co* C 2½
32 71 Broughton & Smith BldBlocks 6 2x
72 62 Browder Daisy (Mrs R) Mort G 3½
28 93 Bruxton Mfg Co Inc Cosmt 1x
59 43 Burton Daniel . StyBks 4 F 3½
55 31 Cadman & Co Atsup E 2
50 ZN Carlton & Nelson JanitorSup 6 H 4
56 12 Crockett Clothing Store MCl E 2½
50 Z8 Delta Co Fert D 2
A 17 11 Denton Frank H ..... Plbg 1 H 3½
58 12 Dressen & Son Rst —
17 31 Edwards Electrical & Supply Co . F 3½
52 41)2
17 61 Ferguson Joseph B Roofg —
C 32 71 Fulton Bros BldBlocks 6 F 3
54 13 Graves Fred . GrMt E 2½
76 11 Green Edward W Bsmith H 3½
57 12 Greenbaum Isaac R3 . Frn 7 G 4
54 62 Grovetown Bakery F 3
20 33 Grovetown Fruit Co ..... 5 —
52 51 Grovetown Hardware Co .... E 2
20 97 Grovetown Ice Co 2 D 2
52x11 Grovetown Lumber & Supply Co Inc 1x
28 51 Grovetown Mfg Co Inc . Paint E 2½
55 11 Grovetown Motors D 2
59 83 Grovetown Oil & Coal Co . —
27 11 Grovetown Record 2 G 3½
58 12 Gumpton Reese B . Rst Inv
52 12 Gunn & Adams Inc . . Bldsup C 2
57 13 Hendricks George .... Flrcvg 8 F 3½
76 41 Horton Everett L .. . Uphl 7 L 4
57 12 Horton Robert .... Frn 4 F 3½
C 53 93 Hull Wilbur E Gs E 2½
58 12 Jackson Ada & Charles .. Rst G 3
57 12 Jones Charles A ... Frn 6 D 2
59 HA Judson J Reynolds Gifts 6 H 3½
53 31 Juston Five Cents to Five Dollar Store ..... ★★
(See Milford)
20 11 Kent Smith Co* .... MtPkr D+ 1½
A 54 13 Landon Dan ..... GrMt 1 G 3½
52 11 Lane Henry Lbr G 3½
54 41 Lawrence William & Laura Cnf 8 H 3½
59 13 Lawton Irving N ..... Drg —
17 11 Lusk Reginald .. Plbg 5 J 3½
59 21 McCaffrey Archie . . Lg 3 —
15 11 McTaffe Kenneth . Bldr F 3½
57 12 Mason Chauncey E Frn 2 2x
59 FA Moore Samuel Sr . Phtsup F 3
24 21 Moses-Chapman Inc SPmll 2
53 92 Nance Edna (Mrs Norman) Dg 8 G 4
55 41 Norton Bros Sstn 1 H 3½
17 31 Osgood & Hughes ..... Elc 6 —
53 93 Ousler George . . . Gs D+ 2
58 13 Parker Chas L ... ... Tav 6 —

KENDALL ▲ New Castle 53

Bk town Jacksboro
54 13 Bender Raymond J .. GrMt G 3
52 12 Johnson Mrs Beatrice Bldsup F 3
58 13 McGregor C A ..... Tav 6 —
01 41 Peters Charles Darfrm E 2½
70 11 Pratt Rose (Mrs George) Ht 2 F 3
20 33 Rogers Lloyd Canning Co* Vg 8 3x

LAMESA 2,999 Harris 86

1st NAT BK OF LAMESA $281M
D B Jones Pr Oscar Nelson Cas
STATE BK & TR CO ... $727M
Frank L Jackson Pr A D Mason Cas
(Also Branches)

75 38 Anson Aron S ..... Atrp 7 H 3½
54 12 Askin Alton H/ ..... Gr 1 J 3½
72 22 Atwell Roy D/ ..... RugClg E 2½
50 42 Baker Sam J . GrFdSpc C 1½
17x21 Benson Henry & Son .. Ptg 3 H 3½
20 33 Biddle Bros Inc Vg B+ 1½
(Br of San Francisco Cal)
57 12 Bittner Olen ... Frn 8 —
A 52 41 Bradley & Jones .... Elcsup 1 G 3½
53 31 Browder's Stores ..... Vs ★★
(See Centerville)
52 12 Burton L B & Bro R1 ... Bldsup C 2½
17 31 Butler Archie Jr ... Elc H 3½
72 21 Buxton Robert .. Clg 6 4x
54 13 Calder's Food Market .. 5 3
72 62 Caldwell Frank .. Mort —
57 23 Cameron H D & Son . Radios 7 H 3½
C 70 11 Carlton House ..... Ht D 2
59 HA Carter's .... .. Gifts 2 3
15 11 Carver George D .... Bldr E 2½
58 12 Chatfield Miss Rose .... Rst 1 J 3½
17 21 Chester & Mears .... Ptg 5 H 3½
55 41 Childs George W R3 ..... Sstn 3x
59 BA Clifton William E . Flor H 3
75 38 Clinton James .....Atrp 0 K 3½
58 12 Clough Arthur & Ann Rst G 3½
C 59 62 Cody Edward F HayGrn 6 2
73 99 Colfax Interior Decorator —
15 11 Collins Paul J Inc Bldr 4 F 3
01 41 Congreve Herbert R1 ..... Plty 3
59 HA Davis Charles Wm . . . Gifts G 3
52 62 Dawes Howard H .... Agimpt 2 —
75 38 Day Oscar Atrp 7 H 3½
07 23 Decatur Joe NR . PltyHtchy 2
42 12 Dobson Henry ... Trkg 3 F 3½
72 21 Drake Milton R .. ClgDyg 6 3
A 58 13 Eads D B ..... Tav 1 Inv
76 41 Eddy Trim Shop .. .... Uphl 3 H 3½
52 11 Elgar Charles C ..... Lbr D+ 2
17 31 Emerson Charles . .... Elc 9 J 3½
17 61 Evans Frank Co .... Roofg F 3½
17 11 Ewell Bruce J ... PlbgSup 2 G 3
52 21)2
58 12 Frank & Dan's Sandwich Shop 8 3x
52 12 Gibbs Elmer bldsup 6 3
76 11 Gilbert L S NR .... Bsmith J 4
24 21 Girard C Howard ..... Sawmll F 3½
53 93 Gordon Norman L . . . GsTrkg 2 E 2½
42 12)2
76 31 Hearn Roland T ... WatchRp 0 L 4
59 FA Henry Arthur .... Phtsup 8 G 3½
54 12 Hitchens Louis V ..... Gr H 3½
59 12 Hornung Herman G . .... Drg 3 3
C 52 41 Horton J S & Son . Elcsup E 2
72 11 Hysong Martin W Co .. Ldry 7 —
59 JA Iacone David OptGds 4 G 3½
54 41 Iatropoulos Vassillos D . Cnf 3
56 21 Ida's Wnwr D 2
C 25 15 Ideal Bedding Co* Mattresses 2 F 3
56 12 Ideal Clothing Co ..... MBCl 4 E 2½
54 52 Jones Gilbert .. .. Mlkdlr G 3
72 71 Joseph I H ..... Clrp 8 J 4
59 KA King Donald L ..... Lug G 3½
55 41 King William D .....Sstn 1 H 4
55 31 Kit Auto Stores 2x
(Br of Fresno Cal)
42 13 Koster Henry F .... Trkg 2
79 31 Langrell Frank ... Billd 5 G 4
07 23 Layton William E .. PltyHtchy F 3
55 11 Linnecke Harry F ... .. Ats 3 D 2

8

Coded Credit Information. A page from Dun & Bradstreet credit rating book.

KEY TO RATINGS

ESTIMATED FINANCIAL STRENGTH				COMPOSITE CREDIT APPRAISAL			
				HIGH	GOOD	FAIR	LIMITED
AA	Over		$1,000,000	A1	1	1½	2
A+	Over		750,000	A1	1	1½	2
A	$500,000	to	750,000	A1	1	1½	2
B+	300,000	to	500,000	1	1½	2	2½
B	200,000	to	300,000	1	1½	2	2½
C+	125,000	to	200,000	1	1½	2	2½
C	75,000	to	125,000	1½	2	2½	3
D+	50,000	to	75,000	1½	2	2½	3
D	35,000	to	50,000	1½	2	2½	3
E	20,000	to	35,000	2	2½	3	3½
F	10,000	to	20,000	2½	3	3½	4
G	5,000	to	10,000	3	3½	4	4½
H	3,000	to	5,000	3	3½	4	4½
J	2,000	to	3,000	3	3½	4	4½
K	1,000	to	2,000	3	3½	4	4½
L	Up	to	1,000	3½	4	4½	5

CLASSIFICATION AS TO BOTH ESTIMATED FINANCIAL STRENGTH AND CREDIT APPRAISAL

FINANCIAL STRENGTH BRACKET			
1	$125,000	to	$1,000,000 and Over
2	20,000	to	125,000
3	2,000	to	20,000
4	Up	to	2,000

EXPLANATION

When only the numeral (1, 2, 3, or 4) appears, it is an indication that the estimated financial strength, while not definitely classified, is presumed to be within the range of the ($) figures in the corresponding bracket and that a condition is believed to exist which warrants credit in keeping with that assumption.

NOT CLASSIFIED OR ABSENCE OF RATING

The absence of a rating, whether as to estimated financial strength or as to credit appraisal, and whether expressed by the **hyphen** (-), the **dash** (—), or by the (x) sales listing (see below), or by the omission of any symbol, is not to be construed as unfavorable but signifies circumstances difficult to classify within condensed rating symbols and should suggest to the subscriber the advisability of obtaining additional information

LISTINGS ONLY AS TO ESTIMATED ANNUAL SALES

When, after investigation has been made, the information obtained regarding concerns listed in the Reference Book is not sufficiently conclusive to permit the assignment of any of the symbols in the above Key to Ratings, in preference to listing these names with no indication of their relative importance, the symbols (1x, 2x, 3x, and 4x) may be used to express, in wide ranges, the stated or estimated annual sales as an index to assist in appraising size These sales symbols have no other significance, credit appraisal is neither inferred nor implied. The sales bracket ranges are as follows

ESTIMATED ANNUAL SALES BRACKET

1x	$500,000 and Over	Annual Sales	
2x	75,000 to $500,000	"	"
3x	$10,000 to $75,000	Annual Sales	
4x	Up to 10,000	"	"

INVESTIGATING

'Inv " in place of the rating is an abbreviation of "investigating " It signifies nothing more than that a pending investigation was incomplete when this book went to press

See inside cover of Reference Book for complete key.

Dun & Bradstreet, Inc.

Key to Ratings. This Key will enable you to interpret the symbols shown in the credit rating book on the opposite page.

Dun & Bradstreet's evaluation of the listee as a credit risk, based on their investigation of creditors' experience with him as to how promptly he pays his debts.

The key to the Dun & Bradstreet ratings is given above. If one

were to look up the rating of Kennedy & Company, Inc., one would look first for the state in which the company is located and then the city in which Fred's store is situated. Having found the geographical location, the seeker then goes down the page alphabetically until he finds the name, Kennedy & Co., Inc. Immediately after the name appears a code abbreviation to indicate that the firm is in the retail hardware and electric appliance business. Then follows the credit rating in code, for instance, D2.

Turning to the key, one finds this rating means that the estimated financial strength, or net worth, of Kennedy's is "D," or about $35,000 to $50,000; Dun & Bradstreet has given the firm a composite credit appraisal of 2, or "good," which means that the firm does not pay its debts so quickly as to be given the very highest rating, but it does pay all its obligations and pays them off quickly enough to be given this second-best rating.

CREDIT POLICIES

Having obtained information on a prospective customer's character, capacity, and capital, the next step for Mr. Ames or the credit man is to decide on whether to extend credit to the customer at all, and if so, how much. To aid in answering these questions, the firm should have a definite set of credit policies to guide the credit manager. These policies should state generally the terms on which credit shall be granted and the size of the credit given. They should be based on two major factors—the general business conditions the creditor faces and the policy that will result in the greatest profits.

Business conditions obviously make a great difference in the terms and amount of credit a firm will give. In times of prosperity when almost everyone is doing well, considerably more latitude can be given in the extension of credit than during times of business depression when trade is slack, and there is more reason to fear that the customer may be unable to pay his bill when it matures. Another aspect of the business-conditions question is that of how much competition the seller faces. Mr. Ames will naturally be forced to give more credit to customers if Kennedy's competitors are granting liberal charge privileges. Mr. Ames's judgment might also be influenced by the size of Kennedy's own inventories. If the store is overstocked with merchandise, Ames may be more willing to extend credit to a few questionable accounts than he would be if he felt no urgency to get rid of merchandise.

Lenient or Strict Policy. In addition to business conditions, another factor which enters into the setting of credit policies, and one which can

be determined only by past experience, is that of deciding how to obtain the greatest net profit for the firm. Thus Kennedy & Company might be very liberal in its policies one year and grant credit to almost everyone, ending up with total credit sales of $400,000, and a gross profit of $100,000. But this easy credit policy might have resulted in a 10 per cent, or $40,000, bad-debt loss on charge accounts, so that the gross profit would then be cut to $60,000. The directors of the corporation might consider this 10 per cent figure for bad debts much too high and insist that Mr. Ames tighten his credit restrictions. In the following year, then, Ames may be considerably more careful about those to whom the firm extends charge-account privileges and thus may succeed in cutting down bad-debt losses to only 4 per cent. But if this stricter policy limited the firm to credit sales of $280,000 that year, with a gross profit of $70,000, the 4 per cent bad-debt loss of $11,200 would cut this gross profit to $58,800, so that the company was better off with an easier policy and the higher 10 per cent bad-debt figure. Perhaps a third year might prove that a middle-of-the-road policy of 7 per cent bad-debt losses might be best, if this produced $340,000 credit sales and a gross profit of $85,000. The 7 per cent losses of $23,800 would reduce the gross profit to the best net profit figure of $61,200.

ANALYSIS OF EFFECTIVE CREDIT POLICIES

	First Year	*Second Year*	*Third Year*
Credit sales	$400,000	$280,000	$340,000
Gross profit before bad-debt losses (25%)	100,000	70,000	85,000
Bad-debt loss	40,000 (10%)	11,200 (4%)	23,800 (7%)
Gross profit after bad debts	$ 60,000	$ 58,800	$ 61,200

Thus it may take some experimentation to determine the optimum credit policy, but other factors such as the time and effort required in making the sales and collections may have to be considered in addition to the dollar difference in gross profit.

Terms of Sale. Another over-all credit policy that must be set in advance is that of the terms of sale—how long a period of time the customer should be given within which to pay his bill. (Terms of sale—discussed in Chapter 7—indicate the length of the credit period, as well as the cash discount, if any, offered to the buyer to pay his bills promptly.) The length of the credit period will depend on a number of factors. The questions of what competitors are doing and how much Kennedy's

needs the business must be answered. Competition, or an overstocked inventory, may tend to influence Mr. Ames to grant longer terms of payment. The general condition of business—whether prosperity or depression—will also be a consideration. Primarily, however, it is a question of the nature of the article being sold, for the terms of credit should not be long if the life of the article is short. Thus Kennedy's can afford to extend considerably longer credit—as much as 60 days on a charge account or two years on an installment sale—than can the grocer, who normally expects to be paid weekly by his customers. In the retail trade, the payday of the customers should also be considered; if they are paid weekly, bills might be due weekly; whereas if employees in the area are paid monthly, the store will have to wait till the end of the month for its accounts to be settled.

Once the over-all credit policies have been set by the management (in the case of Kennedy & Company, the three former partners who are now the board of directors would have a hand in these decisions), it is up to the credit manager to decide the amount to be extended to individual customers. This means, in each case, the decision first as to whether to open a charge account at all for a particular customer; secondly, the limit of credit that will be extended to him—in other words, how much he will be permitted to charge to his account at one time; and thirdly, the terms of the sale, that is, the length of time granted him in which to make payment and whether he will be allowed any cash discount for early payment. In the case of wholesale credit granted to retailers by manufacturers and wholesalers, it is often considered preferable to notify the customer of the limit of credit he will be permitted, although the customers of a retail store are not usually given this information.

LEGAL RESPONSIBILITIES OF CUSTOMERS

In addition to the problems of granting credit, a seller of merchandise should be familiar with the rights and responsibilities of his customers for purchases made in their name by others. A wife, for instance, has the right to buy household necessaries in her husband's name; and the husband must pay for these articles even though he may not approve of her purchases.

Children cannot bind their parents to purchases of articles considered luxuries, but in most states parents are responsible for debts incurred by minor children in purchasing goods or services necessary to the life or health of the child. The minor is liable himself for the payment of debts involving the purchase of necessaries when his parents do not provide them; but otherwise a sale made to a child is voidable at the option

of the child. Businessmen, therefore, who do business with minors take the chance that the child will change his mind (or his parents change it for him) and demand his money back.

Some, but not all, employees of an employer have the right to buy goods or services in the name of their company or supervisor. Such agents must have authority to bind their principal to a contract, and the seller will be wise in most cases to require that such employees exhibit some authorization from their firm showing that they have the right to make such purchases.

Returning to the question of credit, some firms or persons whose credit standing is not too good occasionally are able to buy merchandise on credit by having another person or firm, of good financial responsibility, guarantee their account. This *guarantee* is a statement that if the customer does not pay for his purchases, the guarantor will. Not only is it advisable to have such promises in writing, but a time and credit limit should also be included in the guaranty statement.

RECORDING CREDIT INFORMATION

A credit file, which will contain all the credit information obtained by the firm on each customer, should be set up and maintained. A separate folder should be used for each account, containing the original application, copies of financial statements, references, credit-bureau reports, and copies of letters written, or other action taken, to encourage or enforce collection of the account. On the outside of the folder, or on a card in a separate card file, credit information on each customer is summarized. This might include his name, address, business or profession, credit rating, credit limits, terms of sale (the latter periodically reviewed to see if any changes are desirable), and the names of banks upon which he has drawn checks in paying bills.

The cards are then marked with colored tabs to indicate how good a risk the customer is considered. When a customer orders goods, his credit can be checked at once. For a customer tabbed as a poor risk, the question of whether to permit him to charge an order might have to be checked by the credit manager himself.

WATCHING THE ACCOUNTS

Once the credit man has authorized credit to be extended to a customer, his work, rather than being done, has only just begun. For he must maintain constant vigilance over *accounts receivable* (the business name for customers' charge accounts) to see that they are not becoming too stale—that is, that customers are not lagging behind in the payment of their accounts. To aid him in the policing of these customer debts,

he makes up periodically an analysis of the accounts known as the *aging of accounts receivable.* This is a chart showing the names and total amount due from each customer, as of the date of the analysis. These amounts are then split up in columns to indicate the accounts which have been outstanding up to 30 days, 60 days, 90 days, and over 90 days. This enables the credit manager to see at a glance the age of each indebtedness and against which accounts action must be taken. Often there is also a column headed "Remarks" to permit the notation of pertinent facts about the account. For instance, part of the analysis made up by Mr. Ames might look like this:

KENNEDY & CO., INC.
AGE OF ACCOUNTS RECEIVABLE
As of April 30, 1958

Customer's Name and Address	*Total*	*1-to-30 Days*	*30-to-60 Days*	*60-to-90 Days*	*Over 90 Days*	*Remarks*
Anderson, James 324 Cedar St.	$ 76.20	$ 38.40	$ 20.75	$ 17.05		Paid $50 on previous account on April 20
Audubon Cabinets 1151 Drake Ave.	137.50	137.50				
Avalon, Harry 27 Second St.	46.86		46.86			Promised to pay before May 10
Barker & Finch 1082 Drake Ave.	187.15	101.10	86.05			
Beacon Construction 451 Fourth St.	386.60	127.50	145.90	73.20	40.00	Cash sales only now permitted
Brown, John 221 Laurel Ave.	37.85				37.85	Given to coll. agency, April 15
Burton, Mark 86 Eleventh St.	29.90	29.90				

COLLECTING ACCOUNTS

The Importance of Collection Vigilance. In addition to watching accounts receivable, it is essential that efforts be made to collect delinquent accounts—those that are past due. Failure to be vigilant and to keep after old accounts not only results in increased losses from bad

debts, but also decreases the profits of the business due to the expense of carrying these unpaid accounts. If Kennedy & Company is not paid by its customers, it will have to borrow money, at interest, to pay its own debts.

Laxity in collecting outstanding accounts also has other disadvantages. For one thing, when a firm does not have a regular system for the follow-up of delinquent accounts, it encourages customers to take their time in making payments. Business experience, furthermore, has shown that the longer an account is allowed to run, the more difficult it is to collect and the more chance there is that it will eventually go bad. Psychologically, too, allowing accounts to run too long is a poor policy, because customers who owe a great deal of money to a store are often ashamed to buy any more from that company and will take their business elsewhere.

The Importance of Tact. Balanced against the need for collection is the desire to retain as a customer the person who is not a complete "dead-beat." A firm does not increase good will and encourage sales by browbeating or hounding customers to pay their bills. The credit manager must, therefore, make every effort to collect accounts; but he must do so with care, tact, and consideration for the customer's feelings. Starting with polite and gentle reminders that the amount has not been paid, the appeals can become much stronger as the delinquency of the account persists. While allowing for slight differences in approach because not all people respond in the same way to methods of treatment, it is best for a regular procedure or routine of collection to be set up, using the various means of encouraging and finally enforcing payment.

Collection Methods. The simplest means of action in the collection of an outstanding account is the writing of collection letters. These will vary in degree of urgency according to the age of the account. The first letter will generally be a polite form letter reminding the customer of the past due account. As the delinquency persists, succeeding letters will use stronger language in urging payment. A telephone call will often be successful in obtaining action, the credit man inviting the customer to come into the store for a talk with him about payment of the account. If this gets no results, a telegram, with its connotation of importance and urgency, might do the job.

If all attempts by the credit manager fail, there is little else left but to turn the account over to an outside agency for collection. Most of the mercantile agencies and credit bureaus mentioned earlier in this chapter maintain collection departments to aid their members in collecting delinquent accounts. There are also professional collection agencies who make a business, for a fee, of obtaining payment of outstanding ac-

Dear Mr. Black:

We have sent you several reminders about your past-due account for $63.27, without a response from you.

In fairness to yourself, we hope you'll consider how important an asset your credit standing is. Certainly, you would place a far higher value on it than the amount you owe us.

To protect this asset, you can write us frankly as to when you will make payment—or better still, send us your check now. By doing so, you'll get this off your mind. Use the envelope we are enclosing for your convenience—and mail it today, please.

Cordially yours

counts. Many firms, however, engage lawyers to collect the accounts through legal process. Although often successful in obtaining payment merely by writing a letter suggesting he will be forced to begin legal action, on many other occasions the lawyer must proceed with such judicial process in his efforts to obtain payment of the account. (This subject will be discussed later.)

Manufacturers and wholesalers use additional methods in attempting to collect from business customers. They try to get their accounts to give them promissory notes for the amounts due, often with interest, so that they may discount the notes at their bank and obtain the funds immediately. Sometimes, in lieu of this, they will take a check dated ahead, known as a *postdated check*, which cannot be deposited until the date written on it, but which is at least written evidence that the customer acknowledges the validity of the indebtedness. Another business method of attempting collection is by drawing a draft on the debtor and giving it to the latter's bank for collection. This method is often successful, since the debtor does not want his bank to learn that he is not meeting his just obligations when they come due, because sometime he may want to borrow money from the bank.

Collection Procedure. There should be a systematic pattern or order in the use of collection methods, with a diary or tickler file kept so that each step in the regular procedure for the collection of the account is taken at the proper time. As an example of such a collection sequence,

let us see the pattern Mr. Ames might set up in the attempt to collect delinquent accounts without losing the good will of the customers.

DAYS FROM DUE DATE	ACTION TO BE TAKEN
0	Mail monthly bills on the first of each month.
30	Mail a statement (an unitemized bill) on the first of the following month.
45	On the fifteenth of this second month, mail another unitemized statement with a rubber-stamped request: "May we kindly have your check for this amount."
60	On the first of the third month, send a polite form letter requesting payment.
75	On the fifteenth, make a telephone call, and if no answer, send a slightly stronger letter. "Freeze" the account by not permitting any further charge purchases.
90	On the first of the next month, send a telegram or letter asking customer to come into store to discuss payment.
105	On the fifteenth, send a registered letter requesting immediate payment so that it will not be necessary to turn account over to attorney or collection agency.
120	On the first of the following month, turn account over to attorney or collection agency.

Legal Collection Methods. If, after going through the above procedure, the account still has not been paid, Kennedy's will have to turn it over to the collection agency or lawyer for legal process against the customer. The agency or lawyer will write the debtor, stating that the account has been turned over to it, or him, for collection and requesting payment since otherwise legal proceedings will be taken. If payment is still not forthcoming, such action at law becomes necessary.

If the sale of the merchandise was by an installment-sales agreement, title to the goods does not pass until they are fully paid for, so that Kennedy & Company can repossess the goods. Under an ordinary sale on credit, however, the seller cannot get back the goods; instead the lawyer will sue the debtor in Kennedy's name and obtain a judgment from the court directing that the amount of the claim be paid. Kennedy's lawyer then has the right to examine the debtor in supplementary proceedings, under oath, as to his ability to pay the judgment. If the debtor has a bank account, it may be *attached,* so that he cannot draw against it until he pays the judgment. If he owns property, it may generally be levied against by a *sheriff's execution* and sold at auction, the proceeds being used to pay off the debt and expenses of the sale, any balance be-

ing returned to the debtor. If the debtor works for a salary, the lawyer can obtain, in most states, an order of *garnishment,* which requires the debtor's employer to pay a certain percentage of his wages each payday to Kennedy's until the debt is paid.

Time Limit on Debts. A claim against a debtor is not good for an unlimited time, however, because most states have a law known as the *statute of limitations,* which limits the time during which a debtor may be forced to pay his debt. While differing in time according to the laws of the individual state, the common limitation is six years. In other words, Kennedy & Company has six years from the date the debt became due in which to collect it; after that the debtor is free of legal action for the collection of the debt. This limitation is extended, however, if the debtor makes a partial payment on account or promises in writing to pay the debt, when the six-year period runs anew from the date of that payment or promise.

Bankruptcy Proceedings. A debtor may free himself of his debts by going through bankruptcy proceedings in the court, or three or more of his creditors may get together and petition the court to have him adjudged a bankrupt. Under these proceedings, the court declares the debtor to be *insolvent,* which means he has more debts than possessions. The debtor then turns over all his possessions (except for a few personal items which he is permitted to keep as necessities of life) to a court-appointed trustee who sells them at auction and, after paying the expenses of the legal action, divides the proceeds among all the creditors in proportion to their claims. The bankrupt debtor is then discharged by the court from the payment of the balance due on his old debts. He may start business life anew bereft of his assets but free from his debts.

INSTALLMENT CREDIT

A type of credit sale that has become extremely popular in recent years is that of selling under an installment contract. Installment selling was once used exclusively for the sale of expensive merchandise, such as automobiles, furniture, and jewelry; today it is used for selling many less expensive items, including such electrical appliances as Kennedy's sells. Most of the hardware items, however, would be too low in price to justify the installment method of sale.

Features of Installment Sales. There are three major differences between the sale on installment and the normal charge-account sale. First, of course, is the method of payment. A charge sale has one date of payment, often indefinite at the time of the sale, so that the account is paid off at one time (although it is occasionally paid for by a few partial payments on account) at the convenience of the purchaser, gen-

erally, however, within the number of days of the terms of sale. An installment sale is made by means of a written contract, which calls for many partial payments made at regular intervals and usually of equal amounts. The due date of each payment is stipulated in advance in the sales contract.

The second distinction is that of legal title or ownership. Goods sold on credit by means of a charge account legally belong at once to the purchaser, even though he has not yet paid for them. The seller cannot get them back if he is not paid, but merely becomes another creditor of the debtor and can proceed, like all creditors, against the debtor and all his assets in general. By means of a legal document, however, called either a *conditional sales agreement* or a *chattel mortgage,* which is usually part of the installment-sales contract, the title, or ownership, of the goods sold by this method remains the property of the seller until the goods are fully paid for, the buyer only having the use of them until that time. Should the purchaser fail to make payment on the contract when due, the seller may repossess the goods and sell them, taking the balance of the amount due on them out of the proceeds.

The third difference involves the matter of interest. Charge-account purchasers seldom pay any interest on their unpaid accounts unless they are long overdue. Installment purchasers pay interest through a "carrying charge" which is added to the purchase price of the goods. This carrying charge is often not noticed by the purchaser, because the terms of payment call for a down payment and equal installments, all of which add up to the actual purchase price plus interest, which can sometimes be at a high rate. There is, of course, considerable justification for a high carrying charge, because it must include enough to take care not only of interest on the money tied up in the merchandise, but the possible cost of collecting the installments, possible bad-debt loss, and the cost of repossessing, reconditioning, and reselling the goods.

Installment selling increases a merchant's sales considerably because it makes purchasing possible through small weekly or monthly payments, by consumers who could not afford at one time the full purchase price of the article. At the same time, it also encourages people to buy items they cannot afford, because they fail to consider the great total cost of the item. Because of this, repossessions and bad-debt losses from installment sales are high. In an effort to reduce such sales, the merchant should make the down payment large enough to help a customer realize that he has a considerable investment in the article. Then he should arrange the payments so they do not continue beyond the period of the article's truly useful life. In the sale of Kennedy's appliances, installment terms should probably require a 10 to 20 per cent down payment on

the purchase price (which includes all carrying charges) and monthly payments lasting from a year to eighteen months, or two years for very expensive, long-lived items.

Financing Installment Sales. Installment-plan selling has an additional advantage to the merchant besides that of increasing his sales, in that he can usually arrange with a *finance company* to take over the financing of the installment account. Under this arrangement, Kennedy & Company can turn over the customer's installment contract to the finance company, which pays Kennedy's in full, less a discount for its services. The finance company then collects the installments from the debtor as they become due. Thus Kennedy's can make sales to customers who can afford to buy only on the installment plan, and still obtain immediate payment for the merchandise.

CREDIT AS A BUSINESS ASSET

There is one additional aspect of credit that the management of any business must constantly keep in mind, and that is the importance of maintaining their own good credit with their suppliers. The ability to obtain credit is one of the most important assets of a business and should be zealously guarded and fostered. It provides the enterprisers with additional working capital both in times of prosperity and distress. When they wish to take advantage of the opportunities for additional sales and profits during good business seasons, or when they need help to tide them over times of slack, their reputation for character, capacity, and capital—in other words, their ability to command credit—is a priceless reserve upon which to call. It is important, for example, that Mr. Ames takes due care that Kennedy's does not injure its credit standing or abuse its credit rating by borrowing too much, buying more on account than it can handle, or being slow in payment. Losses due to theft of cash or destruction of merchandise can be minimized by insurance, but loss of a firm's good name is an asset that is very difficult to replace.

SUMMARY

In most lines of business, it is essential or advisable that sales be made on credit. Management must decide, therefore, whether it will conduct a credit or strictly cash business. If the company does extend charge-account privileges to customers, then proper procedures of administering them must be established.

These require the services of a credit man, or someone to carry out his function. Policies must be decided on as to how strict or liberal the firm will be in extending credit and what its terms of sale will be. In-

formation must be obtained from the customer and from various sources of credit information on which the decision can be based as to whether, and how much, credit should be extended to him. Careful watch and adequate records must be kept, so that accounts do not become too delinquent. The credit manager should then follow an established procedure in encouraging the collection of the accounts without losing the good will of the customer. If customers persist in their failure to settle outstanding accounts, legal process may have to be resorted to. Installment sales are also an important form of credit sales to most business firms. Most important, perhaps, is that a business do all it can to retain its own good credit reputation with its suppliers.

► FOR REVIEW AND DISCUSSION

1. What advantages result to the business by granting credit to customers? disadvantages?
2. Discuss the three "C's" of credit.
3. What are the ordinary sources for obtaining credit information about a customer?
4. How does the procedure for establishing credit by a business firm differ from that for an individual customer?
5. Once an individual's or firm's credit rate has been established, what determines the amount and type of credit extended?
6. How can a credit manager determine the general policy as to who should receive credit and how much credit should be granted?
7. What risks and responsibilities are involved when credit is extended to minors?
8. Describe the legal responsibilities of customers.
9. What type of information should be recorded in a credit file?
10. Why should a firm be careful about allowing an account receivable to get very old?
11. Describe various collection techniques that may be used in collecting accounts.
12. How does the statute of limitations function?
13. Describe the differences in installment accounts and regular accounts.
14. What are the advantages and disadvantages of installment selling?

► CASE-PROBLEM QUESTIONS

1. What factors should Kennedy & Company consider in deciding whether they should sell on credit or for cash only?

2. How can they be sure that credit is only extended to "good risk" customers?
3. What steps should the credit manager take in the collection of overdue accounts?
4. Will the corporation need more capital to operate the business if it sells on credit?
5. Should Kennedy & Company establish credit policies in the very beginning or wait until experience indicates what policies are needed?
6. What help can Kennedy & Company get from the local credit bureau?

► APPLIED BUSINESS PROJECTS

1. Dear Mr. Jackson:

Here it is the 10th of February, and I have not received your check. It was, as you well know, due by January 20. What happened? Surely you don't expect me to overlook your slow paying habit. This is the first—and last—letter that I shall write. If I don't have your check by February 15, the matter goes to my attorney.

Very truly,

In one sentence, or at the most two:

(*a*) Explain whether this is a good collection letter.
(*b*) Should it be stronger? Why or why not?
(*c*) Should it be more gentle? Why or why not?
(*d*) In what ways should it be different?

2. Rewrite the letter the way you think it should be written.

► COMMUNITY PROJECT

The business community provides many opportunities for studying credit and credit policies and collections. Visits may be made to a credit bureau to become acquainted with its procedures; attorneys-at-law can tell you about legal procedures in making collections. Business firms in your community have varied credit policies which you may investigate; banks and loan companies have well-established procedures for determining the credit risk of individuals.

A good project for your class, perhaps, would be to form several committees, each of which would investigate some particular type of credit activity or policy as it operates in your community.

Committees should make reports to the class by preparing special bulletin-board exhibits of credit forms or information, inviting visitors to talk to the class about some special phase of credit operations in the community, and by having committee reports in the form of panel discussions.



14

Risks and Insurance

CASE PROBLEM

During one icy week in winter, three incidents occurred on the same block on which the store of Kennedy & Company is located. They caused Fred Kennedy, the president, to worry about protection against the risks of loss from unexpected events and casualties. First, a customer emerging from the drugstore slipped on the icy pavement outside the door and broke his arm. Later, the delivery truck of the radio and television store across the street skidded into a passenger car and damaged both vehicles considerably. Finally, one night during the week, the cleaning and dyeing store down the block was gutted by fire.

Like most business enterprises, Kennedy & Company does carry some insurance; but Fred wonders if the firm is properly protected against the losses it can incur from sudden unfortunate occurrences, of which the three mishaps on his street are examples. He asks the treasurer, Mr. Ames, to study carefully the problem of protecting a business firm against the unexpected and to make sure the company has sufficient insurance coverage to make good any losses suffered thereby.

- What are the sudden, unexpected possible losses that are the everyday risks of a business enterprise?
- What types of insurance can a business procure to protect itself against these hazards?

BUSINESS RISKS

All business operation is a risk. The enterpriser takes the chance that his product may not satisfy the public needs or desires; that his

location may be inconvenient to prospective customers; that the general level of business conditions may fall and adversely affect his trade —in short, that his income may be insufficient to cover his expenses. These are the expected, normal hazards of a business. The successful enterpriser plans and operates his business, so that he can ride out these storms and eventually find calmer weather and smooth sailing. Equally important, however, is the planning and foresight required to enable the business to survive the unexpected catastrophies that may befall it, sometimes so calamitous as to threaten its very existence.

No business edifice is so well built that it is completely immune to the possible ravages of sudden fire, flood, or storm. No commercial enterprise is so well organized or operated that it is not subject to the possibilities of burglary, a payroll hold-up, or embezzlement of its funds by one of its employees. Nor is any business so well conducted that someone may not be injured on its premises, struck by one of its vehicles, or damaged through the negligence of one of its employees. These occurrences, while always striking suddenly and unexpectedly, are nevertheless part of the normal hazards of business operation. Since any one of them can be sufficiently severe and result in destruction or damage so disastrous as to mean the failure of the entire enterprise, the alert businessman takes steps in advance to make certain that the business will be able to survive these blows.

INSURANCE

An ounce of prevention, in business as anywhere else, is worth a pound of cure, so that the most effective measure against these sudden occurrences is to see that they do not happen. This means, in general, the setting up and enforcement of safety precautions, removal of fire hazards, and a careful control over cash and other valuables. Yet despite the most meticulous care and attention to such details, accidents cannot always be prevented and will occur. The second means of protection against these unexpected hazards is that of insurance.

Insurance does not control the hazard, but it protects the businessman from financial loss by transferring the risk of the loss to an insurance company, an enterprise that makes a business of assuming risks. The insurance company is able to do this because of the number and geographical distribution of the risks it insures. Only a few of the hundreds of properties it insures against fire will burn during a year. The company, by collecting a comparatively small contribution from each of the many individuals and firms it insures, obtains enough to pay the

losses of the burned properties and still have an amount left as a profit for itself.

INSURANCE AND CREDIT STANDING

In addition to indemnifying the insured against loss, carrying adequate insurance serves the additional purpose of improving a firm's credit standing. Banks will not lend money to a business enterprise that is not adequately insured, for the obvious reason that a catastrophic occurrence might be so disastrous to the concern that it might be unable to repay the loan. Before granting a loan, a bank, therefore, will seek full information on the insurance coverage of the borrower. Thus insurance not only aids in freeing the enterpriser from the worries of unexpected perils and hazards, but it also protects his credit standing.

THE INSURANCE CONTRACT

Insurance arises as the result of an agreement whereby the insurance company, called the *insurer,* undertakes to indemnify the person who desires the insurance, the *insured,* against any liability or loss of an item called the *risk,* caused by the occurrence of an unexpected or uncertain event, called the *hazard. Indemnification* means that the company will make good any loss in the event it occurs, even though the occurrence was caused by the carelessness or negligence of the insured, so long as he did not act willfully or purposely. In some cases, particularly in life insurance, the insured may direct that the indemnification be paid, upon the happening of the event, to a third person who is called the *beneficiary.*

While insurance contracts are usually in the form of a lengthy written agreement known as a *policy,* insurance may be obtained orally, and even over the telephone, by agreement between the insured and a representative of the insurer. When such verbal arrangement is made, the agent of the insurance company—in the case of property insurance—usually sends the insured a written memorandum of the agreement, called a *binder,* as evidence of the contract until the company has had time to draw up and send a more formal policy. In the case of life insurance, the company is generally not bound until the policy is issued and the first payment is made by the insured. These payments by the insured to the company, either in one payment or in installments, are known as the *premium.* The *face* of the policy is the maximum amount that will be paid on the occurrence of the loss. If the insurance is by means of a *valued policy,* as in life insurance, the amount paid at the occurrence of the event insured against is the exact amount called

for on the face of the policy. But in most insurance contracts, as in fire and automobile insurance, the agreement is an *open policy* whereby the amount to be paid in the case of loss, not exceeding the amount on the face of the policy, is left to be fixed by an *insurance adjuster* after the loss occurs.

OBTAINING INSURANCE

The average businessman is generally too busy with the problems of his own industry to be familiar with the technical details of insurance or to know precisely what hazards he should insure against and how much insurance to obtain. He usually seeks, therefore, the advice of an established and reliable specialist in that field, known as an insurance broker or insurance agent. In most states they are required to obtain a license attesting to their knowledge of the subject, after having passed a rigid examination. The *insurance broker* is an independent businessman specializing in insurance problems, who knows insurance needs and the insurance companies and will advise not only on the proper insurance coverage, but will also place the insurance with a reliable company. The broker is paid for his services by a commission which is included in the premium the company charges for the insurance. Differing from practically all other types of insurance, life insurance companies employ agents and salesmen to sell their service to the public.

INSURANCE COMPANIES

Insurance companies, often called *carriers*, are also required to be licensed in most states and are carefully regulated and controlled by the state governments to protect the public from improper insurance practices. In general, these companies can be classified as four major types—those specializing in marine, fire, life, and casualty insurance.

Marine insurance companies handle all kinds of transportation insurance on cargo carried not only by ship, but by truck, rail, or plane as well. *Fire* insurance companies insure against losses by fire and also against damage from rain, hail, and windstorms. Many companies insure against both marine and fire hazards. *Life* insurance companies, as their name implies, insure the lives of individuals and groups; while the various types of *casualty* insurance companies take care of all other kinds of insurance risks and hazards, such as health and accident, automobile and aircraft, burglary and theft, public liability, and many other types to be discussed later in this chapter. Almost all insurance companies are stock companies, in other words, corporations with stockholder owners like any other corporation. Some life insurance companies, however, are known as *mutual companies*, because they have

no stockholders. They are owned by their policyholders who, like stockholders, receive a share of the company's profits as dividends, so that the cost to them of their insurance is reduced thereby.

PREMIUM RATES

Since insurance is based on the idea of spreading individual risks over a great many participants, the rate of premium charged the insured depends on how great a risk his contract is to the insurance company. Thus in life insurance, for instance, the rate is based on the face value of the policy that will have to be paid upon the insured's death and also on his age and probable number of years of life remaining to him, based on statistics called a *mortality table*. Fire insurance rates are based not only on the amount of insurance contracted for, but also on the degree to which the property insured is a hazard. Thus the rate for fire insurance on Kennedy's store would be determined in accordance with whether the building is made of wood or brick, the proximity and efficiency of the local fire department, whether the building has a sprinkler system, whether inflammable material is kept in the store, and the like. Rates on burglary insurance for Kennedy's would similarly depend on the character of the neighborhood in which the store is located, the manner in which the building is secured at night, and the efficiency of the police department.

INSURABLE INTEREST

In order to take the element of gambling out of insurance and make sure that a person does not insure something with the hope of collecting the insurance, the law requires that anyone contracting for insurance must have an *insurable interest* in the thing insured. This means that the loss of the thing insured, or the occurrence of the event insured against, will cause him financial loss or liability. Thus for property, the owner, mortgagee, lessee, and purchaser would all have such an insurable interest. Insurable interest in life insurance is limited to the insured himself, those dependent on him or on whom he depends for support, partners in a partnership, employers and employees, and creditors on the life of a debtor up to the amount of the debt. A person can take out an insurance policy on his own life and name anyone as his beneficiary, but a person can only take out a policy on someone else's life if he has such an insurable interest. Mere blood relationship is not enough; the question of dependency must be involved to insure a member of one's family. Furthermore, most states require that the insured must give his consent before someone else can take out a policy on his life, with the exception of a wife on her husband's life, a parent

on the life of a child he supports, or an employer on the lives of his employees collectively.

WHAT INSURANCE SHOULD A BUSINESS CARRY?

Every businessman today realizes the general value of insurance, but an enterprise cannot insure against every possible catastrophe that might befall it. The reason for this is obvious, because each type of insurance must, of course, be paid for; and the total costs of thorough protection might be so great as to require increased prices for the firm's merchandise or materially cut down on its profits. Some perils are so remote or happen so seldom that it might be better to take the chance on their never occurring and save the insurance expense. Others are more likely or normal business hazards and insurance protection is therefore a wise precaution. Thus the man responsible for contracting for insurance for the enterprise must balance the cost of the premiums for the various types of insurance against the probabilities of such disasters striking the firm and how serious a blow such eventualities would be. As will be noted under the subject of self-insurance, some very large firms do not take out insurance, because their properties are so widespread and insurance would be a tremendous cost to them. They believe it would probably be cheaper to suffer the occasional losses from casualties without aid from an insurance company.

In investigating the insurance problems of Kennedy & Company, Mr. Ames should, therefore, discuss with his broker the various forms of insurance his company can obtain and then make a decision as to whether such coverage would be advisable and justify the expense involved. These various types of business insurance can roughly be divided into six major categories:

1. Loss or destruction of physical property
2. Losses due to dishonesty
3. Losses due to injury of persons, or damage to property of others
4. Losses connected with automobiles or planes
5. Insurance connected with the employer-employee relationship
6. Losses of business earnings

Automobile and aviation insurance are considered a separate type, mainly because they involve a combination of the first three categories.

LOSS OR DESTRUCTION OF PHYSICAL PROPERTY

FIRE INSURANCE

The most important form of protection against loss of property, and one which no business should do without, is that of fire insurance. As

its name implies, this type of insurance protects the insured against losses from damage to the insured property from fire, from the chemicals and water used to put out fire, and from the heat or smoke of a fire. The insurance contract is in the form of a *standard fire policy* set up as required by state law, and includes coverage for damage from lightning and from removal of property from the premises in an effort to save it from the fire.

The standard policy sets forth the following conditions:

1. The premium that must be paid for the insurance. Fire policies are for one, three, or five years, the total rate being cheaper for the five-year or three-year policy, than if five, or three, one-year policies were bought. The premium, however, is payable in advance.

2. The policy gives a description of the property insured. Fire insurance on a building does not include insurance of the equipment, furniture, machinery, and stock of merchandise in the building. Nor does insurance taken out by one interested party cover the losses of any other interested parties. Thus, if Kennedy's rents the store, a fire insurance policy taken out by their landlord would cover only the building and would not be any protection for losses suffered by Kennedy's. Similarly, any policy Kennedy & Company takes out on the contents of the store would cover their merchandise and equipment but would not cover the landlord. If Kennedy's owns the building in which the store is located, they could take out a policy on the building with a clause, called an *endorsement,* stating that the contents of the building are also covered by the insurance. They would, of course, have to pay a greater premium for this additional coverage.

3. The policy then sets forth the amount of risk the insurance company will assume. There are many limitations on the amount an insurance company will pay after fire has damaged an insured property. The first limitation is that the recovery can be no more than the face amount of the policy. Second, the amount of recovery is limited to the actual cash value of the property destroyed at the time of the fire *or* the cash amount it would take to repair or replace the damaged property—whichever amount is lower (regardless of how much greater the face value of the policy might be). Third, when the insured has the property covered by policies with more than one company, the liability of any one company is limited to that proportion of the face value of its policy which it bears to the total insurance carried on the property. Fourth, the recovery is based on the co-insurance clause.

Co-Insurance Clause. With modern fire-protection and fire-fighting equipment, few fires result in total destruction of a property; and therefore most business firms do not carry insurance up to the full value of

their property. The policies therefore state that if the insured does not carry insurance up to a certain per cent of the total value of the property (usually 80 per cent), the company's liability is limited to that proportion of the loss that the amount of coverage carried bears to the 80 per cent of the total value of the property. Thus, suppose Kennedy & Company has property valued at $100,000 but insured for only $60,000 (in order to save on the premium), under a policy with an 80 per cent co-insurance clause; and fire damages their property to the extent of $10,000. Had they insured the property for 80 per cent, or $80,000 or more, they would have received the full $10,000. Since they only insured it for $60,000, which is three-fourths of the $80,000 required for 80 per cent coverage, they only receive three-fourths of the $10,000 loss from the company, or $7,500, and are said to be co-insurers for the other $2,500.

Some states, particularly in the South, require that the fire-insurance policy be a *valued policy,* in which the insurance company and insured agree in advance that in case of total loss, the insured will receive the face value of the policy. In most states, however, the policy is an *open* one, the payment to the insured being limited by the factors mentioned above, and the final figure arrived at by appraisal by an *adjuster,* an individual who makes a business of appraising insurance damage claims. These limitations are placed on the recovery because the contract is one of *indemnity,* to make good only for loss suffered. The insured is not supposed to profit from a fire.

4. The standard fire policy next lists the hazards or perils which the contract covers. These were previously mentioned as fire and damage from heat, smoke, water, and removal from the premises due to fire. Certain important pieces of property are considered *uninsurable* and are not covered by the usual fire policy. These include manuscripts, money, securities, deeds, drafts, notes, and other business papers, which may have great value as documents, but are actually only pieces of paper and of no intrinsic value. For an additional premium, an endorsement will be added to the policy covering damage from windstorm, cyclone, tornado and hail, explosion, riots and strikes, and from falling aircraft or colliding vehicles, even though no fire takes place. Additional endorsements may be obtained as well to cover losses to the firm from the interruption of its business due to the fire.

5. The policy then sets forth how the extent of loss is to be determined, usually through adjusters.

6. The action the insured must take to notify the company in case of loss is also given.

OTHER FORMS OF PROPERTY-DESTRUCTION INSURANCE

Mr. Ames will of course procure fire insurance for Kennedy & Company, but there are other forms of insurance for property destruction that he must also consider. Since the plate-glass windows comprising the show windows, as well as the door, of the store are very expensive to replace, he might be interested in *glass insurance*. Under such a policy, if the glass is broken, the insurance company will have the glass repaired, rather than pay cash for the damage. Some stores insure the glass in their showcases also; but in the case of a hardware store like Kennedy's that sells heavy items, they probably would not have glass showcases, or if they did, they might have trouble getting a carrier to accept such a risk.

Other hazards which can be insured against, and to which Mr. Ames should give some thought, would include those of tornadoes and hurricanes (which can be obtained separately or as part of the fire insurance policy), earthquakes, and floods. Whether to obtain any or all of these insurance coverages would depend on the location and susceptibility of the Kennedy building to such hazards.

Many business buildings and stores are equipped with automatic sprinkler systems to help reduce the losses from fire. Yet these systems themselves cause a hazard from water damage due to leaks or accidental discharges from the pipes or sprinklers. Risk of such losses can be covered by *automatic-sprinkler insurance*. Some firms also obtain *steam-boiler insurance* to cover losses due to the explosion of steam boilers which heat or supply power to their plants.

MARINE INSURANCE

Marine insurance, which once covered only the risks of ocean transportation, today encompasses the general area of all transportation. Policies can be obtained not only to protect merchandise sent by ship, but any goods shipped by any means, whether by water, rail, truck, or air. Shipment by parcel post or by express can be insured with the post office or express company. Mr. Ames would therefore have to consider the problem of insuring merchandise that Kennedy & Company might send to customers by the various means, as discussed in Chapter 11.

LOSSES DUE TO DISHONESTY

BURGLARY, ROBBERY, AND THEFT INSURANCE

Another important form of business loss, to which Mr. Ames should give considerable attention, is that occasioned by dishonesty. There are

many forms of insurance against this regrettable hazard that business firms frequently face. The most popular of these forms with enterprises like Kennedy's, which Mr. Ames would doubtless procure, would be insurance of some kind against burglary, robbery, and theft. This will require considerable study on his part, because there are many different coverages that can be procured, at various premium rates; and Mr. Ames will want to obtain those types most needed by his particular firm.

In the first place, a distinction is made between the three types. *Burglary* refers to the taking of property by forcible entry into the store at a time when it is closed to business. *Robbery* means the taking of property, while the store is open, but by violence or threat of violence, such as by an armed bandit. *Theft,* however, refers to any unlawful taking of property, whether by employees, customers, or sneak thieves. Policies can be obtained at cheaper rates to cover only one or more of these hazards; and at greater cost, to protect against all forms of larceny. Special policies may be procured, ranging all the way from *mercantile safe* policies, which cover loss of valuables from a locked safe or vault, to *hold-up* or *shoplifter* insurance. For a truly broad coverage, there is available *floater* insurance which protects against all forms of loss to property, no matter where it may be located at the time, and from any cause, including theft, fire, or just being misplaced. Naturally, this form of coverage is expensive. Another broad coverage is the so-called "3D" policy, covering all losses from dishonesty, destruction, and disappearance of property mainly in the form of money, checks, and securities.

Mr. Ames would have to decide which of the various forms of larceny Kennedy's would be most susceptible to and then determine how much coverage for these hazards would cost. Rates are based on the type of business and the protection the store has against various forms of stealing. Thus if the merchandise is kept in a vault, or the store has a good burglar-alarm system, the rates, at least for burglary insurance, will be less.

FIDELITY BONDS

A form of insurance to reimburse an employer for the dishonesty of an employee who takes money entrusted to his care is the fidelity bond. These bonds may be procured to cover one specific employee or all the employees of a firm, but they are usually only obtained for cashiers and others who handle large amounts of money. Kennedy's might possibly even want to obtain such a bond on Mr. Ames himself, because he is the treasurer and cashier, although as an officer and director of the corporation, he would normally be a person to be trusted. Some employers require the employee to pay the cost of the bond; but most employers

pay the cost of this protection themselves, the premium being based on the amount of money the employee normally handles. A business which cashes a great many checks can obtain protection from cashing forged or altered checks, or securities, by obtaining *forgery* insurance.

LOSSES DUE TO INJURY TO PERSONS OR DAMAGE TO PROPERTY OF OTHERS

PUBLIC-LIABILITY INSURANCE

Still another hazard to which every business firm is subject is the possibility of liability claims for injuries received in the company's store or place of business, or as the result of some action by a company employee while going about his duties for the firm, or from some fault in a product sold by the company. There are many special forms of liability insurance to cover specific hazards of this type, such as owner, landlord, and tenant policies; elevator insurance; theater, sports, and professional public-liability and property-damage insurance; product liability; and operations-and-premises policies. Comprehensive public-liability and property-damage coverage covering many of these hazards can be obtained in one policy. Such contracts exclude injury or damage caused to the insured's vehicles or to his employees. These elements are covered by separate forms of insurance to be discussed below.

Premiums for these various coverages are computed on many different bases, as, for example, front footage on the street, over-all square foot of floor space, or dollar amount of annual sales. Mr. Ames would, therefore, have to decide how much coverage Kennedy's needs to protect itself from claims arising from these three kinds of accidents—on the premises, caused by the employees, or by the products sold. He would then obtain estimates of the cost of such protection and decide just how much and which types of this insurance Kennedy & Company should carry.

LOSSES CONNECTED WITH AUTOMOBILES

A form of insurance coverage which combines all three types previously mentioned (loss or destruction of physical property, loss due to dishonesty, and loss due to injury to person or damage to property of others) is that of automobile or aviation insurance. There are many different hazards connected with the operation of such vehicles, each of which can be separately covered by individual policies. Some, but not all, can be combined in a comprehensive policy. Among the hazards to which the owner of an automobile or plane is subject, and for which insurance coverage is available are:

1. For damage or loss of his own car, from:
   a. Collision or upset
   b. Fire, lightning, or while being transported
   c. Theft
   d. Windstorm, earthquake, explosion, hail, or water
   e. Glass breakage and vandalism
2. For losses to others, from:
   a. Bodily injury
   b. Medical payments caused by such injuries
   c. Property damage

Collision or Upset. Automobile and aviation insurance may be obtained to indemnify the owner for loss from damage to his vehicle by collision, when the car or plane comes into contact with another object, either moving or stationary, or from an upset, when the vehicle has been overturned so that it no longer rests on its wheels. Few such policies are of the full-coverage type, on which the company pays the full amount



A. Devaney, Inc.

No One Was Injured. This picture presents a highly dramatic reason for insuring property (and lives)! No one, of course, can foretell such events.

of the loss, because the premiums for such insurance are very high. Rather, most policies contain a deductible clause, whereby the first $25, $50, $100, or $250 of damages are deducted from the amount of any claim made on the policy, so that these smaller amounts are at the risk of the insured, the premium being smaller for higher deductible-clause policies. In some states, a convertible collision clause is sometimes included, whereby the insured pays only half the full-coverage rate but must pay the balance if he makes any claims during the policy year.

Fire, Lightning, and Transportation. As its name implies, this insurance covers the automobile or plane itself from damage or destruction by fire, lightning, or while being transported over land or water in some type of conveyance. It does not cover articles of personal property left in the vehicle. Like all other coverage on the owner's own car, he is protected only to the amount of insurance he has obtained, but cannot, in any case, recover more than the value of the car at the time it is destroyed, or the amount to repair the damage.

Theft. Loss of the vehicle, or damage to it, due to theft and pilferage are covered by this type of insurance. Here again, theft of personal property left in the car is not included in the coverage.

Windstorm, Earthquake, Explosion, Hail, or Water. Damages caused by natural phenomena are covered by insurance against such eventualities. A very common form of insurance is called *comprehensive insurance*, which in one policy protects the owner from loss or damage from fire, lightning, and transportation, theft, windstorm, earthquake, explosion, hail, or water, and other hazards such as vandalism, and glass breakage from any cause. Excluded from such coverage is damage to tires, unless by fire or theft, and loss or damage to the vehicle due to wear and tear and mechanical breakdowns, war and civil commotion. Premium rates for all damage to own-car coverage are based on the make and style of the vehicle, its age, whether it is used for business or for pleasure, and the area in which the owner resides or has his place of business.

Bodily-Injury Liability. The greatest hazard to any vehicle owner is the liability to other persons for accidental injuries or death due to being struck by the car. Such damages can run into many thousands of dollars, and one such judgment against a responsible business firm could ruin it, were it not for *automobile public-liability insurance.* This coverage is usually expressed in two amounts, generally limited to $5,000 for injury to one person and $10,000 for any number of persons involved in one accident. By payment of an additional premium, these limits may be raised to as high as $100,000 for one and $300,000 for any number of people in the same accident.

Medical Payments. This insurance provides for payment of medical and related expenses, due to injury in an auto accident involving the insured's vehicle, and incurred by any occupant of the insured automobile, regardless of whether the insured is legally liable for such payments. The insured himself is included in this coverage, which ranges from $250 to $2,000 per person, according to the premium paid.

Property-Damage Liability. Insurance of this type can be procured to cover any damage caused by the insured automobile to property of others, whether another automobile, a house, or anything else, other than a person. The insurance also covers the insured should he be driving another car rather than his own. The amount is usually limited to $5,000, but additional coverage can be obtained upon payment of a higher premium.

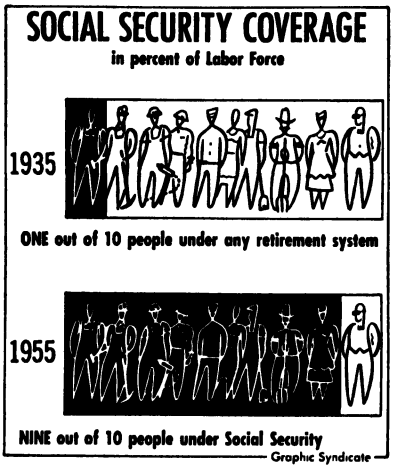
Many states now have laws providing for compulsory liability insurance, although most of them merely require that the car owner furnish proof of financial responsibility, and many of them make this requirement effective only after the individual has been involved in one accident. Rates for liability insurance depend, in addition to the amount carried, on the use to be made of the car, the previous accident record of the driver, and the amount of traffic in the area of the insured's home or place of business. When loss does occur, the policies require that the insured notify the company or its agent as soon as possible and file a written report or proof of claim within a short time thereafter.

Mr. Ames would certainly be advised to take out a full-coverage policy, covering all the various aforementioned hazards, on all motor vehicles that Kennedy & Company owns or operates. The only real decision required of him would be what limits of insurance to procure. In the case of the most serious hazard, that of bodily injury, it would be best for the firm to take out the maximum insurance of $100,000/$300,000 ($100,000 limit for one person; $300,000 limit for all persons struck in one accident), since the additional premium for these high limits is surprisingly small.

INSURANCE CONNECTED WITH THE EMPLOYER-EMPLOYEE RELATIONSHIP

SOCIAL INSURANCE

In the area of the employer-employee relationship, there are several forms of insurance a business firm must carry because law requires it. Some of these take the form of social insurance, which is administered entirely by the Federal or state governments. One of these is the compulsory *Old Age and Survivors Insurance,* more commonly referred to as



Twenty Years Later. In 1935, one out of ten persons was covered by Social Security; in 1955, nine out of ten. This graph illustrates dramatically the increasing importance of Social Security. How many groups can you identify?

Social Security. It is administered by the Federal government and is designed to give individuals covered by its provision a monthly benefit when they reach age 65. It also provides certain benefits to dependent survivors. Both employer and employee are required to contribute a small percentage of the pay the worker earns (up to $4,200 annually) to support this social program. The Federal government also sponsors a program of unemployment insurance, usually administered by the state governments. Businesses employing more than a certain number of workers must contribute a small percentage of their payroll total to the Federal and state governments to support a program whereby covered employees receive a certain sum each week (up to 26 weeks a year) during periods in which they are unemployed. The premium paid by the employer is based on his experience rating in frequency of unemployment and number of workers unemployed. Some state laws require the employee to contribute to this insurance, others do not. A few states have an additional form of social insurance that gives covered employees *health-and-disability insurance,* assuring them a portion of their salaries for a limited period of time when unable to work because of sickness or accident not connected with their work.

WORKMEN'S COMPENSATION

The laws of practically all states now hold an employer responsible for injuries sustained by most employees while on the job and require the employer to be financially able to compensate the injured employee. Not all workers are so covered, the laws differing in the various states. Not all states require the employer to carry insurance to cover this type of compensation claim, but most business firms do procure workmen's

compensation insurance. *Employer's liability insurance* is available to cover those situations where the injured employee does not come under workmen's compensation laws. In both cases, the premium is based on the hazards of the occupation involved and on the amount of the annual payroll.

GROUP INSURANCE

Many firms now insure their employees against loss of life, loss of salary caused by accident or sickness, and the expenses of medical and hospital care. These policies are usually a type of insurance in which the employees as a group are insured, with no medical examination required of the individuals covered, and with rates for the group lower than they would be for similar policies if purchased by the employees individually. Some firms require their employees to pay all or part of the premium for this coverage; other employers pay all or part of the cost themselves, as an added remuneration or as a "fringe-benefit" form of inducement to the employees.

Payroll Deductions. Kennedy & Company are required by law to contribute toward the Old Age and Survivors Insurance of their employees, as well as to deduct the requisite percentage from the employees' paychecks to cover their contribution to this form of social insurance. Depending on the number of employees working for them, and the state in which they operate, Kennedy's would also have to contribute a percentage of their payroll toward unemployment insurance and sickness-and-disability insurance programs for their employees as well. Workmen's compensation insurance, even where not required, would also be advisable. Whether the firm should participate in a group insurance plan for its employees would be a matter for Mr. Ames and the directors to decide, provided, of course, they have enough employees to enable them to obtain a group policy. Certainly such coverage would be welcomed by employees (particularly if the employer pays all the premiums) and would give them a feeling of security and loyalty to Kennedy & Company. The premium would, however, be an added business cost; and the directors would have to decide whether the benefits to be derived by the company itself from this type of employee protection would be worth the expense.

LOSS OF BUSINESS EARNINGS

Insurance under this heading takes many forms and covers a wide variety of eventualities. One of these, *business-interruption insurance,* is seldom obtained by itself, but rather as an added endorsement to a

fire or other casualty insurance policy. It does not protect a business from loss of its property due to fire or casualty, because that is covered by the fire or casualty insurance. Rather, it protects a business against loss of earnings resulting from interruption of its business activities caused by damage to, or destruction of, its physical property through fire or other hazard. Specifically, this coverage takes the form of *use-and-occupancy insurance; profits-and-commissions insurance;* and *rents, rental-value and leasehold insurance.* The latter covers a landlord for the rents he loses while his property is being rebuilt and made habitable after a fire.

Another form of insurance which protects against loss of business earnings is *weather insurance.* Such a policy would indemnify the exhibitor of an outdoor attraction for loss of earnings due to poor gate receipts because of inclement weather. Although in a different field, yet not too dissimilar in result, is *credit insurance,* which protects a creditor against loss from bad debts of his charge-account customers. All the forms of loss-of-earnings insurance mentioned so far are comparatively expensive and not always procured by the ordinary business firm. Mr. Ames might consider adding a business-interruption clause to Kennedy's fire insurance policy, but he would generally not be interested in the other forms.

SURETY AND PERFORMANCE BONDS

Loss of earnings due to the failure of someone to perform an act or obligation is covered by surety bonds, which guarantee the faithful performance of a contract. Although not important to the Kennedy hardware store, these bonds are commonly used in certain forms of business. They are often required when contracts involve construction of buildings, furnishing large quantities of merchandise at a specific time and price, or becoming an agent or distributor for a large manufacturer or principal. *Title insurance* protects the insured against subsequent loss should his right of ownership or title to real estate ever be questioned. Kennedy's would be interested in such coverage when buying real estate.

Major Types of Insurance

Fire	**Public Liability**
Property	**Automobile**
Marine	**Employee Groups**
Burglary, Theft, Robbery	**Life**
Fidelity	**Social Security**

LIFE INSURANCE

While primarily a factor in one's personal life and estate, life insurance is nevertheless an important form of business loss-of-earnings insurance. When a sole proprietor is the center of a flourishing business, he will be able to obtain business credit much more readily if he has some form of life insurance that will assure that all his business debts will be paid on his death. A large insurance payment on the death of the sole proprietor may carry the business over until a suitable successor is found to run the enterprise, or until it can be sold without being sacrificed at a forced sale.

Since a partnership generally is dissolved upon the death of a partner, the proper use of life insurance can do much to eliminate one of the serious hazards of this form of business organization. By taking out insurance on each other's lives, the partners can be certain that on the death of one partner, the surviving partners will have money enough to buy out the widow or heirs of the deceased partner at a good price and thus be enabled to continue the business themselves.

In the case of a small, closed corporation like Kennedy & Company, it might be worthwhile for the corporation to carry life insurance on Kennedy, Ames, and Grebs, its principal stockholders, so that if one dies, the company will have sufficient cash on hand to buy his stock from his widow or surviving heirs. Or, as is common in large corporations, insurance may be carried on the life of a key executive, payable to the corporation, to reimburse the corporation for its loss of earnings due to the death of this important component of the management.

Mr. Ames should give thought not only to the desirability of such insurance in the case of Kennedy & Company, but also to the kinds of life insurance available, so that the most advantageous type will be purchased.

Ordinary versus Term Insurance. The primary distinction in types of life insurance, as they affect a business firm insuring the life of one of its executives, is ordinary life insurance versus term insurance. In an *ordinary* life policy, the premium is paid annually from the date of the policy until the death of the insured. In addition to paying the face amount of the policy at death, the contract also builds up a *cash-surrender value,* which is the amount of money the insurance company will pay back if the insurance contract is dropped by the firm taking out the policy (perhaps because the insured executive leaves the firm) at any time before the insured's death. If the firm insuring its executive needs money, it may also borrow on this policy against this cash-surrender value. Very important is the fact that, once entered into, the ordinary life contract

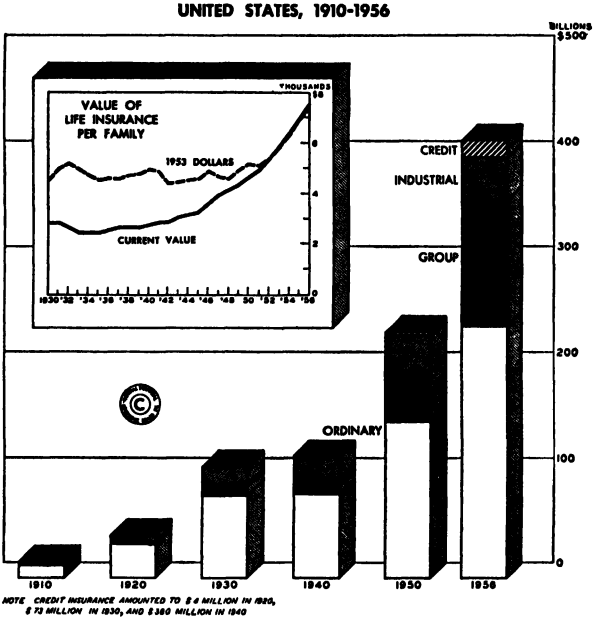
cannot later be canceled by the insurance company, so long as the annual premium is paid. Special forms of ordinary life policies may be obtained, such as the *limited-payment* life policy, which requires payment of a higher premium for a certain number of years, after which the insurance remains in force as fully paid up. An even more expensive form of contract is the *endowment* policy, wherein the insurance company agrees to pay the face amount of the policy on the death of the insured, or on his attaining a certain age.

In contrast to the ordinary life policy is the much cheaper form of *term* insurance. This is a life-insurance contract for a definite number of years, usually five, which does not build up any cash-surrender value to be repaid to the firm when the policy is discontinued or against which money can be borrowed. At the end of the term, the insurance company has the option of renewing the insurance for another term (usually at a slightly higher fee) or of refusing to so renew if the insured is now a poor risk, because of age or bad health.

If the firm has a sufficient number of executives, a group insurance contract may be obtained, which insures all the executives as a group at an inexpensive rate and without the medical examination that is required of the insured under both the ordinary and term life-insurance contracts.

Growth of Life Insurance. Study the bar showing life insurance in force in 1956. Approximately how much of the total is represented by ordinary life insurance? by group? by industrial? by credit? What was the average value of life insurance per family in 1956? (See inset.)

LIFE INSURANCE IN FORCE
UNITED STATES, 1910-1956



Courtesy National Industrial Conference Board

SELF-INSURANCE

As was mentioned earlier in the chapter, very large corporations, with property scattered in many parts of the country or the world, find it cheaper not to take out insurance, but instead to set aside a percentage of their profits each year to absorb the loss from casualties against which the smaller firm normally insures. The premiums charged to insure the numerous properties of these very large companies would be extremely high. Since their various plants are widely distributed and separated from each other, it is unlikely that more than one would suffer serious damage from fire, flood, etc., at the same time. It is, therefore, cheaper for the corporation to stand this loss itself, in other words, to insure itself, than to pay the premiums on all the properties in order to get back this one loss from the insurance company. Although the loss of a plant would ruin the uninsured small enterprise, the large one has sufficient assets to withstand the loss of one plant without seriously disturbing the financial condition of the entire company.

SUMMARY

All businesses are subject to the risks of sudden unexpected losses which might be so great as to threaten their very existence. Fortunately an enterprise can protect itself against many of these hazards by obtaining insurance. Policies may be procured covering loss through destruction of physical property—such as fire, windstorm, earthquake, flood, and glass breakage. Losses due to dishonesty—such as burglary, robbery, theft, and embezzlement may also have insurance coverage. Protection against various forms of liability for injury to persons or property damage of others is advisable for most business enterprises. Full coverage against all these hazards, as well as collision, is a necessity for the business firm that owns or operates automotive, air, or marine transportation facilities. Many forms of insurance to cover protection and liabilities arising out of the employer-employee relationship are also required, or at least worth the serious consideration of the management of an enterprise. Finally, various types of protection against loss-of-business earnings are available, including the important insurance on the lives of executives and key employees. Although some very large companies may find it cheaper to do their own self-insuring, every business enterprise must give considerable thought and attention to the vital problems of insuring against the unexpected risks of business.

► FOR REVIEW AND DISCUSSION

1. What types of business risks can be covered by insurance?
2. Explain the meaning of these insurance terms: insurer; insured; risk; hazard; indemnification; beneficiary; policy; binder; premium; and face.
3. What is the difference between "valued" and "open" policies?
4. Name and describe the four major kinds of insurance companies.
5. How do the insurance companies determine premium rates? How are such rates regulated?
6. How does co-insurance operate?
7. What types of property are uninsurable?
8. Describe the nature of insurance available for covering losses connected with automobiles or planes.
9. What are the characteristics of the social insurance required by law?
10. How do group insurance plans operate? What does group insurance usually cover?
11. When can life insurance be used to protect business interests? What values are derived from it?
12. Distinguish between the features of term insurance and ordinary life insurance.
13. Is self-insurance ever advisable? If so, under what conditions?

► CASE-PROBLEM QUESTIONS

1. How can Kennedy & Company decide on the amount of each type of insurance to carry?
2. Could Kennedy & Company carry their own insurance by setting aside the same amount of money they would pay an insurance company? Would it be wise for them to follow such a policy?
3. What types of losses are Kennedy & Company more likely to incur?
4. Does it make any difference where they buy their insurance protection?
5. Should Kennedy & Company buy insurance for a year at a time or on longer-term contracts?
6. How should Kennedy & Company deal with the cost of insurance? Should they provide for insurance in figuring mark-up? Should they meet the cost out of their own pockets? Should some of the cost be deducted from personal income?

► APPLIED BUSINESS PROJECTS

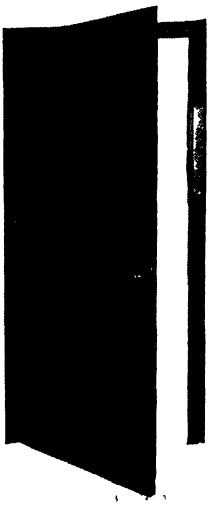
Below is a list of human risks:

Fire; theft; death; ill health; accident; loss of income; loss of worker; loss of parent; loss of wife or husband; loss of affection; war; flood; depression; old age; rising costs; bad credit; drop in price; inability to get goods; inability to sell; riot.

Section Four

Production Management







15

Production Planning

CASE PROBLEM

Kennedy & Company, Inc., the retail hardware and electrical appliance business whose history we have been following, has now been in successful operation for several years and is a thriving, growing enterprise. Fred Kennedy, its president, and its board of directors, composed of the former partners who initiated the venture, have been considering the possibility of further expansion into the manufacture of hand tools, an important item among the many the company sells.

They receive a proposition from a man named John Hughes, who has had many years of experience as a factory manager in the production of hand tools. He offers to invest a considerable amount of money if the firm will transfer stock to him sufficient to give him a one-fourth interest in the corporation, and if the firm will agree to open a factory for the manufacture of hand tools, under Hughes's personal supervision.

The Kennedy directors realize that if they are to create products that will have public acceptance and beat competition, they will have to produce well-designed tools of good quality at a cost which will be low enough to enable them to sell them at competitive prices and still return a profit to the company. Hughes asserts that with a modern factory, well designed and efficiently operated, these goals can be met. The directors are therefore interested in the planning, erection, and operation of a factory which can compete successfully in present-day industry.

► What are the general areas of problems that face the enterpriser who initiates a manufacturing venture endeavoring to compete in today's business world?

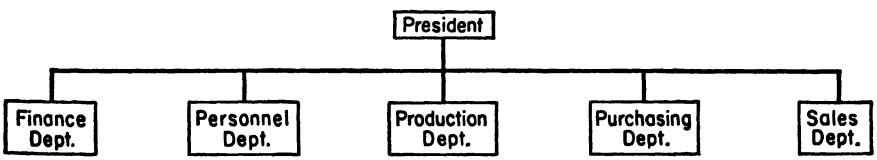
► **What over-all planning must be done by management to facilitate the efficient operation of a modern factory?**

Although all areas of business operation and management have made great strides in the past fifty to seventy-five years, none has seen more tremendous growth, nor undergone such startling changes in methods and practices, than has the important function of manufacturing. The key to this stupendous development has been the introduction of *mass production.* Where one man used to labor for hours making one pair of shoes, performing all the operations himself and using hand tools, today in the same elapsed time hundreds of pairs of shoes are turned out by almost automatic machines requiring few men, and each man handling one specialized operation which comprises a minor segment in the manufacture of the shoes. Mechanization, specialization, and scientific organization and management are the factors that have made such mass production possible.

PRODUCTION ORGANIZATION

Before studying the details of production management, it is perhaps best that we get an over-all view of the organization of a typical factory, in order that we may start out not only with a picture of the plant as a whole, but also enable us better to appreciate its parts and examine each problem in detail, and thereby familiarize ourselves with the section or division of the factory set up to handle the problem.

As previously explained, whenever organization charts have been presented, two points must be kept in mind when viewing an organization. In the first place, the following chart is not necessarily the best form of organization for a factory. Each plant must be set up to fit best the personnel that compose it and to manufacture the article it is built to produce. No one plan of organization could be the most satisfactory for all factories. This chart is given merely as an example of one organization that is fairly typical of the usual plant set-up. Secondly, while this is a chart for a fairly large factory, it does not mean that it should be ignored



Skeleton Organization Chart. This chart shows only the major departments in a business. Each department, of course, reports directly to the president of the company.

in the management of a small plant. What is important is not the divisions or sections of the plant organization, but rather the functions covered in the chart. All factories have primarily the same major functions; and while one person may handle more than a single such function in the small plant, it is nevertheless important that the smaller factory's organization provide for the proper handling of each function by someone, so that none is neglected or duplicated.

Relation with Other Functions. In a typical plant organization, as shown here, it is assumed that production is one of the major departments in the company and that personnel and purchasing are also on an equal department level with manufacturing.

It can be seen from the first diagram that production in this company is one of five departments, each of which reports directly to the president, and all co-operating and working together to make the enterprise a success. The activities of the production department are closely related to those of the finance department, because the latter must provide the money to finance the new machines the production department needs to make the products more efficiently and at less cost. Finance also supplies the funds needed to carry the inventories of raw materials, and the finished-goods inventories of products it has manufactured. Conversely, the more efficiently the production department conducts its operations, the greater should be the profits and the financial return to the company from the goods so manufactured and sold.

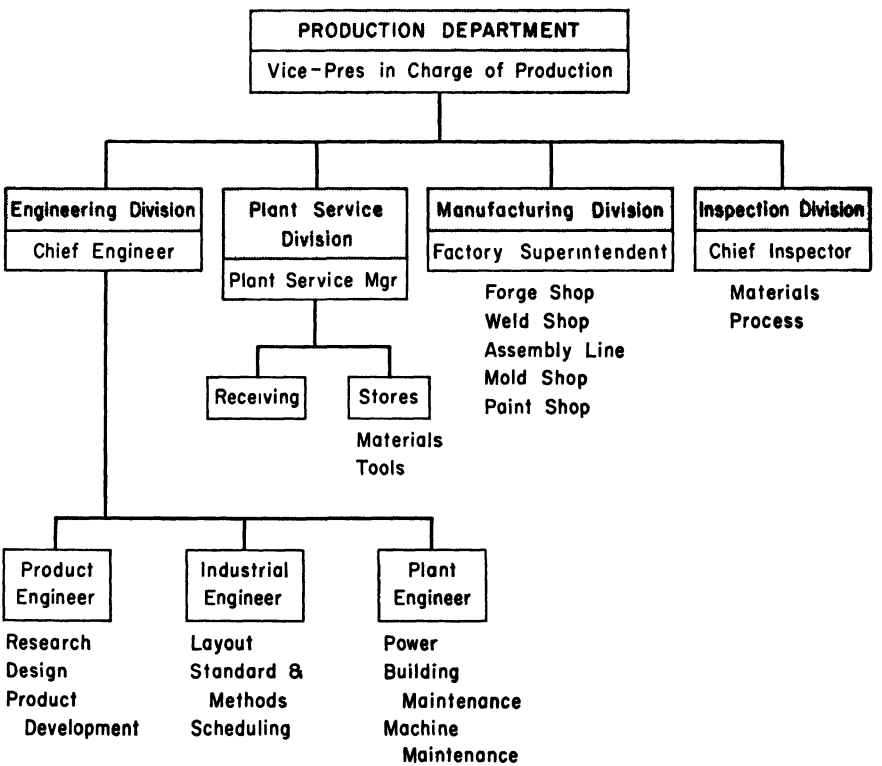
In this company, the production department looks to the personnel department to obtain for it the workers it needs, as well as many of its supervisors, and to train them to do their jobs with skill and with enthusiasm. The personnel department in turn expects the production supervisors to treat the workers properly, so that they will be happy in their jobs and thus reduce the burden on personnel for constant replacement of employees. The interrelation between the production and purchasing departments is equally important. The manufacturing function needs satisfactory materials and supplies at a specific time and depends on purchasing to have them on hand when needed. The purchasing agent will need the co-operation of production in knowing what the latter wants and when it will need it.

Greatest of all, perhaps, must be the integration between the production department and the sales manager. It is of course vital to the company's success that the factory turn out products that the sales manager can sell. The latter must therefore be in constant consultation with the head of manufacturing to advise him as to those features of the product in the greatest demand by the public. The sales manager, in turn, must work with production in an effort to smooth out any seasonal

problems of the firm, so that the factory will not be forced to run at peak operation in one season and then, because of slack sales, reduce operation in another. The sales manager must make sure that he sells only those items that the factory can economically produce and at a price which will more than cover factory costs.

Because of this necessary co-operation, with every one realizing and appreciating the problems of all the others, each of these five functions is set up as a department. Each one is headed by a department head, on an equal level with, and consulting with, the others. All report to the same supervisor—the president of the firm.

Factory Organization. The factory of the company whose organization chart is shown in the second diagram is a large one and is under the supervision of its department head, who has the title of vice-president in charge of production. The department has four divisions, two major



Organization Chart of a Department. Here is a more detailed chart showing the division of a single department. (See the skeleton chart illustrated earlier in this chapter.) To whom does the Plant Engineer report? the Chief Inspector? the Stores Section?

ones, those of engineering and manufacturing, and two smaller ones, plant service and inspection.

The engineering division, under the chief engineer, has three sections. The product engineer is charged with the important research and experimentation that leads to the design and development of new products. The industrial engineer has as his responsibility the discovery of better and less costly ways of making the present products. Thus, he is concerned with arranging the layout of the plant to produce an efficient flow of work; with developing the best method for performing each operation; and with scheduling the work through the plant to afford the smoothest flow and least confusion. The plant engineer is the superintendent, or janitor, of the factory and takes care of the maintenance of the building, its machinery, and its power facilities.

The plant-service division, headed by a plant-service manager, receives the incoming materials, unpacks them and stores them in the materials-and-tools inventory storerooms until needed for production. The inspection division, under the chief inspector, inspects the incoming materials and the output of the plant as it passes through the processes of the factory, to see that both come up to the specifications set for them.

The manufacturing division is the largest in the plant, for it comprises the heart of the factory, and is headed by the factory superintendent. In the plant illustrated in the second diagram, the operating division is divided into five sections, the forge shop, mold shop, weld shop, paint shop, and assembly line, each under the supervision of a foreman.

PRODUCTION PLANNING

Its Aims. The first step in any operation, particularly in manufacturing, is that of planning in a broad and general way the methods to be used in attaining the objective. To the company engaged in production, this means not only the planning that must be done before a factory can be designed, purchased or built, but also the planning that must go on every year and every season, so that the company can proceed during the ensuing period with some direction, some idea of what it is aiming for, where it is heading, and how it proposes to get there.

The management must formulate their plans with a fairly accurate estimate of the total size of their expected operations and even of the profit they hope to earn from them. The estimate of the production that must be carried out in the next period will of course be limited by the market demand for the product. They will want to produce only as much as they believe they will be able to sell, plus a little extra to carry in stock as an inventory. But over-all planning requires that

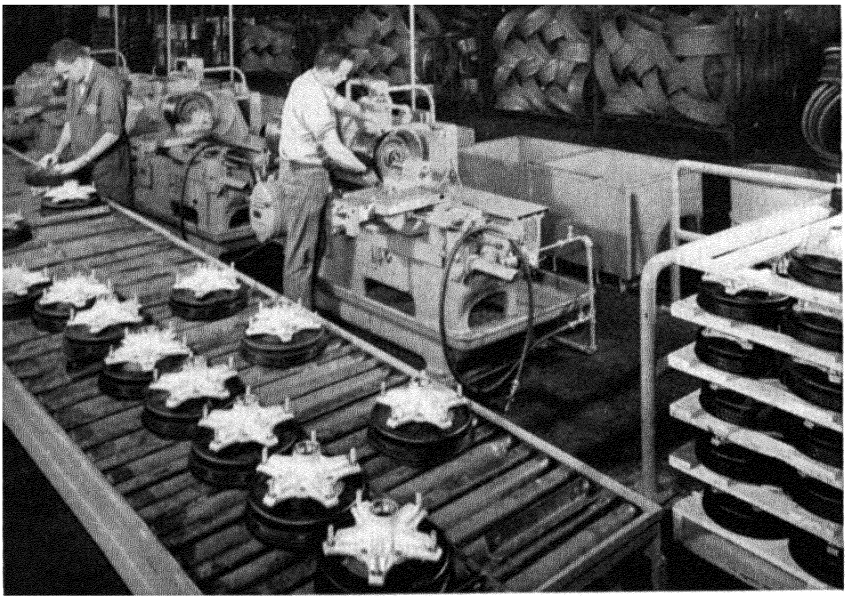
thought be given to more than just how many articles should be produced, for there is also the question of making the best and most economical use of the plant facilities—its men, materials, and machines. This means adjusting to the normal ups and downs of production due to the fluctuations in demand caused by the business cycle or to seasonal factors. To Kennedy & Company, for instance, it might mean producing garden tools during the winter, in time for spring and summer sale, and utilizing the same facilities for manufacturing snow shovels and ice choppers during the summer for winter demand.

FACTORS IN PRODUCTION PLANNING

The secret of manufacturing success today is mass production. An enterprise can only compete if it utilizes to the utmost the advantages of large-scale production, which must therefore be planned in such a way as to afford the greatest use of this phenomenon of present-day manufacturing. What then are the elements of mass production, the factors that must be considered in effective production planning? Primarily they involve problems of specialization, standardization, diversification, expansion, contraction, and integration.

Specialization. Doubtless the greatest single difference between the manufacturing of today and the handiwork of our forefathers is our use of specialization, which is based on the principle that few people can do many things well, but that most people can do a few things well if the scope of their activities is small enough. Years ago one man would do all the work in fashioning an article, from start to finish, working with hand tools and perhaps one or two simple machines. Today this same article is produced in vast quantities with men and machines specializing in just one minor operation in the whole process. Often a whole factory is devoted to the specialized task of turning out only a certain part of the finished product. Application of the principles of specialization can be made in the equipment used, the labor being utilized, and even in the manufacturing process itself.

Automation. A comparatively recent innovation in factory operation that makes the utmost use of equipment specialization is the development of *automation.* An automated plant is the nearest thing to the so-called "push-button factory" (one that supposedly operates with no human labor except for the pushing of a button to start the machinery) that has been devised. Automation involves not only specialized machinery to fabricate the parts of the product, but also automatic machinery to move the parts from one operation to the next and finally to assemble them into the finished product. Since the entire process is done by the equipment, with practically no human labor, it can be seen that



Courtesy Goodyear Tire & Rubber Company

Specialization. In this type of operation, each worker specializes in one particular skill. What are the advantages of specialization? the disadvantages?

this requires expensive, highly specialized machinery, usually electronically controlled, so that it is only feasible in a huge plant engaged in large-scale production of a single article.

Many people fear that automation may eventually cause unemployment because its automatic features eliminate the need for workers. Because of its cost, however, the use of automated machinery is limited at the present time to very large factories and does not affect the majority of manufacturing plants. Furthermore, automation requires the services of many highly skilled people to design, produce, and service such specialized equipment. In the end, therefore, the industry making and caring for automated machinery may hire more workers, at higher pay because of the greater skills required, than were displaced at the plant installing automation.

Standardization. Another important element in successful manufacturing, and an essential factor to be considered in production planning, is that of *standardization*, sometimes called *simplification* or *uniformity*. At one time, every pair of shoes was just a bit different from any other pair. But to permit large-scale production, with all its advantages in

cost savings and speed of output, a sufficient number of shoes of exactly the same size, shape, and style must be manufactured. This means the simplification of the thousands of models possible to a few standard ones, so that these can be produced in quantity. Kennedy's cannot produce cheaply a few saws of many different sizes and teeth arrangements. Only if they can simplify their line by reducing it to about a dozen or so standard sizes, can they produce a sufficient quantity of each to enjoy the benefits of specialization.

Such simplification can also help Kennedy's in making their advertising and selling more efficient. Salesmen will have fewer products to understand and push; and thus, like the company's advertisements, can concentrate on doing a thorough job on this limited line of products. Simplification is not too feasible, however, in some lines, like women's apparel, where variety is essential.

Diversification. Equally important as a factor to be considered in long-range planning, and an essential element in the success of a manufacturing concern, is the problem of diversification, which is the opposite of standardization and must be weighed against it. A manufacturing concern may obtain great savings in production costs by limiting its line to a few standard products, but it may find this costly from the marketing standpoint. Perhaps the company cannot sell enough of its output to keep the factory going all year round; or perhaps the salesmen are not successful in selling because the company does not offer sufficient variety, or a complete line of products at various price ranges; or perhaps the product has become obsolete, and a competitor is getting out a newer and more efficient or more attractive article.

All these marketing difficulties may cause the management to discount the savings in production costs from standardization of its product and adopt the opposite policy of diversification of its offerings.

Expansion. An important element in the planning of production, and closely tied in with the problems of diversification, is that of expansion for increased production. Let us say, for instance, that Kennedy's factory is in operation and business is very good, so that it is desirable to increase the production of the plant beyond its present capacity.

The easiest solution is to have the men work *overtime;* but this, of course, is at best only a temporary solution, suitable solely for limited expansion when it is believed the increased demand for the product is not a permanent one. A more permanent solution to the expansion problem would be to add a *night shift,* or perhaps go on a three-shift basis, with some workers operating the plant from 8 a.m. to 4 p.m., for instance; others from 4 p.m. to 12 midnight, and, if necessary, others work-

ing at the plant from midnight to 8 a.m. This method of expansion has many advantages. For one thing, it can double or triple the plant output and can be carried on permanently.

The third alternative is to *expand the size of the plant.* This will, of course, permit the expansion to exactly the size needed and enable the company to obtain the very latest types of equipment. It is easier to get day workers and supervisors, and no expensive overtime wages need be paid. Like extra-shift workers, however, these new employees would have to be trained. However, this is a permanent expansion, and cutting back production would result in greatly increased expense.

Contraction. Just as management must sometimes plan to expand production, there usually arises a time when the opposite problem must be faced, namely, that of the best way to cut down on production because of a decrease in business. Here the production planners must decide what to do about factory production in view of the falling demand. One alternative might be to continue production in order to build up inventory. This has the advantage of keeping everyone working, so that the morale and skill of the employees are not adversely affected. But it is not a form of contraction and might be a very dangerous practice, since the firm continues to multiply factory expenses in building up a large inventory which it may later be unable to sell. Another possibility is to run the factory full time for only two or three days a week instead of the usual five. This might give the needed contraction; but it satisfies no one, because the employees become unhappy over their reduced earnings and worry about the possibility of the plant shutting down altogether. Some key employees might refuse to accept a cut in pay and might quit, leaving vacancies that will be almost impossible to fill because part-time work is all that can be offered to prospective employees.

Integration. Another serious and important problem faced by production planners is the extent of production integration. How much of the article which they manufacture should they produce themselves and how much of it should they procure from subcontractors or independent parts producers? One of the items of hardware that Kennedy & Company will manufacture, for instance, is hammers. The question then arises whether they should themselves make all the parts of each hammer, as well as assembling the finished piece, or whether they should buy some of the parts from other manufacturers who specialize in such pieces. To make all the parts would require Kennedy & Company to cut and shape the wooden handle, to forge and finish the steel hammerhead, and to fabricate the metal wedge that goes into the top of the handle and holds the head in place—all this in addition to the putting together of the

three essential parts of the hammer. Fred Kennedy, Hughes, and the other directors must make the decision as to just how much of the hammer Kennedy's themselves will make.

PRODUCT DEVELOPMENT

Design Problems. As was mentioned in the discussion on technological diversification, a major area in production planning is the thought that must be given to the introduction of new products. The first step in such planning is, of course, the design of the article which is to be added to the line. From the planning standpoint, the design problem is actually a three-sided one: the new product must be studied from three separate approaches, functional, market, and production design. *Functional design* emphasizes the article's performance in use. Thus, if Kennedy & Company is considering adding a jig-saw to the line of tools it manufactures, its designers would be interested, from a functional standpoint, in the saw's ability to cut from all angles, the strength of the blade and its resistance to breaking, its ability to stay sharp, and the like. Consideration of its *market design* refers to those features of its construction that will attract and incite consumer demand. Thus, the saw might have an attractively colored plastic handle, or it might be made in a modern "streamlined" shape, neither of which add to the effectiveness of the saw as a tool, but do add to its ability to interest prospective owners. These two approaches to design would be of interest to all those involved in developing the new saw, but most of all perhaps to Mr. Grebs, the sales manager, who will be charged with selling this addition to the line. The third approach, that of *production design,* is, as its name implies, of most concern to Mr. Hughes, the factory manager, for it involves the question of designing the saw so that manufacturing costs can be kept at a minimum.

Steps in Product Design. Once the design of the new article has been temporarily decided on from the functional and market standpoint, the production engineers, or experts, study it from the purely manufacturing standpoint. The first step would be the *manufacturing requirements preview.* This would involve an over-all study of the new saw from the standpoint of its production requirements. Preliminary decisions would have to be reached as to the steps in operation needed for its fabrication; how much of its production would be done by Kennedy's factory and how much obtained from outside parts-producing sources; what machines, materials, and labor would be needed for the operation; and how its assembly would be accomplished. Next, a *preliminary cost estimate* would be made to determine roughly how much it would cost per unit to make it in the Kennedy plant, and, therefore, whether it would

pay them to go ahead with the production of the saw, in view of the price at which it would be sold. If the operations required are feasible and the cost seems satisfactory, the decision would then be made by Kennedy, Grebs, and Hughes for the latter to go ahead with it.

The next step in the development of the product, now that the decision has been made that the saw is definitely to be manufactured, is the preparation of *final drawings*. This requires the drafting of detailed blueprints of the saw, each of its parts, and the assembly of the completed tool. This is followed by preparation of *specifications*, which show precisely the amount, quality, size, and tolerance of each of the materials and parts that will go into the construction of the saw.

PLANNING THE MANUFACTURING PROCESS

Now the final, detailed plans of the steps in the production of the saw are set up. Decisions are made on precisely the operations to be undertaken in the plant. Its route through the factory, from raw materials to finished product, is traced, indicating any changes required in the plant layout, the machines, tools, and dies that will be utilized. Consideration is given and decisions made as to the labor problems involved in the construction of the new saw. Computations and standardized detailed specifications are made regarding the number and placement of workers needed in fabricating the product; whether they must be skilled or unskilled; the time required; motions to be made; and output expected, of or by each of these employees. Testing and inspection procedures are specified to make certain that the saws turned out will meet the standards of quality required for the tool. In addition, safety rules to prevent employee injuries are defined.

Provision of the Necessary Elements. The final step in planning for production of the new product is the logistical one of making sure that all the needed materials, equipment, and labor will be available when production begins. The wheels are set in motion for the procurement of any new machines, tools, or dies required in producing the new saw. Whatever additional employees are needed are hired and trained for their jobs. The sources of raw materials to be used in the manufacture of the saw are investigated and orders placed for the first shipments. All these elements have to be so scheduled and arranged that they are ready on the day actual production of the saw is due to begin.

SUMMARY

The modern manufacturing process, a very complex operation, involves problems of over-all planning, of the control or execution of the actual

production operations, and of procuring the needed materials, men, and machines at the proper time. Production planning concerns itself with questions of what the factory aims to do, and how it is expected to reach those goals. Under modern mass production, the planning mainly involves problems of specialization, standardization, diversification, expansion, contraction, and integration. The design and development of a new product is also one of the major types of over-all plans that must be formulated in the successful operation of a factory.

► FOR REVIEW AND DISCUSSION

1. What changes have taken place in the past fifty years in the manufacture of goods?
2. Explain the relationship of the production department to the following departments of a manufacturing enterprise: (*a*) finance; (*b*) personnel; (*c*) purchasing; (*d*) sales
3. What functions are usually performed by a factory engineering department?
4. What are the essential factors to be considered in production planning?
5. How can a factory be geared to specialization and at the same time produce the needed sizes, shapes, and weights of the product being manufactured?
6. How does standardization affect the efficiency of production?
7. How does diversification help make a manufacturing operation more profitable?
8. How can production be expanded without increase in plant capacity or equipment?
9. What are some of the problems connected with the contraction of operations?
10. Describe the factors that influence product design.
11. Identify the steps that should be taken in the design of a new product.
12. In what way are each of the elements of production planning related to one another? How are they related to the successful operation of a factory?

► CASE-PROBLEM QUESTIONS

1. What factors should Fred and his associates consider before deciding to go into a new line of business?
2. Is it wise for them to consider operating a manufacturing enterprise along with their retail business?

3. What new management problem may develop for them if they go into the production end of business?
4. How can they find a market for the manufactured product?
5. Where can they get information about available markets?
6. Where can they get information about pitfalls that should be avoided in setting up their plant?
7. What planning can they do to help make the operation efficient?

► APPLIED BUSINESS PROJECTS

1. The Davids Merchandise Company sells over $300,000 worth of clothing a year. They make a final net profit of 4 per cent on sales and 10 per cent on capital. They have a proposition to take over, for obligations of $25,000, a clothing manufacturer whose assets are $26,000. The manufacturer has been losing money for several years. One director says that they can make the plant pay because it will have a direct outlet through their merchandise store and that they can reduce the costs of manufacturing and selling. A second director says that they will only put the distributing business into a loss position by taking over the firm.

a. List the conditions under which the first director would be right.

b. List the conditions under which the second director would be right.

2. John Napier has developed a new idea for a ladies' handbag. He wishes to exploit his idea.

a. Napier decides to manufacture the handbag himself. List at least ten decisions Napier must make in planning for the manufacture of his handbags.

b. Napier finds that it would be unwise for him to manufacture the handbag himself. He has become acquainted with a manufacturer of women's gloves and now plans to form a manufacturing company with his acquaintance to produce the new handbag as well as women's gloves. List all the decisions (at least eight) that Napier and his associates must make in manufacturing the handbag.

c. The glove manufacturer with whom Napier had planned to associate himself has withdrawn from the project. Upon further investigation Napier finds a manufacturer of brief cases who is interested in manufacturing handbags for Napier. What problems will Mr. Napier and his manufacturer have to solve? List at least five of these problems. Explain each of the problems faced by Mr. Napier and the handbag manufacturer.

► COMMUNITY PROJECT

Select a manufacturing business in your community. (If a city, select representative manufacturing firms.) Obtain its organization chart and study the relationship of its plan of organization to the products which it makes, the plant utilization, and general factory planning. If possible, the manager of a factory should be invited to discuss such problems with the class. If this cannot be done, the class should select a panel of their own members to discuss the features of the plan of organization and methods for their improvement.



16

Factors of Production

CASE PROBLEM

Kennedy & Company, Inc., has decided to accept Mr. Hughes's proposal and to expand into the manufacture of hand tools. At a meeting of the board of directors, Fred Kennedy, the president of the firm, insists that they must not go into production haphazardly, making whatever moves are easiest for them. He insists that the location of their store is not necessarily the best for their factory. He believes care must be taken, in choosing the type of building and in designing the layout of the factory, to obtain the most efficient and economical results. They ask Mr. Hughes to make a thorough study of the various logistical problems to be solved before they commit the firm to any actual production facilities.

- What factors should be considered in selecting the location of their plant?
- Should the production facilities be centralized in one place, or decentralized in several areas?
- Should their factory buildings be single-story or multistory structures?
- How should the actual layout of the factory be designed?

The over-all strategic plans of production have been made by Kennedy & Company. They have decided, at least initially, that they will expand into the production field and will manufacture a complete line of hand tools. They have estimated the total amount to be produced annually and seasonally and the number of types, models, and sizes of tools they will make. They have decided how much of each tool they will make themselves and what parts they will purchase from subcontractors

and parts producers. They have also given thought to the volume and types of materials, machinery, and labor they will need. Their attention must now be given to the problems of logistics—supplying the proper factory building and equipment, the power to drive the machines, and the materials and men the plant will use. These problems involve the factors of production. A primary consideration in this regard is that of the location of their factory or factories.

PLANT LOCATION

A manufacturer may have a good product, and he may do an excellent job in both its design and fabrication; but if he cannot beat or at least meet the competition in his field, he is doomed to ultimate failure. Too many producers have concentrated solely on the questions of design and manufacturing techniques and have ignored another factor that can contribute considerably toward improving their competitive position —that of selecting the best location for the plant. A properly placed factory can often make all the difference in lowering operating expenses and prices and obtaining a higher quality product, thereby giving the producer the competitive advantage he seeks. Rather than taking the first site that is offered to him, the manufacturer should give careful thought and consideration to the location of his factory as one of the major steps in initiating his production. The first question, at least for the large manufacturer, is that of how centralized his production should be.

CENTRALIZATION OR DECENTRALIZATION

Centralization of plant—that is, the assembly of all production facilities in one concentrated location—has many advantages and for many years was the goal of most companies engaged in manufacturing. These may be summarized as:

1. Ease in administration
2. Economies of large-scale operations
3. Less duplication
4. Intracompany transportation costs reduced
5. A pool of skilled labor can be built up

In recent years, however, there has been a definite trend away from the centralization of manufacturing plants. This reversal in plant-location thinking has favored decentralization by either of two methods. Under *horizontal decentralization,* a firm has many plants, each factory manufacturing a complete product or line of products. Thus Kennedy & Company might have a factory for the manufacture of hammers and

chisels in one location; for the production of saws at another site; and still a third factory located somewhere else for the manufacture of files, pliers, and planes. Under *vertical decentralization,* also known as the "hen and chicks" method, various plants (the chicks) in scattered locations make parts and ship them to the main plant (the hen) for assembly. Under this method, Kennedy's might have a plant in one area for the production of wooden handles for the tools; another plant for making the steel forgings; another for fabricating the screws, nails, and bolts that hold the tools together; and an assembly plant for receiving all these parts and putting them together into the finished tool.

The advantages of decentralization of plants include:

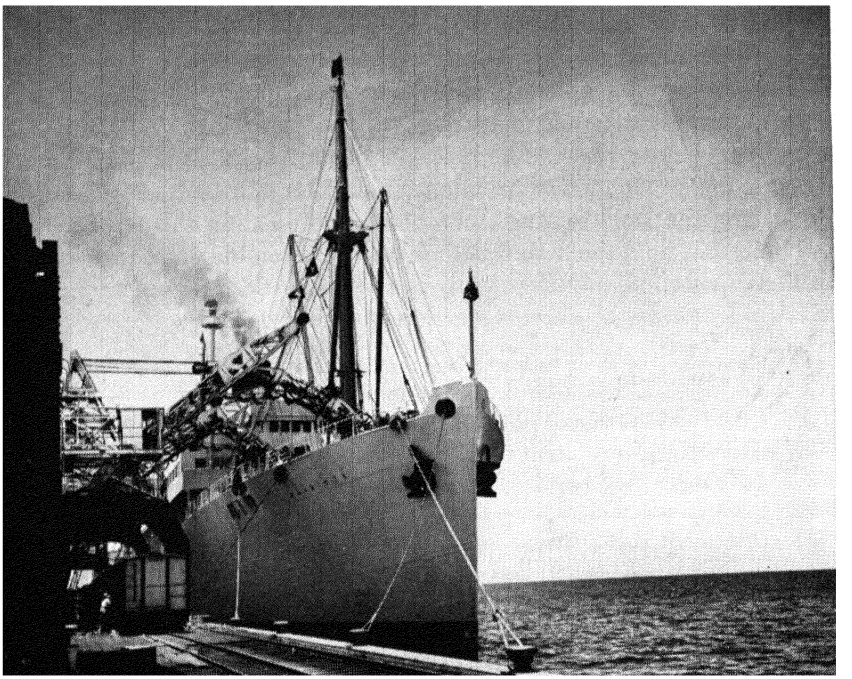
1. Plants can be near raw materials, markets, or power sources as needed.
2. Operation of the entire organization is less unwieldy.
3. Labor and personnel problems may be fewer.
4. Over-all transportation costs may be less.
5. Advantage may be taken of local conditions.
6. Expansion is easier.
7. Disaster strikes a less serious blow.

CITY OR SUBURBAN LOCATION

Another general problem in plant location that must be settled before a site is chosen is whether to have the factory in a city or in a suburban area. Many years ago, practically all manufacturing plants were located in or near the heart of a city. This was done because of the greater convenience in obtaining workers and in their transportation to and from their homes, and because only in the city facilities, such as power, freight transportation, police and fire protection were obtainable. The modern trend, however, has been away from cities and toward suburban, or even rural, sites. This is largely because today there is scarcely a suburban, or even a country, area that does not have the same facilities available as does the city. Since most workers today have cars, transportation to and from their homes is no problem. Many employees prefer suburban living to that of the city for their families. In addition, the assessed valuation of the plant, for tax purposes, is considerably lower in a surburb, so that the cost of real-estate taxation is greatly reduced. There is generally more room for future expansion in a country area than in the city, and more parking space is available for the large number of employees who drive to work.

PROXIMITY TO COMPETITORS

A minor question that must be given consideration before the specific problems of choosing a site are brought up is that of whether to locate



Courtesy United Fruit Company

Loading Up. From rail to ship and ship to rail, goods must be transported by the most economical and convenient methods possible. Inland waterways play an important role in American shipping.

the plant in an area where others in the same industry are concentrated, or whether to build the factory in a location away from all such competitors. Companies engaged in the same industry used to locate their plants near one another because of the advantages of familiarity toward the industry that would develop among all those in the area. Thus not only labor, but also raw-material suppliers, bankers, and transportation workers would become skilled in supplying the services the firm needed, thereby lessening many problems. But since such concentration develops excessive competition for the labor, raw materials, etc., in one area, it can become scarce and costly. More serious is the possibility that labor trouble in one company can become industrywide and affect all plants.

FACTORS OF PLANT LOCATION

Having decided whether to locate in an urban or suburban locality and whether nearness to others in their industry is important, the directors

of Kennedy & Company are now ready to choose the location for their plant. There are many factors that should be considered in making such a choice, the relative importance of each depending on the industry or the articles to be manufactured. For some industries, one factor may far outweigh all the others and must be given the most consideration; whereas in other industries, that same factor may be unimportant.

Two factors in plant location that often have considerable influence in the choice of the site should, from the standpoint of scientific selection, not be considered at all. These are the choice of a location on the basis that it is the area in which the business has always been located and on the basis that it is the area in which the executives of the firm prefer to live or work. Many businesses are located in certain localities for just those two reasons. They ignore, however, all considerations of efficiency and economy in operation; and if successful, it is because the lucky choice was a coincidence. Plant location should be chosen on a much more scientific basis, with consideration given to such factors as:

1. Proximity to raw materials
2. Proximity to markets
3. Adequacy of transportation facilities
4. Adequacy of power, water, and fuel
5. Labor supply and labor-management relations
6. Climatic conditions
7. Living standards and conditions
8. The type of community

Transportation Costs. A most important element in the location of a factory is that of placing it where transportation costs will be low. This requires consideration of many matters and a balancing of several opposing possibilities. In the first place, the plant must be placed where transportation facilities are satisfactory, with adequate railroad, waterway, highway, and trucking services available. The nearness of the site to the source of the major raw materials, to the major marketing or distribution centers for the finished product, or perhaps to the source of its principal fuel must be balanced against one another. Transportation costs of raw materials, fuel, and finished product must be compared, and the factory located where the total of these costs would be at a minimum.

Adequacy of Power and Labor Supply. The plant must be located where sufficient power, or fuel, is available to run its machines and where the local population is large enough and of a type to provide a satisfactory supply of workers for the factory. It is important that management consider the history of local labor disturbances, if any,



Courtesy Cities Service Company

The Working Force. Labor supply is an important factor influencing the choice of a location.

to obtain some indication of the future labor-management relations of the company. A few years ago, for instance, many companies began locating their new plants in the southeastern part of the United States in order to get away from the restrictions of the highly unionized northern states, only to run into labor difficulties over racial problems. The question of the climatic conditions might also be important in certain industries, affecting either the physical conditions under which the product can be produced, the efficiency and attitude of the workers, or the availability of labor in certain seasons of the year.

The Community. Finally, in the choice of a plant site, a careful study must be made of the community in which the factory is to be situated. Living standards and conditions in the area may affect the morale of the workers and the wages that must be paid. The educational facilities in the locality will usually be indicative of the type of employees that will be

available to the plant. In addition, there is the question of whether the factory will be welcomed in the community. Some neighborhoods are anxious to obtain new industries and will make considerable concessions in the form of tax exemptions and even free land in order to get them. Others discourage the building of factories and make every effort, in the form of zoning restrictions, high taxes, assessments, and the like, to keep them out of the area.

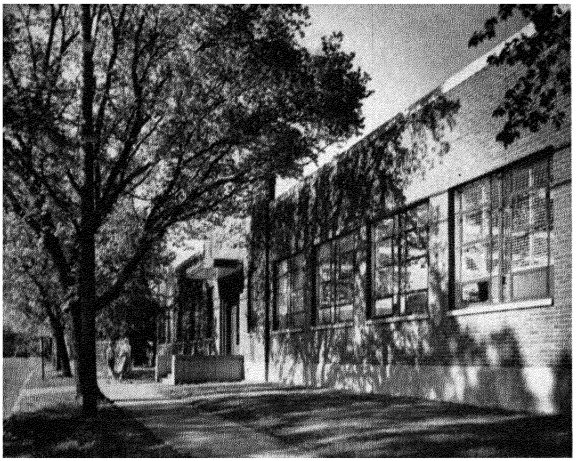
CHOOSING THE SPECIFIC SITE

Having decided on the general locality in which to place the company's plant, the next problem is to choose the exact site upon which the factory will be built. Here many more specific factors must be considered, such as the topography, acreage, and convenience of the site. Questions to be answered would include:

1. Is the topography good for building?
   - *a.* Quality of the subsoil
   - *b.* Elevation and drainage
   - *c.* Need for grading or landscaping
   - *d.* Nearness to roads and highways
   - *e.* Flood hazards
2. Is the acreage adequate?
   - *a.* Sufficient light and air for the plant
   - *b.* Room for expansion
   - *c.* Adequate parking space
   - *d.* Restrictive zoning ordinances
   - *e.* Limitations on rights of way
3. Is the site convenient?
   - *a.* Local transportation for employees
   - *b.* Possibilities for railroad siding or dock construction
   - *c.* Power lines, gas lines, water mains, and sewage
   - *d.* Facilities for waste disposal
   - *e.* Fire and police protection
   - *f.* Low insurance rates

BUILDING DESIGN

In addition to choosing the site, the design of the factory building must also be decided. Primarily this is a question of whether a single-story building or one of many stories would be more suitable. The *multistory building* has the tremendous advantage of making more efficient use of the land, where space is a limitation. Thus a factory within city limits is almost always several stories in height. The multistory building allows for compact factory layout because of the vertical arrangement permissible, making use of gravity flow of materials. Thus it is



The Efficient Factory. This single-story, modern factory fits well into the general surroundings. What are the advantages of this type of building?

Courtesy Ingersoll-Rand Company

possible to begin the fabrication of the product at the top of the building; and as the article grows larger and bulkier, it slides down chutes to succeeding operations on the lower floors. Multistory factories are cheaper to heat; and because they are generally made of solid materials, they are more fire resistant. Furthermore, since there are fewer outside walls and less roofing in a tall building, construction costs per square foot of floor space may be less.

The single-story building is more useful where plenty of land is available and space is not at a premium. It permits greater flexibility in plant layout and greater ease of expansion through extensions to the building. Since no space is needed for stairways or elevators, the single-story building makes more use of available floor area and is important in factory operations where floor-bearing capacity and lack of vibration are important. While the upper floors of a tall building have good light and are relatively free from dirt and street noises, the single-story building, particularly one with a saw-tooth roof, affords good light and ventilation throughout the factory. Construction savings can be made because the single-story building requires only a limited foundation.

The trend in the design of plant buildings has been toward greater use of single-story factories, with wide, high interiors, free of columns. Many factories are built with metal or brick walls that are easily removed, so that an extension of the plant, or a change in its layout are easily effected. Automatic sprinkler systems are almost universal in factories today, and noise control and air conditioning are used more and more frequently. Many factories are designed, built, and laid out in such a way that they can quickly be altered from the manufacture of civilian

products in peacetime to the production of war material. Thus Kennedy's tool plant might be designed with the possibility of conversion to the manufacture of small arms in time of war.

PLANT LAYOUT

PRODUCTION PROCESS

Closely related to building design is the layout of the equipment in the plant. This is greatly influenced by the processes of production that will be carried out in the factory. An *extractive* process is one of separation, such as obtaining magnesium from sea water or extracting metal from the ore that has been dug out of the ground. A *conditioning* process involves a change in the form or physical properties of the thing being made. This is illustrated by rubber vulcanizing, leather tanning, glass making, and metal working. If Kennedy's fabricates their own metal tool parts, they would be engaged in conditioning.

An *analytic* process resolves a raw material into its constitutent parts. Examples are the meat-packing plant, which transforms a steer into beef, tennis-racquet gut, hide, bone for buttons, gelatin, etc.; and the petroleum refining plant, which cracks oil into gasoline, naphtha, kerosene, paraffin, etc. Like the branches of a tree, the layout for such a factory would branch out from the central source of the raw material.

A *synthetic* process involves the assembly of the component parts of a product. Just as the automobile is put together on the assembly line, so Kennedy's tools would be similarly assembled. Such a plant would have a layout resembling many streams merging to form a river as the parts come together to be combined into the finished product.

Types of Production. Layout is also affected by the type of production —whether it is to be flow work or done in job lots. *Flow work* refers to the continuous production of one or a few standard products. Thus if Kennedy's plant is set up so that it is continuously producing the same size and style of pliers all the time, it would be engaged in flow-type production. If on the other hand, it turns out a lot of 10,000 pliers of a certain size and style, then produces a 20,000-lot of hammers of a particular size and style, and then a 15,000-lot of chisels of a certain model, it is engaged in *job-lot* operations.

Advantages of Line Layout. A plant has a *straight-line layout* when the article moves along a line of operations with each operation performed in sequence as it continues on its way from raw material to finished product. Automatic routine is thus built right into the plant, with the greatest possible use of specialized machinery and movable belts. Backtracking of materials is eliminated, the pace of the operator

is set by the movement of the material along the line, and production control is greatly simplified. The line layout permits *automation,* the use of machines that control their own operations and flow of work with little or no human assistance. Some factories have so many specialized machines as to be almost entirely automatic, requiring only a few technicians to keep the machinery in running order. The line layout and the automated factory are only feasible when there is flow work; that is, the continuous production of the same article on a mass-produced basis.

Advantages of Functional Layout. When job-lot manufacturing is to be done, and the factory is not involved in the continuous manufacture of the same product, a *functional layout* for the plant is usually the best. Under this method, each operation on all types of products is performed in a separate department. Thus the factory might have a forge department for the fabrication of all metal parts for any type of tool; a welding department; and a grinding department for all work of that type. Such a layout allows for maximum flexibility—the plant can manufacture any type of tool with little difficulty. The machines are general purpose and therefore less expensive, and they can be used for any tool the plant makes. This means that the machinery and its operatives are kept busy a high percentage of the time, and it is easy to shift work when one machine is overloaded.

POWER

Another area in which a considerable number of decisions must be made before a manufacturing plant can be built is that of the power that will be used to run the machinery in the factory. The engineers and management of a large company must first decide whether it will be more economical for them to generate their own power, by running their own power plant, or to buy the electricity from the local utility. This is a highly technical question, involving considerable engineering knowledge in order to determine which alternative promises the most efficient and economic results. Some companies produce some of their power and buy the balance from the electric company, in order to have both sources available, should one or the other fail.

In the case of Kennedy & Company, their factory would probably be too small, at least at first, to permit them to make their own power. It might pay them, however, to have a stand-by gasoline generator to be used in emergencies when the power company's facilities have failed.

SUMMARY

Once the over-all plans for production have been made, the logistics of the factory must be considered. It is important that the plant be located in an area that will permit the most efficient and economical operation. A site must be chosen that will be adequate and convenient. The decision must be made as to whether the building will be single-story or multistory, and the equipment must be laid out in such a manner as to be most effective for the type of process the factory is to carry out. The question of how the manufacturing machinery is to be powered must be carefully considered. (Problems of procurement of personnel and of raw materials and supplies are also matters of factory logistics, but they are discussed in other chapters of this book.)

► FOR REVIEW AND DISCUSSION

1. Why is plant location important?
2. What are the advantages of plant centralization?
3. Why has there been a trend away from plant centralization in recent years?
4. Compare the advantages of city versus rural location for plant site.
5. Is it advisable to locate a plant near competition? Explain.
6. What are the factors to be considered in plant location?
7. What elements of transportation costs should be considered in plant location?
8. What community characteristics are favorable to plant location in an area?
9. What factors should be considered when choosing the exact plant site?
10. Compare multistory factory buildings with single-story units.
11. How does the production process influence plant layout?
12. What types of goods are produced by each of the following processes: (*a*) extractive; (*b*) conditioning; (*c*) synthetic?
13. What is the difference between flow-work and job-lot production?
14. What productive conditions are favorable to automatic operations (automation)?
15. Describe the distinguishing features of line layout.
16. What are some of the important decisions that must be reached regarding power supply for the factory?

► CASE-PROBLEM QUESTIONS

1. Why might Fred have decided that it would not be best to locate the factory with the retail store?
2. How can Kennedy and Hughes select the proper type of building for the factory?
3. Where can Mr. Hughes get information pertaining to the factors in plant location that would enable him to make a wise choice?
4. What principles should be considered by Mr. Hughes in deciding whether the factory should be centralized in one building or decentralized in several buildings or communities?
5. How can Mr. Hughes decide whether the company should own or rent the factory building?
6. Who can help them design an effective factory layout?
7. How will the type of tools made influence the type of building that Mr. Hughes should select?

► APPLIED BUSINESS PROJECTS

1. Towne can buy an excellent factory that just meets his needs. It is on the fringe of the area in which he sells goods. He is unable to buy an adequate plant in the center of his area of distribution. Should he:

a. Buy the factory?
b. Build a plant in the proper location?
c. Decide to buy his goods from some other firm?
d. Expand his sales so that the factory he can buy will be more nearly in the center of the trade territory he serves?

Which procedure should Towne follow? Give five factors he must consider in carrying out his decision. (For example, if Towne decides to buy from an outside manufacturer, one factor he must consider is uncertainty of supply when he wants goods.)

2. McLellon and Associates operate a plant that requires a flow of production from one work station to another in twelve steps. They now use gravity flow. The factory is located in a narrow six-story building. The work is divided into two cycles. At the sixth step the work in process is moved to the top floor by an endless belt. The plant is to be torn down so as to make way for a new superhighway, and McLellon and Associates must select a new location and decide whether to continue the same plan for production. An industrial planning expert advises them to build a one-story plant and use a horizontal movement of work.

List five factors which might encourage McLellon to take this advice. (For example, by moving into the suburbs where the price of land is lower, a one-story building could be built more cheaply.)

► COMMUNITY PROJECT

From the local chamber of commerce, industrial committee, or a businessman who is well acquainted with the local situation, find out about the following:

a. Two or three of the most modern factories
b. Two or three of the most efficient factories
c. Two or three of the oldest factories still in use
d. Two or three factories that have gone out of business in the past few years
e. Report on:
   (1) The extent to which these factories meet the standards of good management suggested in this chapter
   (2) What caused the factories that went out of business to quit operation

(You may have to go considerable distances in some rural areas, or you may have to substitute farms or ranches for factories. In many ways a factory and a farm have much in common.)



17

Production Control

CASE PROBLEM

The hand-tool factory, which Kennedy & Company has purchased and redesigned, is nearing completion. At a meeting of the board of directors, Mr. Grebs, the executive in charge of sales, states that competition in that line is such that selling prices must be kept low. If the company is to make any profit, its production costs must be kept at a minimum. To keep manufacturing costs at a low figure will require great efficiency and little waste. The directors agree on the need for effective controls on their productive processes. President Kennedy asks Mr. Hughes, the supervisor of production, what controls he intends to introduce in the company's factory to assure a high level of efficiency, and which subordinates of Mr. Hughes will be responsible for maintaining efficient productivity.

- What supervisory officials are responsible for the maintenance of smooth factory operations?
- What steps can be taken to control production, so that the factory will constantly operate in an efficient way?
- How can the quality of production be most effectively maintained and waste minimized?

Once the over-all strategic production planning has been done and the questions of manufacturing logistics (procurement of a properly designed plant in a satisfactory location) have been settled, the problems of the tactics of production must be faced. These involve the difficulties of the day-to-day operation of the factory; the assignment of work to men and machines; the operation and maintenance of equipment; and meeting the demand for the manufactured goods with articles that

meet specified quality standards produced at an acceptable cost. These are the basic problems of production control.

THE FOREMAN

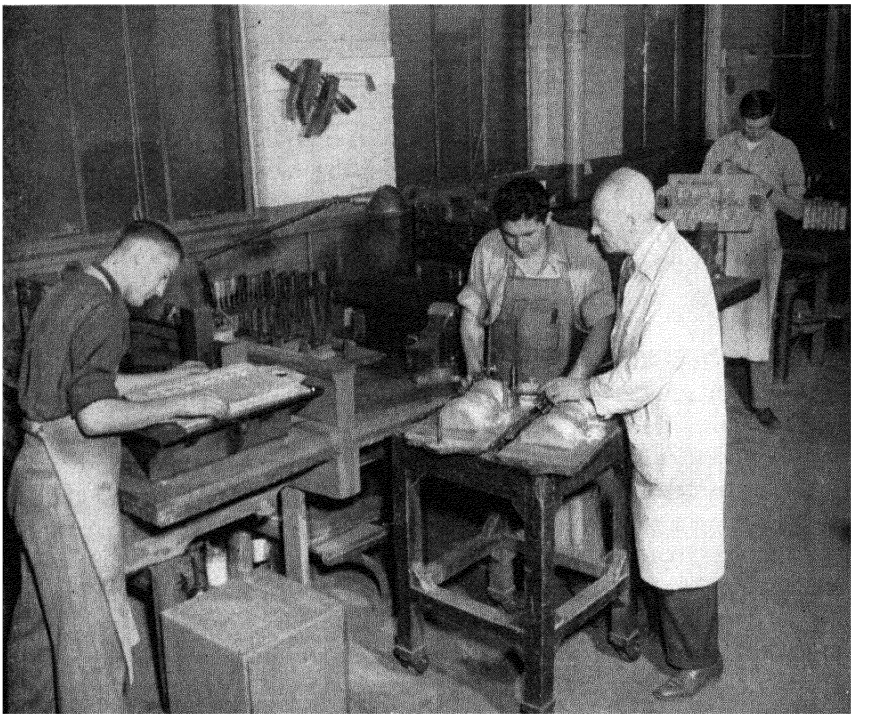
His Importance. Although there are supervisors above him in the chain of factory command—for example, the factory superintendent or works manager—the key man in the actual production of goods in a factory is the *foreman.* He is the man in charge of the shop, department, section, or subdivision in the factory, who has the immediate supervision of the employees on the "firing line"—the machine, work bench or assembly line.

Like the "top-kick" in the army or the chief petty officer in the navy, the foreman stands between management and workers and represents an important point of contact between the two. Management decisions are implemented and interpreted to the employees by the foreman. Worker satisfactions and complaints, in turn, are called to the attention of management by the foreman. He is not an officer of the company, nor is he a representative of labor, but he stands as the important intermediary and buffer between them, the agent that blends these occasionally opposing elements into a smoothly operating compound that results in efficient production. He must understand management's plans and orders and see that the workers carry them out. Conversely, he must see the viewpoint of his men and fairly present this to management for consideration.

The Foreman's Duties. Whereas the officers of the company—Mr. Hughes, for instance, in Kennedy & Company—view the over-all picture and make the basic plans and factorywide policies and decisions, it is the foremen of the various shops who execute those plans, policies, and decisions. Mr. Hughes is the administrator who unites the entire factory into an effective working whole. He does not necessarily get to know the idiosyncracies of each individual worker, nor is he expected to know how to perform the jobs in the factory as well as or better than the workers assigned to them. The foreman, on the other hand, does not need the over-all view of the entire factory as a producing unit that Mr. Hughes requires. But the foreman is expected to know his individual workmen thoroughly, to understand their strong points and limitations, and to know how to perform their specific tasks as well as, or better than, they can.

THE CONTROL OF PRODUCTION

The foremen are thus the key figures about which the operations of a factory revolve. But efficient manufacturing, especially in the large plant, requires some kind of over-all plan or scheme for the orderly



Courtesy ***Brown and Sharpe Manufacturing Company***

Quality Control. Quality in manufacturing is not an accident. It must be carefully controlled at every step in the production process. This is one of the foreman's biggest responsibilities.

flow of the production in the plant with which the foremen of the various shops must conform. This regulation of the movement of factory production from raw materials to finished product is what is known as *production control.*

The Kennedy planning has indicated which models the factory will produce in the next six months and, generally, the quantity of each type. The physical plant has been procured and is ready for operation. Still decisions must be made as to precisely which tools will be made today; what route they will follow through the plant; which machines will be used and which men will work on them. The work must be scheduled in such a way that when the hammer heads arrive at the point of assembly, the matching hammer handles and wedge pins—both of which required different lengths of time to produce—will also be on the assembly line, ready to be put together.

Production control thus involves some planning, but it is day-to-day

Advantages of Production Control

1. More effective use of manpower and equipment
2. Lost time of workers cut to a minimum
3. Overtime cut considerably
4. More efficient purchasing of materials results in smaller raw-materials inventory
5. Good for morale of workers
6. Definite delivery dates can be maintained

and hour-by-hour planning and direction of operations at the actual point of work. It involves the decisions that must be made and the last-minute revisions of plans that must be effected, as the work proceeds through the production processes, with occasional machine breakdowns, important employees absent, and other emergencies that cause adjustments in what had been the expected order of operations.

Major Steps in Control. There are generally four major steps in the control of production in a factory—routing, scheduling, dispatching, and expediting. *Routing* determines the sequence of operations or the flow of production through the factory. *Scheduling* establishes the timetable of the proposed operations. *Dispatching* is the issuance of the orders which actually move the work through the factory. *Expediting* is the checking or follow-up of the operations as they are carried on, in an effort to eliminate difficulties and remove bottlenecks which might slow up future production.

Routing. The first step in production control, that of routing, is a study of what is to be produced and of what is available for its production, a determination of the machines and personnel to be used in the production of the article, and the path and sequence of operations in its movement through the factory. Production control, in all of its four steps, may be compared to the steps in the operation of a railroad. Let us take, for instance, the main line of the Pennsylvania Railroad between New York and Philadelphia. Routing would involve a study to determine the number of passengers embarking and disembarking at the various stations between the two terminals and of the hours when they do. A survey would also be made of the total number of engines, passenger cars, engineers, and other trainmen available to that particular run of the railroad. Routing would then determine the number of trains that could be run daily, the frequency and number of stops that should be made at the various stations along the line.

In the Kennedy factory, routing would involve a careful study of the articles that over-all planning has decided should be produced during

the next few months. The tools to be made would be analyzed to determine which parts should be manufactured and which should be bought from outsiders. Of the parts to be made by Kennedy's, further study would be made to determine precisely what materials would be needed in their manufacture and the operations to be made on the materials in order to make the parts and finally to assemble them into the finished article. This would involve determination of the most economic size of the lot, the quantities of each item to be run through the machines at one time, and the number of machines and men that would be required to perform the needed operations.

From this study, route, or operations, charts would be made up showing the flow of the work as it will proceed through the plant. This will be affected by the layout of the plant, whether there are general-purpose or specialized machines to do the work, the type of labor available, and other physical factors. Finally, forms and written procedures to carry out the routing as decided will be designed and set up. Thus the route of the flow of the manufacture of the articles through the plant will be figured out and preparation made for such flow to be a smooth one.

Scheduling. The next step in the control of production is to devise the actual timetable of the work as it will be done in the plant. In our New York–Philadelphia railroad example, the number of trains and stops required would now be molded into a timetable with the actual running time of each train specifically scheduled. In the Kennedy factory, it would be the listing of the precise lot, by model, size, and quantity of each tool, and the time at which each lot will be placed in production. This master schedule for the plant might even be broken down into a schedule for each shop and possibly for each machine or operator.

Dispatching. The issuance of the orders that start the various lots of work and keep them moving through the factory, in accordance with the schedule, is the function of dispatching. Suppose, for instance, our railroad schedule called for train No. 631 to leave New York City at 11 A.M., stopping at Newark at 11:15, Trenton at 12:45, and arriving at Philadelphia at 1:25 P.M. Dispatching would then involve the choice of engine and cars that would make up train No. 631 on a particular day, as well as the engineer who would run it. It would also involve the tower operator who assigns it a track in the station at New York, the dispatcher who gives the train the "high-ball" and sends it on its way, the tower operators who switch the train on the various tracks as it moves along its scheduled run, and the conductor who signals the engineer to proceed out of each station.

Dispatching in the Kennedy factory would involve the actual requisi-

tioning of materials, tools, and supplies to the point of use; the assignment of work to operators and specific pieces of equipment; the authority to move the work from one operation to the next; and control of the progress of the material through the plant, including the making of necessary adjustments in the schedule or route as emergencies occur or unusual conditions arise.

Expediting. The final step in production control is the checking or follow-up stage. This includes reporting production operations as they take place and investigating variances from the operation schedules, in an effort to assure a close connection between planned and actual production. The expediter is ever on the alert for bottlenecks caused by breakdowns of equipment, lack of proper tools or material, labor difficulties or absences, lags in speed on some operations as compared with others, excessive production of defective parts, and other causes of disruption in the planned schedule of factory activities.

Specialized Control. In the small factory, the steps in production control are all carried out by the plant manager, in consultation with his foremen. In the large plant, however, an important problem arises as to whether to maintain the system of decentralized control by the foremen or to have a centralized group of specialists take over the entire control function, thus leaving the foremen free for more effective supervision of their immediate shops. Thus, in Kennedy's, for example, instead of having the routing and scheduling done by Mr. Hughes in consultation with his foremen, and the dispatching and expediting done by these same shop foremen, under centralized control, Mr. Hughes would hire a small staff of specialists whose sole job would be the control of production, the routing, scheduling, dispatching and expediting of the work as it moves through the factory.

STANDARDIZATION OF OPERATIONS

Another factor which contributes greatly to the efficient operation of a factory is that of standardization of operations. Standards of operation are usually set up as the result of a scientific *time-and-motion study,* which involves a careful analysis of each movement of the worker in doing his job and recording the precise time required in performing each detail of the entire operation. An effort is then made to eliminate useless motions and to rearrange the order of movements into the most efficient sequence, with the final result of performing the whole operation with the least possible expenditure of effort and in the shortest possible time, yet observing all precautions for protecting the safety and health of the worker.

In the large plant, time-and-motion studies are conducted by industrial

engineers who use slow-motion moving-picture cameras to record the operations, with a large clock with a sweep-second hand divided into hundredths of a second placed behind the worker. In a factory like Kennedy's, the hiring of engineers to make such careful and precise studies might be much too expensive. Analysis of each job or operation should, however, be made by the foremen and the workers themselves in an effort to eliminate unnecessary movements and to rearrange the sequence of movements so that the operation can be performed in the least time and with a minimum of effort.

QUALITY CONTROL

Still another area which can contribute considerably to the efficiency of a factory and aid in reducing production costs is that of quality control. This includes techniques and systems for the achievement of the required quality in the articles produced and for the elimination of substandard goods.

Quality in production is a relative term, the meaning of which differs according to the type of articles turned out by the particular factory. In the first place, it depends on the *measurable characteristics* of the product. Thus the handles used in the Kennedy hammers might be unsatisfactory if they did not meet exact measurements with a tolerance of one thirty-second of an inch, or if their weight was off standard by a certain percentage, or if the surfaces were not planed to a certain smoothness. Other bases for rejection of the handles on grounds of quality might include the grain of the wood and its lack of knots, or the viscosity or translucency of the varnish used on them. Each of these requirements might become the basis for measuring quality, the standards for such measurement being set in accordance with other factors of quality determination.

The ultimate use that will be made of the product is an important determinant as to how precise and fine the quality standards must be. Thus a one-pound hammer that is to be sold as part of a tool kit for "do-it-yourself" enthusiasts might vary in weight by as much as an ounce without necessarily requiring its rejection because of the deficient quality. On the other hand, a one-pound hammer that is to be part of the trigger assembly for a 40-millimeter machine gun might have to be rejected if it varies even one-fiftieth of an ounce, because it would throw such a delicate mechanism off balance.

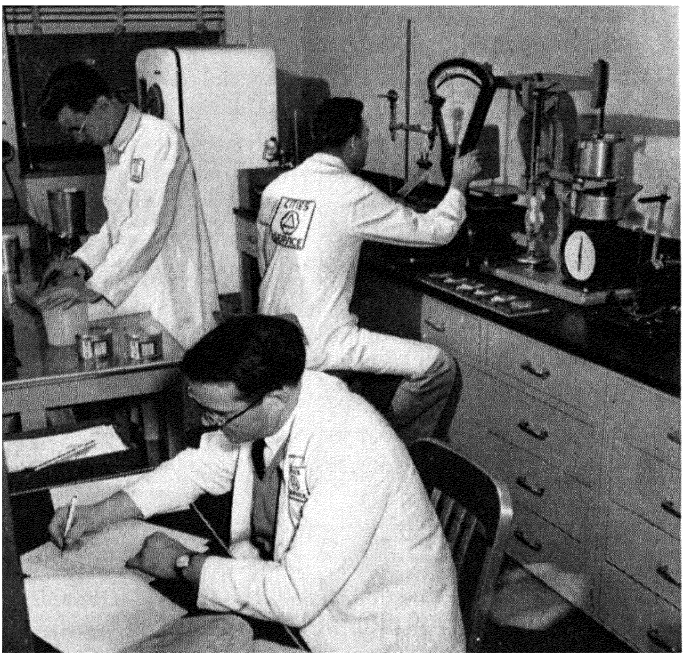
Finally, the economics of the manufacturing process must also be considered in the determination of quality standards. The manufacturing costs and selling price of the article are consequential factors in deciding how much precision will be required in its production. Obtain-

ing high quality is difficult in quantity production, so that the higher the quality, the higher will be the costs. Kennedy & Company cannot afford to set as high standards for the steel hammer-heads in their hammers retailing for 35 cents as they can for hammers that will be sold for $1.50. Yet, since quality is relative, they can insist that their 35-cent hammer be of good quality for that price hammer, just as they can set standards for the $1.50 hammer that will be consistent with that price article. The question resolves itself into a judgment of just how much quality they can economically demand in each hammer, balancing the cost of quality against the selling price of the product.

Inspection. Inspection is one of the most important management techniques for the achievement of quality control. This is especially true if, instead of waiting for the final examination of the completed item, the inspection takes place while the article is in process of manufacturing, since deficiencies can then be caught at once and corrected or the partially completed tool rejected, rather than the costly process of completing the article and then being forced to reject it as substandard.

Inspection itself takes three forms. First, there is the examination of all materials, parts, and supplies that go into the article to eliminate anything that will cause trouble in subsequent operations or in the use of the article. Thus the wood coming into the Kennedy factory must be inspected, so that especially knotty pieces can be rejected before they go through the processes of being made into handles. Secondly, there should be inspection of the work as it progresses through the factory, so that deficient pieces may be removed before more work is done on them and costs pile up on wasted goods. Finally, of course, there must be a finished-goods inspection to make sure that no defective or substandard goods are shipped out of the factory.

Analysis. Effective quality control includes the analysis of inspection results to locate points where too many rejections are occurring and to determine the reasons for the substandard work. And, finally, control provides for salvaging of the rejected goods. Rejections take three basic forms, depending on how serious the deficiency is. The articles are considered *defective goods* if they can be reworked and brought up to standard, so that they can be sold as regular items. *Spoiled goods* cannot have their defects corrected, but their deficiency is comparatively minor; and they can be sold as "seconds" at a reduced price. Goods so badly defective as to be completely useless can only be sold as *scrap,* or junk, along with other waste. A proper system of quality control would provide for the disposition of these three types of rejects, so that additional costs and financial loss caused by substandard items would be reduced as much as possible.



Courtesy Cities Service Company

Testing and Research. These men are testing samples of wax in order to find new ways in which it can be used in other products and also to check its quality.

WASTE CONTROL

The control of waste, and its disposition as a source of income, is an element of cost cutting in factory production that has been receiving increasing emphasis in recent years. Not so long ago, scrap and leftovers from the manufacturing processes were discarded, burned, tossed into streams, or even carted away at the expense of the company. Today attention is given to the recovery of all waste and scrap for further use, or sale.

Thus, for instance, instead of discarding the leftover pieces of wood from which the hammer handles are cut, Kennedy's can sell this scrap to a paper company for use as wood pulp. It might even be economical for Kennedy's to gather the sawdust from the sawing and planing machines, since sawdust, too, can be sold. Much of the scrap from the metal fabricating operations can be melted down and reclaimed. Large factories even collect the smoke and steam, which formerly went up their chimneys and into the air, using the latter for heating the building and reclaiming from the former small amounts of usable coal.

When management makes conscious efforts to obtain some return from what was formerly considered useless waste, suitable only for filling dumps or polluting streams and rivers, considerable savings in production costs of the factory can be attained. Many industries have been able to develop their waste products into highly successful by-products, which contribute a good proportion of their total income. The paper industry, for instance, used to dump the sulfide liquid, left over from making "slick" paper, into rivers and streams, which then became polluted to such a degree that fish were killed and swimming was made impossible. Today this same liquid is being used to serve mankind in many ways. Instead of discarding it, uses have been found for it in textile dyes, road-surfacing materials, food flavors, fuel, and other valuable products. The paper industry has developed former waste into a money-making sideline.

SUMMARY

To survive under today's competitive conditions, a manufacturing company must plan, organize, and operate its factory with careful attention to efficient management and reduction of production costs. The key man in the successful operation of the plant is the foreman, who stands as the intermediary between management and labor, looking out for the interests of both. An important element in the cutting of manufacturing costs is that of production control, the systematizing of factory operations. This consists of proper routing of manufacturing, careful scheduling of operations, effective dispatching and expediting of the work as it proceeds through the plant. Another element in the cutting of factory costs is the control of quality. This is most effectively done by preventive measures; but inspection of raw materials, of work in process, and of finished goods is a necessary aspect of such control. Finally, the proper disposition of defective goods and the reclamation of factory waste can both be highly consequential factors in the reduction of production costs.

► FOR REVIEW AND DISCUSSION

1. What is the foreman's responsibility in factory operation?
2. What does production control involve?
3. Identify the four major steps in the control of production.
4. How does factory routing influence the production of goods?

5. In what way is scheduling important in the manufacturing process?
6. Describe the function of dispatching in manufacturing.
7. What is the nature of the work of the factory expediter?
8. What are the advantages of production control?
9. What are the advantages and disadvantages of centralized control?
10. How does time-and-motion study help improve the efficiency of production?
11. What is quality control? Is it always of the same importance?
12. What factors help determine the extent of quality control?
13. How is inspection related to quality control?
14. Describe how waste control operates and how such control increases the efficiency of production.

► CASE-PROBLEM QUESTIONS

1. How can Kennedy & Company keep their production costs down in order to meet competitive prices?
2. Is it absolutely necessary that Kennedy & Company sell their hammers as cheaply as the lowest price at which competitors offer a similar product?
3. How can Mr. Hughes learn the most efficient manner of factory operation?
4. How can he be sure that the quality of goods produced is kept high?
5. How can Mr. Hughes be sure that he is selecting the right person as foreman?
6. How can waste of materials and of time be controlled?

► APPLIED BUSINESS PROJECTS

1. *a.* Give three reasons why a skilled factory worker should check his own production for quality of work performed. (*Example:* Has time left over after doing his quota of work to inspect his production.)

b. Give three reasons why a factory worker should not check the production of his own work. (*Example:* Does not have the skill to check his own production.)

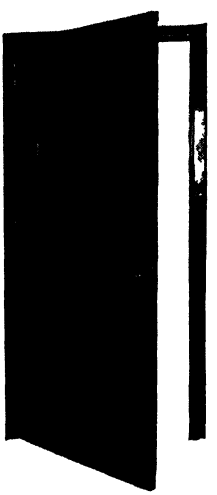
2. Define, in one sentence, the meaning of each of the following terms as they relate to production control:

(*a*) Quality; (*b*) routing; (*c*) scheduling; (*d*) dispatching; (*e*) expediting; (*f*) specialized control; (*g*) time-and-motion study; (*h*) preventive quality control; (*i*) inspection.

Section Five

Personnel and Human Relations







18

Selecting and Hiring Employees

CASE PROBLEM

Kennedy & Company, Inc., has grown from a small partnership to a sizable corporation employing several hundred workers. For several years Fred Kennedy, the president, selected all employees, trained them himself, and watched out for their personal interests. Later, each of the various department heads hired his own workers. As the firm has grown larger, however, it has become increasingly difficult for Kennedy and his executives to maintain personal contacts with the workers they have hired.

At a meeting of the board of directors, Fred suggests that a personnel department be set up, under a personnel manager, to handle this function. He believes it should be the responsibility of this department to find employees for the company when they are needed, hire them, train them for their jobs, look after their health, safety, and morale, and handle any labor-management difficulties that may arise.

Some members of the board, all executives of the company, express concern over the effectiveness of such procedures. They feel that employees hired for their departments by a personnel manager may not always be satisfactory. Kennedy then introduces Harry Rogers, an experienced personnel man whom Fred has been considering for the job. He is asked to explain to the board how a personnel department would operate in their company.

- What are the purposes and activities of a personnel department?
- How is the department organized in a large firm?
- How does the personnel department learn what type of workers are needed by the company?
- How does it then obtain satisfactory employees?
- What training does the personnel department give employees?

THE PERSONNEL DEPARTMENT

When a business grows in size, one of the great disadvantages is the loss of the personal contact between employer and employee. When Kennedy & Company was small, for instance, Fred Kennedy himself hired all employees. He and his associates saw them daily and had the opportunity to pass the time of day with them—perhaps even to talk with them at some length about the problems of the business or about difficulties in their own personal lives. This usually led to a fairly free, friendly informality among the workers and the partners, so that if the employee had a problem or grievance—or even some difficulties at home—he was not afraid to discuss it with the "bosses." This generally led to a sense of loyalty toward the owners and good feeling among the employees.

When a business grows—and the number of employees multiplies—the pressure of many problems on the time and energy of top management makes it impossible for them to cope personally with such matters as the hiring of a new machinist's helper for the assembly shop, deciding whether the porters in the salesrooms are entitled to a raise, or whether a new drinking fountain is needed in the forge shop. If Henry Conte, a welder, is disturbed because working conditions are not to his liking, or if he has a problem at home that is worrying him, he probably will not go to Fred or one of the former partners to discuss the situation. The bosses have now become much too busy and unapproachable for Henry; the personal contact between employer and employee has been lost.

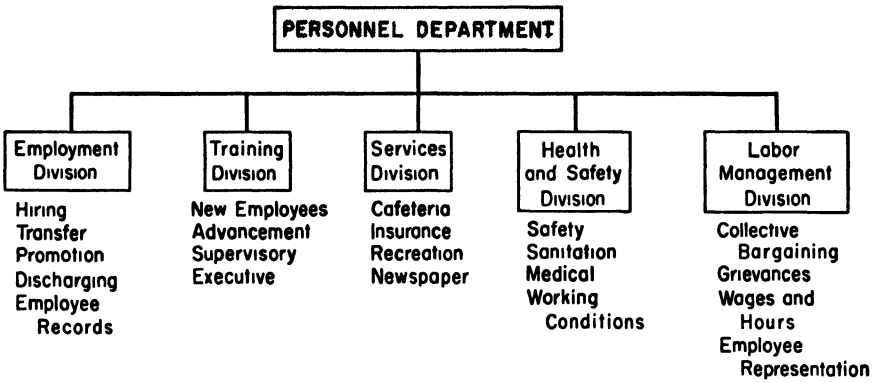
In an effort to delegate this important function of maintaining close relations with the employees and their problems, most medium- or large-size firms assign this task to a personnel director or manager and, depending on the size of the organization, his personnel department.

ORGANIZATION AND SCOPE

The personnel department has the responsibility for maintaining the efficiency and morale of the workers. It is a staff function, for it aids

all the other departments of the organization. This department hires employees; trains them for their jobs; sets up the wage scales of the workers; handles their grievances; looks after their health and safety on the job; provides cafeterias, athletic programs, and the like to maintain morale; and investigates the reasons why workers leave or are discharged.

An organization chart for a typical personnel department in a medium- to large-size business might look as follows:



Organization of a Personnel Department

The Personnel Staff. Although personnel functions may be handled in smaller firms by the owner, or by a plant or office manager, personnel administration is such an important activity that in businesses large enough to afford it, the activities are usually handled by this separate department of specialists in the field of human relations in business. They must be experts in handling people, with a knowledge of psychology, sociology, and industrial relations. It takes considerable skill to obtain the right kind of working force, to keep the workers satisfied and on the job, and to avoid labor unrest and strife. Furthermore, the personnel department tries to keep not only the employees satisfied, but also strives to have foremen and supervisors understand the labor force, so that the plant functions more smoothly and with as little friction as possible.

THE CENTRALIZED EMPLOYMENT OFFICE

The oldest function of the personnel department, and the one most universally carried out by business firms, is that of maintaining a centralized employment office. This office obtains and screens all prospective personnel and hires most of the employees, although the foreman or supervisor often retains the right to make a final selection among the several applicants recommended by the employment office.

Centralization of the hiring function has several advantages over the old system of allowing each supervisor to do his own hiring. Not only does centralized employment relieve the supervisors of the time they would have to devote to interviewing, selecting, and training new employees; but, because of his knowledge and experience, the employment manager is better skilled in choosing qualified applicants and fitting them into the right jobs. Furthermore, centralization not only provides all job seekers with one place to apply, but it centralizes knowledge of all positions available, so that if the applicant is not suitable for a position in one department, he may well be placed in another type of job in a different department. Centralization of employment applications and records also aids in filling positions and in making transfers or promotions.

HIRING THE WORKER

Job Analysis and Specifications. The first step in the employment process is to know exactly what jobs or positions the company has available to its workers. To find out exactly the requirements of each job or position, a job analysis is made. A *job analysis* is a detailed study that includes:

1. What the workers do in a particular job
2. Duties and responsibilities of the worker
3. Location of work and equipment used
4. Working conditions and hazards of the job
5. Training and education needed
6. Pay, hours of work, and promotional opportunities

After the job analysis is made, a brief summary of the position is made which quickly gives the employment manager or interviewer an understanding of the job when he has a prospective worker before him. This summary is called a *job specification.* Often the worker is given a copy of this job specification, so that he may know what he is expected to do, and the nature of the working conditions.

SOURCES OF LABOR

Another step in the employment process is seeking out and developing the various sources of supply of prospective workers. The sources that are most effective for a given firm will depend on the location of the business, the type of industry, and the kind of job being filled.

An important source of workers for many jobs is the *employment agency.* The Federal and the state governments maintain agencies in connection with their unemployment insurance programs; these are valu-

SOURCES OF WORKERS

Government employment agencies
Commercial employment agencies
Direct applications
Transfer and promotion from within
Newspaper and magazine ads
Radio and television advertising
School and college placement offices
Recommendations from employees

able sources of employees. Private and institutional employment agencies, especially those specializing in workers for particular industries, are also important. Newspaper advertisements—and in rare cases where large numbers of employees are needed, radio and television advertising —are used by many firms to great advantage. Schools, colleges, and unions are valuable sources of prospective employees with special qualifications.

Many companies can satisfy their personnel needs by relying on those who come to them directly in search of positions. They keep an active file of applications and send for the applicant as opportunity arises. Another good source is that of friends recommended by present employees. This is especially true if the company has a good reputation for fair dealings with its own labor force.

Finally, an excellent place to find workers for all but the beginning or lowest positions is among the present employees of the company. Such a policy of advancement within the firm's own personnel, instead of taking on an outsider, is bound to enhance the efficiency and morale of the workers, because they feel that ambition and good work are recognized and will pay off in a better position. There are those, however, who feel that this policy of filling all advanced positions from present personnel is too smug and limiting. They argue that, if no workers who received their training or experience in other firms are hired, not only are the doors closed to good men and women but the firm will seldom be exposed to the stimulating new ideas these people might bring with them. There is, of course, much to be said for both sides, the best solution perhaps being to give the firm's own qualified personnel the first chance at the job, but to consider outsiders as well.

THE EMPLOYMENT PROCESS

When a vacancy occurs in a department—let us say, the sales department—the department head, Mr. Grebs, sends an *employment requisi-*

tion to the personnel department, requesting it to recommend someone for the position. The employment division of the personnel department then consults its files for three purposes, the first of which is to ascertain, from the appropriate job specification, the qualifications for the job. Next, the division looks through its records of present personnel to see if there is an employee in a lesser position with the company who has the required qualifications to fill the position. If there is, the employment manager interviews this employee and if, after consultation with the man who will be his immediate superior in the sales department, he is satisfied that the man can fill the job, sends him to Mr. Grebs for final approval, or possibly further interviewing by him.

If there is no employee of the firm who can fill the job, the employment division then consults its file of employment applications to see whether there have been applicants who have applied for similar work in the past. If so, these applicants are sent for by letter and asked to come in for an interview; however, if there is still no eligible person available, the employment office then seeks someone by means of an agency, advertisement, or some other method.

The Application. The first step taken by an applicant is to fill out a rather detailed application blank in his own handwriting. This application gives the company considerable information about the prospective employee and serves as a record card to be retained in the employment-division files. The manner in which the application blank is filled out by the applicant gives valuable clues as to his neatness, thoroughness, and ability to express himself and to follow instructions.

The Interview. After the applicant has completed the application blank, he meets a trained interviewer in the employment office. This interviewer tries to learn all he can about the applicant and whether he is the type the company is seeking—his interests, hobbies, ability to get along with others, and so on.

Tests. Many firms today also give a series (or battery) of tests to determine whether a prospective employee has the qualifications and aptitudes required for the various jobs in the company. These tests usually include carefully constructed and administered intelligence, aptitude, psychological, and achievement tests. As their names imply, these tests help to show whether the applicant has sufficient intelligence for the job he seeks; whether he has a natural ability to handle, or learn to handle, work of the type he is to do; whether he has already developed some skills in the work he is to do; and whether he is emotionally suited for such work.

Many firms also require a new applicant to take a physical examination (given by the company doctor) to determine whether he has



Credit Koppers Company, Inc.

Off to a Good Start. The new employee receives his initial indoctrination to the company from the personnel department. It is important to everyone that he gets started off on the right foot.

any physical handicaps that would prevent him from doing his job properly. Reports of physical examinations also provide valuable records for later reference should the employee use a physical handicap as a claim for compensation or damages against the company.

References. Most firms still require applicants to list references—people who know them and can vouch for their character and ability—but less reliance is placed on these recommendations than in previous years. Some employment managers still consider it worthwhile to contact the persons an applicant has listed as references. This is usually done by a letter in which a short form is included for the reference to complete and return.

Because most people are inclined to say only good things about others, favorable letters of reference are not necessarily proof of an employment record. Rarely are they used as complete evidence of an applicant's desirability as a worker. By inquiring of former employers, schools attended, and other objective sources, the employer is likely to

obtain a more reliable picture of the applicant's character, ability, and performance.

If the applicant is judged a good employment risk—on the basis of the application blank, the interview, tests, and previous employment record —he is sent to the head of the department in which the vacancy exists for further interviewing and approval, or rejection. In rare cases, as for routine work, the worker may be hired directly by the employment office. In most instances, however, the executive under whose direction the employee will work has the final "say" as to whether he will be employed.

MAINTAINING CONTACT WITH THE EMPLOYEE

Induction Procedure. Once he has been hired, every effort is made by the employment division to get the new employee off to a good start and to make him feel at home with the other employees. He is furnished with information about the company, its policies, and procedures, some firms issuing printed booklets for the guidance of the new worker. In this booklet are included such information as hours of work; information on locker rooms, rest rooms, cafeterias, coffee breaks; and other company regulations. Usually, the new employee is taken to his department by a member of the personnel staff and introduced to his department head, supervisor, or foreman. This official then arranges for introductions to those with whom he will work, and for his general orientation to his new position and location.

Follow-up. After he has been hired, the new worker does not lose contact with the employment division. A few weeks after he has commenced work he is "followed up"—either through his immediate supervisor, or directly by the employment division—to find out whether he is a satisfactory employee and whether he is happy on the job. This follow-up is made not only to check on the validity of their selection of the worker, but, should he not be suitable for his present job, they may be able to transfer him to another position for which he is better suited.

The personnel department retains the new employee's record and makes later follow-ups in order to arrange for possible transfer to another job or his promotion to a better paid position if he merits it.

Discharges. The employment division of the personnel department generally has the final contact with an employee who leaves the firm. A worker—and the investment the business has put in him in education and training—can be kept if he is transferred to another supervisor, instead of being discharged because of a dispute with his superior. Such

and success in his job and to possible advancement. Most employers long ago began to realize that money spent wisely in employee training paid off in big dividends by raising the quality of work, by reducing labor turnover and waste, and by developing individuals qualified to hold more important positions with the company.

On-the-Job Training. Employee training at one time was limited to teaching a new man how to do his job. Sometimes this took the form of *apprentice training,* in which the new employee worked for a period of time as a helper to an experienced worker, receiving considerably less pay during this period of apprenticeship. He received no formal instruction but picked up what he needed to know from observation and a certain amount of practical experience. The period of apprenticeship might last from two weeks to as long as two years, depending on the degree of skill needed in the job. When the apprentice had learned enough to justify his promotion to a *journeyman,* a full-fledged worker and craftsman, he was permitted to work at the tasks by himself and was given the wages that went with a job of that type. Apprenticeship as a means of training new employees has died out in most industries, because in times of full employment it is difficult to find people who are willing to work at reduced wages during their learning period.

Another way of teaching a new worker what he is to do is known as *on-the-job training.* This consists of putting the man to work immediately at the machine he is to operate, and giving him the starting salary for that job. The foreman or an experienced worker is assigned to show him how to do his tasks, and after a time he is left on his own. Improperly organized on-the-job training can be wasteful because it takes up the time of the instructor with only one trainee. It is a poor form of instruction because the method used is usually only telling or showing what should be done, and does not actually teach. Furthermore, any bad habits or improper methods of the instructor are automatically passed on to the new employee.

In a large plant where many new workers must be taught their jobs at one time, the method used is known as *vestibule training.* Here a separate training division is set up which gives all new employees vocational-type instruction, in class and at machines, until the new worker is sufficiently skilled to go into the factory and begin work on the actual equipment. For purposes of employee morale, it is customary to give the new employee his full pay from the day he is hired, even during this period of instruction.

The value to the company and to the workers of training as a continuous process, available to all personnel right up to top management, and not merely to new workers, has led to the expansion of the

and success in his job and to possible advancement. Most employers long ago began to realize that money spent wisely in employee training paid off in big dividends by raising the quality of work, by reducing labor turnover and waste, and by developing individuals qualified to hold more important positions with the company.

On-the-Job Training. Employee training at one time was limited to teaching a new man how to do his job. Sometimes this took the form of *apprentice training,* in which the new employee worked for a period of time as a helper to an experienced worker, receiving considerably less pay during this period of apprenticeship. He received no formal instruction but picked up what he needed to know from observation and a certain amount of practical experience. The period of apprenticeship might last from two weeks to as long as two years, depending on the degree of skill needed in the job. When the apprentice had learned enough to justify his promotion to a *journeyman,* a full-fledged worker and craftsman, he was permitted to work at the tasks by himself and was given the wages that went with a job of that type. Apprenticeship as a means of training new employees has died out in most industries, because in times of full employment it is difficult to find people who are willing to work at reduced wages during their learning period.

Another way of teaching a new worker what he is to do is known as *on-the-job training.* This consists of putting the man to work immediately at the machine he is to operate, and giving him the starting salary for that job. The foreman or an experienced worker is assigned to show him how to do his tasks, and after a time he is left on his own. Improperly organized on-the-job training can be wasteful because it takes up the time of the instructor with only one trainee. It is a poor form of instruction because the method used is usually only telling or showing what should be done, and does not actually teach. Furthermore, any bad habits or improper methods of the instructor are automatically passed on to the new employee.

In a large plant where many new workers must be taught their jobs at one time, the method used is known as *vestibule training.* Here a separate training division is set up which gives all new employees vocational-type instruction, in class and at machines, until the new worker is sufficiently skilled to go into the factory and begin work on the actual equipment. For purposes of employee morale, it is customary to give the new employee his full pay from the day he is hired, even during this period of instruction.

The value to the company and to the workers of training as a continuous process, available to all personnel right up to top management, and not merely to new workers, has led to the expansion of the

original vestibule training into a training division of the personnel department. This division holds classes for employees at all levels and for many purposes other than teaching them how to do their specific tasks. The training for the job itself may still be of the on-the-job type, but it is done by selected instructors themselves trained in the art of teaching others. The training division has for its aim the education of all company personnel, in a continuous and systematic manner, so as to improve the individual well-being of the employees and the collective welfare of the company as a whole.

Whereas employee training was originally only entrance instruction, teaching the new worker the skills needed for the specific job he was about to perform, today employee training in many companies has expanded into instruction at all levels, with education not only in skills, but also in knowledge and attitudes. Thus a well-rounded program of employee training would include courses in company orientation, operator instruction, promotional training, supervisor and executive training, and even general education courses. Many large corporations have sizable training divisions that give all the courses in company buildings. Other firms limit the courses their own staffs give to orientation and operator training, but pay some, or even all, of the expense of sending their employees to night schools and colleges to receive advanced instruction. Some firms sponsor conferences and seminars, conducted by staff members of universities, and held at the factory or office of the company.

Training at all levels, from the new employee right up to the executive, would cover general knowledge and attitudes as well as merely job skills. Thus, for instance, courses might be given that would discuss company plans and policies, safety and health facts, the place of the company and the industry in the American economic scene, and courses which might be classified in the general area of knowledge. In addition to running their own machines, skills that might be taught to employees might include getting along with others, public speaking, writing up suggestions and orders, and waste- and cost-control measures. Attitudes which could be developed might be sympathy with company problems and a desire to help, group spirit, the value of suggestions, and responsibility for waste control and cost-cutting measures.

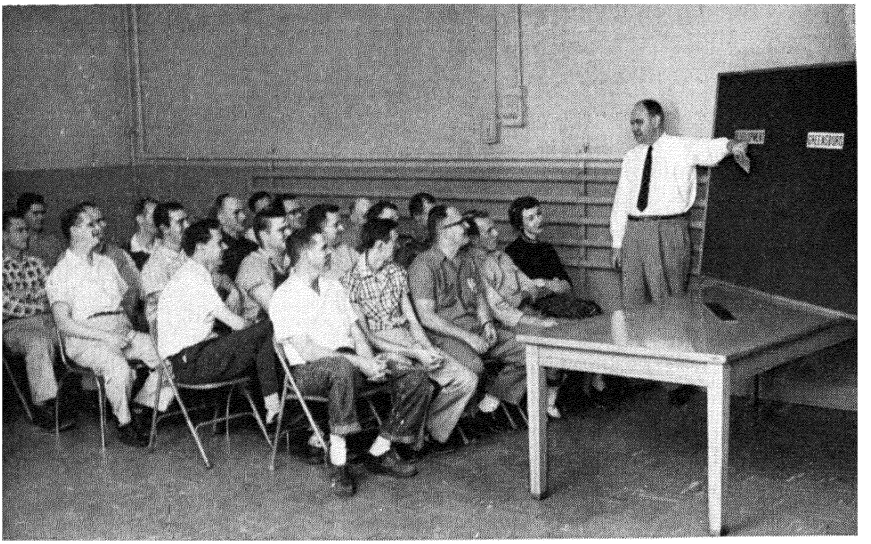
Orientation Training. At the same time that he is receiving operator training, when he first enters the company employ, a worker is given orientation training. This type of training usually includes a short history of the company, a discussion of its products and their costs, company advertising and sales promotion, and a comparison with the products of competitors. Sessions also are held to cover such topics as working

hours, absence and lateness, holidays, sickness, pay deductions, union relations, and safety and fire precautions. Vacations, group insurance, workmen's compensation, medical services, social and athletic activities might also be discussed. Finally, the company organization and lines of authority, as well as the vehicles of communication between management and employee; employee suggestions; personal counseling and advancement opportunities are covered, followed by a tour of the entire plant.

From such instruction, the employee will start off with an understanding of what the company is doing and how it goes about doing it. Fear of the unknown, so common in any new situation, is reduced; and mistakes caused by lack of knowledge of company ways can be greatly reduced. The time of the employee in asking questions and that of the foremen in teaching and explaining company rules and policies, is saved; and the worker knows what to do, or where to take his problems.

Operator Training. The instruction of new personnel (or employees promoted to a higher paying job) is done either by the class or vestibule method when there are enough new operatives to be taught at once to justify such procedure, or by on-the-job training. The instructor should be an employee who has been selected for such work on the basis of his own competence at the job, his ability to inspire confidence in others, and his understanding of the art and techniques of good teaching. The job to be taught must be carefully analyzed so that only the correct, standard methods to be used by the operative are taught to him, with a proper concern for quality, safety, and machine care emphasized from the start.

The instructor should make every effort to put the learner at ease and should impress on the worker the importance of his job in relation to the finished product. Then, step by step, following the standard method of procedure for doing the job, the instructor will tell, and show, the new employee how to do the task, stressing all key points and precautions. This step should be repeated until the employee has some grasp of the subject. Next the instructor will perform the job while the learner tells him what to do in each step. In this way the instructor discovers the points at which the worker is weak or confused and can straighten them out. The instructor then has the worker perform the job, telling the instructor exactly what he is doing at each step. Finally the worker performs the job several times in the presence of the instructor to make sure he has mastered it. The instructor should return to the new worker at increasingly longer intervals to answer any new questions that may have come up in the employee's mind, and to make



Courtesy Burlington Industries

Job Improvement and Advancement. A continuing training program for employees is a must in the modern factory or office. Do you know what types of courses are offered?

certain that the worker is still following the standard methods and procedures for the proper performance of the job.

Supervisor Training. Instruction is also given to employees who have been newly appointed as supervisors, or who are in line to become foremen, or even as refresher training for experienced foremen. This type of instruction generally uses the conference or seminar method, so that the supervisors will be more receptive to the training and have an opportunity for sharing experiences. Included in this curriculum would be discussion of their duties and responsibilities, leadership, developing morale, giving orders and directions, handling employee grievances and problems, correcting and reprimanding workers, industrial housekeeping, quality, cost and waste control, and safety and health measures.

Junior Executive Training. Many companies run programs of training for junior executives, often new employees who have recently graduated from college, in the hope that many of them will develop into future leaders of the firm. The method closely parallels the old apprentice training, for the young men and women are usually assigned to work in each of the various departments for a period of about three months, so that they obtain an idea of the many functions of the business and a fairly good grasp of the problems of each department. A close watch

is kept on how each of them does his work, and after two to three years the satisfactory young man or woman is made a junior executive in the department of his choice, or where he showed most promise. This apprentice training may perhaps be supplemented by class instruction, usually of the conference method type; many of the subjects discussed are the same as those for supervisors. The trainees might instead, or in addition, be encouraged to take advanced night courses at universities or similar institutions, either at their own or at company expense.

Executive Training. Even top management can profit from additional training. For that reason, many firms also have training programs for their executives. These generally take the form of seminars and deal with such subjects as technological problems, "human engineering," and the latest management practices and techniques. Executives are encouraged to attend conventions and conferences of business leaders and to take courses at graduate schools that will broaden their background and intensify their knowledge.

General Education. In addition to all the various specific areas of training already mentioned, many companies realize the value of general instruction and encourage their personnel to take courses of a general educational nature. Many firms invite universities to send instructors to their plants to give after-hours courses in many subjects—vocational, business, or personal in content—to aid their employees in self-improvement. Other companies pay tuition fees for their employees to take such courses at colleges, extension schools, vocational or business schools, YMCA's and the like. This type of training helps the worker to live more happily and to get along in his environment, as well as aiding him in getting ahead. Such methods of developing the morale of the workers, and their improvement as individuals and as a group, is usually well worth the expense the company may incur in aiding and encouraging such instruction.

SUMMARY

While Kennedy & Company is still too small to afford a complete employee program of training on all levels, it could certainly provide an organized and careful orientation and operator-training program. Furthermore, it could probably establish contact with a nearby school or university where many of its personnel could take worthwhile courses, paid for by the company in many cases. It might even arrange for a seminar or conference course to be held for its supervisory staff right in its own plant. Then, as the company grows and the staff becomes

larger and larger, a full program of training at the company plant might well be instituted.

When a business is too large for its top management to have personal contact with its employees, there is usually a need for a personnel department headed by a personnel manager who specializes in such work. This department hires employees, trains them, looks after their health, safety, and morale, and handles labor-management difficulties. In hiring workers, the personnel department analyzes the job to be filled and the sources of labor, and carefully screens the job applicants in order to obtain one who will do his work well and thus be satisfactory to the foreman or supervisor under whom he will operate. Once the worker is hired, the personnel department retains an interest in him to see that he stays on the job, thereby reducing the company's labor turnover. One of the department's tasks is employee training, which should be a systematic, continuous process aimed at the education of personnel at all levels. In addition to orienting and instructing the new employee, training should be given to supervisors and future supervisors, junior executives and executives. All employees should be encouraged to participate in general-education programs, since self-improvement of any type aids the firm as a whole as well as its employees individually.

► FOR REVIEW AND DISCUSSION

1. Why is personal contact with the employee difficult to maintain in a large business?
2. What are the major responsibilities of the personnel department?
3. Are there advantages in having the hiring of new employees centralized in one department? If so, what are they?
4. Describe the difference between a *job analysis* and a *job specification*.
5. What are the advantages of looking among present employees of a company for promotional possibilities?
6. Describe the process for filling a job with a new worker.
7. What is the usual procedure in inducting new employees?
8. What can a personnel worker expect to discover through follow-up procedures?
9. How can the factors in labor turnover be controlled?
10. What is the responsibility of a business firm for the training of its new employees?
11. Should employer responsibility for training be confined to entrance instruction or be on a continuing basis? Why?

12. What kind of information should be included in orientation training?
13. What is the importance of general education in the training of skilled employees?

► CASE-PROBLEM QUESTIONS

1. What factors must Kennedy consider before recommending the establishment of a personnel department?
2. How can the personnel director be of assistance in helping Kennedy & Company hire the right employees?
3. How can Harry Rogers be sure he will hire the kind of manpower needed?
4. To whom should Kennedy & Company delegate the training activities if they decide to set up a personnel department?
5. What type of internal responsibilities should Kennedy expect the personnel department to handle?
6. What kind of a man should Kennedy and his board seek for the position of personnel director?

► APPLIED BUSINESS PROJECTS

1. List at least five factors that should be considered in making a job analysis and prepare a short description of each.
2. For each of the types of personal training listed below, list on a separate sheet of paper at least *three* types of positions for which such training is suitable: (*a*) Apprentice training (for example, apprentice tool maker); (*b*) On-the-job training; (*c*) Orientation training; (*d*) Operator training; (*e*) General education.

► COMMUNITY PROJECT

Visit the nearest employment office to find out the types of labor needed in your community. Determine such characteristics as sex, age, experience, and education of the manpower needed by industry. Determine also the types of labor that are in surplus supply.

What are the reasons why certain kinds of workers are out of work and are looking for employment? What kind of industry or business does the community need in order to provide these people with work?

What kinds of labor are needed by industry? What can be done to help local industry get the type of manpower which it needs?



19

Employee Remuneration

CASE PROBLEM

Harry Rogers has only been on the job as personnel manager of Kennedy and Company a short time when he reports a serious problem to the board of directors.

The immediate issue is a complaint by the sanders in the wood-handle shop that they are doing work similar to that done by the polishers in the plant's metal-fabricating shop, yet they are receiving less pay than the latter. Mr. Rogers, however, noted a general dissatisfaction among the employees of the plant, not only with the amount of wages, but also with the differences in remuneration received by workers doing similar jobs, and even among those doing dissimilar work. He believes that wages paid to the employees have been decided on in an arbitrary, unscientific, and more or less hit-or-miss fashion. Furthermore, he feels that there is little incentive for turning out better work.

The directors recommend that Mr. Rogers make a thorough study of employee remuneration. After he has consulted with Mr. Kennedy and with union officials representing the workers, the directors authorize Mr. Rogers to make any changes in the wage set-up that he deems advisable.

- What are the basic incentives that encourage employees to do their best work?
- How should plant wage rates be set in order to reward workers in relation to prevailing wages in the area?
- How should wage scales be set to reflect job differences?
- What other employee benefits besides wages must the company take into account in remunerating employees?

► **What recent developments in the field of employee remuneration should be considered by the company and its workers in their attempts to maintain good management-employee relations?**

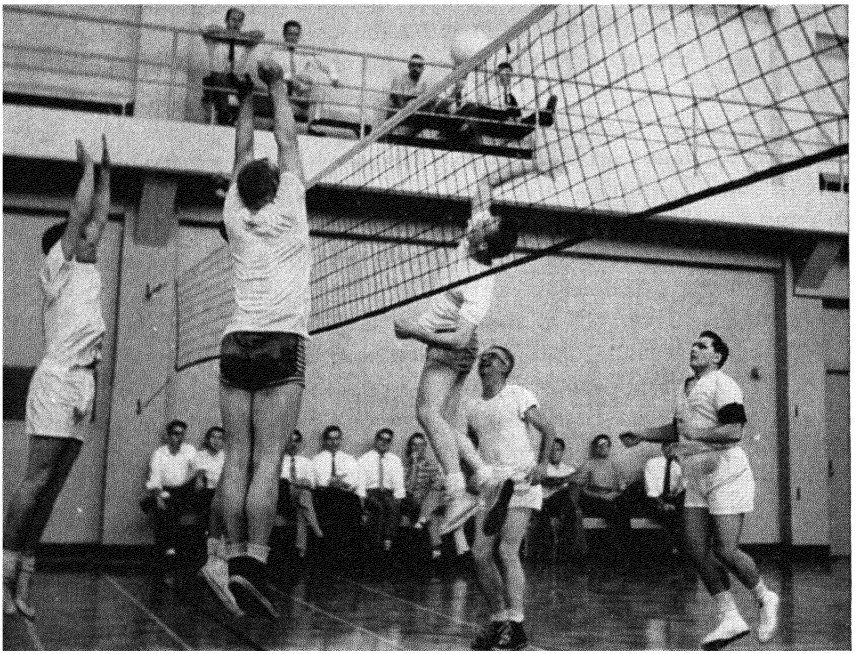
Among the many problems facing a business enterpriser today, perhaps none is more important than that of maintaining a happy and satisfied working force. For most employers it is also one of their most difficult tasks. A prime factor in the maintenance of employee morale and loyalty is that of proper reward for his efforts and a suitable incentive to encourage him to do even better work.

Not many years ago, remuneration and incentive meant only one thing to the average employer—the wages he paid the worker. While the monetary return is still a vital part of the problem, the enterpriser has come to realize that a great deal more is involved in the question than merely wages, and that for some employees their weekly pay checks are even secondary to other forms of reward. Their grievances over insufficient salary often take a back seat compared to other "gripes" that disturb them.

FORMS OF INDUSTRIAL MOTIVATION

There are four major types of incentives which motivate the employee to do his best work. First, of course, is the *primary financial incentive* of wages. It is the oldest recognized form of rewarding workers, and is still given the most publicity and attention. But many recent labor disputes in this country have involved, instead of, or at least in addition to, wages, the *secondary financial incentives,* known as *fringe benefits.* These include special privileges and special services available to employees, such as pensions, free insurance, and sick pay and vacation pay. Many of these were once thought of as merely incidental to the basic issues between management and labor, but they have now assumed increasing importance in such negotiations.

Organized Nonfinancial Incentives. A third form of worker motivation takes the shape of *organized incentives of a nonfinancial nature.* These include the affirmative steps taken by a company to give labor a voice in the operation and management of the organization. Thus, if Kennedy & Company sets up a permanent management-worker committee, to discuss and make recommendations on improving physical equipment or working conditions of the employees, or devises a system for receiving suggestions from employees and rewarding them for those accepted, it is appealing to the employee's co-operation through self-expression and a feeling of being an important part in the running of



Courtesy Synchroscope, Detroit Edison Company

Up and Over. Many firms have organized activities for their employees, such as a volley-ball club, to boost morale, build company loyalty, and simply to provide recreational fun.

the plant. Other organized morale builders include such things as athletic teams sponsored by the company, employee publications, and hobby clubs.

Nonorganized Nonfinancial Incentives. Finally, but often foremost in the mind of the worker, are the *nonorganized, nonfinancial incentives,* the attitudes and desires on which it is hard to place one's finger, but which often make the difference between a happy and a grumbling work force. These would be attitudes and actions of the executives and supervisors, and aspects of the jobs themselves, that appeal to the employee's desire for security, for advancement, and for commendation. They would include opportunities for some degree of competition among the workers and measures taken to improve working conditions.

These latter factors are given little of the publicity that wages and fringe benefits get, and strikes and labor strife are seldom attributed directly to them; but time and effort spent in appealing to these emotional motives accomplish a good deal in cutting down management-labor friction and employee dissatisfaction. The time has passed

when enterprisers think of workers as machines, with the production they turn out measurable in the amount of wages they receive, as machines receive steam or oil. Rather, they are human beings—each one a different individual, whose emotions and thinking must both be considered—who are motivated by incentives far more complicated than the mere payment of a certain number of dollars a week.

WAGE PROBLEMS

Although other factors of employee motivation should be considered, the basic core of the problem of worker incentives is still that of giving him adequate financial remuneration, principally in the form of wages. It is essential, especially in a large organization with many employees, that rates of pay should not be set up in a haphazard, unorganized fashion, with each worker being offered whatever wage the personnel manager, or any other person who does the hiring, thinks satisfactory at that moment and for that particular job. Instead, management should establish a definite, well-thought-out wage policy to cover all personnel for the guidance of its staff in all wage matters. Rather than being hit or miss, the remuneration offered an employee should be in line with an established company wage structure, set up on a logical basis after careful investigation and study. Generally, such a study, and the remuneration plan devised as a result of it, should consider three basic factors: (1) payment of a wage in accordance with prevailing rates; (2) payment of a wage in accordance with the job to be done; and (3) payment of a wage that will offer an incentive for better work.

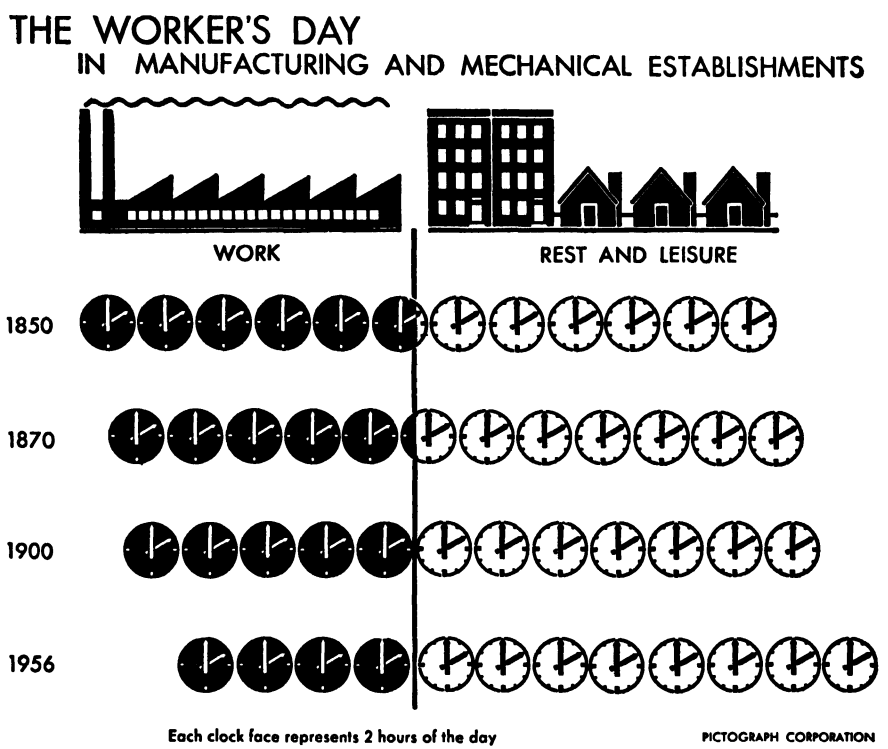
PREVAILING RATES

If a company is to compete successfully, it is important that its wage rates are in line with those prevailing in the community and in the industry in which it operates. To compete with other hardware manufacturers, Kennedy & Company must turn out hand tools at a low enough price. This means that it cannot pay its employees very much more than other factories in the same industry are paying, or its costs of production will, in comparison, be too great. On the other hand, to compete with other factories in the area in obtaining satisfactory employees, Kennedy's cannot pay its workers too little or it will be unable to get good workers. Thus it is important that its wage structure is closely aligned to the prevailing rates in its community and industry.

Factors Determining Wage Rates. The prevailing over-all wage rates are influenced by a number of factors, all of which the personnel manager should study and consider before attempting to set up a wage-rate schedule for the company. In the first place, there is, of course, the question of worker scarcity or surplus in the area—the relative

condition of employment and unemployment. In periods of full employment, with few persons unemployed, to obtain good workers a company must pay the highest wages it can afford and still keep its costs of production within the limits of competition. If, however, there is considerable unemployment in the area, with jobs hard to get even for good workers, the company is not bidding against other firms for employees; and its wage structure may be on a lower level. Since unemployment usually coincides with periods of depressed business conditions, such lower wages will be necessary to keep costs, and therefore prices, low in an attempt to encourage sales.

A second factor in the problem of relating wages to the prevailing rates is the standard of living and the cost of living generally in the area in which the plant is located. Lower wages can usually be paid, for similar work, in a community where standards and costs of living are at a lower level, than in areas where such standards and costs are high. Although it sometimes means that the general level of employee quality



Fewer Working Hours. How many working hours per day did the 1850 employee put in? the 1956 employee? Do you think the trend is toward even shorter working hours?

and intelligence will be lower in low-standard communities and higher in communities where living is better, this is not always so. Often it is merely a matter of geography—some areas being more developed and commercialized than others—so that the quality of workmanship will be every bit as good, after some training, in the undeveloped localities as in the very advanced communities.

Closely tied in with the factor of standards and costs of living is the degree of unionization or employee organization in the area in which the factory is to be located. Wage rates are usually considerably higher in communities where employees are thoroughly organized and members of unions than they are in localities that have not yet become unionized. Conversely, however, it is usually more difficult to obtain skilled workers in nonunion communities; and when a factory does locate in such an area, it is normally only a question of time before the employees become organized to bargain as a group with management for better conditions.

The question of minority groups and of the sex of the employees are other factors entering into the fixing of the over-all wage structure. Although the differential is disappearing, women have traditionally been paid less than men for similar jobs, so that if Kennedy & Company hires mostly women in its factory, it will probably have a lower payroll than if most of its workers were men. Other firms take advantage of the fact that the foreign-born, foreign-language-speaking workers, or those coming primarily from some minority race group, may be hired at cheaper rates than the so-called "100% American." Normally however, this too does not last long, for it does not take the newcomer long to assimilate himself into American ways and demand wages that will enable him to raise himself and his family to the standard of living of the community around him.

Finally, the question of setting wage rates in accordance with legal requirements must be considered. For industries engaged in interstate commerce, in which manufacturing is generally included, the Federal Fair Labor Standards Act, known as the Wages and Hours Law, sets a minimum hourly wage below which employees, with few exceptions, cannot be paid. The law also sets a maximum number of hours a week for which an employee can be paid regular time and requires that overtime rates be paid for any work over this maximum. For industries engaged in intrastate business (within the boundaries of the one state), which generally are the retail and service trades, many states have their own wage-and-hours laws. These usually follow a pattern different from the Federal law. Whereas the latter sets a nationwide floor on wages and a ceiling on hours, the state laws usually set different limits for each of the various industries in accordance with the particular locality.

JOB EVALUATION

The second of the basic problems in setting up a wage pattern or rate structure for remuneration of employees, after adjustment to the over-all rates in the area and industry, is that of aligning the wages to be paid within the plant in accordance with the job to be done. Workers are conscious, not only of dollar differences, but of their place on the prestige ladder on which their salary puts them in comparison with other workers. Not only, then, must employees be paid generally at rates that are in line with those prevailing in the community; but each one must be paid at a rate that will satisfy him in direct comparison with the jobs that others are doing, all the way up the scale from the lowest unskilled worker to the top foreman or superintendent. This requires careful analysis and evaluation of every job in the plant to determine the relative value of each position and to fit it into the rate structure, so that all jobs are paid under a uniform scheme. In the settlement of disputes over individual wages, a uniform scheme is a great aid.

A job analysis and evaluation must be designed to study carefully all the factors that enter into the value and importance of each job. A rating scheme should then be set up that will exactly compare one position with any other in the plant. An example of such a job-evaluation scale, which would require the rating of each factor up to the relative maximum weights given, and then the addition of all the various points to arrive at a total comparative score, might be as follows:

JOB-EVALUATION RATING SCALE

Job Factor	Maximum Percentage for Each Factor	
Responsibility		
For work of others	6	
For material or product	6	
For equipment or process	4	
For safety of others	4	
		20
Skill		
Education required	15	
Experience required	20	
Initiative and ingenuity desirable	15	
		50
Effort		
Degree of physical work involved	9	
Mental or visual effort involved	6	
		15
Conditions of Work		
Hazards or dangers of the job	11	
Disagreeable or dirty working conditions	4	
		15

It can readily be seen that the task of evaluating jobs, by this or any other scheme, is a difficult and controversial one. It must therefore be done with the utmost care and as objectively as possible, so that consideration is given to the job to be done and not to the individual who happens to be doing the work. In large plants which can afford such measures, job evaluation is generally done by industrial engineers in connection with time-and-motion studies to determine the most efficient way of performing the job.

WAGE AND SALARY PAYMENTS

A final basic factor in the setting up of a wage schedule for a plant is to devise a system that will give employees an incentive for doing better work. This requires a study and comparison of the various methods of paying workers to determine which best fits each occupation, grade, and type of worker. There are two fundamental methods of wage remuneration—that based on the lapse of time and that based on the completion of work units.

Lapse-of-Time Methods. Although the lapse-of-time methods are commonly known as *day rates,* employees are seldom paid by the day. Executives are normally paid on an annual basis, with salaries stated in dollars per year, although they receive paychecks of the proportionate amount of that salary either weekly, biweekly, or monthly. Junior executives and minor supervisors are generally paid on a monthly basis, with their salaries expressed as so much per month. Office workers are usually paid on the basis of weekly salary rates. Factory workers, when paid on a time basis, or day rate, are usually paid on the basis of so much per hour. Thus, while they ordinarily receive their paychecks every week, their remuneration is on an hourly basis.

Time, or day, rates have many advantages. For one thing, they are the simplest method of payment, and accounting is simplified. The employee's income does not fluctuate, so that there is a considerable measure of security which permits him to plan fairly accurately the expenses of his personal and home life. Day rates tend to preserve seniority recognition, since the employee with the longest service record usually gets the best pay for that particular position. And, since the pay is not based on the number of units of work an employee turns out, day rates tend to emphasize quality rather than quantity work. In the factory, then, such rates are best adapted to work that requires considerable precision, artistry, or pride in workmanship, and where the quantity of work turned out is a secondary factor.

Piece-Work Methods. For the type of work where the number of units, or quantity, of work turned out is the most important element, with quality (often built right into the machine) of secondary conse-

quence, a system of payment that gives an incentive to the production of more units is better suited. The most important of the various incentive systems is that of *piece work*, where the worker is paid, not for the number of hours worked, but for each piece he turns out. Normally, though not necessarily, a certain minimum pay is guaranteed the worker no matter how few pieces he produces; but he has the opportunity of increasing his remuneration by turning out more units than those called for to earn the minimum guaranteed pay.

In addition to the straight piece rate, there are many bonus incentive systems which have been devised and are used as added compensation for exceptional performance on the part of the workman. Most of these are based on a standard of performance for the job, a rate of output which the average worker should be able to meet. In addition the worker is given a bonus for greater accomplishment; rarely is a penalty imposed for not meeting the standard. Point or unit systems—such as the Bedeaux and Haynes Manit—are still used occasionally. After the operator has completed a specified number of units or points an hour, the excess units produced are paid for at a given percentage of the unit cost.

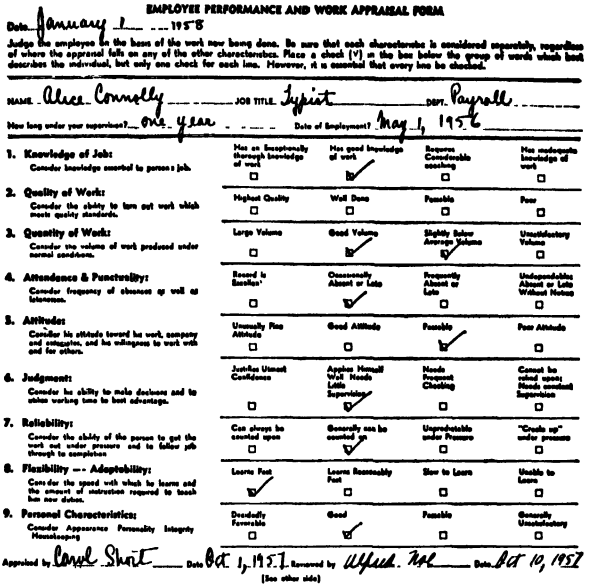
All these incentive systems are best suited to production where repetition and quantity of output are important and where the results of an employee's output are easily determinable. Their faults are that they tend to de-emphasize quality in the rush to turn out quantity and that the employee does not know in advance how much he will earn in any period. Furthermore, most systems are so complicated that the worker does not even know how to compute how much he has earned.

Merit Ratings. The employee is entitled to know from time to time how he is measuring up to the standards of performance expected of him. The supervisor responsible for giving him this information may do so by means of a *merit rating*—a form designed for the purpose. The main object of the merit rating is to help the supervisor evaluate the work of each employee; in many organizations, the formal merit rating is used as a basis for promotion to better jobs.

Formally or informally, the concept of extra pay for merit is always present whenever there is a range of salaries for a given job and when advancement is not based on seniority or time employed on the job. Labor unions are opposed to personal or informal plans as a basis for wage increases, because they believe these often result in conscious or unconscious favoritism. Unions will, however, co-operate in working out such plans if the procedure is made as objective as possible.

Much of the effectiveness of rating devices depends on the adequacy of (1) the items which are rated—that is, are they the items important

for the job; (2) the fairness of the persons doing the rating; and (3) the manner in which the ratings are used.



EMPLOYEE PERFORMANCE AND WORK APPRAISAL FORM

Date January 1 ... 195-8

Judge the employee on the basis of the work now being done. Be sure that each characteristic is considered separately, regardless of where the appraisal falls on any of the other characteristics. Place a check (✓) in the box below the group of words which best describes the individual, but only one check for each line. However, it is essential that every line be checked.

NAME Alice Connelly JOB TITLE Typist DEPT. Payroll

How long under your supervision? One year Date of Employment? May 1, 195-6

1. Knowledge of Job: Consider knowledge asserted to person's job.	Has an exceptionally thorough knowledge of work ☐	Has good knowledge of work ☑	Requires Considerable coaching ☐	Has unfavorable knowledge of work ☐
2. Quality of Work: Consider the ability to turn out work which meets quality standards.	Highest Quality ☐	Well Done ☐	Passable ☐	Poor ☐
3. Quantity of Work: Consider the volume of work produced under normal conditions.	Large Volume ☐	Good Volume ☑	Slightly Below Average Volume ☑	Unsatisfactory Volume ☐
4. Attendance & Punctuality: Consider frequency of absences or will or lateness.	Record is Excellent ☐	Occasionally Absent or Late ☑	Frequently Absent or Late ☐	Unacceptable Absent or Late Without Notice ☐
5. Attitude: Consider his attitude toward his work, company and associates, and his willingness to work with and for others.	Unusually Fine Attitude ☐	Good Attitude ☐	Passable ☑	Poor Attitude ☐
6. Judgment: Consider his ability to make decisions and to utilize working time to best advantage.	Justifies Utmost Confidence ☐	Applies Himself Well. Needs Little Supervision ☑	Needs Frequent Checking ☐	Cannot be relied upon; needs constant Supervision ☐
7. Reliability: Consider the ability of the person to get the work out under pressure and to follow job through to completion.	Can always be counted upon ☐	Generally can be counted on ☑	Unpredictable under Pressure ☐	"Cracks up" under pressure ☐
8. Flexibility — Adaptability: Consider the speed with which he learns and the amount of instruction required to teach him new duties.	Learns Fast ☑	Learns Reasonably Fast ☐	Slow to Learn ☐	Unable to Learn ☐
9. Personal Characteristics: Consider Appearance Personality Integrity Housekeeping	Decidedly Favorable ☐	Good ☑	Passable ☐	Generally Unsatisfactory ☐

Appraised by Carol Short Date Oct 1, 195-7 Reviewed by Ufford Mgr. Date Oct 10, 1957

(See other side)

Evaluating Employee Performance. Performance rating scales vary widely. This is a typical rating scale for office positions.

EMPLOYEE ATTITUDES TOWARD INCENTIVE PAYMENT

Employees tend to be suspicious of a management that uses a system of compensation wherein the employee cannot himself compute his earnings. Incentive and merit systems have also been under attack because of the way many of them have been administered. For example, it has been asserted—often in the past with considerable truth—that every time the worker develops his proficiency to the point where he earns good money, management raises the standard, so that he again has trouble earning the bonus over the regular rate. One further objection to piece-rate systems has been that, in some cases, production is slowed and therefore the employee's remuneration lowered, through breakdown in machinery or failure in the smooth flow of the process which was not the fault of the worker himself.

What, then, are the criteria of a good, workable incentive system of employee remuneration? In the first place, of course, the plan should provide an attractive incentive to encourage the worker to greater effort. Second, the system should only be used for those jobs where there is a direct relationship between the employee's efforts and the amount of work turned out. There must therefore be no outside elements that can

slow production through no fault of the worker. Third, an incentive system should be chosen that will be superimposed on a fair, guaranteed base rate to assure the worker at least the earnings he made prior to the installation of the piece or bonus system. Fourth, production standards, on which the bonus system depends, should be based on carefully detailed studies which will be certain to represent the job adequately; and no production standards should be changed while working conditions remain the same. Fifth, careful, correct records should be kept, and accurate and careful inspection of results maintained. Finally, all workers, and the union leaders who represent them, should be able to understand the system, to compute wages due under it, and should have a say in any changes made in the system.

Group Bonus Plan. Organized labor has looked with some disfavor on wage-incentive plans that recognize only increased productivity from individual personal effort, with one worker in competition with others. It prefers plans that apply to all workers and tend to strengthen a feeling of group co-operation, thus generally favoring some form of *group bonus plan.* Under such a system, all workers in the plant receive an extra bonus, usually in proportion to their regular wages, if the factory as a whole produces more than a certain quota during a particular period of time. Some group bonus plans are limited to certain groups within the plant, such as the assembly crew, which must work closely together and as a team. These group systems are most advantageously used in four different situations. The first would be where the work moves along on mechanical conveyors, so that group operation is necessary; and the workers assist one another. This system might well be used in the Kennedy assembly line. In situations where output is limited by machine speed, and the machines need constant attention by different workers, group bonuses might also be effective. Another situation where it might prove useful is in temporary work, like fruit picking, which must be done in season and where speed is important. Finally, in maintenance or cleaning work done by a group, where individual effort is not readily discernible, it might be wise to encourage the whole group to greater efforts by means of such a bonus system.

The disadvantage of such an incentive method is that the group bonus may have a tendency to encourage both the best and the poorest worker to ease up on his work and thus to "lie down" on the job. The poor worker may take it easy figuring the good workers will do it all anyway and he will get the same bonus as they. The best workers sometimes become disgruntled because they are doing most of the work and yet get only the same bonus as all the other members of the team. Thus the group bonus has possibilities for the encouragement of work by the

group, but only under excellent leadership, with high morale, so that all are encouraged to do their best to raise the bonus for everyone.

REMUNERATION OF SALES PERSONNEL

The problem of incentive pay is not limited to the factory alone. A similar question arises in the compensation of sales personnel. In some firms, salespeople are paid a straight salary; but most companies prefer to stimulate their sales force to greater selling efforts by having their pay closely tied to the sales they bring in. This is usually accomplished by paying salesmen a commission on their sales instead of, or in addition to, a straight salary. Some firms pay traveling and other expenses of their salesmen; others pay a higher salary or commission and require their sales personnel to pay their own expenses. When salesmen are paid on a commission basis—that is, a percentage of the sales they bring in, they are usually given a drawing account against these commissions. This means the salesman may draw a certain amount of money each week or month against the commissions he is earning. This in turn raises the question of what to do in case the salesman draws more than he earns in commissions. Some firms take the loss themselves, others charge this overdrawing against future commissions earned on sales in the next year.

Different Plans. Just as there are requirements for a good incentive system of payment in the factory, so there are criteria for a satisfactory compensation plan for salesmen. First, of course, the plan should be so designed that it will attract and hold people of the caliber needed to do the job properly. This refers not only to the ability of the salespeople, but also to their loyalty and sense of responsibility. It is therefore essential that the plan should give competent people at least as much as they could earn elsewhere for comparable work. But, like the factory incentive system, the plan must keep the salesmen's remuneration at a figure that will not allow selling expenses to get out of hand and force the company to charge such high prices as to be unable to meet competition.

The plan for salesmen's compensation should be set up in such a manner that it provides a stimulus and incentive for extra effort. This means, first of all, that there should be a fixed-income base to give the salesman some sense of security. Above this base there should be some financial reward for extra effort on his part, and it should be so designed that it will be an incentive to the salesman not only to sell more, but to exert his efforts in selling those items that the company wants pushed. The plan should be fair and equitable to all the salesmen and should be according to a definite schedule, so that it is not subject to the whims

or arbitrary decisions of the sales manager. Furthermore, it should not penalize salesmen for conditions that are beyond their control; each man's remuneration should be directly tied in with his efforts and results. Finally, the plan should be simple and easily understood and operate with a minimum of clerical and administrative confusion and expense.

FRINGE BENEFITS

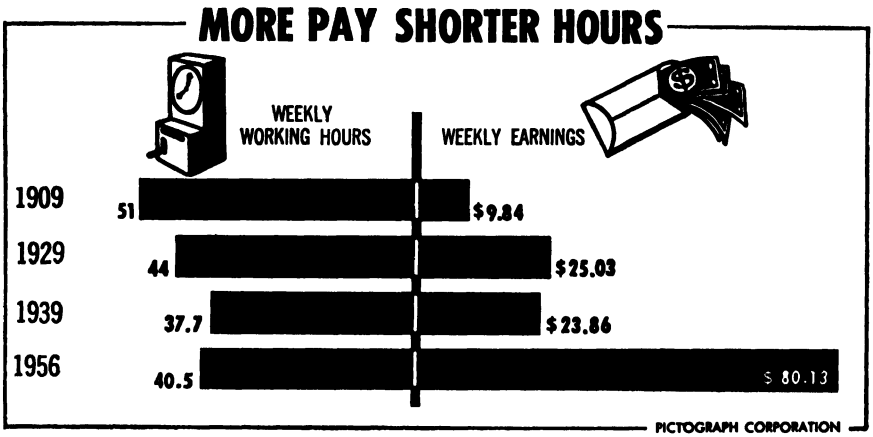
As was mentioned earlier in the chapter, the secondary financial incentives, usually called *fringe benefits*, have received increasing attention in labor-management negotiations in recent years. Long, protracted strikes have occurred because of disputes over the number of such benefits to be given to the employees. Included under the heading of fringe benefits would be the number of paid holidays granted during the year, paid vacations, the amount of sick leave and other time off, payment for the time spent getting to, and returning from, the place of work (as in getting from the mine entrance to the place where the miner actually does the digging), coffee breaks, and insurance and pension plans.

These items do not appear in the figures of the so-called direct labor costs—in other words, the weekly payrolls, the pay per hour, or the labor cost per unit—but when added together, they can amount to significant increases in the costs of running the factory and producing its goods and substantially add to the annual outlay of the company for its personnel. When the cost of these fringe benefits (called "fringe" for the very reason that they are not part of the directly assignable and recognizable costs of labor) is added to payroll taxes for old age, disability, and unemployment insurance, these indirect personnel costs can become a very large figure indeed.

A recent annual report of the Eastman Kodak Company, for instance, showed regular wages and salaries paid to employees that year of approximately $239,000,000. Fringe benefits that year were as follows:

Pay for vacations and legal holidays	$20,027,000
Sick benefits	5,227,000
Premiums for life insurance, retirement annuities, and disability benefits	19,026,000
Hospital, surgical, and major medical insurance	2,438,000
Unemployment insurance and Federal old age benefit taxes	6,097,000
Other miscellaneous employee benefits	543,000
	$53,358,000

These additional benefits therefore increased labor costs by as much as 22.3 per cent of the total regular payroll.



More Money for Less Time. Only when you study this graph can you realize the benefits the modern worker enjoys as compared with his father and grandfather.

RECENT DEVELOPMENTS IN EMPLOYEE REMUNERATION

In the past few years, many plans for special remuneration of workers have been receiving considerable prominence and are being put into effect in more and more plants. They must, therefore, be carefully considered by the personnel manager, so that their impact on the personnel costs of his plant will be understood. The company will then either be in a position to utilize one of these ideas in its own employee remuneration plans, or be ready to put up effective arguments against the adoption of such schemes should the employees' unions include them in their demands.

Rising Cost of Living. One of the principal sources of labor unrest has been the fact that wages have not kept pace with the rising costs of living. To avoid expensive and damaging strife over this issue, many contracts between management and labor unions, setting a wage scale for the plant, have included a so-called *escalator clause,* which ties in wage rates with the cost of living. Typical might be a provision that if the cost of living rises one percentage point, as shown by the monthly index of prices issued by the United States Bureau of Labor Statistics, then wages would automatically be increased 1 per cent, or perhaps a certain number of cents per hour. Some contracts call for a reduction in wages should the index fall, but unions generally oppose such a measure and have been mostly successful in keeping out of their agreements any provision for reducing wages to meet reductions in the cost-of-living index.

Guaranteed Annual Wage. Whereas it is the usual custom to keep

office and sales employees working and on the payroll during slack as well as busy seasons, it is general practice for factories to lay off employees during periods when production is slow or has been stopped entirely. This means that for certain periods of the year, many factory workers are without income unless they can find other temporary work to keep them going during the lay-off period. This has led workers to seek some form of guaranteed annual wage, so that they are assured of at least a minimum income throughout the entire year. Of increasing importance, guaranteed annual wage plans have not yet received much acceptance in industry, although a few firms have accepted such ideas and put them into effect. Generally, they take the form of retaining any overtime pay an employee earns during the busy season to finance the payment to him of a minimum wage during the time he is laid off. Other firms attempt to schedule their production in such a way—usually by building up inventory in slack periods—that it will not be necessary to shut down and lay off the workers. Usually, firms that have offered their employees the advantage of a guaranteed annual wage are those in stable industries where employees are seldom laid off anyway.

Supplemental Unemployment Benefits. In less stable industries, where plants often do shut down for periods of time and men are out of work, agitation for some form of guaranteed annual wage has resulted, in many cases, in a modified form of such plan, known as *supplemental unemployment benefits.* These schemes generally call for the company to pay a certain number of cents for each hour the employee works into a fund that will be used to give the worker some compensation, in addition to the amount he receives from the state in the form of unemployment insurance compensation, while he is out of work. Thus this system, rather than guaranteeing his wages, adds to the remuneration he receives from government unemployment-insurance funds while he is laid off. To receive such payments, the employee must be eligible for unemployment insurance; and the length of time he receives such compensation is limited to the time he would receive unemployment insurance benefits, usually a twenty-six-week maximum.

Profit-sharing Plans. A form of added remuneration that has achieved some degree of popularity is that of *profit-sharing plans,* whereby employees share in the profits made by the company. Usually these plans are limited to the key executives of the company, because there is a fairly direct connection between their efforts and the success of the company. A few big firms, however, have extended the sharing of profits to all employees, having elaborate and intricate schemes whereby a share of the profits is set aside for the employees, divided into that proportion due each employee, and then distributed as a bonus at the end of the

year. The purpose of the plan, of course, is to give the employee an interest in the success of the company and to have him share in the added prosperity that his work and a successful year bring.

While this form of additional compensation is indeed an incentive so far as key executives are concerned, it is not generally very effective as a form of added compensation to the average employee. In the first place, there is usually very little connection between the profits of an employer and the performance of the rank-and-file employee; furthermore, the employee who has loafed receives his share just as does the conscientious worker. Second, workers do not like to have their remuneration dependent on the profit that a company makes. They feel the enterpriser takes the risks, and therefore they should be paid whether a profit is made or not. The various factors that enter into whether a company makes a profit or not are difficult for the ordinary employee to understand; and having his remuneration in any way dependent on such mysterious calculations tends to make the worker distrustful of management's reports. Third, the distribution of the profits takes place considerably after the employee has done the work for which he is getting this extra remuneration. Despite these objections, however, some companies have made use of profit-sharing plans for many years and believe them to be effective in building up employee loyalty and morale. The Eastman Kodak Company, whose recent payroll of about $239,000,000 was mentioned previously, gave an additional profit-sharing wage dividend that year of $32,078,000 to its employees, amounting to 13 per cent of their regular wages, in addition to the aforementioned fringe benefits.

Stock Ownership. Although not exactly a form of employee remuneration, another plan for fostering the loyalty of employees and affording them the opportunity of sharing in the profits of the company is that of encouraging *stock ownership* by employees in the shares of the corporation. Many companies offer their workers the chance to buy the stock at a reduced price and to pay for it in installments. Other companies match with equal contributions any amount the worker invests in the shares of the company, so that the employee gets double the amount of stock for the money he puts up.

Stock ownership by employees is encouraged on the grounds that the employee will take a proprietary interest in the affairs of the company and that labor-management friction thus will be reduced, in addition to the fact that the worker shares in the prosperity of the corporation. Employee ownership of shares has on occasion, however, proven embarrassing to the employer corporation. The presence of employees at stockholder meetings, raising labor-management issues and setting forth employee views, is often disturbing to the company officers. More seri-

ous, however, is the reaction of the stockholder-employees when the price of the company's stock falls below the comparatively low price the worker paid for the stock. Because few employees understand the factors that make stock prices go up or down, most of them believe the drop in price to have been caused by some manipulation on the part of the management of the company. Instead of goodwill and company loyalty, so much ill will often develops that corporations have felt compelled to buy back the employees' stock at the price the latter paid for it, letting the company suffer the loss rather than the workers. Thus employee stock ownership, a dubious advantage in good times, can become a heavy burden in bad times.

It is more common, however, for corporations to give their key executives and salaried employees *stock options* to buy company shares at a certain price within a particular period of time. If the stock goes up in value, these executives can exercise their option, buy the stock at the cheaper price and sell it for a handsome profit. Should the stock not rise in value, the executive does not exercise his option, does not buy the stock, and therefore loses nothing.

SUMMARY

One of the most important problems of a business is that of maintaining the loyalty and morale of its workers. This is accomplished by four methods of motivating them to do their best work. The first of these is the primary financial incentive of wages, but the secondary financial incentives, called fringe benefits, are becoming increasingly important. Nonfinancial incentives, such as giving labor a voice in management, suggestion programs, and appealing to the employees' emotional sense of security and the need for commendation, are also effective in encouraging workers. Wages must be set in accordance with the prevailing rates in the community and the industry; they must be in relation to the job performed and should offer an incentive for better work. An over-all wage schedule should be set up which will make certain that wages are in line with what comparable workers are earning, and job evaluations should be undertaken to align properly the wages among the men within the plant. An incentive system should be set up to encourage the men to greater efforts. Attention must also be paid to the additional employee fringe benefits and to the latest developments in employee remuneration. These include escalator-clause contracts, guaranteed annual wage and supplemental unemployment benefit systems, profit sharing, stock ownership, and stock-option plans.

► FOR REVIEW AND DISCUSSION

1. What are the four types of industrial motivation (incentives)? Which is probably the most important?
2. How should wages for a worker be determined?
3. What is meant by job evaluation?
4. What are the two fundamental methods for employee remuneration?
5. What are merit ratings? Do unions usually favor their use? What factors influence their effectiveness?
6. What are the essential elements of a good workable plan for employee remuneration?
7. What particular characteristics are most always tied to remuneration of sales personnel?
8. What are fringe benefits? How do they influence the cost of manufactured goods?
9. How does the escalator clause in a wage contract operate?
10. What conditions have led workers to demand a guaranteed annual wage? Why is it not generally accepted by industry?
11. How can business afford to use profit-sharing wage plans?
12. Why do business organizations encourage workers to own stock in the company in which they work? How do they encourage employees to buy the stock?
13. Is the problem of job satisfaction basically one of the amount of remuneration? What other factors are often a part of the problem of job satisfaction?

► CASE-PROBLEM QUESTIONS

1. What can Mr. Rogers do to determine whether the wage scale is right or wrong?
2. Should he be permitted to make changes in the labor contract in order to please the union without first relating these changes to production costs and selling prices?
3. Where can Mr. Rogers get assistance in determining the kinds of fringe benefits that should be considered?
4. Do any of the recent developments in employee remuneration offer Mr. Rogers a possible solution to his problem?
5. How can he set wage scales that will take care of differences in job requirements?
6. Should Mr. Rogers let such matters as sex, nationality, or age of the worker influence the wage rates?

► APPLIED BUSINESS PROJECTS

1. Mary Ann is a stenographer who has been employed for seven years. Her salary is now $70 a week. June is hired as a new stenographer; it was

necessary to offer her $60 a week to get her to accept employment. Mary Ann objects to the small difference in pay. Is she justified?

a. What three factors might justify her attitude?

b. What three factors would indicate that her attitude is wrong?

2. In many firms, merit- and job-evaluation procedures are used. In some firms the employees are enthusiastic about the use of these procedures. In others the employees raise considerable objections to such schemes.

a. Write up a situation in which the employees are likely to be enthusiastic about the use of merit- and job-evaluation procedures (100 words or less).

b. Write up a case in which the employees will not be enthusiastic about the use of merit- and job-evaluation procedures (100 words or less).

► COMMUNITY PROJECT

Have each member of the class select a different business or industry in the community and find out how the employees are paid. Get answers to such questions as the following:

1. Are they paid by the day, week, month, or year?
2. How do the rates of pay range?
3. What benefits do they get other than wages?
4. How does the pay received relate to the work being done by each person?

After each member of the class has obtained this information from the neighborhood businesses, discuss the findings in class and determine the similarities and differences.



20

Employer-Employee Relations

CASE PROBLEM

Another serious problem, caused by the rapid growth of Kennedy & Company arises not long after the appointment of Harry Rogers as personnel manager of the firm. He reports this to the board of directors. In the past, the company always dealt with the individual worker on questions of wages and other employee matters, deciding such issues when a man was hired, was promoted or given a raise, or when the worker complained that his advance was too slow. Recently, however, a large percentage of the employees joined a union. A union officer, who did not work at the Kennedy plant, had come in to see Rogers and had insisted that the company hereafter deal with the union in employee matters, and that the company sign a contract with the union granting a raise to all plant employees and an additional two days of paid vacation every year. He threatened that if such an agreement were not signed, the employees would go out on strike.

Fred Kennedy, company president, immediately recognized the importance of the problem and realized that the firm's haphazard methods of handling questions of employee rights and grievances, which might have been good enough when the company was smaller, would have to be changed at once. Better organized and more mature policies and procedures were needed.

At Kennedy's urging, the board authorized Rogers to hire an industrial-relations specialist to aid Rogers in administering the employer-employee affairs of the company. The board instructed Rogers to investigate the practical and legal rights of the company and of its employees in their relations with each other and to take any reasonable steps to keep the workers contented and to avoid strife.

- Must the company deal with this representative of a union to which many, but not all, of its workers belong, particularly when this union officer is not in the company's employ?
- Should, or indeed, must, the company abandon its former practice of settling wages and other such problems with each individual employee directly, and now negotiate with them as a group?
- What steps can the union take to enforce its demands, and what measures are open to the company should it seek to combat these pressures?
- What immediate affirmative action can the company take to reduce labor-management friction and to enlist the future loyalty and support of its workers?

INDUSTRIAL RELATIONS

One of the most difficult and serious problems facing a business today, if it has in its employ any sizable number of workers, is that of maintaining peace and harmony between the company, represented by management, and its employees. This area of activity, involved with the encouragement of worker satisfaction and loyalty, and with minimizing labor friction and strife, is known as *industrial relations.*

The problems of industrial conflict are among the most difficult facing enterprisers, because they are steeped in human emotions and tied in with the clash of self-interests that divide the workers from "the bosses," often blinding one side from seeing the other's point of view. Part of the trouble is the heritage of the sorry relationships between the two in the past, so that instead of developing as a team working together, they have been plagued with mutual distrust and antagonisms, which require little stimulus to turn a minor source of irritation into a serious and open rift.

It has always been the first task of management, the directors and officers of the concern, to make profits for the company. In their desire to increase the income of the firm, managers are often thoughtless in their handling of employees, treating them as though they were just so many machines. Consideration is often given only to minimizing costs, no matter what effect such actions may have on the income of the workers. Decisions are made, in many cases, arbitrarily and impersonally, laying off so many workers in this plant, increasing hours or cutting wages in another factory, without a thought to what this will do to the affected employees and their families and without giving the former any reason for these actions.

On the other hand, the workers, too, usually see only one side of the picture. They believe, all too often, that the major purpose of the business is to provide them with jobs and are uninterested and unsympathetic with management's desire to keep costs down and to make profits. They usually look on their company as an excuse for the officers to squeeze from labor the fruits of their work in order to line the pockets of the stockholders with profits, which the workers seem to believe are endless and inevitable.

Such approaches to labor-management difficulties fairly describe only the attitudes of the extremists on both sides, but this difference in outlook is latent in all their associations with each other. It is the task of industrial-relations experts to try to make management see that labor is not a machine, to be turned on or off as one throws an electric switch. They must likewise try to make labor see that their jobs and welfare are closely related to the prosperity of the company, which cannot long exist if it does not yield some return to those who have put up the capital to run the factories.

When a company like Kennedy & Company is small, and the owners and their employees have a great deal of daily personal contact with each other, it is comparatively easy for the management to see the worker's problems and for the employees partly to understand the company's point of view. But when a company becomes larger, and personal contacts between the two sides diminish, the natural conflict between the two classes and viewpoints arises, demanding skillful tactics on the part of management and the leaders among the employees to maintain harmony in their relations.

LABOR UNIONS

Early in the history of large-scale industry, workers discovered that they were at the mercy of the employer, in their mutual relationships, if they acted as individuals. Because of the difference in size and strength between the worker and the large company, the individual worker has little opportunity to enforce his demands, and few employees have the ability or aggressiveness to present their side of a situation to the educated manager in his imposing office. These limitations on the effectiveness of the individual worker in his relations with his employer led naturally to the development of the labor unions, which gave workers the advantages of the strength of numbers and the services of experienced negotiators to represent them. Just as some corporations have grown to colossal size and become leaders in their industries, so too, although more slowly, some unions have grown. They can now throw

the weight of their large membership against the strength of these powerful employers in the struggle to obtain for labor what it would be impossible for the individual worker to obtain for himself.

Types of Labor Unions. Unions in this country are of two major types. Historically, the first to develop were the *craft unions,* where members of the same trade or craft in an area, such as carpenters, plumbers, or painters, banded together in one union, regardless of the company or type of industry in which they worked. Later, however, the *industrial unions* grew in size and importance. These were organizations of all employees in the same industry in an area, regardless of their particular trade or craft. Thus all automobile workers would band together, whether they worked as machinists, smiths, or painters, and regardless of the company for which they worked.

A third type of union, the *company union,* composed of employees of one company, regardless of their tasks, has never become very prominent because it was often started by, or at least secretly dominated by, the management of the company. Employees were always suspicious, often with just cause, whether the company union really represented their interests. As we shall see later, unions that receive financial contributions or support from management are frowned upon by the law today.

Union Organization. Unions are normally formed within small geographical areas and are called *locals.* These locals in turn band together into larger organizations, usually of nationwide, or even international, scope—such as the International Ladies' Garment Workers Union and the United Automobile Workers—known as *national unions.* Most of these national unions have in turn banded together to form the gigantic American Federation of Labor and Congress of Industrial Organizations. It has this large cumbersome name, because until recently it was two separate nationwide organizations. The American Federation of Labor, the elder of the two, was composed of thousands of international, national, state, and local unions, organized mainly on the craft basis. The Congress of Industrial Organizations was an equally powerful combination of many unions, organized primarily on the industrial basis. These two combined to form the one tremendous labor organization they are today.

Several *independent unions,* generally nationwide, have never joined the A.F.L.-C.I.O. combination. Most notable of these are some unions of professional workers and of foremen and supervisors. There are also other unions scattered throughout various industries that have never affiliated with the A.F.L.-C.I.O.

LABOR TECHNIQUES IN EMPLOYER-EMPLOYEE RELATIONS

Collective Bargaining. In their negotiations and dealings with employers, workers and their union representatives have developed certain techniques, devices, and weapons to aid them in presenting, and attempting to enforce, their demands. Foremost of these is *collective bargaining,* whereby, through their union leaders and representatives, they negotiate collectively, as a group, with an employer, or group of employers, over the terms and conditions of employment. Thus, instead of one employee of Kennedy & Company requesting a raise from Mr. Kennedy, and, if refused, having the alternatives of accepting defeat or quitting the job, a union representative, recognized as the authorized agent for the workers, can ask for a raise for all employees, backed by a threat that all the employees of the Kennedy factory will stop working until the company is amenable to their demands. For years many employers tried to avoid bargaining collectively with their workers; today, the law specifically recognizes the right of employees to such collective bargaining and requires both management and unions to participate in it.

Union Membership. To accomplish their purpose of obtaining concessions through collective action, it is important that unions represent all, or at least a very large percentage, of the employees of a plant. Unions are therefore opposed to the *open shop,* that is, a factory or company that hires employees regardless of whether or not they are union members. In their negotiations with employers, union representatives in the past tried vigorously to get the employer to sign a contract that he would maintain a *closed shop,* which would mean that only workers who belonged to the union with which he had a contract would be hired. This closed-shop arrangement has been declared illegal in both Federal laws and under the laws of many states, on the ground that it interferes with an individual's right to work wherever he wishes and at whatever job for which he is qualified. The laws, however, have not been too effective, since most of them require a complaint to be filed by the employer. Many employers are loath to do so because of the prejudicial effect it will have on the loyalty and co-operation of their employees.

A compromise arrangement that is often used is that of the *union shop,* where, for instance, Kennedy's and the union agree that the company can hire anyone, whether or not he belongs to the union, provided he joins that union within a certain length of time after starting to work. In an agreement calling for a *preferential union shop,* Kennedy's would

agree to hire any available union member before taking on anyone else, and would, in times of contraction, lay off all nonunion employees before letting any union member go.

Limitations Set by Unions. Another of the techniques used by unions in their attempts to make the voice of labor more effective in matters of industrial relations has been the limitations they have placed on certain aspects of work. These have generally been of three different types. In some crafts, the unions have limited the number of those who can be given jobs in those trades by requiring a certain period of *apprenticeship* before a worker is qualified to seek and accept a position. In many cases, such apprenticeships have been worthwhile and necessary to the development of the needed skills in the trade. Many of these enforced apprenticeships have been legalized by incorporation in local ordinances and building codes, so that to get a license as an electrician or plumber, the applicant must undergo the apprenticeship training set up by the local union. In some crafts, however, the apprenticeship period is unduly long, merely to limit the number of workers who will seek jobs in that trade.

A second limitation set by many unions is that of the type of work to be performed, referred to generally as *jurisdictional limitations.* For example, the union might insist that metal work in the Kennedy plant must be handled by members of the metalworkers union and would not permit an operation on a metal part to be done by a carpenter. Conversely, the carpenters union might be equally zealous in making sure that none but members of their organization worked on any of the wooden parts of the tools fashioned in the plant. Sometimes the line between types of work is difficult to draw, and jurisdictional arguments which take place between rival unions lead to work stoppages and considerable strife, of which the employer is the innocent victim.

In the crafts, primarily, a third type of restriction is set by unions in the limitation of the output of any one worker. Thus the number of pieces a worker turns out in one hour may be limited, or the size of the brush a painter uses may be prescribed, or the use of rollers or spray guns may be prohibited. These limitations are set in order to give work to more people or to prolong the work when the labor is paid for by the hour. When the limitations or requirements are such that the employer is forced to hire unnecessary people who add nothing whatever to the productive process, the practice is known as *featherbedding.* Featherbedding is prohibited by Federal law, but its definition is so ambiguous, and it is so difficult to demonstrate that a job is unnecessary, that this legal restriction is seldom enforced.

Strikes. The major weapon in labor's arsenal, in its efforts to obtain more pay, shorter hours, longer vacations, better pensions, etc., is the *strike,* where the workers refuse to work until their demands are met or a compromise can be effected. Strikes are economically unsound; the workers lose their pay during the work stoppage, and the employer's business or production usually comes to a stop, thereby causing him losses. On the other hand, it is often only by means of a strike that the workers can force employers to yield to their demands. It is doubtful if many of the benefits that labor enjoys today could have been obtained had it not been for the protracted, costly strikes that were endured in many cases to win these concessions.

In the usual strike, the workers walk off the job or refuse to go to work. There are, however, many variations of the general pattern. A type of strike which was popular with workers for a time, but was declared illegal and is seldom used today, is the *sit-down strike.* The workers go to their places at their machines or jobs but refuse to work, even refusing to leave the premises until the strike is over. Another technique is the *slow-down,* in which the workers continue their work but do so at a much slower pace, thus impeding the general operations of the plant. Since they are still working, they are entitled to pay. A *sympathy strike* takes place when workers who are not directly involved in the dispute go on strike to help, or show sympathy with, the group that is on strike and is directly involved. Thus if Kennedy & Company should fire a painter for a reason the union feels unjust, the painters union might call a strike of its members (if the plant is organized on a craft, rather than an industrywide, basis). If, to help the cause of the painters, the metalworkers union calls a strike, despite the fact that none of its own members is involved in the controversy, this would be a sympathy strike.

In order to call to the attention of the public the fact that a strike is going on, and to dissuade others from entering the plant or doing business with the company, it is common for the union to place members at the entrances of the plant to walk up and down carrying placards stating that the employees are on strike. These persons are known as *pickets.* To show sympathy with those who are on strike, many union members will not cross any picket line, so that a strike at the Kennedy plant might even halt deliveries of raw materials by the employees of Kennedy's suppliers, if they honor the picket line and will not cross it to make their deliveries. When the union posts so many people at the plant entrances that admittance to the plant is forcibly denied the public, or when the pickets resort to violence to stop anyone

from entering, this is referred to as *mass picketing*. Because of its threat to the peace of the community, mass picketing is usually forbidden by the courts.

Boycotts. Should the workers of Kennedy's have a grievance against the company, another weapon available to them is the *primary boycott*, in which the workers refuse to buy any of Kennedy's products. This is effective only if the number of employees engaging in the boycott is large enough to affect Kennedy's sales sufficiently, so that it hurts the business. When the workers try to influence others not to buy from Kennedy & Company, or attempt to exert pressure on firms that buy from Kennedy's, by means of pickets, strike threats of employees of such firms, and other tactics, this is called a *secondary boycott* and is generally illegal.

MANAGEMENT TECHNIQUES

Just as labor has its weapons in employer-employee disputes, management also has its techniques, although most of them are frowned on as being unethical, or even illegal. The trump card held by the employer, after all, is the fact that he owns the company and has the final say as to whether or not to heed labor's requests or demands. Perhaps the most important technique used by management in a labor dispute is the right to appeal to the courts for an *injunction*. This is an order from the judge requiring that a person or persons desist from doing something prohibited by the injunction, or be subject to punishment for contempt of court. At one time employers were generally able to obtain injunctions to stop almost any move made by striking employees; but today employers can obtain injunctions only for acts of labor involving violence, such as mass picketing and sabotage, which include injury or threatened injury to persons entering the struck plant, denying access to the factory, or damaging the employer's property.

Devices occasionally used by management, although usually not considered good business ethics, include lockouts and the use of strikebreakers. A *lockout*, more or less the opposite of a strike, is the closing of the plant by the owner because of a dispute with his employees and refusal to permit them to enter it to go to work. When, on the other hand, a strike is in progress, and the employer hires other persons to work in his plant in place of the striking employees, in an attempt to break the strike, these substitute employees are referred to as *strikebreakers*, or, in a more derogatory way, as *scabs*. In many great and bitter labor disputes in the past, employers often hired tough, brawny men, in the guise of strikebreakers, to give physical battle to the strikers should an occasion for a fight arise.

In their early attempts to stop the spread of unionizing among their employees, companies also used to compile lists of names of union organizers or sympathizers and secretly give such lists, called *blacklists*, to their competitors, so that no one would hire such an agitator. Companies would also force prospective employees to sign agreements, known as "yellow-dog" contracts, promising that they would never join a union while in the company employ. Both blacklists and yellow-dog contracts are illegal today.

MACHINERY FOR SETTLING LABOR-MANAGEMENT DISAGREEMENTS

The entire picture of employer-employee relations has changed somewhat today, for several reasons. In the first place, the union is much more the accepted bargaining agent for workers, because more employees are now union members; because most employers have come to recognize unions as representing their workers; and because the laws prescribe collective bargaining. Second, much, although not all, the violence of former labor strife has disappeared; and considerable machinery has been set up to lessen industrial-relations difficulties. Third, as already mentioned, a considerable body of laws has come into existence that regulates employers and employees in their mutual dealings. It is therefore better for any company to make as much use as possible of lawful methods and devices to reduce friction between management and workers.

Contracts. In practically all plants of any size, the employer enters into a written agreement with the union representing the employees, known as a *labor contract*. This agreement is normally arrived at through negotiation between union officers and officers of the company, usually those responsible for industrial relations. The agreement generally specifies the length of time it is to run, procedures for amendment or termination, and the requirements as to union membership in the plant. The contract usually stipulates the agreement between employer and employees—the result of collective bargaining—as to wages, hours, overtime, vacations, pensions, insurance, and other benefits. Questions of hiring, promotion, seniority, and dismissal of employees are covered in the contract. If the company is to co-operate in *dues checkoff*, wherein the employer deducts from the workers' pay their union dues and turns this money over to the union, this too is stipulated in the contract. Finally, the agreement usually sets forth the procedures to be used in case of grievances or disputes.

Grievance Procedure. Most employers usually have a clearly spelled-out procedure for handling the minor complaints of their employees

and disputes of lesser importance, known as *grievances.* In the case of Kennedy & Company, for instance, it might be arranged that an employee who complains of an alleged improper action or injustice of the company toward him, shall take up his grievance with that worker in his particular shop who officially represents the union and who is known as the *shop steward.* If the shop steward believes the worker's complaint is a just one, he discusses it with the employee's foreman or supervisor. If no satisfaction is obtained at that level, the contract might then call for the matter to be taken up by an officer of the union with the industrial-relations manager of the company.

In some plants labor-management committees are formed to discuss matters of shop rules and discipline, safety, waste reduction, cost control, job evaluation, suggestion systems and recreation. If the employee's grievance is about a matter that involves a shop rule or other matter concerning the welfare of employees and their conditions of work, it may be referred to such a committee for advice and recommendations. If, however, no settlement of the grievance, satisfactory to both the company and the union is reached, it takes on the character of a full-fledged labor dispute. A properly drawn contract between the company and the union would also set up procedures for the peaceful settlement of such issues, so that a strike need not be called. Such techniques might include conciliation, mediation, investigation, or arbitration.

Methods of Promoting Industrial Peace. There are four major means whereby representatives of management and labor get together formally in an effort to settle peacefully an employer-employee dispute and thus avoid strikes or other open strife between them. The first of these is known as *conciliation,* which consists of a series of conferences between the representatives of the two sides, with no outsiders present to see if they cannot iron out the difficulties among themselves. When, however, the conference is held with an outsider as chairman, the process is known as *mediation.* The chairman, or mediator, is a third party who favors neither side and who, while making no decisions himself, tries to help the parties to the dispute to come to terms. The Federal government, most of the state governments, and many cities maintain mediation services to supply trained officials to aid in this manner in the settlement of industrial disputes.

A more formal procedure is that of *arbitration.* Here a third person, chosen by agreement between the company and the union, holds a hearing in which he listens to presentations of both sides of the dispute and then renders his decision. Since, in this country, most arbitrations are voluntary on both sides, the obligation to abide by the arbitrator's decision is a moral, rather than a legal, one. The losing party is not

placed in a favorable light if it does not agree to carry out the terms of the decision. Arbitrators are supplied by many organizations interested in the maintenance of industrial peace, an important one being the American Arbitration Association. Some industries pay the salary of a full-time arbitrator, known as an *impartial chairman*, who acts as a mediator or arbitrator in all disputes between labor and management in that industry. Under compulsory arbitration, seldom used in this country, but required in Australia and New Zealand, the parties to the dispute would have to abide by the decision under compulsion of the law.

A fourth method of attempting to obtain the settlement of employer-employee disputes is *investigation* by a fact-finding commission. Here a group of men are appointed to hear all the facts in the case and to make a public report as to what they find. They do not render a decision, since it is hoped that their report will give a pretty good indication of which side is in the wrong and shame it into an agreement. It is also hoped that tempers will cool during the investigation and that both sides will be more amenable to agreement.

TAFT-HARTLEY LAW

Industrial relations of firms engaged in interstate commerce are thoroughly regulated by the Labor-Management Relations Act of 1947, more commonly known as the Taft-Hartley law, after the members of Congress who sponsored it. Although it has many provisions, the law covers four major subjects as follows:

1. Guarantees labor the right to organize and requires collective bargaining.
2. Prohibits interference with, or discrimination against, union activity.
3. Sets up a board to hear complaints of violations of the law and to provide for election and certification of unions as qualified representatives of employees.
4. Provides for governmental action in strikes that endanger national health or safety.

Recognizes Unions and Collective Bargaining. The law specifically grants to workers the right to organize and become members of labor unions and requires both the employer and the union to use collective bargaining in reaching labor-management agreements, when the union has been certified as the official representative of the employees of the plant. Employers need not, however, bargain with unions of foremen or supervisors, as they are considered to be part of management.

Prohibits Coercion or Discrimination. The law forbids both employers and unions to discriminate against any worker because he is, or is not, a union member or a union organizer. The union shop, however, is

permitted when the agreement calls for it. Unions are forbidden to engage in secondary boycotts, or to strike against a plant where another union has been certified as the official representative of the employees. Neither employers nor union officials may attempt in any way to coerce employees to vote on union matters, to join, or refrain from, joining a union or participating in union activities.

The National Labor Relations Board. The law enlarged and strengthened the semijudicial body called the National Labor Relations Board to perform two major functions. In the first place, it is designated to hear complaints of any alleged violations of the law. The injured party to any violation of the labor-relations law brings his complaint to the board's general counsel who, if he feels there is merit to the claim, prosecutes it before the board. The board's decision is then issued as an order, which is enforceable in Federal courts. The second major task of the National Labor Relations Board is to conduct elections, on the petition of an employee, union, or employer, to decide by vote of the employees whether they want any union to be the officially certified bargaining representative of the employees, and, if so, which union it shall be.

Strikes. The law further provides that when a threatened or actual strike or lockout is so important and the work stoppage is so widespread



Safety First. The safety of employees, especially in hazardous jobs, is a responsibility of many personnel departments. Many large firms have a special staff of safety personnel. Can you name occupations where safety would be a vital factor?

Courtesy Dupont "Better Living"

that the national health or safety is imperiled, the Attorney General of the United States may obtain an 80-day injunction to halt, for that period of time, the strike or lockout. This 80-day period is to act as a "cooling off" time during which it is hoped that the parties will get together and settle the dispute peaceably without resort to strike. If no settlement is made, the strike or lockout may resume, or begin, after the period of the injunction has ended.

OTHER LABOR LAWS

In addition to the Taft-Hartley law, there are several other laws that affect employer-employee relations, some of which have already been discussed. Some, although not all, states have labor-relations laws, not too dissimilar to the national legislation, to regulate intrastate industrial disputes. The wages-and-hours laws of both the Federal government and the states have some effect on labor-management relations, as do the various child labor laws. Some states have passed so-called "right to work" laws, aimed at the prohibition of the closed shop; a few have experimented with antistrike laws, outlawing strikes in public utilities. Most of these have, however, had little success.

Thus it can be seen that if, after an election for that purpose, a union is certified as the bargaining representative of the employees in the Kennedy plant, the Kennedy management must deal through the officials of that union in all collective bargaining with its employees on matters involving their contracts of employment. Not only may the management of Kennedy & Company not interfere with the unionization activities in its plant, but it may not discriminate in hiring, promoting, remunerating, or discharging employees because of their association with, or activities on behalf of, the union. Actually, of course, the company would do better to set up a definite grievance procedure, so that minor irritations between supervisors and employees will not develop into major disputes.

EMPLOYEE HEALTH, SAFETY, AND WELFARE

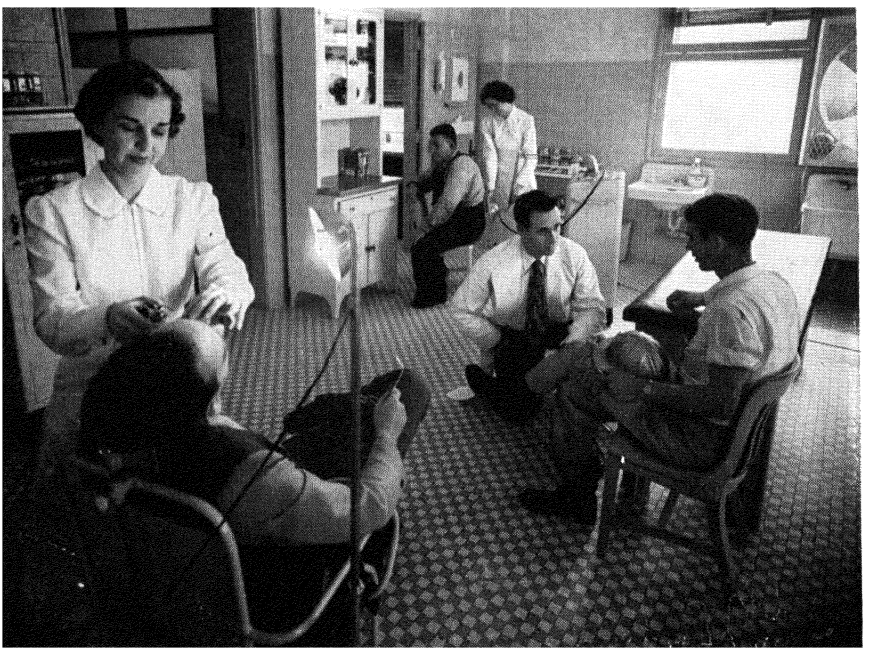
Another important area of possible friction between management and its employees, in addition to wages, hours, pensions, and union activities, is that of their health, safety, and welfare. Kennedy & Company, for instance, has certain obligations toward its employees, and they in turn have some toward Kennedy's, which they are not only morally, but even legally, bound to carry out.

The employer is required to provide a reasonably safe and suitable place for the employee to work in, depending on the dangers normally incident to the type of work being done. The employer must provide

reasonably safe and suitable tools, with proper safeguards for the employee, if the machinery is of a dangerous nature. The employer is required to see to it that employees are reasonably fit and suitable for their work, so that others will not be injured through the negligence or ignorance of fellow employees. In this regard, practically all states have some form of workmens' compensation. Accordingly, an employee will receive some compensation for injuries suffered on the job, even through his own or another employee's negligence, so long as the injury was not caused willfully or while the employee was under the influence of liquor.

The employee, on the other hand, owes loyalty and obedience to any reasonable order of the employer. He is required to be diligent in his work and not to be habitually careless or neglect his responsibilities. He further owes his employer honesty, which includes not revealing trade secrets to others.

Aside from what is required by law, many firms provide their employees additional health, safety, and recreational facilities in order to foster their loyalty and morale and to reduce employee dissatisfaction. Many firms have a full-time doctor and nurse, with a well equipped



Courtesy Cities Service Company

Sick Call. A modern medical department is only one of the services offered to today's employee in a typical large organization.

infirmary on the premises. Companies sponsor baseball teams, bowling tournaments, and picnics for the employees and their families; publish company newspapers; and conduct many other activities to help make the workers feel more like a big happy family and make the factory seem a pleasant place rather than a place of drudgery.

SUMMARY

An area of extreme importance to modern business today is that of employer-employee problems, known as industrial relations. The enterpriser no longer finds himself dealing with individual employees, but he must instead negotiate with unions which represent many, or all, of his employees. By means of strikes and other similar measures, the unions can make the demands of labor strongly felt. The law requires that the employer permit the workers to organize and that he bargain collectively with their representative. Here, as in many other things, the ounce of prevention is worth the pound of cure. If the company can negotiate an equitable labor-management contract and set up appropriate procedures for the handling and peaceable settlement of grievances, much costly strife can be eliminated. A constructive program of health, safety, and welfare measures also contributes to employer-employee peace.

► FOR REVIEW AND DISCUSSION

1. What are the major problems in industrial relations from the employees' viewpoint? from the employers' viewpoint?
2. What factors led to the development of labor unions?
3. Describe the process known as "collective bargaining." What are its advantages? disadvantages?
4. What is meant by *open shop; closed shop*? Why are unions opposed to open shop? What is the legal status of the closed shop?
5. What is the nature of a union-shop agreement; of a preferential union-shop agreement?
6. On what grounds can a strike be defended? What are the arguments against a strike?
7. What major defenses may industry use against strikes?
8. What subjects are usually covered in the labor contract?
9. How may a worker's grievance be handled, so as to avoid friction between labor and management?

10. Identify and describe the four major means whereby labor and management settle disputes and labor-contract problems.
11. What are the basic principles in the Labor-Management Relations Act (i.e., the Taft-Hartley Law)?
12. What are the duties and responsibilities of the National Labor Relations Board?
13. Identify other types of labor legislation which are designed to help bring industrial peace to American labor and industry.
14. Describe the responsibility of management and the worker as to health, safety, and welfare factors.

► CASE-PROBLEM QUESTIONS

1. What type of person should Mr. Rogers employ as an industrial-relations expert?
2. Should the company deal with representatives of the union and with nonunion members at the same time?
3. Is it wise for Mr. Rogers to recommend a union-shop policy in order to solve the problem?
4. Should he negotiate with the union representatives before a strike is called, or wait until after a strike is called?
5. How can Mr. Rogers encourage loyalty to the firm among the workers?
6. Should Mr. Rogers seek legal advice regarding the rights of the company and its legal responsibilities?

► APPLIED BUSINESS PROJECTS

1. The president of the Mercury Electric Company is amazed to hear that his workers have organized and affiliated with a large national union. He says he has been fair to his workers, treated them "like a father" and now they "rise up against him."

Give five reasons why his feelings may not be justified.

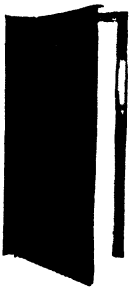
2. Using a large letter "T," list the gains in industrial relations that have been made that benefit labor and management. Label the left side of the "T" "Gains for Labor" and the right side "Gains for Management."

► COMMUNITY PROJECT

Select someone to find out if there have been any strikes in your immediate neighborhood. Interview a worker to get his point of view. Interview a management representative for his attitude. Have each interviewer bring his findings to class and discuss the value of the strike for the workers in terms of benefits. Losses to the worker.

Have one representative of the class interview a member of an independent union and another a member of a nationally affiliated union. Bring the results of the interviews back to class for discussion.

(*Note:* The question will not be practicable in a rural or small-town area away from organized labor.)



21

Management of the Office

CASE PROBLEM

Kennedy & Company has now become a large manufacturer of hand tools. This growth has brought about a type of inefficiency that Fred Kennedy, the company's president, feels must also be a cause of considerable waste and added cost. He has noticed that each department has its own secretaries and office personnel. Many of these employees duplicate the work done in other departments. Some of them are not kept busy all day and have time on their hands. None is guided by any standards of operation or procedure, each one apparently doing the work in the way he feels is best or easiest. Much work is done by hand that presumably could be done more efficiently by machine. Furthermore, it is often difficult to locate a letter, invoice, or other communication once it has been filed—the clerk in each department usually insisting it must be in the files of some other department.

Kennedy suggests to the board of directors that they hire an office manager and give him full authority to study the office problems of the firm and reorganize the secretarial and office help into a unit to handle the office functions in a more efficient and less costly manner.

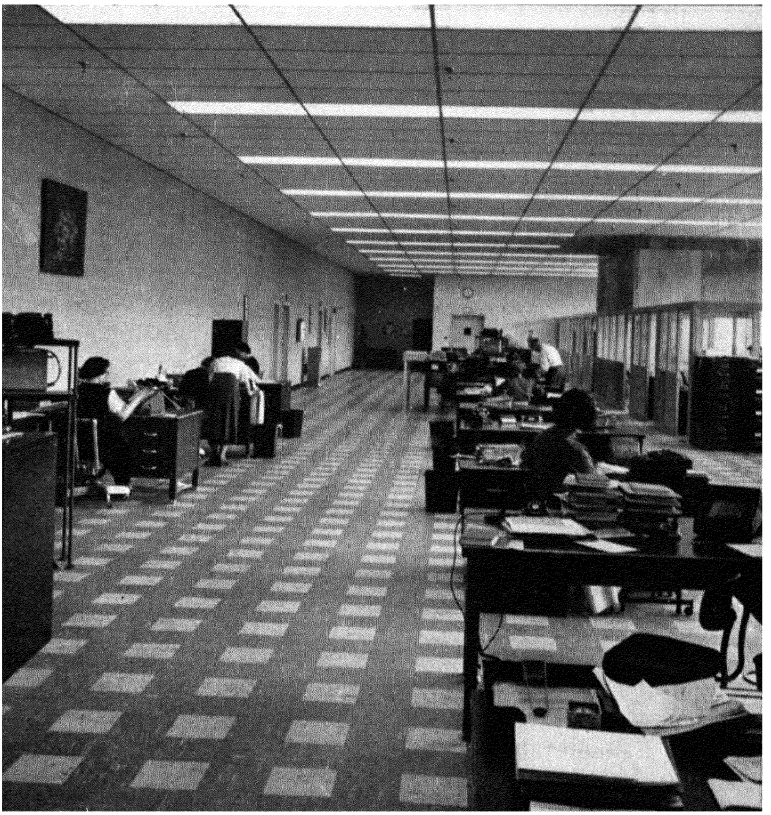
- What are the office functions of a business?
- What is the work of an office manager, and what qualifications should he have?
- How should a company office be arranged physically, and how should it be organized, to perform the office functions efficiently?

PHYSICAL ORGANIZATION OF BUSINESS

A business may be divided, from the standpoint of organization, into many departments, such as purchasing, selling, financing, and manufacturing, in accordance with the functions to be performed. The physical plant of the firm—its store, loft, building or buildings—may be classified into three or four major divisions—the sales area, the inventory area, the manufacturing area (if any), and the office area. The amount of space devoted to each of these uses depends on the type of business carried on, and the size of the firm itself. It is possible for some concerns to do without a sales, inventory, or manufacturing area, but none can do without some office space. If a firm sells only through outside salesmen who call on customers, no sales showroom is needed. If the enterprise is a sales agency or a broker for an independent producer, it need not carry any stock, because the manufacturer ships directly to customers, thus eliminating the need for a stockroom. If the firm does no manufacturing of its own, it obviously needs no factory space. But no matter how large or how small the enterprise may be, it needs at least some office space.

When Kennedy & Company was just a small retail hardware store, it did no manufacturing and thus had no factory. Its sales showroom was in the front of the store where the counters and display centers were located. Shelves in the rear and in the basement of the store comprised its stockroom for storing its inventory. And while, as a small store, its partners might never have referred to the location as such, it had space devoted to office work. Mr. Kennedy and Mr. Ames needed at least a desk, where they could keep the business records and work on them, where they could open the mail, write letters, and file copies of this correspondence for future reference.

As the firm grew in size and went into manufacturing as well as retailing, the need for office space also grew. More records were needed, the correspondence grew and demanded more time, personnel, and space. The partners even needed a special place where people who came to do business with the firm could be received and directed to the individual whom they wished to consult. Furthermore, someone was soon needed to handle all incoming and outgoing telephone calls. As the number of telephones and calls increased, a switchboard was required. Finally, as the business grew very large, there was the problem of communication among the various departments within the firm itself. Thus, what had originally been handled at one desk had now become a function requiring a considerable amount of space and equipment, and demanding the full-time services of several employees.



Courtesy New York State Electric and Gas

Light and Modern. Good lighting helps to increase the efficiency and output of office workers.

THE OFFICE AS THE NERVE CENTER OF THE BUSINESS

The office has been called the "heart" of the business organization. More properly, the office functions as the nerve center or the brains of the enterprise, because its activities more closely resemble those of the brain—receiving the stimuli and directing the reactions in the other parts of the body. This similarity between an office and the brain of any living creature is more apparent if one considers just what these two organisms do.

The brain receives from the senses the stimuli of sight, sound, feeling, etc., as well as pain due to disorders of the system. So, too, the office receives information and communications from the outside world; and records and memoranda from departments within the organization. Thus

the Kennedy office would take care of the reception of callers, the operation of the switchboard, and the handling of incoming mail, telegrams, and cablegrams, as well as receiving reports, records, and communications from the various departments of the firm.

Second, the brain records or remembers whatever the organism needs for future use. So, the Kennedy office would record the accounting, sales, and other data it receives, and would keep the various documents, reports, and records on file for future reference.

Third, like the brain, the office staff would coordinate and integrate all the information and data it receives, so as to carry out the main function of the office, which is to aid in the thinking and planning of the organization—to assist the executive officers in directing the operations and movements of the firm.

Finally, the brain sends out responses, ordering the movements of the various parts of the body. Similarly, the Kennedy office would take the dictation, type, and dispatch the various orders, letters, telegrams, and interdepartmental communications by which the executives set in motion the activities of the organization.

The office is therefore an area of tremendous importance to the entire enterprise, out of all proportion to its size when compared with the rest of the organization. It is essential that the office operate as an efficient division of the firm, partly because inefficiency may be costly in wasted time, effort and money in its own division. More significantly, its efficiency is important because the conduct of the office affects the entire business; and a mistake in the office, like a voice in the microphone, is magnified many times when transmitted to the whole organization.

Areas of Office Service. In other words, the offices of a business enterprise perform a *service* function, giving clerical assistance to the various operating departments and taking care of communications and records so that those subdivisions of the organization will be free of routine details and able more effectively to carry on their own specialized duties. Generally, the activities of the office can be outlined as follows:

1. Oral communications
   - *a.* Receiving visitors, giving them information, and directing them to the various executives
   - *b.* Operating the switchboard
   - *c.* Handling the firm's intercom and loud-speaker systems
2. Written communications
   - *a.* Receiving, opening, sorting, and delivering incoming mail and telegrams

   b. Collecting, stamping, and dispatching outgoing mail and telegrams
   c. Collecting and delivering intracompany memoranda
   d. Maintaining a messenger service
3. Providing clerical assistance
   a. Giving secretarial aid to executives
   b. Taking dictation and typing correspondence, reports, and interdepartmental communications
   c. Maintaining statistical and budgetary records and reports
   d. Maintaining accounting books and records
4. Maintaining files
   a. Filing correspondence and records
   b. Procuring them from the files for reference

OFFICE ORGANIZATION

As already mentioned, every business carries on the office functions of oral and written communications, clerical duties, and maintenance of files. In a small enterprise, these may be handled by the boss himself, or by a young woman, generally referred to as the secretary. She answers the telephone, types the letters, files the correspondence, makes out the bills, and keeps the books. Larger firms divide these various activities among many employees and use expensive office machinery to facilitate their work.

Centralization or Decentralization. A serious organizational problem in the large firm is determining whether the office should be centralized, decentralized, or a combination of the two. In the centralized set-up, all dictation and typing are handled by a corps of stenographers and typists who work in a central office or "pool." There are no stenographers or typists in the departments themselves, with the possible exception of a few private secretaries assigned to the most important executives.

Girls are sent to the various departments to take dictation or do typing as needed. In some cases, recorded dictation is used, and the record is sent to the central office for typing; or dictation is given by telephone to centrally located dictating machines. Under the fully centralized plan, all files and records are also maintained in the same office, as well as all mail and messenger service.

In a decentralized office arrangement, each department has its own secretarial help to handle its correspondence and maintain its files and records. Many firms have some sort of combination of centralized and decentralized organization. Thus, for instance, Kennedy & Company may find that its sales department has enough correspondence and re-

ports to make it worthwhile giving that department its own stenographers and having the other departments use stenographers from a central office. Perhaps each department might have its own stenographers and typists, but use a centralized filing system, or, vice versa, use centralized stenographic services, but maintain separate files.

The advantages of a centralized office are many. In the first place, office employees are kept busy doing useful work much more regularly than they might be under decentralization. Unless the firm is very busy, it is doubtful if each department can use the services of a stenographer for dictation and transcribing all day. The girl, under decentralization, would therefore spend part of her day doing nothing; or she would be kept busy with filing and other clerical work which could be done by a less-highly paid employee. Under centralization, she is usually able to spend her entire day doing the work of a stenographer by rotating in the various departments as she is needed.

Centralization, therefore, in addition to the first advantage of keeping all office employees busy, also permits the hiring of less expensive workers to do the less-skilled jobs.

This in turn brings out the third advantage of centralization, namely, the elimination of duplication in equipment. Under decentralization, each office may require a typewriter and filing equipment. Centralization would require only two typewriters, or possibly even one, and might reduce the needed filing cabinets to one set instead of three.

A fourth advantage of centralization is the better control over the office functions than is possible under a decentralized system. Supervision would naturally be better, and more standardized, when all office help reports to one office manager, rather than each departmental office having its own supervisor, each with his own ideas of standards and procedures. Often in a decentralized office there is no supervision at all, each secretary reporting only to the head of the department in which she works. Since he is interested in the problems of the department he supervises, he usually knows little, and cares less, about the work of his office help. Their work is therefore often inefficient.

Fifth, it is usually easier to locate filed correspondence and other documents, particularly of an interdepartmental nature, when they are filed in one central place by an experienced full-time clerk, than when there are departmental files in various locations. This is especially true when the filing is done by the department secretary, who considers filing an unimportant part of her work and does it whenever she has time left over from her other duties.

A centralized office has its faults, however. There are certain situations in which the advantages of decentralization might make it prefer-

able or even essential. One consideration is the physical location of the various departments. Thus, if the Kennedy showrooms are not near the factory, and if the latter in turn is far from the treasurer's office, it might be almost a physical impossibility for them to share office personnel. In many firms of any size, each department may have a small office to handle its own records and correspondence, and a large general office centrally located to coordinate the business activities and take care of most of the firm's office work.

Another drawback to complete centralization of office personnel is the shifting of secretaries and clerks from department to department, as their services are needed. None becomes interested or experienced in the problems peculiar to any one department; and the lack of anyone really familiar with the way forms and correspondence of a particular department are handled may result in less efficiency and a greater waste of time than if each department had its own full-time staff.

Furthermore, there is the difficult question of coordination, or timing, under centralization; that is, making sure a department has the help it needs at the time needed. If, instead of a secretary for each of the three departments, Kennedy's tries to save money by hiring one stenographer, one typist, and a clerk, there are bound to be times when two, or even all three, departments will simultaneously require the services of the stenographer, or the typist, or even the clerk. The waste in time in waiting for the particular worker may cost considerably more than the salaries of individual secretaries for each department. Use of transcribing machines may reduce competition for the stenographers' services; but there may be times when conflicting demands for the filing clerk can be just as urgent, and delay in locating records just as costly.

The foregoing arguments for and against centralization of office personnel bring out the reasons why a company like Kennedy must give a great deal of thought to how its offices should be set up. At least in the large business organization, a combination of centralization and decentralization which will give the optimum results can usually be devised.

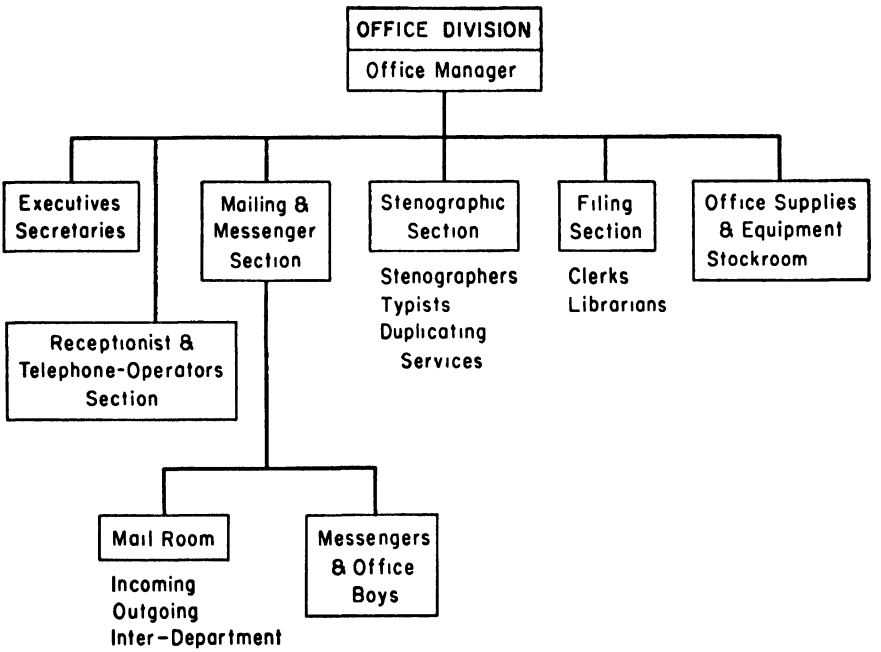
PLACE OF THE OFFICE

When a company uses the decentralized office plan, there is no problem as to the place of the office in the total organization of the firm. Each department has its own office staff and that staff is then a division of its department, and reports to the department head.

When, however, as in most large companies, some form of centralized office is used, the question arises as to just where the offices should be placed in the organizational pattern of the firm. If the company has

a large general office, with hundreds of employees, it is sometimes given the status of a separate department, with the office manager (who is in charge of the office staff) as department head reporting directly, with other department heads, to the president. Since, however, the function of the office is to facilitate the routines of the operating departments and since the president does not want to be weighed down with the details of too many departments and too many officers reporting directly to him, it is more customary to have the office manager of the general office report to one of the officers of the firm. Thus, in Kennedy & Company, the office might be one of the divisions under the supervision of Mr. Rogers, the personnel manager. Sometimes the office is placed under the treasurer; in many companies it is common to make the general office a division of the accounting department, headed by the comptroller, whose duties will be discussed later.

Office Organization Chart. Since the office is a service function, set up to facilitate the work of the major operating departments, its planning will vary with the size of the company and the type of industry.



Courtesy New York State Electric and Gas

The Office Division. The office is the "paperwork division" of the business, performing countless services for the entire company personnel. What training do you think an office manager should have? what personal qualities?

Shown on page 346 is the organization chart of an office division of a large corporation, shown not because it is the best or even the commonest arrangement, but rather because it is a typical office pattern.

In smaller offices, bookkeepers are also placed under the supervision of the office manager, often because they do other office work in addition to bookkeeping or because many of the office personnel help out in bookkeeping. In a large firm, however, record keeping is done by a separate staff of bookkeepers and clerks, under the chief accountant, and they are not considered part of the general office.

Office Personnel. In charge of the office is the *office manager.* It is his duty to see that the office runs smoothly and efficiently and that it provides the services needed by the operating departments. Since the office is an important co-ordinating factor, the manager must have an understanding of the over-all objectives of the firm and must use tact and good judgment in his contacts with the other departments, as well as with his own subordinates. It is his responsibility to see that the office personnel are properly placed, that they do their work efficiently and with the least cost and waste, and that the office functions are promptly and properly carried on. He must be ever on the alert for new and improved office equipment, methods and procedures. In large offices he must be ready to delegate authority and responsibility to section heads who take charge of specialized sections of the division, carrying out the broad policies and directives of the office manager.

A large division might have as its second in command a *chief clerk,* or assistant office manager, who acts as the executive officer to carry out the instructions of the office manager. Each section may have its own section head—such as the chief receptionist, head file clerk, head stenographer—to take charge of that particular function.

Highest in the hierarchy of the workers in the office division is the *secretary.* The secretary, who must be well versed in all the duties of the usual office employee, is generally the administrative assistant of an executive of the company. She not only handles the correspondence of the official to whom she is assigned, but also takes care of many of the administrative details and responsibilities of the executive, so that he is free to spend his time in making the broader policy decisions. The good secretary is a professional worker, devoted to her job and loyal to the executive for whom she works, and can be trusted with important and confidential duties. She can direct the work of other office personnel; can take on many responsibilities; is capable in drafting correspondence, handling telephone calls, taking dictation and transcribing; and in seeing that details are carried out properly and promptly.

Stenographers are office workers who have the ability to take dicta-



Courtesy Westinghouse Electric and Manufacturing Company

The "Right Arm" of Business. The secretary has been called the executive's "right arm." It is her job to free him of as many details as possible, so that he will have more time for decision- and policy-making activities. Most secretaries are women, but there is a demand for men, too.

tion and to type attractive-looking letters and reports. *Typists* are expert at the typewriter, but do not take dictation in the form of stenographic notes. Typists often type from recorded dictation. *Clerks* are office workers who take care of such matters as filing, checking figures, opening and routing incoming mail and sealing and stamping outgoing mail. *Receptionists* and *telephone operators* are usually girls with pleasant voices, appearance, and personality, who take care of those who call, either in person or over the phone. Finally, *office boys* and *office girls* are young people who handle messenger and other less responsible duties connected with the office.

Sections of the Office Division. The office manager seldom has much control over the executives' secretaries, because they usually report directly to the officers whom they are assigned to assist. There are, however, certain office matters concerning which the secretaries must look to the office manager for suggestions and decision. The company may have standard procedures and forms for correspondence with which the secretaries must comply. They would also probably have to draw their supplies from the office stockroom. There may be a few other ways, sometimes even with reference to their salaries, that secretaries are in contact with the office manager and under his supervision.

Oral Communication. The subdivision of the office having to do with communication with the firm by means of the spoken word is the *receptionist* and *switchboard* section. In many cases, these two functions are handled by the same girls, the telephone switchboard being placed in the visitors' reception room. In other offices, they are separate operations, handled by different people. In either case, these employees, usually women or girls, must be neat in appearance, have attractive personalities, pleasing voices, and friendly, helpful manners. They must be well informed of the various departments of the company, their locations and their officers, in order to direct callers—in person or by telephone—to the proper individual.

Written Communications. The mail and messenger section, and the stenographic section, handle the firm's written communications, primarily by mail, telegraph, teletype, cable, and radiogram. The prompt and efficient handling of correspondence and messages can contribute much to the general efficiency of the company as a whole, and experience shows that this work should almost always be taken care of centrally. Incoming mail, telegrams, etc., must be accepted and entered in a record, opened either by hand or by machine, stamped with date and time of receipt, sorted, and delivered to the department concerned. Outgoing correspondence must be collected, folded, and placed in envelopes, sealed and stamped, and delivered to the post office or mail box. In large companies, most of these operations are handled by machine, which saves time and speeds up the mail. Teletype messages, when the company has a volume of communications large enough to warrant the expense of this form of transmission, are handled by special operators who are skilled in typing and who have been instructed in the peculiarities of this mode of communication. The mail room often takes care of the delivery of intracompany memoranda and other interdepartmental messages and usually supplies the company with any messenger service it may need.

The *stenographic section* takes care of the very important function of typing the many letters and communications the firm sends out. Because letters are often the first, and sometimes the only, contact that others have with the company, it is essential that they be well written and present a neat, businesslike appearance. It is therefore the responsibility of the office manager to see that the letters sent out by the firm measure up to those standards and that the stenographic and typing personnel are familiar with good letter forms and styles. A decision must be made as to whether voice-recording equipment can be used to advantage, reducing the number of stenographers needed and increasing the number of typists. Assigning employees in this section to the various

departments of the company, as they are needed, is one of the most difficult coordinating jobs in the office.

Files and Supplies. The *filing section,* as its name implies, handles the filing of all correspondence and written reports and communications, so that they may be available when needed. The office manager and his aids must decide which system, or combination of, filing systems should be used by the company. The system chosen should be the one best adapted to the particular needs of the company, should be simple to operate, and permit ready accessibility to needed information. The commonest method is *alphabetical filing,* with the material filed alphabetically by the name of the person or company from whom the letter or paper was received, or to whom the original of the letter or paper, the copy of which is being filed, was sent. Under *subject filing,* the material is filed in accordance with the subject to which it refers; and in *geographical filing,* it is filed in accordance with the geographical area of the sender or recipient, or the location of the subject written about. Some filing is done *chronologically,* the material being placed in the files according to date. Some chronological files are *tickler files,* arranged as reminders that something must be done on certain dates. Occasionally, a *numerical file* system is used, with each article numbered and filed accordingly. An index of all numbers is then required.

A combination of filing systems is often used. Thus, Kennedy's may keep its system primarily on a geographical basis, so that correspondence is first sorted for filing according to the part of the country from which it comes or to which it is going. A subheading under the geographic file may be that of subject matter, so that material is next divided under tools, electrical appliances, garden equipment, and the like. Having been classified in this fashion, the letter would then, for example, be placed in the file drawer for Midwest, electrical appliances, under the dealer's name in alphabetical order; and, finally, it would be placed in the particular file folder in chronological order according to its date, the most recent letter on top.

The office manager must not only determine what filing system to use, but he must be certain that all file clerks are thoroughly familiar with the filing procedures and follow these principles uniformly. Nothing is more difficult to locate, or more annoying, than an important communication that has been misfiled. A mistake in filing may be very costly, for it may be days, months, or even years before the lost item is located in a large file.

Some system should be set up for the regular weeding out of obsolete material, which is either transferred to a *dead file* and stored in a less expensive, and probably less accessible, area; or, if definitely of no further



Courtesy Mutual Life Insurance Company

Records in Business. Records "remember" what people forget. The need for records grows year by year, and often highly specialized clerks are needed for work in the filing section. What kinds of records might be kept in such files?

use, is destroyed. Proper procedure also requires that when a paper is temporarily removed from the file, a card—called an *out-card*—noting what material was taken and by whom is substituted in the file for the missing material until it is returned.

A separate section of the typical general office of a large company usually handles the *supplies and equipment storeroom.* Most offices use a considerable amount of expensive portable equipment, and care must be taken to see that these various machines are properly used and are not stolen. Offices not only use large quantities of stationery and desk and typewriter supplies, but also many kinds of forms devised to facilitate reports and communications. It is therefore important that a place be set aside for the storage of all this, and that someone be given the responsibility for its care, procurement, and accounting.

MANAGERIAL CONTROL OF THE OFFICE

Location and Layout. Since the office is the co-ordinating factor in the organization and is designed to serve all departments, it must be

so located that it can perform these functions adequately. This might depend on proximity to the department or departments which the office is to serve, or on its convenience for callers who have business with the firm. Other factors would be adequate light and air and a minimum of distracting elements.

In the layout of the office, the flow of work should be studied carefully, so that it will move in as straight a line as possible. It is important that sufficient space for each function be allocated, yet none wasted. Furthermore, the layout should be designed to facilitate efficient supervision. Proper ventilation, lighting, and perhaps even air conditioning, are also important.

Equipment and Supplies. An important problem is the degree to which the office should be mechanized. Thought must be given to the relative costs of doing the work by hand, by simple machines—such as typewriters—or using more expensive apparatus like addressographs, duplicating machines, etc. Machines have been devised for almost every type of operation, with several makes of each type available, so that the office manager must compare the efficiency of each, the original cost and the maintenance cost, as well as the repair service the equipment companies provide. It is advisable to place responsibility for procurement and maintenance of office equipment in the hands of one person, perhaps the head of the supplies and equipment storeroom, so that a check is constantly being made to insure that all necessary equipment is on hand and operating at optimum efficiency.

Careful control must also be exercised over office supplies, because they are used in large quantities, are easily wasted, and are usually readily accessible for personal use. Careful supervision must be maintained over the purchase and issuance of office supplies, with requisitions and stock records required, and with one individual responsible for the stock of such supplies.

Standardization in the Office. One of the most significant contributions that the office manager can make to the over-all efficiency in his division, and at the same time to cut costs of operation, is that of devising standardized systems and enforcing their use. Standards should be set both for form and for procedure.

Much time and a considerable amount of the cost of running the office can be saved when standard forms are employed. This means first of all cutting down the number of sizes and kinds of stationery, forms, and supplies used in the office. Thus, for example, instead of each department of Kennedy & Company using paper of different size or quality, all could use the same size and quality. The number of

forms should be cut down to bare essentials, so that a minimum of this type of paper is used; and the stock on which each is printed should be the same. This type of standardization throughout the office, and the company as a whole, will lead to economy in purchasing, because large quantities can be bought. Furthermore, fewer reports and forms will mean less paper consumed.

Standardization of form also refers to the setting up of general standards for correspondence. Fixed rules should be established for the appearance and the content of letters written by anyone in the company. The appearance of a firm's written matter is important, because a neat, businesslike letter makes a good impression on the reader, who, as already mentioned, very often has no other contact with the company. Appearance, therefore, should not be left to chance, or to the typist's whim, but rather should follow certain standards, set by the office manager, as to the placement of the heading, salutation, body, and close, as well as margins, indentions, paragraphing, etc. The tone and phrasing of the letter should also be in accordance with patterns required by company standards. This, however, is more a question of reflecting the proper approach and attitude in all correspondence leaving the office, since letters should not become too stereotyped.

Procedural standards must also be set up, with the proper steps for doing the various office jobs set down in writing and with the time each operation should take carefully computed. The office personnel should then be trained to perform routine operations in accordance with these standards. The output of each worker should be compared with the standard rate. An office, especially a large one, carries on many daily routine activities, just as a factory does; and in many ways can make similar use of standardization of methods to cut down on inefficiency and waste.

Office Control. Once the office has been established and its work is under way, the office manager's task is one of *control*—the constant, vigilant effort to increase efficiency and cut costs in performing the office functions. As when he first planned the office layout and the office routines, the office manager must continue to exercise careful supervision over all the elements in the operation of his division which will maximize efficiency and minimize cost. These include the following measures of office control:

1. Study and re-evaluation of the office layout and standards of form and operating procedures to assure optimum results at reasonable cost.
2. Continuous survey of the types, uses, and economics of office equip-

ment to make certain that the office maintains the greatest possible production at the least proportionate expense.

3. Control of supplies so that they are available when needed, yet not wasted or unnecessarily duplicated.
4. Scheduling and distribution of the work to assure high efficiency and timely service with few bottlenecks and delays.
5. Supervision of the quality of work being turned out and the time consumed in its production.

SUMMARY

The office of a business concern has an effect on the operations of the company out of all proportion to its size and the number of persons it employs. It is a service function, which co-ordinates the various departments and handles communication and many daily routines. In many business organizations the office is centralized; in others each department has its own office staff. When set up on a centralized basis, the office is generally supervised by an office manager who is not, however, normally a department head, but reports to the personnel manager, the treasurer, or the comptroller. The office usually handles such matters as reception of visitors; operation of the telephone switchboard; incoming, outgoing and interdepartmental mail; correspondence; reports; and filing. The office manager should set up the office and exercise control over it in such a manner as to permit the maximum of efficiency while operating with as little cost as possible.

► FOR REVIEW AND DISCUSSION

1. Why is the office of a business called the "brain" or "nerve center" of a business?
2. What is the difference between a centralized and a decentralized office set-up?
3. What is the usual relationship between the executives' secretaries and the office manager?
4. What is the function of the stenographic section of the office?
5. What types of files and filing systems may be used in the office? What responsibility does the office manager have with regard to filing?
6. What factors should be considered in planning the layout of the office?

7. What type of control should be established for the purchase and issue of supplies?
8. To what extent should work and equipment in the office be standardized?
9. What should standardization of correspondence include?
10. What are the five major factors of office control?
11. Is it wise for a business to spend large amounts of money on expensive office equipment which is nonproductive in terms of yielding income?
12. Discuss the advantages and disadvantages of a centralized and a decentralized office in various size businesses.

► CASE-PROBLEM QUESTIONS

1. How can an office manager become a valuable employee to a firm like Kennedy & Company?
2. What type of person should Mr. Rogers employ as office manager?
3. What physical arrangements should Mr. Kennedy and Mr. Rogers provide in setting up a larger office?
4. How important is air conditioning and good ventilation to effective office operation?
5. If Kennedy & Company employs an office manager, to whom should he be responsible?
6. How can Mr. Rogers and Fred Kennedy obtain reliable advice on whether they should employ an office manager?

► APPLIED BUSINESS PROJECTS

1. Mr. Harris, the comptroller of a firm, complains that the letters sent out by the firm are very poor and that it costs far too much to produce each letter. Each section manager has his own secretary and, if necessary, an additional typist.

In 100 words or less write a specific suggestion for solving Mr. Harris's difficulty.

Give five reasons why your solution may not be entirely satisfactory.

2. The Gem City Cement Block Company has an office connected with its major plant, but no office help in the six smaller plants which are scattered in an area of about 50 to 100 miles around the main plant. The managers of the smaller plants complain that they spend too much time filling in invoices, filing receipts, filling in forms, and doing other office work. The office manager in the main plant complains that letters are not written properly in the branch plants; that the files are not kept properly; that the payroll forms are sometimes incomplete; and that the office procedures in some of the branch plants are difficult to understand.

(*a*) There are at least three possible methods of remedying the apparent weakness in office procedures in this organization. List them.

(*b*) Explain in one or two paragraphs which of the procedures you think would be the most satisfactory in solving the office difficulty of this organization.

► COMMUNITY PROJECT

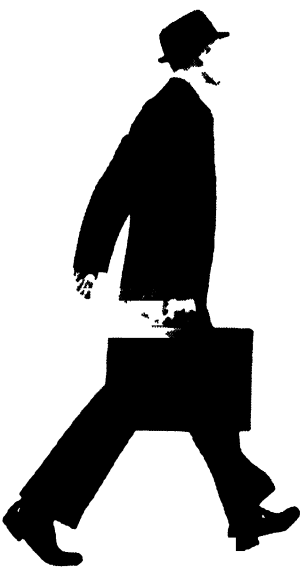
Have one member of the class interview one or more of each of the following to determine the answers to the four questions listed below for each job: (*a*) office manager, (*b*) stenographer, (*c*) typist, (*d*) bookkeeper, (*e*) file clerk, (*f*) receptionist.

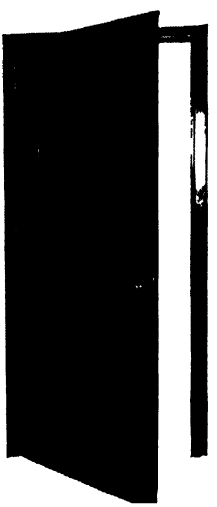
Questions which should be answered in each interview:

1. What are the principal duties of the job?
2. What are the attractive features of the work?
3. What are the undesirable features of the work?
4. What are the opportunities for promotion?

Section Six

Internal Financial Management







22

Financial Accounting and the Determination of Profits

CASE PROBLEM

At a meeting of the board of directors of Kennedy & Company, now a successful company engaged in the manufacture of tools and the distribution of hardware and electrical appliances, Mr. Ames, the corporation treasurer, brings an important problem to the attention of the board. He points out that so far the company has been moving ahead haphazardly, with no blueprint or plan for its future operations and without control over its business costs. He contends that the corporation could be even more successful if it paid more attention to estimating, planning, and analyzing its costs and profits.

Mr. Ames believes that the company is now large enough to need a comptroller—operating separate and apart from his own work as treasurer—to supervise the accounting and budgetary functions of the firm, so that profits can be maximized and costs reduced. He asserts that this comptroller could coordinate the planning for the entire firm.

The directors ask Mr. Ames to be more explicit and to describe more fully just what the functions of the comptroller would be and in what way he would be connected with profits.

- What are the duties of a comptroller, and how does his job differ from that of the treasurer?
- What financial facts does the firm need to know in the determination of its profit, and what records are needed to accumulate those facts?

- **What are some of the important problems involved in the determination of the profit of a business?**
- **Once its profit has been determined, what are some of the problems involved in its disposition?**

RECORDS AND PLANNING

No matter how large or small a business may be, it can only be successful if there is careful planning of its activities and future progress, and if adequate records of its affairs are kept. A study was made by the United States Department of Commerce in an effort to determine the causes of the tremendous number of business failures that occurred during the 1929 depression. This investigation disclosed that while the depressed state of business was the occasion that brought about the failures, the depression was not actually the cause of the bankruptcies and the closing of so many business enterprises. Rather, the true cause of the failure, in almost all cases, was the faulty management by those who conducted the firm's affairs. Well-run concerns usually rode out the storm, the poorly managed ones generally foundered. Furthermore, the study disclosed that in more than 60 per cent of the cases, the failure was directly due to inadequate planning and record keeping. Such firms kept practically no books, overstocked their inventories, or extended too much credit. When adverse business conditions developed, they failed —while their more efficient competitors kept going.

It is therefore essential to the well-run business enterprise that a member of its top management be assigned the specific responsibility of planning its progress, budgeting its activities, and keeping records of its transactions. In many firms, this official is known as the *comptroller* (often spelled, as it is pronounced, *controller*).

THE TREASURER VERSUS COMPTROLLER

Although in smaller firms the treasurer often assumes the duties of the comptroller in addition to his own, the functions of these two officials are different. In large business enterprises these offices not only are held by two separate individuals, but each is in charge of a department of his own. It was seen in Chapter 12 that the treasurer is concerned with the external financing of the company. He is usually charged with the following duties and responsibilities:

1. Receives and disburses the company's funds
2. Borrows money for the firm, either on a short- or long-term basis
3. Invests surplus company funds
4. Handles the insurance of the company's properties

5. Occasionally supervises, through the credit manager, the extension of credit to the firm's customers

The comptroller, on the other hand, has been described as handling the firm's internal financial problems. Chapter 12 brought out the importance of separating the cashier, who receives or pays out money, from the bookkeeper who records the receipts and disbursements. The comptroller, as distinguished from the treasurer, represents this same separation of cash and records on a higher level. The comptroller of a business is generally charged with the following duties and responsibilities:

1. Devises the methods and systems for the business records and supervises the keeping of the general or financial accounting records
2. Devises the cost-accounting system and supervises the keeping of cost records
3. Supervises and co-ordinates the budgetary activities of each department and prepares the over-all business plan or budget
4. Handles the tax problems of the company in an effort to keep its taxes as low as possible
5. Sees to it that the records of the firm are properly audited, that is, checked for completeness and accuracy. Generally, however, he calls in an outside firm of independent accountants to do the actual auditing
6. Sometimes has charge of the gathering and evaluation of statistical information useful in the making of future plans
7. In many firms, the general office, while directly supervised by the office manager, is made an additional general responsibility of the comptroller
8. Some firms have the credit manager and his function of extending credit under the comptroller, rather than as a separate department of its own, or under the sales manager or treasurer

ORGANIZATION OF THE ACCOUNTING DEPARTMENT

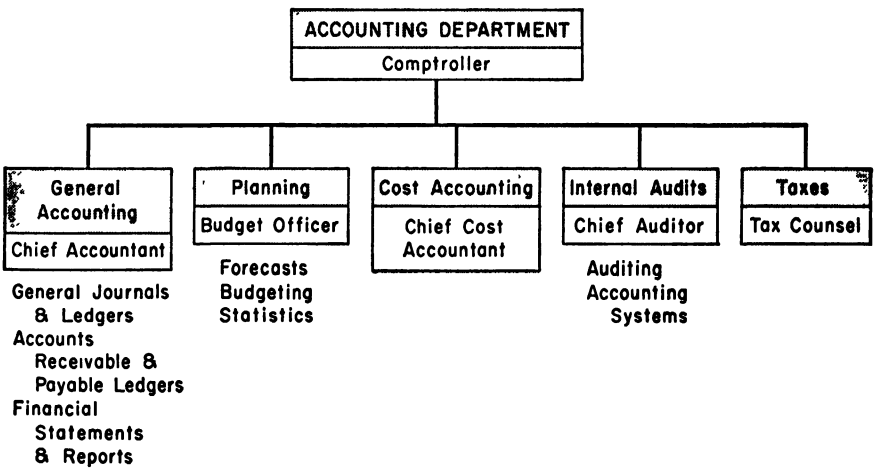
In a firm large enough to afford a comptroller separate and apart from the treasurer, he is usually a top-level officer of the firm, equal in importance to the vice-presidents and, like them, is the head of his own department, generally called the *accounting department.* As was seen in the discussion of the comptroller's functions in the previous paragraph, the accounting department usually includes a general or financial accounting division for keeping its regular books of account and for the preparation of statements showing the financial condition of the firm and its success in making profits. Another division usually handles the cost-accounting function, maintaining records of the costs involved in the

manufacture of each of the company's products, so that these may be controlled and the goods properly priced. A third division of the department makes forecasts of future operations and business conditions, assembles the budget figures submitted by the various departments, and prepares an over-all budget for the entire business. Gathering statistics and information on sales and business activities may be part of the budget division; may perhaps instead be a division in itself; or, as in many firms, may be included under the market research activities of the sales department.

Shown below is an organization chart of the accounting department as Kennedy & Company might set it up. Like other charts presented in this book, it is not suggested as the only, or even the best, way of setting up such a department, for each firm must organize it in such a way as to meet its own individual problems. Rather, it is an illustration of how such a department might be arranged in one fairly large firm, showing the separation and handling of its various functions.

FINANCIAL ACCOUNTING

Perhaps the most important of the comptroller's functions is keeping the general account books of the firm, usually referred to as *financial accounting,* or merely as general accounting. Although bookkeeping has always been necessary to the well-run business, there was a time when small firms kept neither books nor records except, perhaps, for a checkbook or a simple day-book record of purchases and sales. Today, however, not only does practically every businessman recognize the need for



Organization Chart of an Accounting Department

good records to aid him in charting his business course, but income tax regulations require every business to maintain adequate records.

Just what should these records include—what does a businessman need to know about his business? Naturally, the exact answers to this question depend on the size of the enterprise and the particular line in which it engages. There are, however, certain general facts management needs to know about any business and which properly designed accounting records can disclose. This information is summarized in two statements which provide, in comparatively simple and readable fashion, most of the facts needed in making important business decisions. One is a statement of the financial condition of the enterprise on a given date, usually at the close of business at the end of the year. The other—the profit and loss statement—and perhaps more important, gives a brief review of what happened during the course of the year with reference to income received and expenses incurred and their effect on the net profit of the firm.

THE STATEMENT OF FINANCIAL CONDITION

The *statement of financial condition* or *"balance sheet,"* is a summary of the detailed facts taken from the records of the enterprise, showing what the firm owns, what it owes, and therefore what its net worth is. It has often been compared with a snapshot or "still" picture, showing the financial condition at a given moment.

First, it lists all the property that the enterprise owns, called its *assets.* Each item is carried on the books of the firm at its cost and is listed in the statement under certain groupings. *Current assets* are those which are used in the operations of the business and will normally be turned into cash or used up within the year. Included on the balance sheet, therefore, under current assets would be such items as cash on hand and in banks, securities the company owns, the cost of the merchandise it has in its inventory, the cost of the supplies (stationery, paper towels, etc.) it may have in its storerooms, and the amounts owed it by customers, which it can reasonably expect to collect. The latter are referred to as *accounts receivable.*

Fixed assets are those which are not normally used up or sold within the year and are used in carrying on the business. These would include such items as land and buildings owned by the enterprise, furniture and equipment, factory and office machines, and delivery trucks. These are shown on the statement at their original cost, less the amount they have depreciated since their first use; that is, the cost value is reduced by that percentage of the normally expected useful life of each fixed asset since the asset has been used by the firm. Thus, very simply, if a building cost $400,000 and is expected to give the company 40 years

KENNEDY & CO., INC.
Statement of Financial Condition
December 31, 1959

Assets

Current Assets			
Cash		$ 15,500	
Accounts Receivable	$ 40,000		
Allowance for Bad Debts	2,000	38,000	
Factory Inventories:			
Raw Materials	6,000		
Work in Process	11,000		
Finished Goods	7,000	24,000	
Store Merchandise Inventories:			
Hardware	25,120		
Appliances	23,780	48,900	
Supplies Inventories		600	
Prepaid Insurance		200	
Total Current Assets			$127,200
Fixed Assets			
Delivery Equipment	12,000		
Allowance for Depreciation	4,000	8,000	
Office Equipment	4,000		
Allowance for Depreciation	800	3,200	
Store Equipment	28,000		
Allowance for Depreciation	2,800	25,200	
Factory Machinery & Equipment	90,000		
Allowance for Depreciation	20,000	70,000	
Building	100,000		
Allowance for Depreciation	13,000	87,000	
Total Fixed Assets			193,400
TOTAL ASSETS			$320,600

LIABILITIES

Current Liabilities			
Bank Loans Payable		$ 15,000	
Accounts Payable		18,900	
Income and F.I.C.A. Taxes Withheld		1,100	
Taxes Payable		14,200	
Total Current Liabilities			$ 49,200
Fixed Liabilities			
Mortgage Payable			65,000
TOTAL LIABILITIES			$114,200

Stockholders' Equity

Paid-In Capital			
Common Stock		$160,000	
Retained Earnings		46,400	
TOTAL STOCKHOLDERS' EQUITY			206,400
TOTAL LIABILITIES AND CAPITAL			$320,600

service before becoming too antiquated for any further use, it would then depreciate $\frac{1}{40}$, or $10,000 a year, and after 10 years would be shown on the balance sheet at the net figure of $300,000.

The debts of the company are known as its *liabilities;* and these, too, are divided into current and fixed. The *current liabilities* are those the firm will usually pay off within one year, such as its debts to trade creditors for merchandise purchased on account (known as *accounts payable*), loans from banks, unpaid telephone and light bills, and other current debts. *Fixed liabilities* are obligations of the firm, like bonds and mortgages, which are not to be paid off in one year.

Deducting the total liabilities from the total assets discloses the net investment of the owners in the business, called *equity, net worth,* or *capital.* This may be analyzed in the statement, showing the share each partner is entitled to in the total net worth; or it may show the original investment of the owners and the difference between the original investment and the present total net worth as profit or as loss. In a corporation, the original investment is generally referred to as *capital stock; retained earnings,* which for many years was referred to as *surplus,* represents previous profits that have not been distributed to the stockholders as dividends but rather have been kept as a business asset for further growth or as a hedge against possible future losses.

The balance sheet, for instance, of Kennedy & Company might look like the one on page 363.

Uses of the Statement of Financial Condition. The balance sheet is most valuable to the enterpriser as an indication of the health and growth of his business. It is useful also as a source of information for banks and vendors of merchandise and office supplies in deciding whether to extend credit to the enterprise.

The statement of financial condition is important because it indicates the degree of solvency of the business. An enterprise is *insolvent* when its total assets are less than its total liabilities. A concern in such a condition cannot long remain in operation and will soon go into bankruptcy or be forced to close its doors.

The statement is also an indicator of the *liquidity* of the enterprise. This refers to the amount of funds available to pay off current liabilities as they become due. A comparison is usually made between current assets and current liabilities to see if the so-called liquid assets are sufficient to take care of the debts coming due within the year. This comparison, called the *current ratio,* is made by dividing the current assets shown on the balance sheet by the current liabilities also listed there. Many businessmen believe there should be $2 of current assets for every $1 of current liabilities—a ratio of two to one—but the

validity of this "rule-of-thumb" depends on the industry within which the business is operating.

Another way of expressing the same concept is by subtracting the current liabilities from the current assets to arrive at the *working capital.* The more working capital the statement reveals, the more liquid is the condition of the company, and the better position it is in to meet its obligations and weather any financial difficulties that may arise.

Another use of the statement of financial condition—by comparing it with similar statements of previous years—is in indicating the growth of the enterprise, as can be seen if the net worth of the business increases over the years. Although it is good to note that a company's assets grow larger year by year, it is more significant to deduct its liabilities in each case, for they too may have grown, so that the true growth of the business can only be deduced from an increase in its capital—the net equity of its owners. An enterprise may be making profits, but if its owners withdraw too much for their own living expenses, they can be hurting the firm just as much as if it were suffering losses rather than making profits, a fact that the balance sheet should also disclose.

THE PROFIT AND LOSS STATEMENT

Just as the statement of financial condition has been called a snapshot or "still" picture of a business at a given moment, so the *profit and loss statement* may be compared with a motion picture showing what has been taking place in the affairs of the enterprise over a period of time. This statement shows the gross profit from the sale of the company's merchandise, less the cost of those goods, plus any other income of the firm, and then subtracts, from the total gross profit, the expenses of operating the business, to arrive at the profit for the period.

For instance, the profit and loss statement for Kennedy & Company during a year of operation might look like the one illustrated on page 366.

Uses of the Profit and Loss Statement. Since the basic reason for conducting a business enterprise is normally the making of profits, the profit and loss statement is therefore the fundamental summary of the operations of the concern. Its major purpose is thus to disclose whether the enterprise is earning a profit or suffering a loss and to show the extent of these increases or decreases in the owner's capital.

In addition, considerable use can be made of the statement to learn important facts about the business operations. Ratios or percentages can be computed to show what proportion of sales income is used in the conduct of the affairs of the enterprise, and these ratios can then be compared with ratios for the average business firm in a similar industry and of comparable size.

KENNEDY & CO., INC.
Profit And Loss Statement
For the Year Ended December 31, 1959

Sales—Manufactured Items			$240,350
Cost of Manufactured Items Sold:			
Raw Materials Used		$43,200	
Direct Factory Labor		91,240	
Factory Overhead:			
Supervision and Indirect Labor	$32,400		
Factory Maintenance and Repairs	7,050		
Factory Heat, Light and Power	2,065		
Factory Insurance and Taxes	3,540		
Factory Supplies and Miscellaneous	3,725		
Depreciation—Building and Equipment	7,000		
Total Factory Overhead		55,780	
Total Cost of Manufacturing		190,220	
Less: Increase in Factory Inventories		9,644	
Cost of Manufactured Items Sold			180,576
Gross profit on Manufactured Items			59,774
Sales—Retail Stores		265,787	
Cost of Retail Goods Sold		203,136	
Gross Profit on Retail Items			62,651
TOTAL GROSS PROFIT ON SALES			122,425
Operating Expenses			
Delivery Expenses		4,300	
Depreciation of Delivery Equipment		2,000	
Advertising and Sales Promotion		8,600	
Store Salaries		26,000	
Store Supplies and Miscellaneous		1,703	
Bad Debts Expense		620	
Depreciation of Store Equipment		700	
Office and Officers' Salaries		33,000	
Office Supplies and Miscellaneous		1,011	
Office and Store Taxes		2,600	
Office and Store Rents		6,000	
Depreciation of Office Equipment		200	
Accountants and Attorneys Fees		715	
Interest Expense		350	
Total Operating Expenses			87,799
Profit before Income Taxes			34,626
Federal Income Taxes			15,238
NET PROFIT			$19,388

Important among these various ratios, for instance, is that of *merchandise turnover*, or *stock turn* as it is sometimes called. Here the cost of goods sold is divided by the average inventory at cost (or net sales divided by average inventory at selling price) to see how many times during the year the stock of merchandise was sold or "turned over," showing how successful management was in purchasing its goods and in promoting them for sale. There is of course no "rule-of-thumb" or set formula for what the stock turn should be, for certainly the stock in a 5-and-10-cent variety-type store should turn over many more times in a year than that of a piano store or one selling steel safes and vaults. Rather, the comparison must be made with other enterprises in the same business, or with the average of such figures, and with the firm's own stock turn for previous years.

By comparing the ratios in the profit and loss statement of the current year with the ratios in the statements of previous years, the progress of the concern in cutting costs and expenses and increasing net profits can be measured. By departmentalizing the statement, that is, distinguishing sales costs and incomes from the hardware and appliance departments of Kennedy's, for instance, or showing separate figures for each of its stores, it is possible to learn which department or which store is contributing most, or least, to the net profits of the company. A study can then be made to analyze why one department or store produces the best results, and why the laggard department or store contributes less to net income, and an effort made to use these findings to increase sales, or cut costs of all departments or stores, so that those at the bottom of the scale can carry their own weight.

RECORDS NEEDED

The two financial statements—the balance sheet and the profit and loss statement—are the summaries of what the records of the firm set forth. While they are the end results of the financial or general accounting of the enterprise, the books and records also give considerable information needed daily in the operations of the business. Such month-by-month facts as the amount of money the firm has in the bank, the amounts owed by various customers, or by the firm to its creditors, the sales of hardware, appliances, or manufactured tools, are some of the facts with which management needs to be constantly supplied as it conducts the every-day affairs of the firm. The business books must therefore be set up to supply this daily information, as well as the facts to be ultimately summarized in the two financial statements to determine the profit made during the entire period.

Journals and Ledgers. There are two major types of books of account

in any bookkeeping system—journals and ledgers. The *journals* are chronological records of transactions as they take place in the operations of the business. The sales journal, for instance, would have recorded that on July 1, 1959, cash sales of hardware were $964.37, cash sales of appliances $1,625.30, and the credit sales made, giving each customer's name, the full amount of his purchase, and how many of these charge account sales were for hardware and how many for appliances. The entry in this same sales journal for July 2, 1959, would similarly show the cash and credit sales for the day, and so on for the rest of the month.

The *ledgers,* on the other hand, are books in which the records of transactions are assembled together according to each particular item, called an *account.* Thus, instead of having all the business transactions for July 1 together, as in the journals, all transactions involving sales of hardware, for instance, or expenditures for stationery and supplies, or the charges against and payments by H. Jones, a customer, are recorded on separate pages, or accounts, in the ledger. The entries made in the journals in chronological order are subsequently transferred or *posted* to the various relevant accounts in the ledgers. Thus, to learn what occurred at Kennedy's on July 2, we would look at the journals for that day, but to learn how much Kennedy owes to the Smith Corp., a creditor, we would have to look at the Smith account in the accounts payable ledger.

Name Smith Corporation
Address Portland, Oregon

DATE		EXPLANATION	POST. REF.	DEBIT	CREDIT	BALANCE
19— Apr.	3	Inv. 3201	P3		125—	125—
May	10	Check #17235	CP2	100—		25—
	16	Inv. 4731	P3		65—	90—
June	10	Check #19007	CP3	90—		—
	20	Inv. 6409	P4		78—	78—
July	2	Inv. 7320	P4		45—	123—

We see from the above account, for instance, that Kennedy's made purchases from the Smith Corp. of $125 on April 3, $65 on May 16, $78 on June 20, and $45 on July 2. Kennedy's made payments on account to the Smith Corp. of $100 on May 10, and $90 on June 10; so it owes the Smith firm a balance of $123.

The figures for the two major accounting statements are taken from the *balances* of the various accounts in the ledgers. These balances

would be the net difference between all the items appearing on the left, or *debit,* side of each account, and those appearing on its right, or *credit,* side. Asset and expense accounts will normally have debit balances, and liabilities, net worth and income accounts will usually have credit balances.

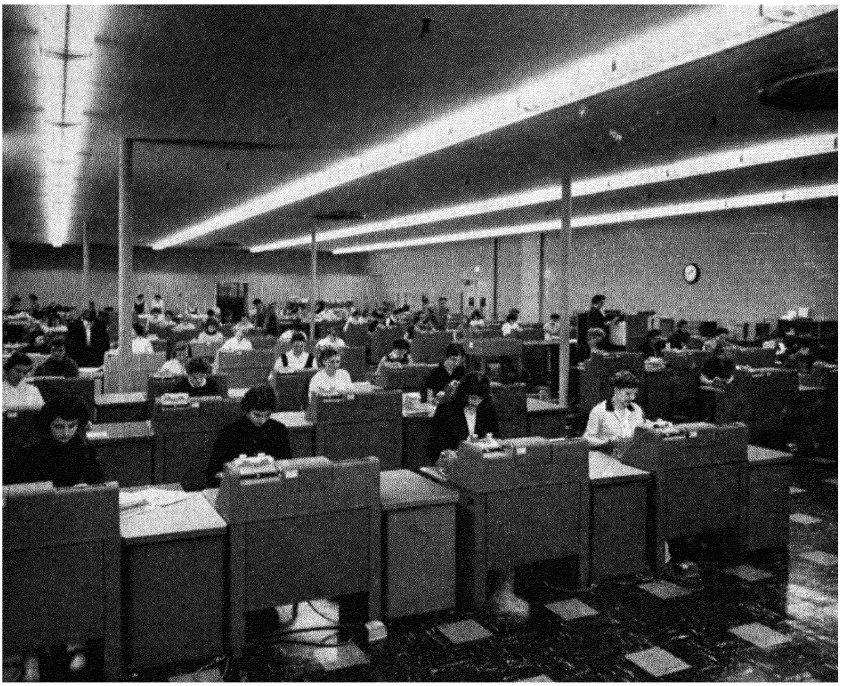
In the usual bookkeeping set-up, several journals and generally three ledgers are maintained. Normally there is a *cash receipts* and a *cash payments* journal to record all cash transactions. (Cash, to the accountant and bookkeeper, refers to money kept in the bank; the money kept on the premises in cash registers and cash drawers is generally called "petty cash.") A *sales journal* to record merchandise sales is usually kept, as well as a *purchases journal* for recording all the firm's purchases of goods for resale. Finally, there is normally a *general journal* for the recording of transactions which do not involve the receipt or payment of cash, or the purchase or sale of merchandise. Thus, if Kennedy's bought a new showcase and gave a promissory note to the vendor in payment, this would be entered in the general journal since no cash or merchandise, for resale, is involved.

The usual bookkeeping system generally involves the use of three ledgers, the *accounts receivable,* or *customers' ledger;* the *accounts payable,* or *creditors' ledger;* and a *general ledger* for all accounts other than customers or creditors.

In the small business firm, all the bookkeeping may be done by hand; and the various journals and ledgers are often separate pages in a large loose-leaf book. As a firm grows in size, its bookkeeping becomes more complex. Instead of being kept in one binder, the various journals may be kept in separate books and the ledgers in separate loose-leaf binders, which often become thick. Sometimes the firm has so many charge-account customers or creditors that it keeps their accounts on cards in a set of file drawers instead of on pages of a book.

Most medium- and all large-size firms today use some form of bookkeeping machines for the keeping of their accounting records. In their simplest form, cash register tapes may be substituted for a sales journal. Many companies have multipurpose billing machines, which prepare customers' invoices, keep a total tape that acts as a daily sales journal, and print the customers' account cards, for insertion in a ledger file, all at the same time. Bookkeeping has become so complex for many large firms that card-punch machines and electronically operated devices—like Univac—are used to keep records, print customers' invoices, and employees' paychecks.

Payroll Records. In addition to the above-mentioned books of account which are necessary for the proper operation of a business, and



Courtesy F. W. Woolworth Company

Mechanized Accounting. Pencil and paper will no longer do the accounting job in the average business firm. Highly intricate—and costly—machines must be utilized.

from which income and other tax returns are made, it has become essential for modern business to keep a separate payroll record. This book has a separate page, or account, for every employee of the firm, and lists his name, social-security account number, the number of regular and overtime hours he has worked each week, and the amount of pay due him. Deductions from his wages for Federal income tax, for contributions to old-age, unemployment and disability benefits, union dues, group insurance, savings bonds, etc., are all recorded as well.

SAFEKEEPING OF THE RECORDS

The accounting records of a business soon become vital to its operations, and must be protected from theft and loss and, most important, from destruction by fire. It is therefore essential that the records be kept in fireproof safes or vaults when not in use. It is especially important that they be placed in such a safe or vault overnight. Many fire insurance policies contain an "iron safe" clause, which invalidates the policy and prevents the insured from obtaining recovery in case of a fire,

if the accounting records were not kept in a fireproof place and therefore were not found intact after the fire. The reason for this rule is that in most cases the records are necessary to determine the amount and value of the goods and equipment destroyed by the fire.

PROBLEMS OF PROFIT DETERMINATION

Although financial records are essential to the successful conduct of a business and to a determination of the profits earned or losses sustained, the facts they disclose involve many estimates and are therefore not as definite and conclusive a measure of profit as the figures might seem to indicate. If a man could wait until a business were sold or dissolved then perhaps, many years hence, he could compute exactly how much it had earned above his original investment over the years. But when businesses continue in operation for many, many years, as they usually do, the owners and the tax collectors want profit computations on a yearly basis. The records do give such figures, but they contain very many estimates, which can make the resulting profit figure very much a matter of the policy of the firm or its accountants and often questionable. Let us see, for example, what some of these estimates might be in the case of Kennedy & Company, and how they affect the resulting profit figure shown in the financial records.

DEPRECIATION

It can be seen from the Kennedy profit and loss statement shown on page 366 that depreciation of the fixed, permanent assets of a business can involve a considerable figure and amount to a sizable deduction from its profits. Yet these depreciation expenses—in the Kennedy case, on factory building and machinery, delivery equipment, office and store equipment—are not actual cash expenditures during the year, as are most other operating expenses of the business. Rather they represent the writing off, or *amortizing,* part of the original cost of the assets or equipment bought and paid for some time ago—the amount of the original cost to be written off in any one year is entirely a matter of estimating.

A common way of computing the amount to be charged off against gross profit for the annual depreciation of fixed assets (i.e., the amount by which those assets are reduced in value each year because of wear and tear, becoming out-dated, and obsolescent) is by the so-called "straight-line" method. Under this system of computing depreciation, an estimate is first made of the number of years of useful life the asset can be expected to give the company. An estimate is also made of what the asset should sell for second-hand, when the firm can no longer use it, this

amount being referred to as the *scrap value*. The scrap value is then subtracted from the original cost and this difference divided by the number of years of estimated life to arrive at the annual depreciation charge. Suppose for instance, the Kennedy delivery equipment cost $12,000 when it was bought new. The comptroller may estimate that the equipment should be used by Kennedy's for about 5 years, at which time they ought to be able to realize a trade-in value of $2,000 on the trucks. Annual depreciation would then be computed on the straight-line basis as follows:

$$\frac{\text{Original Cost} - \text{Scrap Value}}{\text{Estimated Life}} \quad \text{or} \quad \frac{\$12{,}000 - \$2{,}000}{5} = \$2{,}000$$

The operating expenses are therefore increased, and the net profit decreased, each year, by the $2,000 write-off on the cost of the delivery equipment for depreciation. Profits are similarly reduced by the depreciation write-off on the cost of other fixed assets.

It can easily be seen, however, that the depreciation computation is based on estimates; and profits would be a different figure if other estimates were used. Thus, if the comptroller believed, for instance, that the trucks might be used for eight years and then traded in for $1,600, the annual depreciation charge for the same assets would be

$$\frac{\$12{,}000 - \$1{,}600}{8} = \$1{,}300$$

or $1,300, instead of $2,000 every year, so that each year would show $700 more in net profit because of this change in the estimate of depreciation of the trucks alone. Of course, the actual length of time the trucks are used and the amount for which they are traded in will finally show which estimate was more nearly correct and will mean an adjustment in the profit figure for the year of their final disposition.

The United States Bureau of Internal Revenue recognizes, as do businessmen, that depreciation of fixed assets is one of the costs of doing business, and permits depreciation deductions from profit for income tax purposes. To aid enterprisers in estimating depreciation, the Bureau has published a booklet that catalogues the probable useful life and rates of depreciation it believes reasonable for many different types of fixed assets.

INVENTORY VALUATION

Another estimate of assets which affects the cost of merchandise sold and therefore the gross profit, and thus eventually the net profit, is the valuation of inventories. Suppose the price of a certain size screw carried

in stock by Kennedy has been rising during the past year. Let us say Kennedy's had on hand, on January 1, 1958, 30,000 of those screws which had cost $6 a thousand screws. On April 23, an additional 40,000 screws of that size were purchased for $7.50 a thousand; on August 6, 50,000 more for $8 per thousand; on November 30, 40,000 more for $9 a thousand. On December 31, a physical inventory, or actual count of the screws of that size in stock, showed 35,000 screws on hand. What is the value of the screws in the inventory, and conversely, what was the cost of the 125,000 screws of that size which therefore were sold during the year?

Some accountants and businessmen would use the *average cost* as the value of the inventory and the cost of screws sold. Thus they would compute the figures as follows:

Jan. 1	30,000	on hand	@ $6 per M	= $180
Apr. 23	40,000	bought	@ $7.50 per M	= 300
Aug. 6	50,000	bought	@ $8 per M	= 400
Nov. 30	40,000	bought	@ $9 per M	= 360
	160,000			$1,240

$$\frac{\$1,240}{160,000} = \$7.75 \text{ average cost per thousand}$$

This average figure would then mean that the 35,000 screws on hand in the inventory would be valued at $271.25, and the cost of the 125,000 that were sold during the year would be $968.75.

Other businessmen insist that the average is not a correct figure for computation of the inventory. They say that as each sale was made, the oldest screws in stock were sold, so that the 35,000 screws on hand must all be from the November 30 purchase of 40,000 screws. Using this *first-in, first-out* method of inventory valuation, called "FIFO" for short, the 35,000 screws on hand would be valued at $9 per thousand, or $315; and the 125,000 screws that were sold would thus have cost $925.

Still other businessmen point out that when new screws are received, they are thrown into the bin on top of the remaining old screws. When screws are sold they are taken from the top of the bin—the salesman does not reach down to the bottom to pick out the oldest ones. They therefore believe in valuing inventory by the *last-in, first-out* method, called "LIFO" for short, and would value the 35,000 screws as 30,000 of the original inventory at $6 per thousand and 5,000 of the April purchase at $7.50 per thousand, or $217.50, and would compute the cost of the screws sold as $1,022.50.

Thus, for the same 35,000 screws on hand and the same 125,000 screws that were sold, three entirely different estimates can be used to affect

the balance sheet inventory asset values and the profit and loss statement figure for cost of merchandise sold, and thus the net profit.

Method of Valuation	*Value of 35,000 Screws on Hand*	*Cost of 125,000 Screws Sold*
Average cost	$271.25	$ 968.75
FIFO	315.00	925.00
LIFO	217.50	1,022.50

The United States Bureau of Internal Revenue generally permits a business to use any one of these three methods in valuing its inventory, provided it sticks to the same method consistently from year to year.

The foregoing examples of depreciation and inventory valuation are illustrations of a few of the problems involved in profit determination. They indicate the importance of the firm's accounting philosophy in estimating values to determine the profit for purposes of distribution to owners and for computing income taxes due the government. It is one of the duties of the comptroller to make these estimates so that a profit figure can be arrived at which reflects as accurately as possible the true condition of the business and provides a fair net income figure for tax purposes.

DISPOSITION OF PROFITS

As was brought out in Chapter 12, the board of directors has the final say as to what disposition will be made of the profits earned, usually receiving recommendations in this regard from the treasurer. The comptroller, too, may be called on to make suggestions.

Usually a percentage of the annual profits is distributed to the stockholders in the form of dividends on their stock, provided the company has sufficient cash to pay such dividends. Much of the annual profit or, more properly, the additional assets these profits have engendered and now represent, are left in the firm to be used as a cushion against any future emergencies or losses, or to finance further expansion without resorting to borrowing or otherwise obtaining additional funds. As already mentioned, this retention of profits in the firm is referred to as "plowing back the profits," instead of "cutting the melon," by distributing the profits to the stockholders as dividends.

SUMMARY

The accounting function of a business is separate from the financial handling of its funds. In large concerns, accounting is the responsibility of an official known as the comptroller, who also supervises cost accounting and budgeting, as well as auditing and tax problems. General ac-

counting involves the determination of the assets, liabilities, and net worth of an enterprise, summarized in a statement of financial condition or balance sheet, and the computation of its income, expenses and, therefore, net profit, as indicated in a profit and loss statement. The information for these statements comes from the firm's books of account, its journals or chronological records of business transactions, and from its ledgers, which assemble in one place, or account, the items that affect one particular category of financial information. Profit determination, a major purpose of general accounting, is complicated by the fact that it is affected by estimates of such items as depreciation and inventory valuation. The determination of these, in turn, directly affects what disposition is to be made of the profit once a computation of it has been effected.

► FOR REVIEW AND DISCUSSION

1. What has been one of the major causes of failure among small businesses?
2. What are the differences in the responsibilities of the treasurer and of the comptroller?
3. What are the functions of the accounting department?
4. What kind of financial information should be shown by the records of a business?
5. What uses are made of the balance sheet of a business?
6. How can the growth of a business enterprise be measured?
7. What type of information can be obtained by analyzing the information in the profit and loss statement?
8. Why is merchandise-turnover information important to a business manager?
9. What information about a business can be obtained by studying trends taken from financial data over a period of years?
10. How can records be kept safe from loss by fire, theft, or other hazards?
11. What is the relationship between computation of depreciation and income taxes?
12. Can we be sure that the values placed on merchandise inventories are absolutely correct? Why?
13. What happens to the profits of most businesses?

► CASE-PROBLEM QUESTIONS

1. Is size of business the only factor to consider in deciding whether a business needs a comptroller?

2. What should Mr. Ames tell the board about the duties of the treasurer and of the comptroller?
3. How can the employment of a comptroller help in getting more accurate financial data?
4. Why should Mr. Ames know the exact amount of profit retained by the corporation?
5. Should plant and equipment assets be depreciated by the straight-line method or by some other method?
6. Should the inventory be valued at cost? If so, cost as of when? Which basis—i.e., "LIFO," "FIFO," or "Average"—should be used?

► APPLIED BUSINESS PROJECTS

1. Study the following statement and answer the questions below.

Profit and Loss Statement of Munroe Corp. for Year Ended December 31, 1958

Sales		$100,000
Cost of goods sold		
Beginning inventory	$30,000	
Purchases	80,000	
	$110,000	
Closing inventory	60,000	50,000
Gross profit		$ 50,000
Expenses		30,000
Net profit		$ 20,000

a. What per cent of profit was made on sales?
b. What is the per cent of turnover on sales?
c. What information will each percentage give the businessman?

2. Study the statement below and answer the questions that follow.

Balance Sheet of Munroe Corp. for Dec. 31, 1958

Assets		
Current assets		
Cash	$10,000	
Accounts receivable	20,000	
Inventory	50,000	$ 80,000
Fixed assets		
Building	20,000	
Equipment	30,000	50,000
Total assets		$130,000
Liabilities		
Accounts payable	30,000	
Notes payable	10,000	$ 40,000
Total liabilities		
Capital		
Capital stock		70,000
Surplus (caused by profit in 1958)		20,000
Total liabilities and capital		$130,000

a. What is the ratio of current assets to current liabilities?
b. What is the per cent of profit on capital?
c. What do these figures (*a* and *b*) mean to the businessman?

► COMMUNITY PROJECT

1. Go to the local bank and ask for its financial statements. Have a committee study them and present their interpretations in class.
2. Select an insurance company in which some student's parent is a policyholder. Write for this company's financial statement. (Note: Many insurance companies send their policyholders an annual report which contains the financial statements.) Select a committee to analyze these statements and report their findings to the class.
3. Write to the treasurer of a company in which a parent has shares of stock asking for the most recent financial statements. (Note: The annual report sent to stockholders will contain the financial statements.) Appoint a committee of students to study the statements and report their findings to the class.



23

The Determination and Control of Costs

CASE PROBLEM

Fred Kennedy, president of Kennedy & Company calls Mr. Grebs, the vice-president in charge of sales, and Mr. Hughes, the supervisor of production, into his office for a conference. He suggests to them that the company add garden tools to the lines it already manufactures. He believes the tools should include a spading fork, transplanter trowel, garden trowel, garden weeder, weeding hoe, cultivator hoe, short garden rake, and a cultivator, all of which, like most of the hand-tool line, would have steel heads or blades and wooden handles.

Mr. Hughes agrees that all these items could be made on the present company machines, with only minor changes or additions to dies and equipment. Mr. Grebs states that they can use the same marketing outlets for the new products as they do for their hand tools, and finds, after investigation, that in order to meet competition the garden items would have to be produced to sell at retail for between 75 cents and 85 cents.

Allowing for retail and wholesale mark-ups, for the company's own selling and administrative overhead, as well as for some profit for the firm, Fred Kennedy figures this would mean that the factory would have to turn the garden items out at a cost of about 30 cents each. He asks Mr. Hughes whether the Kennedy plant can do it for that figure. Hughes points out that the materials and labor cost involved in manufacturing each garden tool can be computed without

too much difficulty, but that estimating what the additional line of garden tools will do to his factory overhead is a difficult problem.

The officials agree that this is a matter for cost accountants to consider. They call in Mr. Barton, the firm's newly appointed comptroller, and ask him to have his cost-accounting division investigate the matter and give an opinion as to whether the garden-tool line can be manufactured by the Kennedy factory at a low enough cost to meet the competitive retail selling price. Mr. Kennedy also asks what system can be set up to keep costs of production under control, so that they are kept below the figure necessary to allow the firm a margin of profit on any garden tools it manufactures.

- What are the cost elements involved in the production of manufactured goods?
- What difficulties are encountered in the effort to determine the cost of manufacturing an item?
- How does cost accounting disclose the cost of producing goods?
- Wherein does cost accounting differ from general financial accounting?
- How does cost accounting aid the manufacturer in his efforts to control production costs?

It is, of course, essential to the success of a manufacturing enterprise that it make products the public finds useful and satisfactory, so that consumers will purchase them. An important element in the demand for any goods is that they be sold at a price the consumer is willing to pay for them. Furthermore, every business enterprise must operate at a profit or it cannot continue to exist for any appreciable length of time. The factory must therefore turn out satisfactory products at a cost sufficiently low to enable the goods to be sold at a price which will meet competition and still return a profit to the enterprise. Cost of production is thus a key element in the success or failure of a manufacturing business.

It is therefore essential to the well-run factory that the true cost of producing an article be predictable and determinable. Since the amount of profit the manufacturer makes is directly affected by how much he can keep his production costs below the prevailing prices at which he must sell the goods he manufactures, it is also of great consequence that the factory take steps to develop a system to control factory costs. An important aid in predicting, determining, and controlling costs is an efficient cost-accounting system.

AIMS OF COST ACCOUNTING

In a few industries, where the product is fairly unique, the manufacturer needs to know his production costs in order to set the selling price for his goods, after having added a margin of profit for himself. In most industries, however, goods are sold at prices which are set by competition and the market; and the individual manufacturer has little choice in the matter. He must either meet or beat the prices of competitive goods or do little business. In such an industry, it is essential that the manufacturer's true production costs be known in order to determine whether the competitive selling price will render him a profit. Even more important, however, is the need to know the elements that contribute to the total cost of each unit produced. Adequate control measures can then be taken to correct inefficiencies and improve attention to detail in those elements of the total cost that are unnecessarily high. Thus, although the popular notion of cost accounting is that it attempts to arrive at the cost of a manufactured article for the purpose of setting its price, this is true in relatively few cases. Instead, the main goal of a cost-accounting system is to discover the various elements of the costs of production in order to reveal the areas of inefficiency in the manufacturing process where costs can be reduced.

PROBLEMS OF COSTING

At first glance it may seem relatively easy to determine the cost of a manufactured article, but further reflection will show that this is not the case. Too many manufacturers operate without knowing their real production costs. Basically, the elements of the cost of producing a manufactured item are the raw materials that go into it, the labor that is employed in its fabrication, and its share of the over-all expenses, or overhead, of the factory. The cost of the raw materials and of the labor directly employed in the manufacture of a specific item can usually be determined without too much trouble. It is in determining the proportionate amount of factory overhead that should be considered part of the cost of each unit produced that the real difficulty arises.

Let us take the Kennedy factory as an example. One of the garden tools being considered as an addition to the items now being turned out by the plant is a garden weeder, a tool to be used in ridding a garden of weeds by prying them out of the ground by their roots. The instrument is made in one piece, of heat-treated steel about 10 inches long ending in a V-notch blade. At the other end it has a 4¼-inch wood handle firmly attached to the metal. The amount of steel and wood needed to make, let us say, 10,000 of these weeders would be

readily determinable; therefore, dividing the cost of that quantity of steel and wood by 10,000, one arrives at the raw-material cost per tool. Similarly, the wages of the workmen, and the time they take to fashion the steel shank and the wood handle and to assemble the finished part can be computed for the entire run of 10,000 and then divided by that figure to arrive at the direct cost of labor per weeder. But how much of the salary of the factory superintendent, the wages of foremen, maintenance crews who keep the machines in operating condition, and porters who clean up the sawdust and other refuse, should be charged to the cost of one weeder? The factory makes thousands of many different types and sizes of tools each month. How much of the factory rent or real estate taxes, interest on the factory mortgage, factory light, power, insurance and other such items that make up the overhead of the plant should be allotted to the cost of one weeder?

The lathe on which the weeder's handle is made and the machine that stamps out its shank must each bear its share of the cost, proportionate to all the thousands of tools turned out by it during its life. How much, then, does depreciation of the factory building, its machinery and equipment, add to the cost of one tool?

The addition of the garden-tool line will mean that the lathes will turn out many more wooden handles in the course of a year. Although this added production should make the proportionate charge per tool for factory rent, for example, lower, thereby reducing some overhead costs, it will, on the other hand, add to the electric power used in production. It may also wear out the machinery more quickly because of the added work to which it is put. It is therefore a question whether this increased production will decrease or increase the overhead cost per tool through depreciation of the plant and equipment.

An additional complication to the cost problem is the matter of time. An individual garden weeder can be stamped and assembled in a matter of a few minutes. It can then be packed and shipped out of the factory a few hours after it is made. Yet the light and power bill from the utility company, to which this one weeder contributed its mite, will not come in until the middle of the next month. Interest on the factory mortgage will not be paid for as much as six months, and real estate taxes perhaps not until a whole year later. Computation of depreciation of factory equipment may likewise be many months away. Kennedy & Company, however, needs to know the cost of one weeder now, when it is manufactured and sold, and cannot wait a year until all the elements of its cost have been computed or paid. This means that some of the costs of the tool most be predicted rather than determined exactly.

It can readily be seen that obtaining the true cost of each individual garden weeder is a most difficult problem. It will be recalled that Fred Kennedy figured that costs could not be above 30 cents if they are to meet competitive retail prices of between 75 cents and 85 cents. Closely related is the additional task of keeping the over-all cost per weeder as far below the 30-cent limit as possible, to allow the Kennedy firm as much margin for its own profit as can be obtained. It is the aim, therefore, of its cost-accounting system to predict, determine, and keep in line the cost of a weeder as well as of all other tools produced in the Kennedy factory.

COST ACCOUNTING VERSUS GENERAL ACCOUNTING

The usual books and records of a firm (its general, or financial accounting system) are set up to show the assets, liabilities, and net worth of the enterprise, as well as its income, expenses, and profit. The statements and figures which the general accounting system provides are those of the entire enterprise; at best, they can be broken down to show the income, expenses, and contribution to net profit from a single store or a particular department. These statements can also give the sales, cost of goods sold, and gross profit from a class of merchandise. Thus Kennedy's general books of account can show the net profit for the year from the operations of the Main Street store, or the gross profit on sales of hardware in that store for the period, or, if designed for it, even the gross profit on garden tools in that one store for the period. However, the general accounting records do not give the important figure of the actual cost of one trowel, one rake, or one weeder. The statements derived from the journal and ledger entries do not indicate whether the company is making any profit on the manufacture and sale of each individual type of tool it produces. To learn such essential facts, additional cost-accounting records must be maintained.

COST-ACCOUNTING SYSTEMS

PROCESS COST ACCOUNTING

When a factory is designed for the continuous production of only one item, like boxes for a certain breakfast cereal or bottles for a specific patent medicine, and the plant constantly does, and can only, produce this one identical item, the computation of the cost of a single box or bottle is not too difficult. One simply takes all the production costs of the factory for a period of time, divides this total figure by the number of units produced in that period, and thus obtains the cost of one cereal box or one medicine bottle. The problem in such a factory is to isolate

the proportion of the cost which each process, or department, contributes to the total cost, so that comparisons with previous periods can be made, and effort can be directed toward increasing the efficiency of each department, thereby reducing the cost and adding to the total savings in production for the period. A system of cost accounting in a plant producing a continuous flow of only one product is known as *process cost accounting.*

Cost-of-Production Report. The basis of the process system is a *cost-of-production report,* which brings together on one sheet the cost of materials used in production for the period—generally a month —the labor costs for the month, and the costs of factory overhead for the same period, to arrive at the total costs for the month. These figures are allocated to the individual processes or departments responsible for the particular cost. As an illustration, let us take a factory producing medicinal products. Such a plant may have a mixing department, where the product is synthesized according to a chemical formula; a cooking department, which, as its name implies, cooks the raw ingredients; a bottling department, which pours the finished medicine into bottles, seals and labels them; and a packing department, which puts the bottles in cartons and the cartons into shipping cases. The cost-of-production report of this factory would show the cost of materials used by each department—chemicals in the mixing department; perhaps additional chemicals in the cooking department; bottles, caps, and labels in the bottling department; and the cartons and cases in the packing department. Dividing the cost of materials used by each department by the number of bottles each department turned out during the month gives the raw-material cost per unit of production of that department for the period. Similarly, the cost-of-production report shows the payrolls of each department for the month. When the payroll cost of each department is divided by the number of bottles produced in that department, the unit labor cost per department for the period is determined.

Overhead costs per bottle of medicine for each department are more difficult to obtain, because they usually require allocating, sometimes arbitrarily, the distribution of total factory overhead costs among the departments. Factory rent for the month might, for instance, be distributed among the departments by square foot of space each department occupies, in proportion to the total factory footage. The plant's light bill for the month could be determined either by having a separate meter for each department or, if this is not feasible, by the proportionate number of light bulbs (if all are of uniform wattage) in each department compared with the total number of bulbs in the factory.

BASES OF DEPARTMENTALIZATION OF FACTORY OVERHEAD COSTS

Basis of Distribution	*Overhead Costs Distributed on That Basis*
Square footage of space occupied by each department	Rent Property taxes Interest on mortgage Heat Depreciation of building Fire insurance on building Cleaning and maintenance
Amount invested in equipment in each department	Depreciation of machinery Machinery maintenance and repairs Fire insurance on machinery
Employee payroll of each department	Payroll taxes Workmen's compensation insurance Disability and accident insurance
Number of employees in each department	Superintendent's salary Employee welfare expenses Safety and health expenses
Separate meters in each department	Power Light Water

The above table indicates how various factory overhead costs might be distributed among the departments.

Thus the cost-of-production report would give the total cost of one bottle of medicine produced during the month. More important, however, would be its indication of the contribution of each of the four departments, by unit costs, of each individual item of materials, labor, and overhead for the period. It can readily be seen that comparison of any individual unit cost with the same item in reports of previous months would indicate at once whether that department was operating on a more, or less, efficient basis than previously.

JOB-ORDER COST ACCOUNTING

A much more difficult problem occurs in finding unit costs of production in a factory like that of Kennedy & Company, which produces

many types of items. Kennedy's plant turns out many varieties and sizes of hand and garden tools, of different shapes, weights, and materials, requiring various skills or precision work in their manufacture. The amount of materials and direct labor going into one saw, or one weeding hoe, can be ascertained without too much difficulty; but how can we determine the amount of the monthly factory rent, or the electricity, that would go into the cost of producing one saw, weeding hoe, trowel, or pair of pliers? The cost-accounting system that attempts to give such unit figures in a plant which manufactures many different products is known as *job-order cost accounting.*

The job-order cost-accounting method derives its name from the fact that the firm manufactures various runs of products on the basis of orders received for a particular job. Thus, if Kennedy's inventory of 16-ounce hammers is getting low and it is felt the inventory should be built up, or if the company has received orders for these hammers, or if the regular schedule of factory production calls for a run of that particular type of tool, Mr. Hughes, the production supervisor, would issue a job order for the manufacture of, let us say, 10,000 of the 16-ounce hammers based on previously drawn-up designs and specifications. To do this, he would initiate a *job-order production-and-cost sheet*, a form which moves along through the factory with the lot of hammers as it goes through the various stages of production.

Job-Order Production-and-Cost Sheet. In accordance with the specifications for that style of hammer, the foreman of the metal shop would requisition from materials stores the amount of steel necessary to fabricate the heads of the 10,000 hammers called for in this job order; the foreman of the woodworking shop would similarly requisition the wood needed for the handles. Cost-accounting clerks would then post the number of pounds, or feet, of these materials, as well as their cost, on the job-order production-and-cost sheet for this lot of hammers, which, let us say, has been designated as lot No. M16.

Each factory employee keeps a time card, by punching a time clock, to show not only the total hours he works in a day, but also the time he starts and completes work on each lot or job order. Thus, as each employee begins his work on job order No. M16, and later completes his work on it, he punches the clock which affixes the time on his time card on the line where he has written No. M16. While the payroll bookkeepers will use his time card to compute the weekly pay due him, the cost-accounting clerks will learn from these cards the number of hours worked and the labor cost on job No. M16 and will record these data on the job-order production-and-cost sheet.

Thus materials and direct labor costs are easily obtained and charged

to the various jobs done in the factory. As previously mentioned, however, the allocation of factory overhead cost to the various jobs is a more difficult process. The amount of overhead per unit produced is usually estimated by selecting some known figure that can readily be obtained and that gives some indication as to how overhead should be apportioned. One such indicator might be the number of direct labor hours worked on a particular lot.

It was mentioned that the cost-accounting clerk notes on the job-order cost sheet not only the amount in dollars and cents of labor expended in working on job No. M16, but also the number of hours so worked. If Mr. Hughes and Comptroller Barton believe that there is a fairly direct relation between the hours worked on the manufacture of a tool and the percentage of total factory overhead chargeable to that tool, they can decide to use that as the basis for computing overhead per lot and per piece produced. They would take the figures for the past month, past quarter, or even past year, and obtain a ratio from them. Thus, suppose that in 1958 a total of 79,650 hours of work was done by all the Kennedy factory employees who worked directly on the machinery producing its tools. Suppose also that the 1958 total factory overhead of the Kennedy plant—in other words, all factory expenses for rent, power, depreciation, maintenance and the like—amounted to a total of $60,215. This would yield a ratio of overhead to direct labor hours of $\frac{\$60{,}215}{79{,}650}$ or approximately $\frac{60}{80}$ —in other words, 75 cents of overhead for each hour of labor on a particular lot of tools produced. Using this as a basis, the cost-accounting clerk could charge 75 cents in overhead costs to job No. M16 for each labor hour worked on that lot.

This figure would not be completely accurate. One reason, of course, would be that figures are rounded off in computation. This is a minor point and does not too greatly affect the results. More important is the fact that the ratio is devised from last year's figures, and the figures this year may be different. This means that the actual factory overhead for the current year may prove to be slightly more than 75 cents for each labor hour (in which case we say the overhead was *underabsorbed*), or it may turn out to be less than 75 cents of overhead expenses for each labor hour worked (thus being *overabsorbed*). This difference, however, when divided down to each job lot, and, even further, into the overhead cost difference for each individual tool manufactured usually becomes such an infinitesimally small figure that it can be disregarded for cost purposes. If the difference should prove

to be a large amount, then comparison of overhead with direct labor hours was a poor choice; and some other base should be used in finding a ratio with overhead.

Thus, the cost of a lot of goods, and, by division, of individual articles produced, can be computed rapidly and with a fair degree of accuracy. But, as was brought out earlier in this chapter, determination of cost is not enough; prediction and control of costs are equally important. Some degree of cost control can be obtained by comparing the unit cost in making job order No. M16 with the unit cost the last time the factory produced 16-ounce hammers. But after all, it is possible that the factory was inefficient in its work on both lots of hammers and a comparison between the two will reveal little. Prediction of costs, and a comparison with what the cost of producing such a hammer would be in a well-run plant are therefore of considerable importance in judging the operations of the Kennedy factory. This calls for the use of a third cost accounting system known as *standard costs.*

STANDARD COST ACCOUNTING

Standard cost accounting does not actually involve a third, completely different, system of cost accounting, because the standard cost method is imposed on, and is an extension of, either the process or job-order cost methods. Furthermore, standard costs can only be used effectively in the medium- to large-size plant, because it is an expensive system which adds materially to the accounting costs.

Under the standard-cost method, engineers carefully determine the standards of every element in the manufacture of a product and set these up as the criteria of measurement of factory efficiency in producing the item. Thus, from careful engineering studies, they decide exactly how much steel and wood should be used in fabricating one 16-ounce hammer, and also how much those quantities of raw materials should cost. They set up a similar standard for the number of labor hours that should properly be expended in turning out the hammers, and the skill that labor should have, in terms of how much the labor cost per hammer ought to be. They also compute standards of overhead for each hammer. Under this method, the job-order production-and-cost sheet has additional columns which show the standard cost per hammer for each of the elements in the cost of production. Thus the cost of a hammer is predicted before a single move has been made to produce it. Naturally, accurate standards require competent and careful engineering work, which is in itself costly.

Variances. Once the hammers are produced, the actual costs of their production are then entered in another column of the job-order sheet,

next to the appropriate standard cost. The difference between the actual cost and the predicted standard cost, as shown by the sheet, is called a *variance.* If the actual cost is greater than the standard, the variance is a measure of the inefficiency of that particular department. If the actual cost is less than the standard cost for that particular item, the variance is an indication of good work and considerable efficiency on the part of the foreman or department which made the saving.

These variances are computed for the quantity of materials used and the price paid for them. In the case of labor, they are computed for the time, or number of hours, workers spend on producing the lot as compared with the standard, and for their rate of pay. In the case of burden, or factory overhead, three variances are computed. One compares the activity of the factory for the period with its capacity, or with the amount of activity it had been expected the factory would achieve during the period. The second involves the efficiency of the factory; that is, the number of hours it took to produce the hammers compared with the standard hours it should have taken. Finally, an expense variance is computed; that is, the difference between the standard rate of electric current, for instance, and the amount the light and power company actually charged per kilowatt hour.

COST CONTROL

After the variances—the differences between actual costs of production and the predicted standard cost—have been computed, measures to control or reduce costs can be considered. These variances (assuming always that the standards themselves were accurately and carefully computed and are therefore correct) indicate the sources of added cost in the production of the goods. It is now up to management to fix the responsibility for these variances, to try to find the reasons why they occurred, and, when the actual cost was greater than the standard, to eliminate any inefficiencies which may have contributed to the variances.

Causes of Variances. Analysis of variances between actual and standard costs discloses many reasons for them. Responsibility for them should be ascertained and steps taken to eliminate the sources of inefficiencies. Let us see what some of the causes for these variances are.

In the case of quantity variances, the use of more than the standard quantity of materials might be due to loss or destruction of the goods by the workmen, either because they are poorly trained, inadequately supervised, or are careless and dissatisfied. On the other hand, investigation may show that extra materials were used because of lack of proper machines and tools on which to work, or failure to keep the machines in proper running order. The material itself might have been of

inferior quality, causing shrinkage or other waste. Or, perhaps, excess usage might have resulted from failure on the part of workmen to return unused material to the storeroom, failure to salvage scrap material, or even pilferage and theft.

If there is a variance in materials price, in which the actual cost of the goods exceeded the standard, this may have been due to lack of ability, foresight, or care in purchasing the materials, so that the buyer did not obtain them in a favorable market. Perhaps the extra cost was due to inability to obtain the materials from the regular supplier, or perhaps strikes or other occurrences caused unexpected shortages. Sometimes cost differences are due to changes in transportation charges on the goods.

A labor-time variance, with the men taking more time on the lot than the standard predicted they should, may result from many causes. Poor planning in the factory, or improper layout of the factory, can be a contributing factor, as can the failure to provide the workers with machines in good running order. Usually, however, the cause is related to the fact that the workers themselves are of poor caliber; are inadequately trained or supervised; are motivated by improper incentives; or are working under improper conditions. Sometimes the trouble can be traced to worker dissatisfaction and low morale.

A labor-rate variance—that is, when the workmen have been paid more per hour than the standard called for—generally arises from inability to obtain labor at the predicted rates of pay because of labor shortages, union pressures, or other reasons. Sometimes the variance develops because improper scheduling of work has made too much overtime necessary. The reason might even be that jobs were poorly assigned, and highly paid, skilled workers are doing tasks that should have been handled by lower-paid, unskilled help.

The burden variances are difficult to account for in most situations. A difference in the activity variance might arise because the sales department has been less successful in selling than was anticipated—not actually a factory matter at all. But the failure to maintain expected activity might have arisen from materials shortages, machine breakdowns, or excessive absenteeism. Burden-efficiency variances usually exist because of poor planning and scheduling; overhead-expense variances generally result from unexpected increases in utility rates.

THE VALUE OF COST ACCOUNTING

Cost accounting serves as a useful management tool in many ways. First of all, it determines costs to aid in setting prices, although because of competitive factors, cost is usually not the sole basis for setting a

price. More important are its uses as a measure of the achievement and efficiency of the factory units, and as a method of fixing responsibility for inefficiencies in production.

To justify its own cost, however, the system should be relatively simple; should provide worthwhile information; and, most important, use should be made of its data. Many firms maintain elaborate, expensive cost-accounting systems yielding considerable information which is, however, almost completely ignored by management. If the cost-accounting data are not put to use in the control of costs and elimination of inefficiencies, they accomplish little and result only in adding to the costs of production.

SUMMARY

While the general books and records of account reveal the net profit of the enterprise as a whole, they do not indicate the cost of, and profit on, any individual item. This information is supplied by a cost-accounting system, which not only aids in setting selling prices, but, more importantly, serves as a measure of the competency of the factory and as an indicator of inefficiencies. In a plant producing one article continuously, a process cost-accounting system is used; plants manufacturing many different items use a job-order cost system. Superimposed on both of these methods, large factories use a system of predetermined criteria or standards of cost. Comparison between actual costs and these standards shows up variances which, on analysis, can pinpoint the areas of factory inefficiency. To justify its expense, a cost-accounting system should be used effectively by management. In some enterprises, however, because the information is ignored, cost accounting merely adds to the over-all cost of production.

► FOR REVIEW AND DISCUSSION

1. Why is the cost of producing manufactured goods such an important element in the success of a business?
2. Can cost accounting help in the control of manufacturing costs? If so, how?
3. What are the basic elements in the cost of a manufactured article?
4. What is the difference between cost accounting and general accounting?
5. What is meant by process cost accounting?

6. How is a cost-of-production report organized?
7. What are some of the bases for determining factory overhead costs?
8. Under what type of manufacturing conditions would the job-order cost-accounting system be used?
9. How can efficiency of production be measured by the use of standard cost procedure?
10. In what way can cost variances in different steps of the manufacturing process be used to develop cost control?
11. What are the common causes of variances in costs?

► CASE-PROBLEM QUESTIONS

1. Why is it so difficult for Mr. Hughes to compute the overhead?
2. How can the cost elements connected with the production of the new line of garden tools be computed?
3. Should Kennedy & Company manufacture all the necessary parts of all the tools? How can Mr. Hughes and Mr. Barton determine whether they should make all the parts or buy them from a special manufacturer?
4. What is the relationship between producing an additional line of goods and the line now being produced? Can Mr. Kennedy expect to lower the fixed costs per unit on goods now being produced?
5. Is it possible for Mr. Kennedy to determine the total cost accurately enough without actually going into production to learn the wisdom of the proposal?
6. How can he decide whether a production cost of 30 cents per unit is reasonable or too high?

► APPLIED BUSINESS PROJECTS

1. Classify the following manufacturing businesses according to which types of the three cost-accounting systems they should use (job order, process, or standard):

Brick plant
Automobile assembly plant
China factory
Tractor manufacturing plant
Television assembly plant
Manufacturer of men's suits
Refiner of gasoline
Peach cannery
Glass manufacturer
Piano manufacturer
Manufacturer of men's shoes
Publisher of books
Carpet maker
Manufacturer of maple furniture
Thread-spinning mill

2. On an 8½ x 11 sheet of paper explain how each of the following types of overhead costs could probably be allocated.

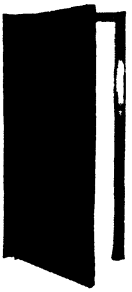
a. Rent
b. Interest on factory mortgage
c. Liability insurance

d. Fire insurance
e. Cost of delivery trucks
f. Taxes on factory building and equipment
g. Workmen's compensation insurance
h. Custodial salaries
i. Heat
j. Light
k. Water

► COMMUNITY PROJECTS

Have a committee talk with one or more merchants to find out how they figure costs. Do these merchants use one of the procedures proposed in this chapter? Are they using composite procedures? an informal, approximate procedure? Are their methods justified?

If there is a manufacturing plant in your community, check the same factors with the superintendent or other officer.



24

Budgets and Budgetary Control

CASE PROBLEM

Not long after Mr. Barton was appointed comptroller of Kennedy & Company, he attended a meeting of the board of directors and suggested that the company adopt a system of budgetary control. He stated that he had observed that all decisions as to future operations of the enterprise are formulated and developed by the firm's president, Fred Kennedy. He had noticed, further, that there was no definite plan or policy for the future progress of the business, but, rather, that the directors, under Fred Kennedy's leadership, decided each problem as it came up and had to be met.

Mr. Barton insists that a company cannot grow, or prosper for long, when it is subject to the guidance and decisions of only one man, no matter how capable he may be. Nor can a firm ever be ready to meet the future without a plan prepared for various eventualities. He asserts that the company needs a system of budget control, in which management as a whole can participate. Progress can then be planned. Objectives and goals can be defined, toward which all can strive, and against which each executive's achievement can be measured.

Mr. Barton says the budget may be compared to the charted course laid out by a navigator before a voyage, from point of departure to destination, taking into consideration all oceanic conditions and the effect of winds and currents. A business, too, Mr. Barton says, needs a course laid out for it. Furthermore, just as the navigator com-

pares his actual progress with his predicted course, so a business should compare its actual results with its budgeted estimates.

The directors are, naturally, interested in Barton's statements. Before expressing their own opinions on such a complicated and, perhaps, costly new idea, they ask him to discuss more fully the details of his plan for a system of budgetary control for Kennedy & Company.

- What is a budget, and what purposes does it serve?
- What problems and procedures must be considered before a budgetary system is instituted?
- What types or kinds of budgets would be important to the Kennedy organization?
- Who would make use of the budgets and what would they gain from them?
- What are the limitations or dangers of a budgetary system of control?

THE BUDGET AND BUDGETARY CONTROL

Every business firm—in fact every individual person—that manages its affairs with any thought and planning makes use of some sort of a budget and practices some degree of budgetary control. This is true even though the firm may not have a formalized, written budget and may not even be aware that any form of budgetary control is being exercised.

A *budget* is a financial estimate of the probable income and expenditures for a definite period of time as the result of a planned program of operations. The careful individual, when planning a vacation trip, considers not only the route he will take and the places he will visit, but estimates the cost of the trip and plans to keep within the amount of money he has available for that purpose. The bootblack figures how much equipment and how many different kinds of polish he will need before he starts his daily business. Both of these people, as well as any businessman who limits his purchases of merchandise to what he thinks he can sell, are drawing up budgets, even though they are far from the formal, detailed financial plans, or budget, of the large business corporation.

The vacationer compares his actual expenditures as he incurs them with his plans, and accordingly cuts down or becomes more generous in his spending toward the end of his trip. The shoeshine boy checks during the day to see how well his polishes are holding out and makes a mental note to go easy on one shade or to get more of it tomorrow. The business firm likewise co-ordinates and checks on its various ac-

tivities in order to stay within its budgeted expenses or to achieve its planned sales. Each one is exercising a measure of budgetary control. The budget itself is an estimate of expected activities and probable future results. *Budgetary control* involves the co-ordination of all departments of an enterprise, so that each one carefully plans its separate activities in line with the desired end result for the organization as a whole. Finally, it is a control, or comparison, of the actual operations of each unit to see how closely each came to its predictions and to indicate the reasons for any differences.

Thus, the purposes of budgeting are planning, co-ordination, and control. The budget is the formal instrument, the written plan that is the backbone of the whole enterprise. The actual working together of all departments to formulate a unified, concerted plan of action, the continual comparisons of actual results with budgeted predictions, and the investigation of the reasons for these differences—these are the elements of budgetary control, the "flesh and blood" of the budgeting system.

FUNDAMENTALS OF BUDGETING

To be worth the effort and the expense of maintaining a budgetary system, it must produce useful results. These can only be obtained if certain fundamental principles are followed in setting up the budget machinery.

1. The budget must be the result of the combined and co-ordinated planning of all the departments. The head of each of these units must comprehend both the over-all goals of the firm for the budget period and the role his own department plays in contributing to that goal. In order to do so and to be in sympathy with the goals sought, each department head must participate in drawing up the budgetary plans. Thus, if Kennedy's production manager, Mr. Hughes, is to understand the figures for his department as set forth in the company's 1960 budget, if he is to try earnestly to live up to the production estimates in that budget, and if he is to keep his factory costs within the budget figures, it is essential that he have a hand in devising those estimates and in preparing the over-all budget, not only for his department, but for the business as a whole.

2. The budget must be arranged in accordance with the organizational pattern of the particular enterprise. If the various department heads are to aid in composing the budget and are to be held responsible for achieving the desired results, the budget must obviously be set up so that the various incomes and expenses are classified in agreement with the business functions as arranged in the organization chart. To

use the Kennedy company as an example, since shipping is a responsibility of Mr. Grebs, the sales manager, the budget should likewise consider shipping expenses as part of the sales budget, so that Mr. Grebs can make comparisons in his efforts to keep actual shipping expenses in line with those predicted.

3. The budget must be prepared only after a careful study of past operations of the firm, combined with equally thoughtful estimates of its future prospects, so that the figures arrived at will be reasonable and bear a fairly close relationship to what the actual results should be. Thus, when the Kennedy treasurer, Mr. Ames, submits his estimate of what interest expenses should be for the first quarter of the coming year, he must consider carefully the amount of money that was borrowed during various quarters of the previous year and what the interest cost of such loans were. Next, he must learn, by consultation with the other executives, what the expected cash needs will be, in accordance with estimates of cash income and outgo during the coming year, to decide how much borrowing he expects to do during the first three months of that year. After discussion with the firm's bankers as to possibilities of changes in the interest rates during the coming quarter, he is ready to submit a figure for interest expense for the coming January–March, which should be fairly accurate and reliable, so that over-all plans can be made.

4. Provision must be made for comparing actual results with the budgeted figures, and the company executives must be impressed with the importance and usefulness of such comparisons. A system is, after all, only as valuable as the amount of use to which it is put. As was shown in the discussion on cost accounting in the previous chapter, there is no sense in going to the trouble and expense of setting up a system, if its results are going to be ignored. The main purpose of a budget is to provide for budgetary control. There is no point in having Mr. Rogers, after careful study, estimate that the expenses of the employment division in the personnel department should be $4,050 for the first quarter, if, later, he does not compare this with the actual figure of $4,935. Even more important, of course, is the effort he must make to explain to himself, and possibly to Mr. Kennedy as well, why the division's cost of operation during the quarter was $885 more than had been anticipated. It may have been a justifiable difference due to an unexpected personnel emergency. It may, however, have arisen as the result of inefficiency and waste; if so, the sources of these should be located and steps taken to eliminate them.

5. If the budget is to be worthwhile and actually put to some constructive use, it follows that the budget and the system that creates

Budgeting

Advantages	Disadvantages
1. Definite plan for future	1. Too inflexible
2. Promotes co-ordination and co-operation	2. Expensive to operate
3. Sets goal	3. Too detailed and rigid
4. Encourages careful administration	4. Stifles initiative
5. Means for judging efficiency	5. Often continues past inefficiencies

it should not be too elaborate or difficult to maintain. Otherwise it may not justify its own expense, or it may become too technical and complicated. Should the latter be true, then the executives who should be consulting the budget may not have the time, inclination, or even sufficient understanding to put it to the use it might, and should, be affording.

6. Finally, the budget should be designed for comparatively easy revision as conditions change. A budget for a firm in a defense industry, for instance, prepared in peacetime 1949 for an anticipated peaceful 1950, would have become meaningless after the start of the Korean conflict in June 1950. To make it more flexible (more fully discussed later in this chapter), a properly designed budget is set up for various steps in, or percentages of, capacity operations.

THE BUDGET PERIOD

An important consideration in devising a budget and budgetary control system is the period of time a budget should comprise. For how far ahead should the Kennedy company, for example, make its plans—a month, three months, six months, a year, or longer? The answer, as so often, depends on the nature of the business. The budget period should, first of all, coincide with the period used in making up the firm's financial accounting statements, so that comparisons of budget estimates and actual figures can be made for the identical period of time. The budget period should at least be long enough to permit completion of production of the enterprise's goods. Thus, if the firm is constructing diesel locomotives, the budget period should certainly not be for less than the time it takes to build a locomotive. Similarly, for a business of a seasonal nature, the budget period should cover at least one entire season and perhaps even a complete cycle of seasons (a full year, for instance, if it follows the calendar seasons). But no matter how long a period it covers, the budget is usually divided into quarterly or even monthly figures for better comparisons.

Where major plant improvements or additional lines are planned, a long-range skeleton budget, lacking the details of the usual seasonal forecast, should be prepared so that financial needs can be ascertained early and plans made to obtain the necessary funds well in advance. Thus, when Kennedy & Company first decided to add garden tools to its line of hand tools, a budget, or forecast, of income and expenditures for the next year or two was desirable, so that the extra cash requirements to finance the additional equipment, labor, and inventories could be anticipated and plans formulated to obtain the funds as needed.

BUDGET ORGANIZATION

Although very large organizations—like the United States Government and a few giant corporations—have personnel who devote their full time to problems of the budget, in most businesses these problems are handled by department heads or their executive assistants. The president of the corporation also takes an active interest in the budget and sets policies and makes suggestions, but direct responsibility for it is usually given to some other executive of the firm, called the "budget officer." Generally this assignment is given to the comptroller, because of the close connection between budgeting and accounting. When the heads of departments work with the budget officer to formulate the budget and co-operate to produce a combined result, they act as a "budget committee."

Budget Committee. The budget committee receives the individual budget estimates submitted by each department head and tries to mold them into one co-ordinated master plan. To do this, they must (1) set general policies; (2) make over-all estimates; and (3) suggest revisions of the individual estimates to fit in with the master budget. Once the committee has approved the various department budgets and the over-all budget has been approved by the president, the committee maintains contact with it by periodic departmental reports showing comparisons of actual with estimated figures. Suggestions are made to committee members whose departmental figures show considerable variations, in order to locate possible sources of such differences and to eliminate inefficiencies. It is essential that department heads take an active part in the development of the budget and in putting budgetary controls into effect, because each one must enthusiastically support the efforts of the firm to operate within the budget.

The comptroller, as budget officer, is the man who sparks the entire budget process and who does the spade work in assembling it. To do so, he has the following duties:

1. He designs the printed forms that will be used in preparing the budget's estimated figures and, later, the actual figures, so that com-

parisons can readily be made. He also sets up the procedures to be followed in carrying out the budgeting process.

2. He obtains and disseminates to the committee statistics and other financial information on anticipated business conditions in general, and the prospects of the particular industry and firm. Thus, for example, Mr. Barton, the comptroller of Kennedy & Company, would supply Mr. Ames (treasurer), Mr. Grebs (sales manager), Mr. Hughes (production manager), and probably also Mr. Rogers (personnel manager) as well as Fred Kennedy, company president, with whatever data he can obtain to forecast business conditions generally, conditions in the hardware and tool industry, and, in particular, conditions in the Kennedy Company for the next budget period—let us say, the months of January, February, and March, 1960.

3. He supplies department heads with information regarding past operations of their units, to guide them in making future estimates. Thus, he might give them the figures on expenses, and income where applicable, for the October–December, 1959 quarter, and perhaps for the January–March, 1960 quarter as well.

4. He requests and receives from the department heads estimates of sales or other income, and of expenses of their departments for the next three months.

5. He summarizes these figures in a unified preliminary master budget and makes up a predicted (called *pro forma*) profit and loss statement and balance sheet showing the results if these estimates were fulfilled.

6. He submits this master plan to the budget committee which suggests over-all changes to make it a more workable unit and to adjust it to their ideas of the future of their industry and of Kennedy & Company.

7. He then submits these revisions, adjustments, and corrections to the department heads, so that their figures will conform to the final draft of the master budget, which has been approved by the budget committee and the president.

8. He issues periodic weekly or monthly reports to the department heads comparing and analyzing actual results with the budgeted figures.

9. He makes any changes in the budget process or form that may be needed in order to keep the operation of the budgetary system as effective as possible.

THE SUBORDINATE BUDGETS

It can be seen, from the foregoing description of the budget process that, in addition to the master budget for the enterprise as a whole, a considerable number of departmental estimates, or subordinate bud-

gets, are required, all of which contribute to the formation of, and eventually dovetail into, the master plan. The number of these subbudgets depends on the organization of the business. Let us see, for instance, what budgets Kennedy & Company would require.

The Sales Budget. The sales manager's estimate of his department's activities for the ensuing period would comprise two separate forecasts. One would be the estimate of *sales income*, based on past sales, forecasts of market and business conditions, and the production capacities of the factory. This budget is often divided into *quotas*, or estimates of the expected sales by territories, stores, salesmen, or products.

The sales manager must also prepare a *sales-expense budget*, forecasting the costs of sales for the period, just as every other department head budgets the expenses of his unit. Included in the expenditures itemized in the sales-expense budget would be forecasts of advertising expenses, shipping expenses, and all other functions under the supervision of the sales manager.

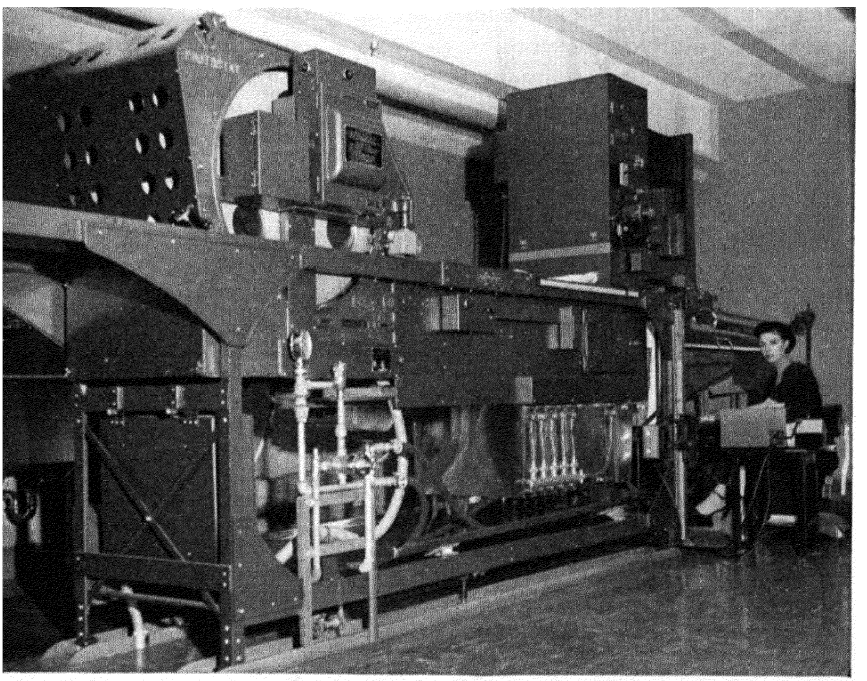
The Manufacturing Budget. This is a combination of a number of separate subbudgets which attempts to forecast all the activities of the factory for the next period. With the sales estimate as his guide, Mr. Hughes, the Kennedy production manager, would first prepare the *production budget*, which estimates by types and units of product exactly what he expects the factory to manufacture during the coming period. From this a *materials budget* would be made, showing what he estimates his raw-material needs for the next quarter will be. A *labor budget* is likewise prepared to estimate the need for skilled and unskilled factory hands for the next three months. Finally, he would make up a *manufacturing-expense budget*, which predicts the costs of manufacturing during the period.

Each of the various service departments would also make up its own budget. The purchasing agent would set up his *purchasing budget* to estimate the purchases of raw materials and supplies that would have to be made in the next accounting period, and taking into consideration the requirements that the production manager has indicated in his materials budget. The purchasing agent would also prepare the usual expense budget to forecast the expected expenses of the purchasing department for the same period. The personnel manager would work up an expense budget for his department; and the comptroller would prepare a similar expense budget for his accounting department, relying for many of his figures on the estimates furnished him by the office manager.

The Financial Budgets. There are usually three of these budgets, and they are devised by the treasurer. After consultation with the

department heads and a study of their various budgets to learn their forecasts of cash income and expenditures during the coming quarter, the treasurer prepares a *cash budget*, which summarizes on one sheet the anticipated cash receipts and disbursements and gives the resulting cash position. It must be remembered that while all these budgets are made up for three months ahead, each one has columns to list the figures for each month. Thus the cash budget will give an indication of the cash position of the firm at the beginning and end of each of the three months. This will disclose any expected shortage of funds, or any surplus of cash, and will therefore indicate where short-term borrowing, or investment, might be advisable.

In addition, the treasurer usually also prepares a *capital-expenditure budget*, again after consultation with the other executives as to future long-term plans of the company. Capital expenditures represent money that will have to be spent to finance additions to the plant and equipment or for the purchase of other expensive fixed assets, which the company contemplates acquiring. This capital expenditure budget



Courtesy Prudential Insurance Company of America

Planning Big Expenditures. The purchase of a photostating machine of this size requires careful budgeting.

is often made up for a whole year in advance, rather than the three months which the other budgets cover. It shows what long-term funds will be needed, so that the treasurer will have an idea of the amount of borrowing he will have to do. He will then be able to consider well in advance the alternatives of borrowing based on a mortgage on company property, floating a bond issue, or possibly even obtaining "equity financing" by selling more stock. Thus, for instance, the year that Kennedy & Company decided to go in for the manufacture of tools in addition to its retail hardware and appliance business, Mr. Ames's capital-expenditure budget would have shown the need for considerable long-term funds to finance the purchase of the factory building and equipment.

Finally, the treasurer must prepare a *financial-income-and-expense budget*, which will estimate income from interest and discounts, and the expenses of financial operation—interest, discounts, and most of the taxes the firm pays.

It can therefore be seen that the master budget prepared by the comptroller, as budget officer, with the aid of the budget committee, is actually a compilation of the forecasts appearing in many budgets. It is also the result of the combined work of almost every executive of the organization, each mutually dependent on the efforts of the others. Thus the need for co-operation and teamwork among the members of top management is readily apparent.

It must be remembered, too, that each of the subbudgets is later compared with the figures for actual operations. These detailed comparisons are invaluable in aiding the executives, as department heads and as the budget committee, to locate sources of inefficiencies and in taking measures to prevent them.

VARIABLE BUDGETS

Since estimates and forecasts often prove inaccurate, a firm which depends on a static, or fixed, budget, with only one set of figures based on a single estimate, often finds its budget and its plans completely inadequate and out of line with reality when an unexpected change in business conditions takes place. Most firms, therefore, use some form of *variable*, or *flexible, budget*, which recognizes the unreliability of predictions of business conditions and makes provision in advance for variations in production and expenditures to fit fluctuations in sales.

A *percentage*, or *proportion, budget* shows predicted income and expenditures at various levels or percentages of capacity production. Thus, when the plant operates at a certain percentage of production, figures can be interpolated to give the estimated figures at that percentage

of production; and a meaningful comparison can be made with the actual operating results.

A *step budget* is a series of separate budgets showing predicted figures of production and sales where pronounced changes occur in the factory set-up. Thus the Kennedy budget may have a column for the estimated figures if the factory operates with only a day shift, another column re-estimating the same figures if the plant runs both a day and a night shift, and still a third column showing the estimates if the plant runs three full shifts around the clock.

In both percentage and step budgets, care must be taken to distinguish, in the computations, between fixed expenses and variable expenses. Whether the plant runs only one shift, let us say, at 40 per cent of capacity, or three shifts at 100 per cent of capacity, some expenditures, such as rent, real estate taxes, and mortgage interest, will still be the same. These fixed expenses would then be shown in all columns of the step budget at the identical figure. It is the *variable expenses,* those that fluctuate as production varies, such as electric power and raw materials used, that account for the different figures in the columns of such a budget.

Advantages of Budgeting. A budget system—involving the preparation of budgets and the implementing of budgetary control by comparing actual operating results with budgeted predictions—has many advantages. These may be summarized as follows:

1. The budget forces the executives to make definite plans for the future. They must study all aspects of the business and therefore take business operations out of the "hit-or-miss" category.

2. Budgeting promotes co-ordination and co-operation among all the departments of the organization, since the budget can only be drawn up with all units working as a team and understanding one another's problems.

3. The budget sets a goal for the entire organization, collectively and individually, and provides a medium whereby the policies of management can readily be translated into action.

4. The budgetary system encourages careful administration and the exercise of economy in operation, in order to meet the goals that have been set.

5. The budget provides a means for judging efficiency and permits unfavorable trends to be recognized and corrected before too much damage is done.

Limitations of Budgeting. Budgeting also has several disadvantages, or dangers, that must be guarded against. Some of these are:

1. Budgets are often too inflexible. Even though variable budgets

are used, it may nevertheless be necessary, in certain situations, to raise the estimates of one department and to lower those of another. Budgets must be used with judgment and be subject to revision where necessary.

2. Budgeting is expensive to operate and if not put to good use may not justify its cost.

3. Budgets can become too detailed and rigid, so that they take away from a manager much of the freedom of action he needs to run his department properly. Because a production manager, for example, sees that sales are going well and that there is a possibility of a shortage of raw materials going into a particular item, he may want to increase its quota; but he may be afraid to run the larger quantity because the budget did not call for it, and his figures for actual operation would look bad when compared with the budget.

4. Budgets sometimes stifle initiative or ambition because they encourage executives to be satisfied with meeting their budgetary figures and make no attempt to go any further.

5. The budget is so often based on past figures that it becomes possible for previous inefficiencies to be hidden or accepted, and carried, undiscovered, into future budgets. Thus it may be that, instead of bringing inefficiencies to the surface as a budget should, it may occasionally preserve them.

Thus the budget should be used as an effective tool, and not as a device to replace initiative and ability. It should not be a strait jacket to limit an executive's imagination and resourcefulness, nor a chore saddling him with meaningless paperwork. A properly designed and operated budgetary system should be of value at all levels of management and in every department of the organization.

SUMMARY

A budgetary system can be helpful in the proper operation of a business because it calls for co-ordinated planning by management and affords opportunities for comparing actual results with the plans, so that the reasons for failure to live up to these plans can be discovered. The budget itself is a carefully devised estimate of the expected income and expenditures of the company for a specific period of time. It is generally prepared by the department heads, acting together as a budget committee, with the comptroller, as budget officer, co-ordinating the separate subbudgets into a master forecast for the entire organization. Budgetary control is exercised by comparison of actual operating results with the budget forecasts, to learn where accomplishment is not keeping pace with predictions and to determine what corrective measures can

be taken. Budgeting has the advantages of forcing executives to plan ahead, to run their departments economically, and to co-operate with the other divisions of the organization. The system can, however, be expensive to operate and tends to become too rigid, so that it stifles initiative and resourcefulness.

► FOR REVIEW AND DISCUSSION

1. Why are budgets important in managing the affairs of a business?
2. Describe the six fundamental processes of budgeting.
3. What should be the relation of income and expenses in budgetary planning?
4. What is the relationship between economic change and budget planning?
5. What factors should govern the budget period? What is the usual budget period?
6. What steps are usually followed in the preparation of a budget?
7. Why should department heads be extensively involved in the preparation of the operating budget?
8. What are the duties of the comptroller in connection with the preparation of the budget?
9. How do the sales budget, the manufacturing budget, the purchasing budget, and the financial budget differ from one another? How are each of the budgets interrelated?
10. Should the capital-expenditures budget be as consistent from year to year as the other budgets?
11. Distinguish between a *static*, or *fixed*, budget and *variable*, or *flexible*, budgets.
12. What factors limit the usefulness and practicability of budgets?

► CASE-PROBLEM QUESTIONS

1. In what way would adoption of a budget give Kennedy & Company a more carefully laid-out course?
2. What elements of operation should Kennedy & Company try to control through a budget?
3. The board of directors are interested in the preliminary preparation they should make in order to place Kennedy & Company on a budget. What is this preparation?
4. How can the officers of Kennedy & Company decide on the budget they should adopt?
5. Where can the officers of the company get assistance in developing a good budget plan?

6. Will the use of a budget provide greater solidarity to Kennedy & Company?

► APPLIED BUSINESS PROJECT

Following are the budget figures as compared with actual figures for John Davidson Inc. for the year ending December 31, 1958.

	Budget	*Actual*	*Increase (+) or Decrease (−)*
Income from sales	$35,000	$36,323	+ $1,323
Cost of goods sold			
Merchandise inventory	50,000	50,232	+ 232
Purchases	20,000	21,934	+ 1,934
Merchandise available for sale	$70,000	$72,166	+ $2,166
Less merchandise inventory	50,000	53,000	+ 3,000
Cost of goods sold	$20,000	$19,166	− $ 834
Gross profit	$15,000	$17,157	+ $2,157
Operating expenses			
Sales	2,000	2,352	+ 352
Advertising	1,000	976	− 24
Depreciation	1,000	1,120	+ 120
Supplies used	1,300	1,278	− 22
General expenses			
Office expenses	1,200	1,250	+ 50
Rent	1,500	1,500	00
Bad debts	500	500	00
Total expense	$ 8,000	$ 8,976	+ $ 976
Net profit	$ 7,000	$ 8,181	+ $1,181

List one possible cause for each difference. Give your answers on an 8½ x 11 sheet of paper set up as follows:

	Difference	Reason for Difference
1		
2		
3		

► COMMUNITY PROJECT

1. Have students go to city hall, to a local industry, to a local public utility and get the budgets for several past years. Sometimes these estimates have been published in the newspaper. Try the newspaper files.
2. Have class as a group or as a committee formulate ten questions they

would like to have answered about the budgets, as, for example, "Why was the budgeted cost of operations decreased, increased, or held the same as in previous years?"

Send a small committee to responsible offices to secure answers to some or all of the questions the class has prepared. Then present them in class.



25

Taxes and Their Impact on Business

CASE PROBLEM

At a meeting of the board of directors of Kennedy & Company, Fred Kennedy, the company's president, presents to the members a proposition which the firm has received to sell some of its real estate. Six months ago, the company had been considering the opening of a branch factory on the West Coast, and Mr. Kennedy had seen a good site there which he purchased for $20,000. Since then, however, the cost of building materials has risen, and wage rates of skilled labor in the area have gone up so much, that the directors have been reconsidering the whole idea. Now Mr. Kennedy tells them he has received an offer from another company to buy the site for $30,000. He recommends that the offer be accepted, since they would make a profit of $10,000 on the deal.

After a few moments' thought, Mr. Barton, the company's comptroller, remarks that the land was bought five months and two weeks ago. He suggests that they attempt a three-week delay in closing the sale. When asked why, he explains that, in accordance with the present Federal income tax law, profit on an investment which has been held for less than six months is taxable as income, at 52 per cent, so that the company would make only $4,800 on the deal after taxes. By waiting until a full six months have elapsed between time of purchase and sale, the transaction is then taxable, not as income, but as a capital gain, at the rate of 25 per cent, so that the company would clear $7,500 on the transaction after payment of taxes.

The directors praise his alertness in this matter and ask him to make a study of the effects of taxation on the company and to discover whether other tax savings can be realized.

- How serious is the impact of taxes on the conduct of the affairs of a business concern today?
- What are the various taxes to which a business enterprise is subject?
- What are some of the measures that can legally be taken by a business firm to reduce its tax burden?

Few business expenses are as important to the conduct of a commercial enterprise today as are those of taxes. Through the medium of high taxes, the government has become, to all intents and purposes, a partner in every enterprise. Business taxation has been largely responsible for formulating the philosophy of businessmen and in influencing their thinking as they cope with the many problems of their enterprise. Taxation has had this tremendous impact on the conduct of business affairs for a variety of reasons.

OVER-ALL EFFECTS OF TAXATION ON INTERNAL OPERATION OF A FIRM

Whereas other expenses are generally encountered at only one stage of business operations or need only be dealt with by one particular department, taxes pervade all business activities. The businessman must cope with them in almost every function carried on by the firm. Costs of materials are largely problems for the purchasing agent to tussle with; labor costs are the headache of the personnel manager or the production manager (depending on the particular difficulty); advertising expenses are the worry of the sales manager; and interest costs concern, almost exclusively, the treasurer. But these officers must all consider the question of taxes in carrying out their duties. The purchasing agent must know whether the firm must pay a sales tax on the many items it buys. The personnel manager must cope with the great variety of payroll tax problems. The production manager views real estate taxes on his factory as a fixed expense to be included in his manufacturing costs, whatever the rate of production. The salesman in the retail store must collect sales taxes. The treasurer must obtain capital from investors who are often reluctant because of the double taxation of corporate profits. Making certain that the firm has the requisite cash on hand to pay the many taxes as they become due is also the treasurer's responsibility. Taxation,

in one way or another, affects almost every move the company makes, and must be dealt with by all departments.

Tax Rates. The rates of taxation are high and contribute significantly to those factors which reduce the net income of a business. The profit before taxes is often reduced by more than half by Federal income taxes. Even before the comptroller arrives at the figure of net profit before income taxes in his computations, he has reduced the firm's income by many other taxes it has had to pay.

The company feels the weight of taxation in innumerable ways. It is taxed for the right to operate as a corporation; it pays property taxes on the land and buildings it owns; it is taxed on its payroll; on the gasoline it buys; on the safety-deposit box in which it keeps its valuable papers; and on many other transactions, all of which add up to a large amount, regardless of the size of the enterprise.

Tax Records. In addition to the taxes themselves, there are the costs and the administrative burdens of maintaining tax records. The fact that tax payments are subject to checking or auditing by a government agency makes it essential that careful and detailed account books be kept. The various payroll taxes make accurate payroll records absolutely necessary. Although expensive and burdensome for all concerns, this need for keeping exact records for tax purposes is not without advantages. Gone is the businessman who kept no books, retaining all the company's records in his head. Now every business is required to maintain complete sets of books to satisfy the various tax authorities. These records are obviously of great benefit to the enterpriser himself.

Tax Collection. Collecting taxes and turning them over to the proper authorities are further sources of trouble and expense for the businessman. The Kennedy company, for instance, must collect sales taxes from its retail-store customers, account for the money received, and turn it over to the state or city tax collectors. It must withhold, from the payroll, the employee's Federal income tax on salary as well as his share of Social Security tax. These withholdings must also be accounted for on the books and eventually turned over to the government agency charged with receiving such payments. It can be seen that all this consumes a considerable amount of time and energy on the part of the Kennedy bookkeepers and cashiers and adds to the company's costs of doing business.

EFFECTS OF TAXATION ON GENERAL MANAGEMENT

The costs and annoyances that taxation entails have many secondary effects on business enterprises. A company, for instance, often finds it

difficult to obtain "equity financing"; that is, more people to invest money in the firm. This shortage of investment capital is due to the fact that the company must pay high corporate income taxes and, in addition, the stockholders are taxed on the dividends they receive from the corporation. The so-called "double taxation" of corporate investors may at times discourage people from buying stock.

Another effect of high taxation can be seen in the fact that merely raising the salary of highly paid executives is insufficient to attract the best men for such positions. Most of them pay so great a percentage of their income to the government in personal income taxes that their added "take-home pay" from such a raise would amount to practically nothing. This forces the company to find other ways—such as giving executives options to buy its stock at a bargain price—to attract capable men to join its executive staff.

ATTEMPTS TO REDUCE PAYMENT OF TAXES

The existence of high taxes strongly affects the thinking of business managers and enterprisers, so that their decisions are influenced by the effects these will have on the taxes the firm must pay. This manifests itself in three ways.

1. The firm will forego possible expansion, or adding a new line, because the large cut that taxes would take does not make the extra effort worth the gamble. Thus Kennedy & Company might consider the possibility of adding sleds and ice skates to the lines they manufacture. It is out of their usual line and therefore they are taking a chance on its success or failure. In view of the strong chance of failure and that, even if the line does well, more than half the profits therefrom must go to the government in income taxes, the directors may well decide that this diversification is not worth the risk the company would have to take on it. Thus taxes can be a decisive factor in stifling production and cutting down employment possibilities.

2. The company will make every possible attempt to cut down on the taxes it must pay. The Kennedy company, for instance, might sell its factory's land and buildings and then lease them right back from the new owners. This releases the money invested for other uses, and since rent is a legitimate business expense, will reduce income taxes. Or the Kennedy company might make expansion of its plant dependent on receiving from the Federal government a "certificate of necessity," because it is in a "defense industry." This would permit the company to charge off a large percentage of the depreciation of the new facilities in the early years, thus reducing the net income and therefore the

income taxes during the early years of the new addition to the plant. As another illustration, the Kennedy firm may decide to raise new money by floating a bond issue, rather than selling more stock, because interest on bonds is a business expense, deductible before income taxes are computed. Dividends on stocks, on the other hand, do not reduce the firm's taxes, since they are not a tax-deductible item.

3. The company may incur expenses it would not otherwise have incurred, merely because much of the costs will be absorbed in reduced taxes. When a business pays more than 50 per cent of its net profit to the government in the form of income taxes, it is less fussy about incurring an expense which could have been eliminated. During World War II, for example, no automobiles were produced in this country for the use of the ordinary civilian, all such manufacturing facilities being devoted to the production of war materials. Yet, although they did not have a single car to sell, the automobile manufacturers continued to advertise heavily. They did so, of course, because they wished to retain their customers' goodwill—to keep the names of their cars before the public until they would once again be able to produce them. But their decision to continue this expensive advertising was greatly influenced by the fact that most of the money they might otherwise have saved by not advertising would only have gone to the government in income and excess-profits taxes. Executives and salesmen may go on more expensive business trips, stopping at the best hotels and entertaining customers more lavishly than necessary. These excessive expense accounts cost the firm little extra, since each dollar spent for the comfort and pleasure of their staff and customers reduces what they would have to pay in taxes. "Why give it to Uncle Sam, when we can use the money in good living for ourselves and our friends?" may be their rather unpatriotic attitude.

Although the excess-profits tax has been eliminated, business taxes are still very high. A company is justified in employing every legitimate means to reduce its annual tax burden. It is, in fact, expected to do so. Many firms pay more than necessary, because they are unaware of exemptions that could be claimed to reduce their taxes. That is why every business should have its activities and financial statements, as well as its books of account, checked by tax experts to see if savings can be effected in this important area of business cost. The comptroller of the firm, with his supervision of its records and accounting systems, is the logical official to be the watchdog over the company's tax bill. Although he may need to consult lawyers and independent accountants on difficult problems, the comptroller should himself be sufficiently versed in tax matters to be of considerable use to the firm in reducing these costs.

KINDS OF TAXES

ECONOMIC CLASSIFICATIONS

Taxes may be classified in many ways. Of some interest to the businessman are the distinctions made by economists and tax theorists in analyzing taxes. One such classification is based on the purpose of the tax: whether it is imposed for revenue or for administrative purposes. A *revenue* tax is one designed solely to obtain money for the government to use in financing its operations. An example of a revenue tax would be the real property or personal property tax. An *administrative* tax is one in which the government has some purpose other than the collection of money, which is incidental to the main goal. Thus, an excise tax on the sale of a bottle of whisky, while it does raise excellent revenue, is also imposed for the administrative purpose of discouraging the consumption of intoxicating beverages.

Another classification of taxes is based on their concept: whether they are progressive or regressive. A *progressive* tax is one which is graduated, so that it rises in percentage as the amount it is based on increases. Perhaps the best example of such a tax is the Federal tax on personal incomes, which may start at the rate of 22 per cent on incomes under $4,000 a year, but for larger incomes increases in percentage until it reaches 91 per cent on incomes that are over $300,000 a year. A *regressive* tax, however, falls hardest on those least able to afford it and is not graduated in accordance with ability to pay. A gasoline tax, which is based on a flat figure of, let us say, 6 cents a gallon, is an illustration of such a tax. The 6 cents per gallon is rather high for the poor man, but means little to the very rich one. Yet the rich man pays the same tax per gallon and does not use much more gasoline than does the poor one.

Another economic distinction, and one which is of especial interest to the businessman, is whether a tax is direct or indirect. A *direct* tax is one that is levied directly on those who pay it, whereas an *indirect* tax is paid by one person or group with the expectation that the tax cost will be shifted to another group. Again, the gasoline tax can be used as an illustration—this time, of a direct tax—for it is paid by the consumer against whom it is levied. Most real property taxes and all business-income taxes, on the other hand, are indirect taxes. The real estate tax is imposed on the landowner, but it is expected, at least in the case of rented property, that the landlord will shift this tax burden to his tenant by charging the latter more rent to cover this tax. The business landowner shifts the real property tax, as well as his business-

income taxes, by charging the consumer more for the product in order to cover those expenditures.

PRACTICAL TAX DISTINCTIONS

These economic classifications are, of course, of interest to the businessman in his understanding of the tax problems of the government. Of even greater direct interest to him, however, are other characteristics of taxes, which may be referred to as practical distinctions. These are threefold: (1) to which agency the tax is paid; (2) how the business firm obtains the tax money; and (3) upon what the tax is imposed.

Agency Receiving Tax. It is essential to know the governmental agency to which a tax is to be paid for the obvious reason that payment must be made to the correct office. Some taxes, for instance, are levied by the Federal government and payable to the Internal Revenue Service. Others are state taxes, which must be turned over to the collector of taxes or other state official charged with their collection. Some taxes are imposed by, and paid to, city or municipal tax authorities. Still others might be county taxes, or township levies, payable to some special administrative unit, such as a local sanitary commission or school district.

Sources of Tax Money. Important to the business enterprise, and especially to its treasurer, is the question of how the tax money is obtained. Some, like sales taxes, are obtained directly from customers as they make their purchases, the business concern acting merely as the collection agency through which the money funnels from the tax-paying consumer to the tax-receiving city or state. Others, like withholding taxes and the employees' Social Security contributions, are obtained from the workers by deductions from their paychecks. The money thus collected is ultimately turned over to the state or Federal tax authorities.

Many taxes are paid directly by the business concern itself. Most indirect taxes also tend in turn to be charged to the consumer in higher selling prices. The money to pay these taxes, however, comes from the general cash funds of the firm. A small percentage of such taxes may be paid in advance by the purchase of tax stamps, which are affixed to the articles manufactured and sold. This is the method generally used for the payment, for instance, of the taxes on the manufacture and sale of liquor, tobacco, and playing cards, on all of which revenue stamps must be affixed. Most other taxes are paid by the taxpayer, who either receives a tax bill, as in the case of real property taxes, or fills out a report, called a *tax return*, showing what taxes are due. The latter method is used in the case of income taxes and in many of the payroll taxes.

Taxable Business. A third classification of taxes distinguishes them according to what they are levied on. This classification, which we can

loosely call "kinds" of taxes, is the most helpful in a general discussion of the subject, because it groups the taxes by the names by which they are generally known. They can be discussed under four major categories: (1) taxes imposed for merely being in business; (2) taxes on business transactions; (3) taxes for employing workers; and (4) taxes for earning profits.

TAXES FOR BEING IN BUSINESS

Several kinds of taxes are imposed on enterprises solely for the privilege of being in business. An important example of such a tax is the *franchise* tax, often called *corporation* or *capital-stock* taxes, levied by the state on an organization for its right to have corporate status and to act as an entity separate and apart from its stockholder owners. A different type of franchise tax is, for example, that charged public utilities for the right to lay power lines under the city streets or to run buses on those streets. *License fees* are a somewhat similar form of tax for the privilege of conducting a special type of business, such as a barber shop or restaurant, or for the right to operate a motor vehicle. *Occupation taxes* are levied for the privilege of using certain locations for business within a city; *use taxes* pay for the right to use a device of some kind in the city. Some states impose a *severance tax* on the extraction of natural resources within their boundaries; exacting a payment, for instance, for the cutting of timber, the mining of ore, or the pumping of oil from land within the state, even though privately owned.

A very important type of tax within this category is that of property taxes, usually imposed by the state or city, for the privilege of owning property. *Real property taxes* are imposed on the owners of real estate—for land and buildings erected thereon. Generally the property is given an *assessed valuation,* an appraisal of its approximate worth, and then the tax is quoted in mills (tenths of a cent) per dollar, or in dollars per thousand dollars, of assessed valuation.

Some states also impose *personal property taxes* on such items as automobiles, jewelry, television sets, and other furniture; still others levy *intangible property taxes* on bank accounts, stocks, bonds, and other securities. These taxes are generally computed on the basis of mills per dollar of property value.

BUSINESS TRANSACTION TAXES

Many taxes are imposed on the conduct of certain business transactions, some by the Federal government, many by the states, and a few by cities. The commonest of these is the *sales tax,* usually based on a small percentage of the retail selling price. The retail merchant is required to

collect the tax, generally 2 or 3 per cent of the total sale, and must in turn eventually remit the tax to the state or city tax collector.

Similar to sales taxes, but limited to a tax on the sale of certain specific articles, are *excise taxes,* generally imposed by the Federal government, but in some cases by the state or even by both. As previously mentioned, some of these are collected by the prior sale of stamps to the manufacturer, which he then affixes to the articles, such as playing cards, bottles and barrels of liquor, and boxes or tins of cigars, cigarettes, and pipe tobacco. Other excise taxes are collected exactly like sales taxes, by the retailer at the time of sale (or when the bill is rendered) to the consumer, such as taxes on safety-deposit boxes, electricity and gas, and telephone and telegraph communications. *Gasoline taxes,* imposed by both the Federal and state governments, are collected by the gas-station attendant for every gallon of gasoline sold at retail. The Federal government has, from time to time, imposed *luxury taxes,* an excise tax involving as much as 10 to 20 per cent of the retail selling price and collected exactly like sales taxes. These are levied on the retail sale of many articles arbitrarily classified as luxuries, such as automobiles, television and radio sets, luggage, cosmetics, jewelry, and tickets to theaters and sports events.

For articles imported into the country from foreign nations, a special Federal tax, called a *tariff* or *customs duty,* is imposed. At one time the sole source of revenue for the United States government, customs duties today are levied almost entirely for regulatory and administrative purposes. Tariffs are raised or lowered to discourage or encourage the importation of various types of foreign-made goods. A *protective tariff* is one that is made especially high, so that little of the goods will be imported; and manufacturers of the article in this country will be protected from the competition of goods made by foreign producers. When tariffs are low, as they are in the case of many items not produced in this country, or when goods come in completely duty free, there is said to be *free trade.* Customs duties are computed on one of two bases. Some are *specific,* with the charge of a certain number of cents per pound, bushel, or yard. Other tariffs are computed on an *ad valorem* basis, with the charge a certain percentage of the value of the item imported.

There are also transaction taxes imposed on the sale of stocks and bonds. A *stamp tax,* requiring the purchase of stamps which must be affixed to the documents, is levied on all deeds involving transfer of title to real estate.

TAXES FOR EMPLOYING WORKERS

A very important class of taxes to the business enterprise is that of payroll taxes. Although sizable in the large company, the payroll tax does

not compare with what must be paid in income or property taxes. The real significance of payroll taxes is in the amount of bookkeeping and other detailed work that their collection, reporting, and payment entail. Payroll deductions include old-age insurance taxes, unemployment insurance taxes, disability insurance taxes, and employee personal income tax withholding.

Social Security Taxes. *Old-age insurance taxes* are often referred to as "social security taxes" because both the old-age insurance tax and the unemployment insurance tax were first authorized by the Federal Social Security Act of 1935. Somehow the old-age tax became associated in the public mind with the social security label. The retirement and death benefits obtained through the old-age tax are therefore generally still referred to as "Social Security benefits." Accountants and businessmen today often use the term "F. I. C. A. taxes" for the old-age insurance tax, after the name of the law which superseded the original Social Security act, namely, the Federal Insurance Contributions Act of 1950.

The F. I. C. A. requires employers to withhold a certain percentage of all wages paid to employees, up to $4,200 each. To this withholding, the employer is himself required to contribute a similar amount, so that the employer turns in to the Federal Reserve bank (the collection agent for the Internal Revenue Service) both the employees' and his own contributions, or double the amount withheld by the employer from his workers' pay for F. I. C. A. taxes.

Every employee has a Social Security account number, which he must obtain from the Social Security Administration, upon application to it when he looks for his very first job. This number he then retains throughout the remainder of his life. When the employer turns in the tax payment, he also submits a quarterly report, called a "return," showing the amount of taxable wages paid to each employee. In some cases, as where the worker is given room and board, his taxable wages may be more than the actual money salary given him. The Social Security Administration keeps records of the wages paid to each employee on an account card it maintains for him, so that it will know how much each person has contributed toward his own retirement and death benefits. On reaching age 65, retirement age (women may elect to retire at 62 at a lower benefit), and actually retiring from work, or becoming totally disabled, or upon death, the worker or his estate are then entitled to certain benefit payments, computed by a rather complicated method.

Since 1951, self-employed persons like individual proprietors, partners, independent contractors, and professional people are similarly insured for old-age and death benefits. For this they pay a tax on their incomes in addition to the Federal income tax. The table on page 418

	SOCIAL SECURITY TAX		
	Employer	*Employee*	*Self-Employed*
1957–59	2¼%	2¼%	3⅜%
1960–64	2½%	2½%	4½%
1965–69	3¼%	3¼%	4⅞%
1970–74	3½%	3½%	5¼%
1975 and after	4¼%	4¼%	6⅜%

shows the scheduled rate of contributions from the present time to 1975 and after for employer and self-employed persons.

Unemployment Insurance Taxes. *Unemployment insurance taxes* are complicated by the fact that there are both Federal and state taxes for this purpose. The Federal tax is paid by any employer who has four or more employees. It is payable once a year, generally at the rate of $\frac{3}{10}$ of 1 per cent on all wages earned by an employee up to $3,000. The state taxes are usually 2.7 per cent of such wages, payable quarterly, and accompanied by a detailed tax return indicating the earnings for each employee. The state laws are not uniform, but generally require the payment of the state tax by employers even though they have fewer than four employees. Adding Federal and state taxes together, the total unemployment insurance tax, all of which is paid by the employer, amounts to 3 per cent of payroll, up to $3,000 earnings of each employee. In a very few states, the employee is also taxed a small percentage of his pay, which, like F. I. C. A. taxes, is withheld from his wages. Some states permit slight reductions in the employer's tax rate when he has had an excellent record of regularity in employment and has not had much unemployment. Such tax reductions are called *merit-ratings* or *experience rates* and act as an incentive to employers to maintain regularity in employment. The Federal unemployment insurance tax is payable to the Internal Revenue Service; the state tax goes to the state tax collector.

As its name implies, the unemployment insurance tax is used to maintain a fund to provide covered employees with weekly benefits for a limited period of time should they become unemployed. The unemployed person is entitled to unemployment insurance benefits as a matter of right, not because he may or may not need the money. The benefits are obtained from the state. The Federal tax is turned over to the states and is used solely for paying the administration costs of the state unemployment programs.

Disability Insurance Taxes. *Disability insurance taxes* are found only in the several states that have passed laws requiring employers to pay an additional small percentage of payroll for disability insurance. A few

states also require a similar payment by the employee by withholding from his wages. This tax sets up a fund which provides employee benefits for loss of pay due to illness or an injury due to an accident occurring off the job. Injuries received while at work are taken care of by workmen's compensation insurance, discussed in Chapter 14. In much of its operation disability insurance is similar to unemployment insurance. Neither type of benefit—disability or unemployment—fully compensate the employee for all the pay he loses because of his illness, injury, or unemployment.

Federal Income Tax Withholding. Employers are required to withhold from the wages of all employees, regardless of how few or how many work for them or the amount of their pay, a certain percentage which is calculated to pay the personal Federal income tax on the wages received. To aid the employer in determining how much to deduct from the pay of each employee, the Federal government requires each worker to fill out Form W-4, which indicates the number of his dependents. The employer then withholds an amount as indicated on charts of figures drawn up by the income tax authorities and known as *wage-bracket tables.* These tables give the exact figure, in dollars and cents, to be withheld, which is based on the employee's earnings and the number of dependents he has declared.

Like the F. I. C. A. tax, this income tax withholding is paid by the employer to a Federal Reserve bank for transfer to the account of the Internal Revenue Service. As with the old-age insurance tax, the employer submits a detailed quarterly report to the tax authorities, giving information about each employee and the amount paid to him and the amount withheld. This income tax withholding is a deduction from the employee's wages only, for, unlike F. I. C. A. taxes, the employer does not contribute to this from his own funds.

At the end of the year, the employer must give to each of his workers Form W-2, which indicates precisely the amount the employee has earned during the year, and the amounts of F. I. C. A. taxes and Federal income tax withholding that have been paid to the government during the year on his account. The employee, in turn, submits the original of this W-2 form with his own personal income tax return, retaining a duplicate copy for his own files.

In addition to the Federal government, some states also impose income taxes and require employers to withhold these as well. In many cases, however, withholdings for state income taxes are limited to the wages of those employees who work in the state that levies the income tax, but live in another state.

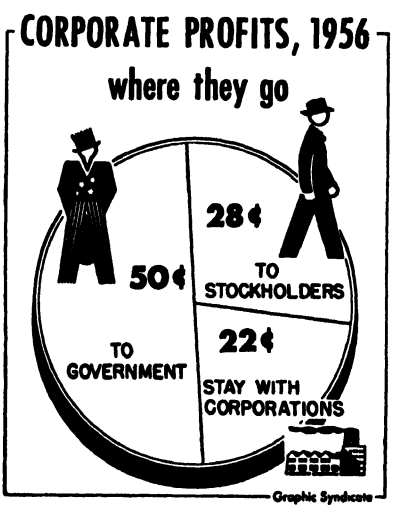
It can be seen that all payroll taxes paid by an employer amount to

less than 10 per cent of the wages and salaries he pays to his employees. Although this may indeed amount to a fairly large figure, it is not by any means as large as the company's own property taxes, nor does it generally compare with the size of the company's income taxes. But the voluminous records that must be kept and the many separate reports and payments that must be made for F. I. C. A. taxes, Federal unemployment insurance taxes, state unemployment insurance taxes, state disability insurance taxes, and Federal income tax withholdings, can be a most intricate and costly proposition for a business.

TAXES ON BUSINESS EARNINGS

By far the largest tax, in amount of dollars, which a company must pay is the Federal income tax on its own annual net profit unless, of course, the company has a poor year and earns little in the way of profit. Individual proprietors and partners report the earnings of their enterprises as part of their own personal income. A corporation, however, itself reports and pays a tax on the income it earns, while its stockholders report and pay, as personal income, an additional tax on any dividends they receive from the corporation. The rate of income tax levied against the net earnings of corporations is usually 50 per cent or more on their net income, so that for a large corporation this can run into hundreds of millions of dollars in a profitable year. In addition, some states also impose their own income tax, although in most cases this is limited to personal, rather than corporate, incomes.

An interesting distinction, which has had a great effect on business,



Corporate Profits. What does a corporation do with its share of corporate profits?

is that of the *capital-gains tax*, as distinguished from tax on income. Capital gain refers to that portion of the selling price over and above the purchase price, less accumulated depreciation if any, of a capital asset. A capital asset is any property which a business has purchased, other than its stock in trade, the things it buys and sells in its everyday transactions. Thus a corporation's factory real estate and equipment, delivery trucks, the stocks and bonds that it owns, office furniture and equipment would all be capital assets and, if eventually sold for more than the purchase price, less any depreciation, would result in a capital gain.

While the income tax regulations provide detailed rules with reference to capital gains, they may be summarized roughly as follows: (1) The profit on the sale of a capital asset, if sold within six months of its purchase, is considered to be income and taxable at full income tax rates. (2) The profit on the sale of a capital asset, if retained for more than six months between purchase and sale, is a capital gain and taxable at only 25 per cent, or one-half the normal tax rates, whichever is lower. It therefore follows that a taxpayer will usually try to retain a capital asset, such as a security or piece of real estate for at least six months in order to meet the tax definition of a capital gain and effect the saving thus possible.

Another Federal corporate tax, which affects management decisions, is that on unreasonable accumulation of retained earnings. If a corporation does not pay out in dividends to its stockholders a large percentage of its earnings (so that they in turn will have to pay personal income taxes on the dividends), it must either justify the retention of earnings or pay a penalty tax of a percentage of the earnings retained. Because it has the administrative effect the tax authorities want, the tax is not paid very often, since corporate directors prefer to declare larger dividends and retain less earnings in the corporation.

TAX-CONSCIOUS BUSINESSMEN

With the many taxes that a business enterprise is called upon to pay, it can readily be understood why businessmen are so conscious of taxes as a business cost, and are anxious to take any step that will reduce the burden. As has already been seen, such measures as proper valuation of inventories, calculation of depreciation, leasing assets instead of buying them, and holding capital assets for long-term capital gains are some of the many methods management uses in attempting to reduce taxes. A good comptroller can more than earn his salary if, aside from all his other important duties, he can, through knowledge of tax laws and prac-

tices, effect a sizable tax saving for his company. Furthermore, all departments of a firm should be tax conscious and do what they can to cut down on this tremendous business cost.

SUMMARY

Taxes are an extremely important cost of doing business and, in addition to affecting practically all phases of business operation, are often the core of the problems encountered by almost every company official. In addition to the tax money paid out, these taxes are costly because they require so much record keeping. Many important management decisions are influenced by tax considerations. Taxes can be classified as revenue or administrative; progressive or regressive; and direct or indirect. For practical purposes, however, they are best distinguished by the agency to which they are paid; how the business obtains the tax money; and on what the tax is imposed. Some taxes are levied on the right to do business and own property, such as franchise taxes, occupation taxes, severance taxes, and property taxes. Others are collected on the basis of business transactions, such as sales, excise and luxury taxes, as well as customs duties. Some taxes are imposed on payrolls, such as old-age insurance, unemployment insurance and disability insurance, as well as the collection work required for the Federal personal income tax withholding. The largest taxes, however, usually are those levied on the profits the business earns, the Federal corporation income tax and personal income tax for an individual or partnership. Trying to reduce a company's tax burden by every legitimate means is one of the most important duties of the comptroller, but in this he needs the help of all company officers, each of whom must be tax conscious.

► FOR REVIEW AND DISCUSSION

1. What are the more common kinds of taxes that the average business must face?
2. What is the relation, if any, between taxes and business records?
3. How do taxes influence management decisions to expand business operations?
4. How does the tax structure influence business decisions to spend money on advertising and to make other flexible expenditures?

5. How can tax experts help in business planning?
6. How do progressive and regressive taxes operate?
7. What is the distinction between direct and indirect taxes?
8. What are the four major categories, or kinds, of taxes?
9. Describe the various kinds of taxes that are imposed on an enterprise for being in business.
10. What are the various types of business-transaction taxes?
11. What is the largest tax that business pays the government?
12. How does the capital-gain tax affect business income?

► CASE-PROBLEM QUESTIONS

1. What difference does it make whether Kennedy & Company sells a piece of land before they have owned it at least six months?
2. Where can Mr. Barton look for other tax savings?
3. Where can he get information about Federal taxes which Kennedy & Company must pay?
4. Are there any taxes which Kennedy & Company can avoid?
5. How can Kennedy & Company reduce its state and Federal unemployment tax rate below 3 per cent?
6. Could taxes ever make further expansion of Kennedy & Company undesirable from management's standpoint; from the profit standpoint?

► APPLIED BUSINESS PROJECTS

1. Frank Doud is the owner of a small but profitable business. He can buy a business not in competition with his own that is losing money. A friend advises him to make the purchase because it will reduce his tax rate; and with Doud's business ability he is likely to turn the new business into a profitable venture.

In a few sentences give five reasons why Doud should make the purchase; explain your reasons.

In a few sentences give five reasons why Doud should not make the purchase; explain your reasons.

2. The Plimpton Company earned $1,000,000 last year and paid about $520,000 in corporation tax to the Federal government. The advertising budget for last year was $80,000. The advertising manager suggests that the budget for advertising be increased to $120,000, maintaining that the additional $40,000 will actually be less than $20,000. Is this true? Why? Answer in a paragraph.

Suggest five reasons why the president should follow the advertising manager's recommendations. Also, suggest five reasons why the president should not increase the advertising budget.

► COMMUNITY PROJECT

Have five students talk with at least one businessman each, each student using the same questions on taxes as the basis for the interview.

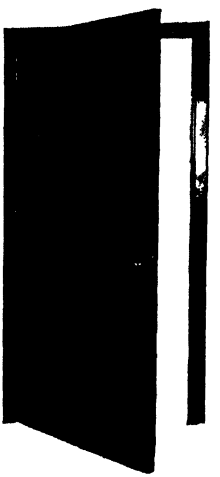
As a class project, in general discussion develop at least ten questions to be used. The following are examples:

1. Are taxes too high, too low, or about right, in _____ county, city, or village, in the state of _____?
2. If they are too high, what public service should be cut in order to reduce taxes? If too low, what services or benefits should come from increased taxes?

Section Seven

Business Management and the Government





Mr. Kennedy points out that the government affects the operations of business enterprises in many ways. He suggests that the officers study the impact of the government on the Kennedy organization, so that they will not again violate the laws; and, further, so that they may take advantage of the services the government offers. To aid in this study, he authorizes them to consult, if necessary, with the law firm to which the Kennedy company gives its legal business.

- **In what ways does the Federal government at various levels regulate business practices?**
- **What aids and assistance do the various government agencies offer to business firms?**

FREE ENTERPRISE VERSUS GOVERNMENT REGULATION

One of the basic principles of capitalism is that the individual should be allowed to pursue his own self-interests, free from governmental interference, coercion, or restraint. Early economists believed so strongly in this economic liberty that they urged a policy, called *laissez-faire,* meaning that the government should "leave alone" businessmen completely and not watch or regulate them in any way. Our country has never, however, applied the laissez-faire idea fully, for American business has always, to some degree, been subject to some form of regulation. Today even the strongest advocates of free and private enterprise will generally concede that the economy must have at least a minimum of governmental control to operate efficiently. Others, while giving lip-service to the American ideals of capitalism, believe that a considerable amount of regulation and policing of business by the government is necessary to the prosperity of our nation and people.

Whether one believes strongly in absolute freedom from business regulation and controls, or leans equally far in the opposite direction toward a planned economy, he is faced with the accomplished fact that the government plays an important role in the drama of American business. Although he may take sides and join in the continuing argument over free enterprise versus government regulation, the successful businessman recognizes the presence of the government on the economic scene and takes measures to see that his own enterprise operates within the boundaries of the law and also takes full advantage of government services; for the government's impact on our economy takes not only the form of regulation, it also makes considerable efforts to be of assistance to the enterpriser. In some industries, moreover, the government even competes against the businessman.

GOVERNMENTAL INFLUENCE ON BUSINESS

FEDERAL

Although the Federal government is limited by the Constitution to the regulation of interstate commerce only, business activity today has become so involved that the national government is seldom hampered by this restriction. Indeed, few articles are produced and distributed in this country that cannot be said to fall within the interstate commerce requirement. Thus the impact of the Federal government on businessmen is very great.

STATE

The state government derives its authority to regulate business from the United States Constitution and from judicial decisions that have interpreted that important document. The Federal Constitution gives Congress the power to regulate interstate commerce. The courts have held that whatever is not specifically mentioned as a power of the Federal government is by implication a power of the several states; therefore, the states have the constitutional right to regulate business conducted wholly within the state's boundaries, known as *intrastate commerce.*

In addition, the states have the right to exercise "police power" to protect the safety, health, and morals of their citizens. It is in the carrying out of this mandate that the majority of state regulations affect businessmen. The state's pure food laws and much of its important factory legislation, for instance, arise from this state function.

LOCAL

Local governments are of many sizes and types, and the scope of their activities varies with the state and general geographical area in which they are located. In most states, the largest subdivision of the state is the *county,* although in Louisiana it is called a "parish." There are no common areas of responsibility that can be said to apply to all county governments. Usually, however, the county handles the lower levels of the administration of justice—such as county courts and jails—takes care of the secondary roads in the state, and generally supervises the activities of the smaller governmental subdivisions within its borders.

In many states, the counties are further divided into *townships,* sometimes called "boroughs," which usually govern the more or less rural areas in such matters as schools, sewage, and local police and fire services. In addition, localities where groups of people have formed small centers of population often are incorporated *villages,* which take care of

local matters for these small towns. Larger centers of population are called *cities,* whose municipal governments take over the functions of townships and villages. Some cities are large enough to be counties, and a few are so large that they comprise more than one county.

In addition to the county, township, village, or city government, some local governmental agencies, covering fairly wide geographical areas, are often established for specific purposes only. Thus a sanitary district may be set up, mainly to handle sewage and health problems in a locality; a school district may take care of educational matters in the area, which may have different boundaries from the township, village, or sanitary district; or a park district may handle police and recreation problems in a prescribed area.

GOVERNMENT PROTECTION OF ORIGINALITY

PATENTS

An important area in which the Federal government strongly affects the dealings of businessmen is in the protection it affords—through the patent, copyright, and trade-mark laws—to those wtih originality. A *patent* is an exclusive privilege given to the inventor or discoverer of a new device, formula, or design, by the United States Patent Office, for the sole right to produce and sell that article in this country for a period of seventeen years. The owner of the patent may sell it, or he may grant to another a *license* which gives the latter the right to produce or sell the invention, usually provided he pays a royalty or fee based on the number of articles sold.

COPYRIGHTS

A *copyright* is an exclusive right granted by the Federal government, through the Copyright Office of the Library of Congress, to print or otherwise multiply copies of an original literary, dramatic, artistic, scientific, or educational work. This privilege also includes the prohibition on others from performing or showing the work in public, as with a play or motion picture. The copyright lasts for twenty-eight years, but may be renewed for an additional twenty-eight.

TRADE-MARKS

A *trade-mark* is an unusual symbol or distinctive way of writing the company's name or trade name (the name under which the firm does business or an unusual name for its product), which is applied to goods to distinguish them, in the mind of the public, from a competitor's products. If the mark is different and novel, it may be registered

with the U.S. Patent Office; and others are then prevented from applying it to their merchandise.

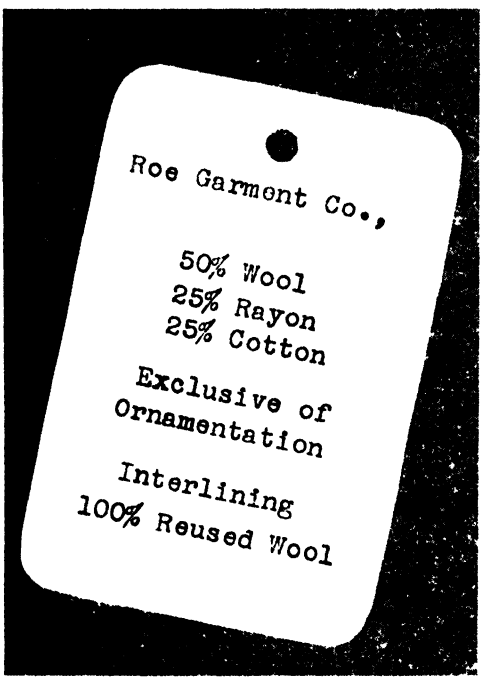
GOVERNMENT RESTRICTIONS OF BUSINESS PRACTICES

STANDARDS OF WEIGHTS AND MEASURES

Standards of weights and measures have been established by the national Bureau of Standards, although a large part of its work has been that of checking on the standards set up by the various individual states. The bureau maintains testing and experimental laboratories and works with scientists and businessmen in the setting, modifying, and maintaining of uniform standards.

QUALITY STANDARDS

The Bureau of Standards has also taken a leading part in the setting of quality standards and of simplified practices for commercial goods. It sets up "Federal specifications" to guide governmental agencies in making purchases; and through co-operation with the industries concerned, it establishes "commercial standards" of content and quality for manufactured articles. Although these standards are not forced upon



Wool Label. This is the type of label required by the Government.

Courtesy Federal Trade Commission

producers, but are only voluntarily adhered to, they have received general acceptance among manufacturers of the goods for which they have been developed.

GRADES

Grades for agricultural products are devised by the U.S. Department of Agriculture, in accordance with the standards of quality and condition it has established for a host of farm products. When agricultural goods are sold by grade in interstate commerce, or are traded on an organized exchange, they must conform to these standards. Articles inspected and graded by the Department include such commodities as fruits, vegetables, fats and oils, peanuts, grains, cotton, butter, eggs, and tobacco. Meat is inspected by the Bureau of Animal Husbandry of the Department of Agriculture. The U.S. Pure Food and Drug Administration sets standards of weight, measure, and quality for foods, drugs, cosmetics, and therapeutic devices. Furthermore, it polices the distribution of these commodities in interstate commerce to prevent the sale of those that are adulterated or misbranded.

Most of the states have their own pure-food and drug laws, which parallel and supplement the Federal law. The state laws are aimed primarily at adulteration, misbranding, and other forms of deception, in the manufacture, distribution, and sale of foods and drugs that do not go into interstate commerce. In addition, many state laws single out certain industries or products for special regulatory attention not provided in Federal legislation.

LOCATION AND CONSTRUCTION

Supervision. It becomes important for a business firm, establishing a plant, store, or office in a certain locality, to learn what the local government units are that will have supervision over its operations and the right to levy taxes or assessments on it. It is possible, for instance, for Kennedy & Company, wishing to open a branch factory in a certain rural area, to discover that it not only must satisfy the requirements of the state division of industrial hygiene and safety with reference to its plans, but must apply to the county government for permission to build a railroad siding across a road leading to the site; it must surround its factory building with a certain area of lawn to meet a township regulation; it must have its sewage plans approved by the local sanitary district officials; and it must pay taxes assessed by the local school district to support educational facilities in the area.

Zoning. A serious, but most necessary, restriction of local law on the enterpriser wishing to open an establishment at a certain site are the

zoning ordinances of the city, village, or township in which it is to be located. No one likes to have a smelly or smoky factory located right next to his home; nor, for that matter, do we usually like a large shopping center or drive-in movie opposite our living-room picture window. Municipalities, therefore, have designated various areas as specific zones, retaining some exclusively for residences, churches, schools, and hospitals, and designating others as business zones. Some localities distinguish between commercial zones, where offices and stores may be located, and manufacturing zones, where factories, tanneries, and other such plants may be built.

Closely related to the zoning laws are other local building restrictions. Some municipalities limit new buildings to those of a certain type of construction, such as, for instance, of brick or other masonry, or set minimum costs, or even go to such extremes as requiring all roofs to be of the same color. A not uncommon requirement for new factories in rural areas is that they must landscape a large percentage of the total plot in order to retain the beauty of the surrounding countryside.



Courtesy General Motors Corporation

Business Moves to the Country. Even large companies are moving from congested cities to suburban areas. Often, entirely new communities spring up almost overnight, close to a new plant such as this one.

Codes. Although so-called building restrictions are established by the state, many communities, through city, county, township, or village ordinances, set up additional limitations of their own. Thus the local building code may require a designated type of connection with the trunk sewer in the street, or insist on special insulation for all electrical conduits.

Many local governing bodies not only maintain their own police and paid or volunteer fire departments, but often establish inspection facilities to make occasional checks on buildings in the community. Thus, in addition to state supervision of its plant facilities, the Kennedy stores or factories may be inspected by a fire or elevator inspector from the county, city, or township authorities. Similarly, many municipalities have *boards of health,* whose inspectors check sanitary facilities, such as washrooms, garbage and waste disposal, and cafeteria and cooking facilities.

UNETHICAL PRACTICES

Federal. The Federal Trade Commission is charged with the surveillance of unethical practices in many fields. These include false and misleading advertising; exaggerated medical claims, or fraudulent claims of official approval in advertising and selling; using false and misleading trade names; misbranding; false statements about a competitor or his products; or unethical tactics used to embarrass or harass competitors. This commission also conducts conferences at which members of a trade or industry voluntarily formulate codes defining fair and unfair practices to guide them in their conduct. A special congressional act authorizes the Federal Trade Commission to enforce the proper affixing of a label on all wool products giving the exact percentage of wool content.

Other Federal agencies specifically police the practices of certain designated industries. The Interstate Commerce Commission, for instance, regulates the railroad and overland transportation industries; the Maritime Commission supervises the merchant marine; and the Civil Aeronautics Board similarly handles the problems of the aviation industry. The electric-power and the natural-gas industries are both under the supervision of the Federal Power Commission; while the Federal Communications Commission regulates the field of communications, which includes telephone, telegraph, cable, radio, and television. The United States Forest Service, National Park Service, Bureau of Mines, Federal Petroleum Agency, Fish and Wildlife Service, Soil Conservation Service, and the Bureau of Reclamation (which controls

water power and irrigation) regulate the economic activities of those engaged in business in the particular field.

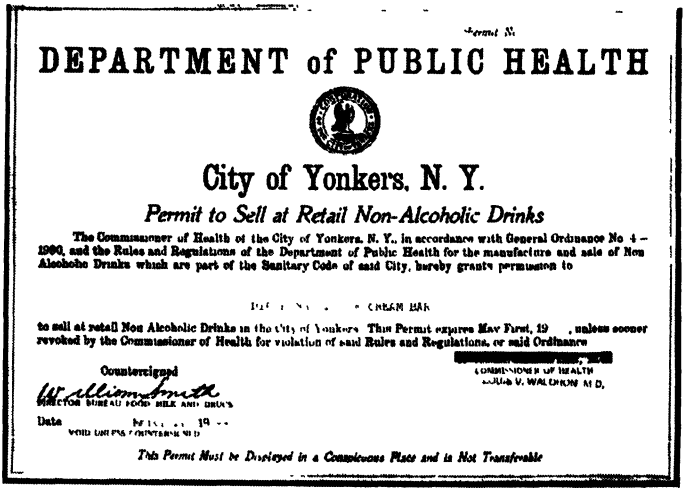
State. False or misleading advertising is prohibited in many states by means of a law, known as the "Printers' Ink Model Statute," first suggested in 1911 by *Printers' Ink,* a trade periodical. In every case, these laws apply only to advertising of an intrastate nature.

The states supervise professional ethical practices by means of *licenses* that individuals must procure in order to engage in such professions in the state. Generally these licenses are granted only after the applicant has demonstrated his ability by means of some type of examination and may be revoked if the licensee is guilty of unprofessional conduct. The professions of medicine, dentistry, podiatry, optometry, and many other allied fields, as well as law, accounting, real estate brokerage and selling, insurance brokerage and selling, and even barbers, electricians, etc., are subject to licensing regulations.

In the interest of conservation, the states usually license hunters and fishermen and set closed seasons during which such sports may not be engaged in. States not only conduct fish hatcheries and breeding farms, but give considerable aid to farmers in solving their problems by means of agricultural experiment stations. Many states inspect cars and trucks entering their borders in order to halt the transportation into the state of fruits, vegetables, plants, and shrubs, which might carry various insects or diseases.

Another important area of regulation and licensing by the states is the liquor industry. Stores selling bottled intoxicating beverages are, in most states, required to obtain a state license; and their number and location are carefully limited. In a few states, liquor stores are operated by the state itself, as a state monopoly. Establishments where liquor is sold for consumption on the premises, such as taverns, hotels, night clubs, and restaurants, are also licensed and subject to state regulation, usually under the supervision of an alcholic beverage control board.

Local. Business enterprisers are also affected in many cases by the licensing powers of the local municipality. Just as the states use licenses to regulate and control certain activities, so the cities, towns, and villages supervise other business pursuits. These local subdivisions may, by ordinance, regulate a number of trades through plumbing, electrical and other building codes, and fire prevention laws. Many municipalities pass ordinances designed to preserve the public peace, morals, and safety by regulating, for instance, the use of the streets and sidewalks. They often require that licenses be obtained by many types of business enterprises, such as restaurants, hotels, motels, tourist homes, trailer camps, rooming houses, circuses, carnivals, theaters, dance-



DEPARTMENT of PUBLIC HEALTH

City of Yonkers, N. Y.

Permit to Sell at Retail Non-Alcoholic Drinks

The Commissioner of Health of the City of Yonkers, N. Y., in accordance with General Ordinance No 4 – 1920, and the Rules and Regulations of the Department of Public Health for the manufacture and sale of Non Alcoholic Drinks which are part of the Sanitary Code of said City, hereby grants permission to

[illegible] CREAM BAR

to sell at retail Non Alcoholic Drinks in the City of Yonkers This Permit expires May First, 19 , unless sooner revoked by the Commissioner of Health for violation of said Rules and Regulations, or said Ordinance

[redacted]
COMMISSIONER OF HEALTH
JULIUS V. WALDRON M D.

Countersigned
William Smith
DIRECTOR BUREAU FOOD MILK AND DRUGS

Date [illegible] 19 [illegible]
VOID UNLESS COUNTERSIGNED

This Permit Must be Displayed in a Conspicuous Place and is Not Transferable

A Typical Retail License

halls, opera houses, billiard and poolrooms, bowling alleys, skating rinks, amusement parks, and public exhibitions. Also subject to license by local governments are taxis, express trucks, auctioneers, pawnbrokers, and dealers in secondhand articles.

Of particular value to retail stores, like the Kennedy hardware chain, are the regulations limiting and controlling itinerant peddlers. They require special licenses for the hawking or peddling of commodities in the local streets. Some communities, to protect the business of tax-paying storekeepers, forbid all peddlers. Farmers and others who grow fruit and other farm products are sometimes permitted to sell their produce on the streets.

EXPANSION

The ability of corporations to combine, and the resulting benefits that accrue to enterprisers from such expansions and combinations, have fostered big business organizations that have become so large as to dominate their entire industry. When one firm becomes so huge and powerful that it alone operates in, or controls, an industry, it is known as a *monopoly.* Where only a few business enterprises dominate an industry and all others are driven out of business, or are permitted to continue operating only if they carry out the wishes of the giants, these latter are referred to as *oligopolies.* The American Telephone and Telegraph Company is an example of a monopoly, for it has practically no competition in its field. The automobile business, dominated by

General Motors, Ford, and Chrysler, illustrates an industry in which oligopolies operate.

When companies become so powerful that they are able to control their field of industry, they can stifle all competition, drive smaller firms in the same line out of business, and charge the consumer unfair prices for their products. To afford some protection to the public against ruthless monopolies or oligopolies, the United States government has taken measures to regulate the combination of business enterprises. The Sherman Antitrust Act of 1890 and the Clayton Antitrust Act of 1914 declare that "combinations in restraint of trade" are illegal; and the Federal Trade Commission has been given the responsibility for enforcing these laws. The regulations did not set a standard of size above which a company could not grow. Rather they prohibited business enterprises from combining together, or even co-operating with each other, if the effect of such combination is to make competition in the industry unduly difficult, or if the companies agree among themselves to stop the free movement of prices. Thus the Standard Oil Company, which grew through expansion and combination into a gigantic monopoly in the oil industry, was ordered by the United States Supreme Court to be broken up into several smaller companies, so that competition in the industry would be restored.

Public-utility companies, like those in the electric-power, communication and transportation fields, however, are permitted by the government to be monopolies. The reason for this can easily be seen if one were to picture the confusion that would result from trying to telephone friends or business associates in various parts of the country having many independent and unaffiliated telephone companies, and if you subscribed to the telephone service of one company while your friends subscribed to service from other companies. These public-utility companies are, however, closely watched and regulated by state and Federal governments, so that they cannot take advantage of the public with reference to the services they render or the prices they charge for such service.

The antimonopoly regulations, called *antitrust laws* because the early large monopolistic companies were referred to as "trusts," are not only aimed at mergers, consolidations, holding companies, and other forms of business combination. They also prohibit separate, independent firms from making agreements among themselves to control prices or to throttle competition. Such informal contracts among competitors to co-operate and not fight each other for business are called *pools,* and when these agreements are on an international level among gigantic companies in different countries, they are referred to as *cartels.* Some-

times the co-operation among competitors in fixing prices or allocating territories of exclusive operation is arranged by having some of the same men serve on the boards of directors of the competing corporations. These *interlocking directorates* are also prescribed by the antitrust laws.

GOVERNMENT CONTROLS OF COMPETITION AND PRICES

FEDERAL

The Interstate Commerce Commission, Maritime Commission, Civil Aeronautics Board, Federal Power Commission, and Federal Communications Commission supervise and regulate the competition, or the government-granted monopolies, in their respective fields. The Securities and Exchange Commission, through the Public Utility Holding Company Act, is empowered to scrutinize combinations among public utilities. An important branch of the work of the Federal Trade Commission is the enforcement of the provisions of the Sherman and Clayton antitrust laws.

As an amendment to the antitrust laws against price fixing, the Federal *fair-trade* legislation permits the manufacturer of a brand-name article, sold in more than one state (that is, in interstate commerce), to obtain an agreement from the distributors of his product not to sell it below a stated price. This law to prevent price cutting and price wars has been subjected to much criticism. This is because it does not generally have the support of consumers, who feel it cuts down their opportunity to buy goods at bargain or discount prices. Many retail storekeepers object to the law because they believe it prevents efficient dealers from getting more business by selling the items below the established fair-trade minimum price; and even many manufacturers criticize the law as a failure because it requires them to bring suits to stop price cutters, rather than calling for a Federal agency to police the carrying out of the law. Many manufacturers merely suggest what the retail price for their product should be, instead of actually setting a fair-trade minimum price under the provisions of the law.

Another Federal law regarding prices which has had an appreciable effect on business is the Antiprice Discrimination law, more commonly called the Robinson-Patman Act, after its sponsors in Congress. This legislation is aimed primarily at the large chain stores, which were given unfair advantages over the small independent storekeeper in the prices they paid for the merchandise they sold. The law makes price and terms-of-sale discrimination between purchasers of like grade or quantity illegal. The Robinson-Patman Act also prohibits the payment of a

Fair Trade Code

for ADVERTISING and SELLING

***of the* NATIONAL ASSOCIATION OF BETTER BUSINESS BUREAUS, INC.**

I	Serve the public with honest values.
II	Tell the truth about what is offered.
III	Tell the truth in a forthright manner so its significance may be understood by the trusting as well as the analytical.
IV	Tell customers what they want to know—what they have a right to know and ought to know about what is offered so that they may buy wisely and obtain the maximum satisfaction from their purchases.
V	Be prepared and willing to make good as promised and without quibble on any guarantee offered.
VI	Be sure that the normal use of merchandise or services offered will not be hazardous to public health or life.
VII	Reveal material facts, the deceptive concealment of which might cause consumers to be misled.
VIII	Advertise and sell merchandise or service on *its* merits and refrain from attacking your competitors or reflecting unfairly upon their products, services, or methods of doing business.
IX	If testimonials are used, use only those of competent witnesses who are sincere and honest in what they say about what you sell.
X	Avoid all tricky devices and schemes such as deceitful trade-in allowances, fictitious list prices, false and exaggerated comparative prices, bait advertising, misleading free offers, fake sales and similar practices which prey upon human ignorance and gullibility.

Fair Trade Summary.

brokerage fee where no broker actually renders any services and requires advertising and other allowances to be made available on proportionately equal terms to all customers.

During World War II and for a time thereafter, the Federal government, through the Office of Price Administration, enforced *price control* through legislation that sought to prevent wartime inflation. Prices for most types of goods were fixed at the figure at which they stood at a chosen date early in the war, and distributors had to post a list of those prices and not charge more than the listed price. Just the opposite of the fair-trade law, which puts a floor under prices, price control sought to put a ceiling over them. To make it more effective, consumer goods were rationed; and consumers were required to turn in government-issued "ration points" with each purchase they made, while producers obtained raw materials only by applying for and receiving government priorities.

STATE

Most of the states have enacted a fair-trade law of their own, generally closely patterned on the Federal law. These laws, however, have been declared unconstitutional in several states, have been repealed in a few, but still remain in effect in most of them.

The states have also sought to regulate competition mainly by means of special kinds of taxes. An example of such action is the antichain-store legislation that was passed by many states during the great depression. Independent merchants complained that the chain stores were hurting their business, so the legislatures were induced to put a tax on chain stores. The Michigan tax, which was typical, levied $10 on retailers with more than one store, with graduated increases up to $250 for each store above twenty-five.

Taxes also play a part in state regulation and control of competition in at least two other ways. Most states license foreign corporations, those incorporated in another state. By means of the license fees and the requirements for obtaining this permission to conduct business affairs in the state in which they are not incorporated, these foreign corporations can be regulated and at least slightly discouraged from competing with domestic firms. Furthermore, many states that impose a sales tax on goods sold within their boundaries, will levy a use tax on goods bought in another state. This, of course, has the effect of reducing purchases by the state's residents of retail products in other states.

THE GOVERNMENT AND FINANCE

FEDERAL

The commercial banks with which the business enterpriser has so many dealings are almost all members of the Federal Reserve System

and are subject to the strict regulation and close supervision of the Federal Reserve Board and the United States Comptroller of the Currency. The ease, or difficulty, experienced by business borrowers in attempting to obtain a short-term bank loan is often a direct result of the Federal Reserve Board's policy in effect at the time. In addition, deposits in the commercial and savings member banks are insured up to $10,000 on each account by the Federal Deposit Insurance Corporation, which also keeps its eye on bank operations.

Before a corporation can sell stocks or bonds to the public, it must register the security issue with the U.S. Securities and Exchange Commission and have the *prospectus,* which gives prospective investors considerable information about the company and the stock or bond issue, approved by that commission. The S.E.C. also regulates the activities of the stock exchanges and the stockbrokers who aid investors in buying or selling corporate securities.

Businessmen are aided by the various governmental agencies that make loans not only to business firms, but also to farmers or home owners who, having obtained funds for improvements, spend the money to purchase the products of businessmen in effecting the improvements. Thus, while the Farm Credit Administration makes loans to farmers and the Federal Housing Administration is concerned with lending to home builders, the funds they put in the hands of these farmers and home builders help to increase the production and sale of the materials and equipment that go into the development of a farm or the construction of a house.

An important source of business lending today is the national Small Business Administration, which devotes itself exclusively to the interests of small business and serves as a clearinghouse for small firms seeking assistance from the Federal government. Its regular lending program is chiefly for the benefit of manufacturers, and loans average about $50,000 each. The limited-loan participation plan of the S. B. A. is concerned with smaller loans (up to about $15,000, and for a term running up to five years) for merchants and service firms, provided a bank will take at least 25 per cent of the loan. In addition, Federal Reserve banks are empowered, under the law establishing the Small Business Administration, to lend directly to industrial and commercial concerns when financing cannot be obtained through customary channels.

Financial aid from the Federal government is also available to large corporations. In the transportation field, for example, railroads, airlines, and merchantship operators are the beneficiaries of governmental help mainly in the form of subsidies for handling United States mails and for other reasons.

STATE

The states, like the Federal government, also exercise their influence over business in the field of finance, including the supervision of banking, security issues, and insurance. Since most lawsuits are brought in state courts, it may be said that by means of court decisions and judges' opinions, the state laws profoundly influence all business transactions and operations. In the areas of investment, banking, and insurance, however, the states have passed special statutes with the major purpose of regulating those specific activities.

Banking. All states pay considerable attention to the carrying on of banking functions within their jurisdictions. In the first place, they generally have *usury* laws, which make it illegal to charge more than a specified rate of interest for most loans. There are usually two exceptions to the usury laws. In many states loans can be made to corporations at any rate of interest acceptable to both parties, even though considerably higher than the legal rate; and, second, loans made by state-licensed personal finance companies to individuals in need of comparatively small amounts of money, may, because of the credit risks involved, be made at a higher prescribed rate. Through its power to license them, the state exercises strict control over the personal loan or finance companies.

The states also pay much attention to the commercial and savings banks that operate within their boundaries. Most states have a superintendent or commissioner of banking who sends bank examiners to determine the general conditions, conduct, and affairs of the banks. The state regulates the types of investments in which savings deposits may be placed, as well as the types of loans that banks may make. Since a large percentage of commercial banks today are members of the Federal Reserve System, and both commercial and savings banks have their deposits (up to $10,000 in any account) covered by the Federal Deposit Insurance Corporation, most bank regulation is by agencies of the United States government.

Security Issues. Although the states for the most part took an early lead in establishing regulations concerning investments and the sale of securities, their influence has been diminished by the growing importance of more recent Federal laws. The number of fraudulent security-sale schemes was so great some years ago that, as far back as 1911, several states passed laws to prosecute the perpetrators. Because some of these stock and bond salesmen tried to sell everything including the "blue sky," the laws were known as the "Blue sky" laws. In some states, these laws are of the "fraud" type, in that they call only for the prose-

cution of offenders. Others are of the "licensing" type, in that they aim at assuring honest security dealings by carefully screening the security sellers before issuing licenses to them. Still other states use the system—later adopted in the Federal Securities Act and administered nationally by the Securities and Exchange Commission—of requiring submission, to an appropriate state agency, of information on the security to be sold. The state then weighs, not the validity of the stock or bond issue itself, but rather the sufficiency of the information given the public. Since most securities are sold in more than one state, the Federal security regulations, enacted in 1933, have replaced in importance the state "Blue sky" laws.

Insurance. State regulation of the insurance industry is very thorough and widespread. States require insurance companies, brokers, agents, and salesmen to be licensed, generally after meeting certain requirements or passing tests. The assets and accounts of the companies are usually investigated by examiners under the state superintendent of insurance. The types of investments in which insurance companies can place their money and the reserves they must maintain to assure the payment of claims are all carefully regulated. Even the forms and wording of some insurance policies are spelled out in detail by state laws on the subject.

THE GOVERNMENT AND DEBTORS

The Federal government, through the bankruptcy laws, extends aid to the honest, although insolvent debtor, to get him out of his difficulties. When a business is failing—with debts greater than its assets and creditors pressing it for immediate payment—there are several possibilities open to the enterpriser to save his firm.

He may try to obtain from his creditors an *extension agreement,* wherein they agree to give him a longer time in which to pay the debts owed to them.

He may obtain a *composition with creditors,* an agreement whereby each creditor agrees to accept a certain smaller percentage of his claim in full payment of the debt owed him.

If the debtor cannot get his creditors to agree to extend the time of payment or settle for less than the full amount due, he must take more drastic steps. One of these might be an *assignment for the benefit of creditors,* by means of which he turns over to someone whom he appoints, called the *assignee,* all his assets. The assignee then sells the debtor's property and pays off the creditors with the proceeds in proportion to their claims.

Sometimes the debtor can get the state courts to appoint an *equity receiver,* who takes over the business from the debtor and continues to operate the business in the hope that he can, with the court's assistance, straighten out the mess, pay off the creditors, and possibly even return the business in satisfactory shape to its former owner.

In most situations, however, when a business falls hopelessly in debt, the firm ends up in the hands of the Federal bankruptcy court. This happens when three or more of the debtor's creditors, or he himself voluntarily, petition the court that he be declared a *bankrupt.* The court frees the bankrupt debtor from all his debts but requires that he surrender all his property to the court-appointed *trustee in bankruptcy,* so that all creditors will have an equal chance to share in whatever proceeds those assets will raise at a sale.

Since the bankruptcy of a large corporation would be a blow not only to its creditors and stockholders, but also to its many employees, the Federal bankruptcy laws give such companies a chance to reorganize. In a *corporate reorganization,* trustees take over the running of the business while all parties get together to try to devise a reorganization plan.

THE GOVERNMENT AND LABOR-MANAGEMENT RELATIONS

FEDERAL

The business enterpriser also feels the effects of Federal laws and regulations in the field of industrial relations. The importance and provisions of the National Labor-Management Relations Act, known as the Taft-Hartley law, which enforces collective bargaining among employers and employees and regulates the activities of management and unions in their mutual dealings, has already been discussed in Chapter 20. In addition, as an aid to firms or unions involved in industrial strife, the Federal Mediation Service, also mentioned in that chapter, is available to lend its help toward peaceful settlement of these disputes.

Furthermore, those businesses engaged in interstate commerce are affected by the Federal Fair Employment Practices Act (generally called the Wages and Hours law), which sets a minimum hourly pay and requires that all employees who work over forty hours in a week be paid for the extra hours at overtime rates.

STATE

Labor Relations. A few states have labor-relations laws patterned after the national laws on this subject, although the New York legisla-

tion, for instance, resembles the old Wagner Act of 1935 rather than the Taft-Hartley law of 1947. On the other side of the labor picture, some states have passed legislation known as "right-to-work" laws. These statutes, in effect, outlaw the closed and union shop, because they say that every employee has the right to work and that union membership cannot be forced on him. Antistrike laws have been passed in a few states. In some of these laws the right to strike in labor disputes has been denied only to employees of the state and municipal governments. In others, the antistrike legislation is directed at employees of public-utility corporations. Along with the prohibition against strikes by employees, these laws generally call for seizure of the company's assets by the state for the duration of the labor dispute. Because of their unpopularity with the mass of workers, neither the right-to-work nor the antistrike laws have been very effective and have been repealed in some states.

As an aid to the maintenance of peaceful labor-management relations, many states have set up mediation services that are available to the parties to a dispute. The state board of mediation will do what it can to get the parties to settle their differences through mediation and conciliation, rather than by means of costly strikes that cause serious losses to both employers and employees.

Just as the Federal Fair Labor Standards Act regulates wages and hours of employees in interstate commerce, many of the states have enacted a minimum wage law to establish minimum rates of wages and, in some cases, maximum hours of work without overtime of employees in intrastate activities. Workers in retail stores, restaurants, hotels, laundries, cleaning and dyeing establishments, and beauty shops are examples of those who would be affected by these state laws.

A comparatively new type of legislation, enacted by a few of the states, is a law generally known as an *employment-practices law* or as a *law against discrimination.* The purpose of such legislation is to prevent discrimination by reason of race, creed, color, or national origin. It makes it unlawful for employers to practice such discrimination in hiring employees, for labor unions to discriminate in admission of members, and for operators of public transportation facilities and resorts to refuse accommodations to anyone because of his race, color, or creed. Furthermore, it prohibits employers from mentioning race, color, creed, or national origin in advertising and application forms for jobs.

Closely allied to state wage and hours laws are the special regulations with reference to maximum hours and night work for women and minors. The prohibited-employment, or "hazardous-industries," legislation further limits the work of women and children in dangerous

occupations. Under these laws, for example, women and girls cannot be employed in certain industries, such as foundries, mines or quarries; and minors may not be employed on dangerous machines or in hazardous operations. In most states, even in permitted occupations, minors under a certain age, usually 16, may not be employed unless they obtain a work certificate from the state department of education. Other laws, in many states, restrict what is known as "industrial homework," namely, the manufacture of articles in the home, in whole or in part, from materials supplied by the employer, and to be returned to him.

Still another wage law found in many states is that prescribing the mode of paying employees. The statute in New York, for instance, requires that wages in factories must be paid weekly within six days following the close of the work week, and in cash, unless permission to use checks is obtained from the state industrial commissioner. An interesting addition to this law in New York and some other states prohibits discrimination in rate of pay because of sex.

Working Conditions. Because the states believe that the first duty of an employer to his employees is to provide them with a proper working environment, most of them have enacted legislation setting up strict safety and sanitation regulations for factories. A company intending to open a factory is usually required to submit plans of the plant to a state agency, usually with a name like "Division of Industrial Hygiene and Safety Service," for its approval. Once the factory is opened, it is subject to periodic inspections by state employees to see that standards of safety and sanitation are maintained. Among the many devices carefully watched are such things as boilers and pressure tanks and valves, which not only must be attended by engineers licensed by the state, but must pass regular mechanical tests conducted by state inspectors.

Social Insurance. This legislation generally includes workmen's compensation, unemployment insurance and, in some states, disability insurance against disabling illness or accidents not occurring while at work. A constructive feature of the work of the states in these areas is the efforts made by most of them to rehabilitate seriously injured and disabled workers. These unfortunate people are given training by the state to prepare them to earn a living in spite of their handicap. The states also conduct campaigns to encourage employers to hire handicapped workers and make considerable efforts to place them in suitable jobs.

Many states have state insurance funds, a program prescribed by state law and state subsidized, although the state usually assumes no responsibility for its operation or eventual solvency. In some states,

like New Jersey, this fund has a monopoly in the workmen's compensation insurance. In others, like New York, the state fund competes with private insurance companies which also write workmen's compensation insurance required of most employers. In states like New Jersey and New York, which have enacted disability benefits laws to protect workers disabled through nonoccupational injury or sickness, the insurance is generally administered by the same state agency that supervises workmen's compensation; and coverage may also be obtained from the same state insurance fund. In the case of both workmen's compensation and disability insurance, an employer may usually qualify as a self-insurer by furnishing satisfactory proof of his ability to pay benefits.

THE GOVERNMENT AS A SOURCE OF BUSINESS INFORMATION

FEDERAL

The Federal government renders aid to businesses by supplying them with a considerable amount of useful information. Many of the regulatory governmental agencies give *accounting advice* to business in the normal course of supervising their specialized industries. In addition, almost every Federal agency contributes to the wealth of *statistical information* which is available to business.

Another way in which the government aids business is in the many informative and readable pamphlets and booklets published by it, which are available free or at very low cost from the Superintendent of Documents at the U.S. Printing Office. These analyze and give advice on specific problems that daily confront the businessman. Outstanding among them are the *Business Service Bulletins* of the Department of Commerce and the *Industrial Series* put out by the Small Business Administration of that department. The various leaflets cover problems in almost every conceivable line of business, such as gas stations, gift shops, millinery stores, and restaurants, as well as particular aspects of retailing or service businesses, such as advertising, record keeping, and insurance coverage.

STATE

Similar to the U.S. Department of Commerce, the states normally maintain their own departments of industry and commerce with the specific aim of helping enterprisers. Most of them collect and disseminate a considerable quantity of business information and statistics about business conditions in the state. And like their Federal counterpart, they usually publish booklets and pamphlets giving advice and instruc-

tion to those going into, or already conducting, a business in any of the various industries carried on in the state.

An interesting and important additional type of service to business people conducted by almost every state is that of industrial development. Many kinds of assistance are given to encourage enterprisers to find suitable locations for their stores, warehouses, factories, or branch activities within the state. Many states also expend much effort and go to great expense to advertise throughout the country the advantages of travel or the location of homes and business establishments within the boundaries of their particular state.

THE INFLUENCE OF LOCAL BUSINESS ORGANIZATIONS

On the level of the local community, business firms have dealings with many organizations of businessmen. In many cases, these groups have a semi-official status in the locality, exercising a measure of control over unethical practices, as for example, the supervision by the Society for the Prevention of Cruelty to Animals over offenders in the area of its interest.

Better Business Bureaus. Perhaps most important of the organizations, among those groups of local businessmen who interest themselves in promoting the welfare of industry and commerce in the community, is the Better Business Bureau. Although this organization supports every effort designed to improve local business conditions, it is especially active in policing the community to detect and prosecute those guilty of unethical business practices. Better Business Bureaus have succeeded in many localities in persuading local governments to pass ordinances making many unethical business practices illegal, or at least subject to close regulation. In some communities, for example, a store must obtain a license and prove the genuineness of its claim before it can run a "fire sale" or a "going out of business sale."

Chambers of Commerce. Another group of local businessmen, active in many localities, is the Chamber of Commerce. Like the Better Business Bureau, the local chapter of this national business organization is composed of business leaders and professional men who pay dues to support the activities of the chapter, which are usually carried on by a paid executive secretary and his staff in an office maintained by the chamber. The chamber advertises the merits of the community as a place in which to do business, both as a customer and an enterpriser. It encourages all worthy efforts to promote the welfare and prosperity of the community as a whole and supports all civic improvements.

Some localities also have a chapter of the Junior Chamber of Com-

merce, composed of younger business people with interests similar to the Chamber of Commerce itself. Other organizations whose memberships are made up largely of business people and who also promote the prosperity of the community, and thus incidentally of local business enterprises, are the service clubs, such as Rotary, Lions, and Kiwanis.

Trade Associations. Although not usually organized on a community basis, there are trade associations in almost every industry, with a membership of the alert business enterprisers in that field. Most trade associations have chapters in many areas, and the businessman usually has direct contact with such organizations on a local level.

The purposes of these associations are to promote the best interests of the members of that particular trade or industry and to foster harmony and good feeling among these competitors. Specifically the associations render assistance to their memberships by supplying financial data and statistics of interest to them, suggesting general and cost-accounting systems, aiding in problems of employee relations, taxation, credits and collections, product standards and business practices. The local groups encourage mutual publicity and public relations, exhibitions and other trade promotion, and lobby for legislation favorable to the interests of the membership.

SUMMARY

Besides the instrument of taxation, the government influences business firms in many ways in their daily operations. This is true even though our democratic economy is based on the capitalistic ideals of free and private enterprise. Because the government regulates many actions of business people, aids them in many others, and even competes against them, it is important for the enterpriser to become familiar with the ways in which the government influences his efforts. He must learn to conduct his business within the framework of government laws and take full advantage of those measures that help him. Among the various ways in which the government affects business is by protecting originality; setting standards and policing against unethical practices; controlling competition and prices; regulating labor-management relations; supervising working conditions; controlling monetary and financial institutions; aiding debtors; providing protection through social insurance, police, fire, and health agencies; and disseminating statistical and other business information.

In addition to the governmental bodies, business firms are often strongly affected, usually to their great benefit, by local organizations of businessmen, such as the Better Business Bureau, Chamber of

Commerce, the service clubs, and trade association in their particular industry.

► FOR REVIEW AND DISCUSSION

1. For what reasons should a businessman be acquainted with the regulations governing business operations?
2. From what document do states derive their authority to regulate business?
3. How does the government protect originality?
4. Why should a company wishing to establish a branch plant or store investigate local ordinances before taking action?
5. What are the purposes of local building restrictions governing such things as type of construction, masonry, and landscaping?
6. Why should the government concern itself with unethical business practices?
7. How do licenses to perform certain services restrict business activity? How do they protect business and residents of the states?
8. When is a monopoly contrary to national welfare; an oligopoly? Are the local utility companies monopolies? Are they good or bad?
9. What is the so-called "Fair Trade Law"?
10. How does the government help with Federal loans? What government agencies are involved? What broad groups receive help?
11. How do states regulate the insurance industry?
12. How may the insolvent debtor clear up his difficulties?
13. Explain the work of the state board of mediation.
14. What types of helpful information does the government provide to the businessman?
15. Describe the nature and purposes of typical local business organizations. Why are they important?

► CASE-PROBLEM QUESTIONS

1. Could Kennedy & Co. obtain a trade-mark? How would they use their trade-mark? Why would a trade-mark be of advantage to them?
2. How can the company officers determine what governmental regulations apply to their business?
3. How might they disseminate this information to the persons in charge of the various operations affected by these regulations?
4. Why would license requirements for controlling itinerant peddlers be of particular interest to retail stores such as Kennedy & Co.?
5. What would you suggest Kennedy & Co. should know about:

a. Labor-management relations (labor-relations laws; right-to-work laws; antistrike laws; minimum-wage laws; and fair-employment-practices laws)
b. Factory legislation (work certificate; division of industrial hygiene and safety service)
c. Social insurance legislation (state insurance fund and disability benefit laws)

6. Since Kennedy & Co. is about to launch a program of expansion, what help could a state's industrial development service provide?
7. Why should the store and plant managers of Kennedy & Co. be interested in local business organizations?

► APPLIED BUSINESS PROJECTS

1. Write a paragraph giving the advantages of government restriction of, or assistance to, business. Write a second paragraph giving reasons why government should stay out of business.
2. Write a paragraph giving the types and specific labor-management regulations that are advantageous to management and explain why. Write another paragraph giving the types of specific labor-management regulations that are advantageous to labor and explain why.
3. The City Coal Company has, for many years, been buying coal and breaking it up in the various sizes in which its customers may need it. In doing this it has had a certain amount of wastage which has been dumped into City Creek. This wastage has killed the fish in the creek. The waste has created all kinds of odors in the creek and has annoyed the citizens. A prominent citizen has proposed that an ordinance be enacted ordering the City Coal Company to desist from using City Creek for its waste disposal. The City Coal Company objects.

   a. List five reasons why the community should bar the City Coal Company from disposing its waste in City Creek.
   b. List five reasons why the City Coal Company should be permitted to continue to use City Creek.
   c. List five possible compromises that might be undertaken.

► COMMUNITY PROJECT

Select three local businesses—a manufacturer, a wholesaler, and a retail store. List the specific types of regulations in each of the general areas of governmental control that pertain to all three firms. Also indicate the effect of the regulation in each case upon the operations of the firms selected. Then, explain the social, economic, and political reasons for the regulations.



27

Planning a Career

CASE PROBLEM

Fred Kennedy's relatives rightly look on him as a successful man and occasionally go to him for advice. His nephew, John Kennedy, is graduating from high school in June. As is so typical of many high school graduates, John is not certain of what his future should be. He is concerned about this and has asked his uncle for advice. Fred Kennedy assures him that being in a quandary about his future is no evidence of weakness. There are many factors to be considered.

John's family is not able to send him to college without assistance; therefore, he asked his uncle whether he should (1) borrow money in order to go to college; (2) work his way through college and take a little more time in finishing; or (3) go to work at once. After considerable discussion Fred and his nephew conclude that John must first make some decisions on a few fundamental considerations.

- How will John's grades—whether exceptionally good, average, or low—affect his decision?
- How will John's interest and activity, or lack of activity, in athletic extracurricular programs affect his possibilities?
- How will John's personality—subdued or gregarious—affect his decision?
- How will John's interest, or lack of interest, in helping others affect his decision?
- How will John's concern, or lack of concern, in making money affect his interests?
- How will John's ambition, or lack of ambition, affect his decision?

THE THINGS WE ALL WANT

All of us—young and old, rich and poor, regardless of our racial background—want certain things out of life. We want security, adventure, and recognition. Each of us thinks of these in different terms. What one person considers security another considers boredom. What one person considers adventure, another feels is nonsense; what a third person considers worthy of recognition by others, leaves others "cold." Nevertheless, everyone needs some feeling of sureness, some excitement in his life, and a conviction that at least a few people feel he is important.

The kind of person John is and the kind of life he wants to lead will help John decide the kind of work he should plan to do, first because the nature of his work will have an influence on the amount of his income, and second, the kind of work John does will influence the amount of leisure he has and his prestige in the community. Third, and possibly most important, John will spend a large portion of his life at work. In considerable measure, most of us get whatever adventure, security, and recognition we have through our work.

Security. Everyone needs to have some feeling of certainty about some things. Many young people are so concerned with security that they think it is the only important element in a job. Salary, opportunity for advancement, and interest are to them of secondary importance. That is why many people like to work for others, rather than take the risk of setting up a business or even buying a business from someone else.

If John is interested primarily in security, he may go into civil service in the community, county, state, or Federal government; or he may plan to work for some large corporation which, in some ways, is similar to government work. The opportunities for earning a very large income are not as great in civil service as in private enterprise or in the more uncertain types of business owned by others, but incomes are adequate. However, the opportunity to duplicate Fred Kennedy's success is not typical in governmental professions nor even in many large corporations.

Nevertheless, another enterprise could give Fred Kennedy and his associates such effective competition that they could be put out of business in a very few years. This is unlikely, but it is possible. On the other hand, the number of people who go into business and achieve Fred Kennedy's success are few, although, of course, every day the newspapers offer evidence that makes even Fred Kennedy's success seem a modest one.

John will have to ask himself how ambitious he is, how important

security is, and what his capacities are for achieving success in civil service, in a large corporation, or in developing his own enterprise. Initiative is important in working for others, but it is even more important in setting up one's own business. How much initiative has John displayed in his schoolwork and at home? How alert is he to the things that are going on around him? How much imagination does he have?

Adventure. Everyone needs adventure, in some form. A life which is unexciting is uninteresting.

Nevertheless, adventure must be defined. It can mean many things. Boys of the age of eight or nine sometimes think that being a train engineer is exciting. As we grow a little older—around thirteen and fourteen—many of us think that being an airplane pilot is the most exciting life. And for some people it is; however, the most competent pilots try to avoid adventure in their lives. They constantly check every mechanism they operate. They study weather reports and try to eliminate every possible uncertainty in the operation of their planes. The outstanding names in the development of air travel are those of men who know how to take a chance when it is absolutely necessary. On the other hand, they strive for a maximum of safety when at all possible. To some people trying to earn a lot of money is adventure. If it is done intelligently, it is not a bad way of finding adventure. Some other people find exploration a means of adventure. Some people like to achieve scientific discoveries.

For many more the small excitements of an everyday business, of getting a new customer, or consummating a good deal, offer much more excitement. In a large corporation, getting a new job, a new territory, can be very exciting. In civil service, the opportunity to render better service, to eliminate red tape, can be a real adventure. Some people even think that writing books and poetry are interesting forms of adventure.

John Kennedy must decide what he wants to have as adventure. If he wants only the things that are most exciting, and if he wants them all the time, then he had better reconsider the goals for which he is working. Many of the things that seem to be most exciting looked at from the outside are often very dull and unexciting when actually practiced.

John should not select a job or business just because it seems to offer a lot of excitement. Nevertheless, the work should seem interesting and important.

Recognition. All of us need recognition; that is, we need to think that other people respect us. We do not need recognition from everybody and under all conditions. But we must get some respect from

some people some of the time. Fortunately, in the United States, every occupation that makes a worthy contribution to the welfare of all, is an occupation of which we can be proud.

The mail clerk who does his job well can be just as proud of what he does as is the scientist who makes a new discovery or the businessman who runs a vast enterprise. In fact, in many ways the worker who merely earns an adequate income often gets more recognition from those with whom he works than does the person who rises to the top. Some who get tremendous recognition from "the outside," get comparatively little approval from those with whom they work closely. No occupation can be satisfactory as a means of living unless it provides us with approval from others and a feeling of personal satisfaction. John will, therefore, certainly want to secure for himself a way of living that is recognized by many, if not by all, as being an occupation which is of benefit to humanity as well as to John himself.

WE NEED TO UNIFY OUR WISHES

John, like everybody else, needs and wants security, adventure, and recognition. However, none of us should, for example, overemphasize security at the expense of adventure. If we do, we become overly concerned about providing for the future, not remembering that we must live in the present also. We must recognize that no one can provide completely for security and that all of us must in some measure take a chance on life. If John, therefore, is too much concerned about a safe job, his Uncle Fred should encourage him to see that security is only one of the things we want out of life and that security striven for at the expense of adventure will in itself destroy a minimum of security.

On the other hand, if John is only interested in excitement and is always seeking it, then he also has an unbalanced attitude.

Although we all want recognition, the person who does everything for recognition, who is always seeking attention, is possibly even more unbalanced than the person who wants over-much security or adventure. The show-off gets attention, but most of us do not want, and none of us should want, the kind of attention that is given to the show-off. We prefer the kind of attention and recognition that is given to the person who does his work for its own sake and gets attention and recognition because of it.

This balance of values is important in all life, but it is especially important in business life. Fred Kennedy was a success at his work because he used his imagination, worked hard, co-operated with others, and had the skill necessary to carry on his business. Unless his work gave him a sense of adventure, lead to economic security, and

brought him respect from others, he would not have had the motivation to use his business competency to create a considerable business. Fred has found opportunity to serve the community and to profit for himself because he found adventure, security, and recognition from others through his business activities.

EDUCATION AS A STEPPINGSTONE TO SUCCESS

If John is going into civil service or into a large corporation, a college degree, while not absolutely necessary, is highly desirable for advancement beyond the minimum level. In some companies lack of a college degree may be a handicap. On the other hand, if John is going into business for himself or to work in a firm which is blazing new trails, a college degree is not so necessary. Even here, however, the learning acquired in schools beyond high school is highly desirable. Even if John decides eventually to go into business for himself, he will profit by college or business-school training.

Some people believe that the best type of college training a person can get is a nonvocational, classical, or general academic program in which the student learns nothing specifically concerned with earning a living, but indirectly acquires the capacities for earning a living. An increasing number of high school graduates, however, feel that they will be at a much greater advantage if, while taking courses that give them a better understanding of how the world operates, they also get specific training in the work they plan to do. Since John is interested in business employment, either as an employee or self-employed, he will have to choose between an academic or a business course.

The important thing, however, is not the kind of course he takes, but what John does with his schooling. If John merely gets by with courses and if he is not interested in the school activities, then, whether he takes an academic or a business course, the schooling will probably be of little value to him. If John is alert to what is going on, uses the opportunity to discipline himself to work more effectively, and to learn what the world is all about, then the schoolwork will, in all likelihood, be of much use to him in whatever kind of job he takes.

In making his decisions as to what he wants to do, it is obvious that further study almost always will be very helpful. The best way is usually to go to college at once—if grades and income make this possible. If it is not possible, there are, fortunately, many opportunities in the United States for further study available to all of us, either by going to college on a part-time basis, through correspondence schools, and even through independent study. All such study is useful and has been used as a means of advancement by many people.

THE ECONOMIC SYSTEM

John Kennedy, like everyone else, must recognize that the economic climate is not uniform. Sometimes we have too few jobs available; sometimes there are not enough people to fill all available jobs. When we are in a period of depression, such as that which existed in the 1930's, people think that chronic unemployment and small incomes are permanent. When everyone can get a job of some kind rather easily, when many people are earning good salaries, people think that this situation is permanent.

John must take this phenomenon of the business cycle into consideration when he decides what his living is to be. If he works for the government or for a large, well-established business, he is likely to suffer less during a period of depression. On the other hand, in periods of prosperity, he does not earn the greater income that people do who are in more uncertain types of work. The person who is in business for himself, or who works for a relatively new type of enterprise, benefits in periods of prosperity. On the other hand, he often loses out in periods of depression and even in periods of recession.

It must be remembered that not all people suffered during the depression, and not all suffered equally. Conversely, not everyone is well off during a period of prosperity; and not all people prosper equally. The change is not as marked between a period of depression and a period of prosperity as the textbooks sometimes make us think. Nevertheless, in general, it is wise to realize that there are these periods of change in our economic life.

If John is interested in starting a business, the best time to do so would be at the beginning of a period of prosperity rather than at the height of prosperity, or in the depths of a depression. Unfortunately, it is difficult to decide at what point the economic cycle actually is. If there is a period of prosperity, we cannot tell whether the prosperity is going to continue, or whether the height of the cycle has been reached. Similarly, if the nation is in a period of depression, we do not know when the very bottom of the depression has been reached and whether an upward trend is beginning or whether the nation's economic health will fail even more.

A person who is starting a new business therefore must think carefully, so as to try to choose the right time. Sometimes, however, a person may have to wait ten or even more years to find the opportune time. Most of us cannot afford to wait that long; therefore, while it is important to recognize the significance of the cycle, it should by no means be at the expense of other factors.

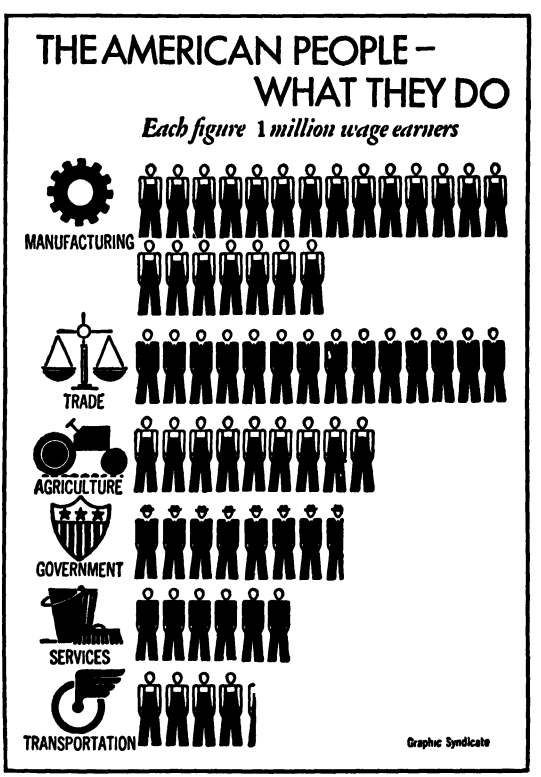
OCCUPATIONAL OPPORTUNITIES

One of the problems that John Kennedy will face, as it was faced by his Uncle Fred, is that of deciding in which area of business he should work.

All levels of work are not represented in all areas of service and business. Some businesses are not large enough to justify people who would ordinarily be labeled as top management. Some of the major areas of employment are described here.

OPPORTUNITIES IN THE CREATION OF RAW MATERIALS

The production of raw materials is still a major field of occupation in the United States. At one time the creation of raw materials required the services of all but a small proportion of the workers. Now, fewer than 15 per cent of all workers are required in this field. Among the workers represented in creating raw materials are farmers, miners, and lumbermen. The proportion of workers in raw materials in relation to the total number of workers in all areas has steadily decreased. Never-



Jobs for Everyone. Where will you fit in?

theless, the need for skilled workers and technicians and, above all, for competent management is more significant than it ever has been. There are still, and will continue to be, many opportunities for the competent and able person in the creation of raw materials.

MANUFACTURING

Manufacturing and various forms of industrial work require the services of more people than any other single area of occupation. The manufacturing process forms the raw materials into semifinished and finished products. The great majority of the workers are unskilled or semiskilled. Nevertheless, as manufacturing becomes more complex, men and women at the mid-management level are finding increasing opportunities. The need for people with imagination to serve as top management is becoming increasingly critical.

There are literally thousands of different forms of manufacturing. Some are very simple; some are so complex that a lifetime of study will not give an understanding of the nature of the entire process. Some forms of manufacturing tend to emphasize small processes; some require huge capital investments. As in the case of the creation of raw materials, the production of manufactured materials requires high degrees of skill; and the person who wishes to rise above the level of a worker must usually be a competent technician in the area in which he is servicing to rise to mid-management and top management. The United States is, perhaps, the greatest manufacturing country in the world; therefore, if John Kennedy has ability in the production of semifinished or finished goods, he will find many opportunities to earn a good living in the area of manufacturing.

TRANSPORTATION

Transportation is one of the major occupations in the United States; however, the nature of transportation has changed considerably. Although the railroads are still a vital part of our transportation system, they are not as important as they once were. Nevertheless, the railroads still offer many opportunities for promotion to the able and alert person. Trucking of various forms, plane service and marine shipping, both inland and overseas, are taking over an increasing proportion of the total transportation process. Here again the worker without much skill will find it difficult to rise to the top.

In the area of transportation, certainly more than in the creation of raw materials, and probably more than in the production of manufactured goods, millions of men and women have obtained a considerable degree of job security.

Much of the transportation service of the United States is in the hands of big business. This is certainly true to a larger extent than in manufacturing and in the creation of raw materials. Nevertheless, there are opportunities for the small individual enterprise.

WHOLESALE SERVICES

Wholesaling, jobbing, and similar areas of work take the materials from the manufacturer and make them available to the retailer. Large numbers of people are employed in the field of wholesaling and its allied services. There are many opportunities for employment by others and for individual enterprise. Here again, technical competence and ability to lead are vitally important.

The ability to sell is probably more important in this area, however, than in transportation or manufacturing; although even in those areas, selling techniques have become increasingly important. Opportunities for the person with highly skilled techniques are considerable in the area of wholesaling.

RETAILING

Tremendous numbers of people find their means of earning an adequate living through various forms of retailing. In the economic system, the retailer is the person who directly serves the consumer. His service must appeal to the consumer; therefore, he must know what the consumer wants and needs and help the consumer to recognize his wants and needs. Technical skill is important in retailing almost to the degree to which it is important in the area of manufacturing, for example.

In some respects, it is easier to start a new enterprise in the area of retailing than it is in any other of the major areas of economic activity. Just because it is easy to enter, many thousands every year begin retailing enterprises with inadequate capital, insufficient management ability, and without the sales ability that is necessary for success. While retailing in all its manifold forms provides much opportunity for the small enterpriser, it is consequently dangerous to go into this type of work without full competence and knowledge. Moreover, just because the opportunities for the small enterpriser are greater in retailing, there is, perhaps, even greater competition than there is in the other areas of economic activity.

SERVICE BUSINESSES

Finally, service occupations which serve the consumer and the other areas of economic activity are becoming increasingly important.

They encompass a wide variety of work, such as banking, credit, advertising, and accounting. At the consumer level, all kinds of specialized services such as operation of laundries and automobile repair shops are needed. The professions, such as law, medicine, and teaching also render services to consumers; however, since they usually require many more years of schooling, they are thought of as a separate category.

Just as in the case of retailing, service occupations are often big businesses, but more often they are small businesses. Here again the opportunities for the small enterpriser are great. Just as in the case of retailing, because the opportunities are great, many people who are not qualified tend to become enterprisers and suffer the consequences. As in the case of retailing, the difficulties are magnified because of the intense competition in small-enterprise service businesses.

WHICH AREA OF OPPORTUNITY

It is true that some forms of economic enterprise are increasing in activity. They therefore present relatively more opportunities. Some areas of economic activity are decreasing in importance, and therefore probably offer less opportunity. The fact remains that there are tremendous opportunities in every one of the areas.

While farming, for example, is an area of work in which there are a large number of marginal workers and enterprisers—that is, people who just barely make a living—there are also many thousands of farmers who gain a very fine living. The thoughtful person who is planning to go into business will try to enter an area in which there are more opportunities than there are in other areas. Nevertheless, this element is not nearly as important as technical competence, managerial skill, ability to get along with fellow workers, and finally, the ability to sell. Fred Kennedy was successful in his enterprise not only because he knew how to sell, but because he could get along with his business associates and knew how to get his workers to co-operate with him. Moreover, when he went into manufacturing, he himself had considerable technical knowledge; but, more important, he utilized the services of people who had even more competence than he. Thus his chances of success were greatly increased.

In other words, while it would be foolish to ignore the fact that there are more opportunities in some areas of economic activity than there are in others, the fact remains that the success or failure of a worker depends not so much on the area in which he is active but rather on his acumen in rendering a service.



Courtesy Thomas A. Edison, Inc.

The Young Executive. The opportunities in business administration for the young man were never better than they are today. Whether your interest is management, accounting, sales, stenography, or production—there's a spot for you.

Chapter 4 gives the elements of leadership required in business. These should be re-read so as to determine to what extent an individual has the leadership qualities necessary for success on the job. At the end of the first chapter there is a list of the qualities required of a person who wishes to establish a business or to go into business. This list should be referred to again as a means of determining whether John or someone like John should try to establish a business for himself, whether he should consider government service, a large corporation, or a smaller enterprise.

PERSONALITY

The personality of an individual is all-important in determining what he should do with himself, and how he should go about making his adjustments to life. Here is a list of qualities each of us should cultivate to improve our chances of success in life generally and in business life particularly.

HEALTH

Many believe the most important single element in success is good health. To a certain extent health is inherited; but to a much greater extent, health is determined by our habits and our way of life. Only as we live sensibly are we likely to have the kind of health and stamina we need for success. Some of us are limited by nature and do not have the energy required for enterprise; but most of us can develop adequate health by practicing good health habits, by proper exercise, and by intelligent eating habits. All of us should know from courses we have taken what these good habits are. If we do not, we should study them again and learn them thoroughly. Then we must practice these good habits.

INSIGHT INTO ONE'S OWN NATURE

All of us need to decide the type of person we really are and want to be. Some of us are big in our dreams—big in our aspirations. Others of us are less anxious for things. We are satisfied with just enough and look for the nonmaterial values in life. None of us is absolutely one rather than the other, but we generally have tendencies one way or the other.

Some of us are sanguine, that is, we are strong in our emotions. Others are relatively even tempered. We should give these basic characteristics of ours some thought and use them as a means of determining what we want to be. Insight into the type of person we are helps us considerably in making up our mind as to the kind of life we want to lead in general, and the kind of work we want to do in particular.

SELF-CONFIDENCE

A modicum of self-confidence is necessary. The person who lacks self-confidence will not be generally successful in life and certainly not in business, whether he works for himself or for others. But we obviously must avoid overconfidence, because that makes us obnoxious to others and makes us try to do things that we are not fitted to do.

John Kennedy must ask himself to what extent he is able to carry on an activity with reasonable confidence after he has determined that this self-confidence is justified. If he lacks this characteristic, he should work to improve himself.

GOOD RELATIONS WITH OTHERS

None of us is able to live by himself. Whether we work for others or get others to work for us, we all need to have others like us and

enjoy working with us. This does not mean that we can make everybody like us all the time. That is impossible. But we must try to conduct ourselves so that most people are willing to give us their cooperation. No matter what kind of business a person goes into, he needs to get along with others. It has been said that we accomplish things only through others. Rarely can we accomplish much by ourselves. Usually, we need only to show goodwill toward others—not constantly trying to impress people.

"GROWN-UPNESS"

No matter what kind of life we lead there will be some hardships. Some of us see every little handicap, every little impediment, as a cause for great emotional disturbance. Other people can face the most terrible ordeals with little emotional strain.

That does not mean that we should not be concerned or that we should not be emotional. The person who has no emotional comprehension of others and of himself might as well be dead. Emotion is a natural and desirable characteristic. It helps us through the things we must do and the situations we must face with enthusiasm. Nevertheless, if a person is upset about every little detail, or every little happening—if he is overexcited about any little hurt that is done to him, he will not be able to live a reasonably happy life. We need to curb our tendency to feel that everything that happens to us is important. A little worrying about the future is good. The difficulty comes when we just worry and do nothing about it. A better way is to study a problem and then plan to meet it as intelligently as possible. If it turns out well, fine; if it turns out not so well, worry will not help. If more of us would learn to plan instead of worrying, many of us would be much better off.

INDEPENDENCE

Independence of thought is particularly important in a large business corporation or in government work, because the very nature of large enterprise may tend to stop us from thinking for ourselves. We need to be able to accept the judgment of others in many cases, but we must keep our personal independence in order to keep our pride. To have our own thoughts even though we are cheerful in carrying through the wishes of others is most desirable in adjustment to work in a large plant or office.

SPIRITUAL UNDERSTANDING

All of us need to see something more than our immediate surroundings. We need to have an understanding of the tremendousness

of our life and of the awesome greatness of the world in which we exist. This calls for spiritual understanding.

For people to assume that all life is material, that they do not need to have an awareness of the wonder and majesty of the world around them, is very unfortunate. The businessman will be successful only in so far as he understands the smallness of the material world. Only so far as he is aware of the tremendous forces that dominate life and with which he must work, can he be a success. If he is to serve people well and thus earn a good living, he must honestly and inwardly feel that people should work together for a common purpose that involves something more than just getting more money and more things.

ENJOYMENT OF LIFE

Most of us want to enjoy and do enjoy life. Nevertheless, occasionally we let ourselves be misled into thinking we must work, and work, and work. When we do this, we become unbalanced. We should enjoy our work. Every occupation has its unpleasant aspects. Most jobs involve an element of boredom. If the work seems boring and unworthwhile for long periods, we should find a new occupation. But if all work seems a bore, we should do some fast thinking. We will find that it is we ourselves who are the bores rather than the jobs. Part of the solution is mental. If we think an occupation is hateful, it soon will be. If we act as if the job or business at which we earn our living is fun, it usually will be.

► FOR REVIEW AND DISCUSSION

1. Does security mean the same to all people? Why?
2. What is adventure? Should it be limited in any way or permitted full scope? Why?
3. Is recognition from others an important factor in life's success? What part does it play?
4. How does a college education help in one's work?
5. How does the economic climate fit into planning one's career?
6. What is the best time to go into business for yourself? How can you tell if the time is right?
7. How can a beginner push himself upward in the beginning level of employment?
8. What are the special difficulties in merchandise and service occupations?

9. What characteristics of personality should be cultivated to improve the chances of success?
10. Why are relations with others important?
11. Why is being independent in thought important to a person working for the government or for a large corporation?
12. Can too much work affect efficiency and success? How can this be remedied?

► CASE-PROBLEM QUESTIONS

1. How will deciding what he wants out of life help John in making his decision as to the type of work he would like?
2. How will the phenomenon of the business cycle influence John's decision?
3. On what basis should John decide what area of work he will enter?
4. To what extent will he try to select his area of work in terms of his personality? in terms of his skills? in terms of his present and future capital?
5. How can Fred Kennedy help his nephew John gain an insight into his own nature? How will it affect his decisions?
6. How can John learn about his relations with others? Who might John consult about this, besides his uncle?

► APPLIED BUSINESS PROJECTS

1. List the aids in choosing a career that are provided in your school.
2. Summarize in outline form the opportunities and difficulties in each major area of service:
   a. Raw material creation
   b. Manufacturing
   c. Transportation
   d. Wholesaling
   e. Retailing
   f. Service occupations
   g. Professions

► COMMUNITY PROJECT

1. Have small committees visit workers and enterprisers in each of the following areas of work:
   a. Raw material creation (for example, farming, mining, lumbering)
   b. Manufacturing or industrial work
   c. Transportation (for example, truck, railroad, airline, bus, etc.)
   d. Wholesaling
   e. Retailing
   f. Service
   g. Profession
2. Ask questions such as the following:

a. Why did you choose this work?
b. Would you select it again if you were starting all over?
c. What special skills are needed?
d. What special problems are faced?
e. What special satisfactions are obtained in this work?
f. Are there local opportunities in this type of work, or in related work?

3. Summarize your answers and decide as a class in which areas there are good opportunities in your community.

Sales budget, 400
Sales department, organization of, 145–147 (*see also* Selling)
Sales promotion, 149–152
Salespersons (*see also* Selling)
  attitudes of, 131–137
  compensation of, 314–315
Secretary, duties of, 347; *illus.*, 348
Selective distribution, 91
Self-employment, advantages of, 6–8
Self-insurance, 246
Selling, 129–148
  appeals in, 130–131
  attitudes in, 131–138
    of correspondence, 137–138
    of salespersons, 131–137
  customer-relations policies in, 138–142
    adjustments, 138–139
    cash receiving, 140–141
    credit extension, 141–142
    delivery service, 141
    returned-goods privilege, 139–140
    wrapping of goods, 140–141
  installment, 222–224
  organization of department for, 145–147
  suggestion, 136, 137
  telephone, 136–137
Service policies, 123
Services, marketing of, 67
Shipping (*see* Delivery and shipping)
Sight draft, 177, 196
Small Business Administration, 440, 446
Social insurance, 240–241, 445–446
Social security, 240–241, 417–418
Sole proprietorship, 14–17
  advantages of, 14–15
  disadvantages of, 15–17
  and trade name, 25–26
Specialization, need for, 56, 255; *illus.*, 256
Standard cost accounting, 387–388
Standardization
  in office, 352–353
  of operations, 281–282
  in production planning, 256–257
Statute of limitations, 222
Stock, corporate, 33–35 (*see also* Corporation)
Stock control, 107–111
Stock ownership
  employee, 319–320
  transfer of, 33
Stockholders (*see* Corporation)
Strikes, 329–330, 334–335
Style, effect of
  on marketing, 72
  on pricing, 118
Success
  chances for, 9
  education as steppingstone to, 455
Suggestion selling, 136, 137
Supervisor training, 300
Supplemental unemployment benefits, 318
Supplies, office, control of, 351, 352
Surety bonds, 243

T

Taft-Hartley Law, 333–335, 443–444
Taxes, 408–424
  attempts to reduce payment of, 411–412
  for being in business, 415
  on business earnings, 36, 420–421
  business-transaction, 415–416
  disability insurance, 241, 418–419
  economic classifications of, 413–414
  effects of
    on general management, 410–411
    on internal operation of firm, 409–410
  Federal income, 419–420
    on corporations, 36, 420–421
  practical distinctions in, 414–415
  social security, 240–241, 417–418
  unemployment insurance, 241, 418
Telephone selling, 136–137
Terms of sale, 104–106, 215–216
Tests, employment, 293–294
Theft insurance, 235–236, 239
Time draft, 177, 196
Time-and-motion studies, 281–282, 311
Trade associations, influence of, 448
Trade credit, 194–195
Trade discounts, 105–106, 121
Trade-marks, 429–430
Trade names, 25–26
Trading on the equity, 193
Traffic manager, duties of, 178–179

Transportation (*see* Delivery and shipping)
Travelers checks, 197
Treasurer, duties of, 184–185, 359–360
Truck shipments, 168–169, 170–171

U

Underwriters, 201
Unemployment benefits, supplemental, 318
Unemployment insurance, 241, 418
Unethical practices, government regulation of, 433–435
Unions, 325–335
Unit control, 110

V

Variances, 387–389
Vouchers, petty-cash, 189–190

W

Wage payments, 304–322
  incentives as factor in, 305–307
    employee attitudes toward, 313–314
    fringe benefits, 305, 315–316
    nonfinancial, 305–307
  job evaluation for, 310–311
  merit ratings for, 312–313
  methods for
    lapse-of-time, 311
    piece-work, 311–312
  prevailing rates as factor in, 307–309
  recent developments in, 316–320
    guaranteed annual wage, 317–318
    profit-sharing plans, 318–319
    rising cost of living, 316–317
    stock ownership, 319–320
    supplemental unemployment benefits, 318
  for sales personnel, 314–315
Want slip, 74; *illus.*, 75
Warranties, 100–101
Waste control, 284–285
Waybill, 177–178
Weights and measures, standards of, 430
Wholesalers, 84–85
  by-passing of, 87
Window display, 160–163; *illus.*, 66, 150, 162
Workers (*see* Employees)
Working conditions, government regulation of, 445
Working hours, shorter; *illus.*, 308, 317
Workmen's compensation, 241–242, 445–446

Z

Zoning ordinances, 431–432