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Business Management Handbook

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McGraw-Hill Book Company, Inc.
NEW YORK TORONTO LONDON

BUSINESS MANAGEMENT HANDBOOK

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This material first appeared as
J. K LASSER'S EXECUTIVE COURSE IN
PROFITABLE BUSINESS MANAGEMENT

Library of Congress Catalog Card Number: 51-12550

THE MAPLE PRESS COMPANY, YORK, PA.

PREFACE

This handbook stemmed from a very natural basis: my own effort to get from experts the answers to a lot of normal questions asked by businessmen.

Organizing, financing, risking capital, marketing, buying insurance—so much more—are the job of the highly skilled advisors to big and little business. The gargantuan difficulties most of us face each day are child's play to them; they've been through dozens and dozens of comparable labor pains.

Given the idea for the book, I naturally moved to a lot of my proficient friends who were recognized walking encyclopedias in their special fields. Out of that has come this practical guide for the average businessman faced with what he thinks is the extraordinary problem baffling him.

This book can also serve the inexperienced in business labyrinths. Your editor's labor pains, at least, got for him a well-earned education in fields where he knew nothing. And that might readily be true of the initiate attempting to wander into such problems as setting up accounting systems, locating a business, avoiding business frauds, creating budgets—and all the other essentials that just had to go into this kind of manual.

Subject matter here was a difficult problem. I got the acres to be covered by talking endlessly to large and small businessmen. I asked them for the road blocks that most unnerved them. I asked for the areas where they would want to spend an hour with an expert. Out of the maze of inquiry finally came the chapter presentation here.

This kind of masterminding by distinguished authorities is a fine basis for intelligent business blueprinting and decisions—whether that be in customer-relations problems—in finding how to do business abroad—or in the dozens of other fields indicated by the index.

I hope *you* find the checklisting by the most adept I could assemble here as valuable as it has all been to me.

J. K. LASSER

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Section 1

HOW TO FIND THE RIGHT FORM FOR YOUR BUSINESS

BY

J. K. LASSER

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HOW TO FIND THE RIGHT FORM FOR YOUR BUSINESS

What problems do you consider when you are organizing or reorganizing a business? The division of the profits, the risk of those interested, the taxes you pay, the capital that can be raised, the method of control—the successful handling of these matters and a hundred other important problems may depend upon the intelligent choice of the business form.

Introduction

The most generally used business forms are the corporation, the partnership, and the sole proprietorship. Variations of these which are often employed to overcome difficulties in particular situations are limited partnerships, joint-stock companies, joint ventures, syndicates, and trusts.

How do you find the best form?

Ease or type of organization may sometimes be important. Other points are vital in one case and a negligible factor in others. Generally, the proper selection of the form of organization will depend upon—

Type of enterprise to be operated
How and when it is proposed to divide profits
What liabilities the owners are willing to assume
Ability to raise capital under the various forms
Governmental control to which each type of business is subject
Tax liability each type of business assumes

A most important factor in selecting a business form is that of taxation. Much shifting from one form to another takes place for tax reasons. It is also the tax gain or loss that has pushed business operation into serious consideration of many previously unused devices, particularly the cooperative, the tax-exempt corporation, the joint venture, the limited partnership, the syndicate. And the same reason today may cause businessmen to organize ten companies when ordinarily one would be set up. Or it may give us a combination of a partnership, a trust, a nonprofit company, and a corporation—all to operate what might have been conducted otherwise as a single enterprise.

The tax study, then, is one of our most essential considerations before the

selection of the type of organization. From it, you can find permissible advantages in navigating a business. Tax ingenuity can sometimes overcome economic or managerial disadvantages; disregard of tax penalties may offset the best financing and the best type of management.

Tax planning can also decrease the risks of business organization. And so much of a chapter on business organization must bear upon the tax advantages and tax mechanics of each form of business. Here, therefore, you will find the business reasons affecting the selection of a business form more briefly discussed than the tax mechanics.

1. Business and tax considerations of a sole proprietorship

Business considerations. The simplest form of business organization is the sole proprietorship. It is well adapted to small-scale activities, requiring comparatively little capital and directed by one person.

The growth of the sole proprietorship is fixed by the ability of the proprietor. Other things being equal, the greater his ability, the larger the enterprise. Conversely, the natural limitation of the ability and energy of a single individual restricts size and growth. As the business grows, the powers of the proprietor are more and more taxed. Finally he reaches his limit. Then the business must stop growing or change its form. If it is to continue to grow, risk and directive authority may have to be altered.

The use of the sole proprietorship is often determined by the nature of the business. It is a logical form where a personal relation between the merchant or owner and the consumer is important. This, of course, is true of most professions and personal service organizations.

What are the limitations of the sole proprietorship? First, the influences of the proprietor's personal, domestic, or economic life are often reflected in his conduct of the business. Other business advantages and disadvantages are compared in the following chart:

Individual Proprietorship—Business Considerations

Advantages	*Disadvantages*
Facility of formation. The sole proprietorship is the easiest form of ownership to get under way.	*Dependence upon the individual.* Death or disability of the proprietor means drastic changes to the business. The heirs may be unprepared or unwilling to undertake management of the business. The estate may be seriously jeopardized.
Retention of profits. The individual proprietor does not share his profits, except in the form of bonuses or wage incentives to his employees.	*Unlimited liability.* The proprietor is personally liable for all debts of the business, not merely for his investment. Risk is concentrated in a dangerous manner.
Freedom of action. An individual can do almost anything anywhere in the United States. He is not bound by restrictive laws, corporate charters, or partnership agreement. (Of course, he	

Advantages

must observe the retail licensing laws, etc., imposed upon all such businesses.)

Singleness of control and maximum centralized authority. The proprietor may act promptly and vigorously. There is none of the red tape encountered in more complicated organizations.

Secrecy of operation. The owner need take no one else into his confidence. The only restriction is that, if he operates under a general title such as the "Fame Cleaning Company," he must file information with the state, showing who actually carries on the business.

Economy of operation. The individual proprietorship may survive depression periods better than the more complex forms of organization It possesses more flexibility and can more easily adjust itself to changing conditions.

Federal and state aid. Many Federal and state laws are designed to help the small businessman. For example: legalization of resale price maintenance, chain-store taxes, the Federal Trade Commission Act, the laws of unfair competition, and the antitrust laws.

Personal contact. The form is ideally suited to retailing and to professional and personal services. It affords the greatest personal contact with customers and clients.

Ease of termination. The sole proprietorship is terminable at any time without legal formalities. The owner continues the business only so long as it remains profitable.

Incentive. Because the sole proprietor takes all the profit (or all the loss) he has the greatest incentive to careful and efficient management.

Disadvantages

Difficulty of raising capital. The individual proprietor is generally limited to his personal funds or his personal credit. The sole proprietorship is therefore unsuited for large enterprises, and is often unable to compete with larger concerns.

Singleness of responsibility. One man must bear all the risk and all the burdens of management. Except in very simple enterprises, this puts a tremendous responsibility upon him.

Personnel difficulties. Competent and valuable employees with managerial ability usually are not content to work long for a salary or even salary and bonus. Capable ones are likely to demand a share in the business or start a competing business.

Tax considerations. From a tax point of view, should you run your business as a partnership or a proprietorship? That sometimes involves a check of the comparative costs of both forms. Sometimes it also involves this: Can a family partnership give you the division of earnings? That may give much lower taxes to the family.

A husband and wife, or a father and son, or any other family members may form a real partnership. This is true even though the partnership is conceived as a means of tax reduction. The only objection is where it is a

sham—a mere paper reallocation of income among the family members. The courts are bent upon upsetting the most technically elegant fictional arrangements. But if the members of a family are the real owners of a partnership interest, if the business is not of a personal-service nature, and if all persons respect that interest as much as they would that of a nonfamily investor, there should be approval.

Family partnerships stand up even where a member gets his interest by gift. But you must follow these rules: partnership profits allow reasonable compensation for services of the partner who made the gift; the new partner's profits share is based on his donated capital. A minor child can be a partner where it is shown that he is competent to manage his own property, or that control of the property is exercised by a fiduciary for his sole benefit. In all family partnerships, it is assumed that all members will—

Contribute substantial policy making and management, and fully control their own capital and earnings

Do important work, in businesses where partners would normally be expected to be actively engaged in contacts with customers, employees, and suppliers. The work must be regular—not sporadic. It should be performed daily

In some businesses, capital is the all-important earning factor; in others, it is skill and knowledge; in others, downright hard work, long hours, etc. In personal-service businesses, the family members should play an important part in producing the partnership earnings. They should have contacts with customers or suppliers, or run a part of the business.

The government policy usually divides all *family* groups into two classes and treats them this way:

Effective partnerships. The agreement is made at arm's length. All members are given the same treatment strangers would get. Actions show an intent to carry on a business as a partnership. The partnership agreement is followed in the operation of the business and in the partners' dealings with each other. These partnerships will generally be approved.

Sham transactions. The agreement or the manner of operating it denies the family member: participation in the management; any voice in the distribution of the assets, or profits; exercise of any control over the assets or profits of the business. In these the Treasury will deny division of profit.

There are some intermediate cases. In them, a fair allocation of the profits between income due to services and to capital is sometimes made. Profits then follow the value of the capital and services contributed by each partner.

* * *

A capital-gains tax may be paid on the sale of partnership interest. But ordinary income follows upon the sale of a proprietorship interest. There is a respectable authority holding that a partnership interest is a capital asset. Except for personal-service partnerships (law firms, some brokers) it is to be generally considered apart from the assets in the partnership.

An individual proprietorship is not considered as a tax unit, separate and apart from its assets. Thus a sale of the entire business is treated as a sale of each of the assets involved. The selling price is required to be apportioned among the assets sold.

* * *

A sole proprietorship may be converted tax-free into a corporation. An individual has no tax to pay if two things are true: his assets are transferred to the corporation *solely* in exchange for its securities; immediately after the exchange he is in control of the corporation through ownership of at least 80 per cent of the stock.

Example: A owns assets which cost him $100,000. They are now worth $250,000. He organizes the *X* Corporation and transfers his assets to it in exchange for all its stock. The exchange is tax-free; he realizes no gain; the cost of the assets to the corporation is $100,000. But *B* owns assets which cost him $200,000. They are now worth $300,000. He gives them to the *Y* Corporation, an existing company, in exchange for 70 per cent of its stock. The remaining 30 per cent of the stock was issued by the corporation in a prior year to *C* for cash. The exchange is not tax-free. *B* realizes a gain of $100,000. He did not have the required 80 per cent control of the corporation immediately after the transfer. The cost basis of the assets to the corporation is $300,000.

If a proprietor, together with others, transfers assets to a corporation, then the two (or more) may have no tax to pay if three points are found: their assets are transferred to the corporation *solely* in exchange for its securities; immediately after the exchange they are in control of the corporation through ownership of the stock; the amount of securities received by each is substantially in proportion to the value of each interest in the assets before the exchange. That may be illustrated this way:

Example. D owns assets which cost him $100,000. They are now worth $200,000. *E* owns assets which cost him $100,000, but are now worth $300,000. *D* and *E* organize the *Z* Corporation. *D* transfers his assets in exchange for $200,000 of stock. *E* transfers his assets for $300,000 of its stock. The exchange is tax-free; neither *D* nor *E* realizes any gain; the cost basis of all the assets to the corporation is $200,000.

2. *Advantages and disadvantages of a partnership*

Business considerations. When a business is too costly (taxwise) or too large to be managed by a single individual, a partnership might be formed. Perhaps the greatest value of this form of organization is that it retains "personality." The individual proprietor is not submerged, as he would be in a corporation. He becomes one of an association of individuals.

The limitations of the individual proprietorship also apply to the partnership, if the business becomes too complex. If large amounts of capital are required, the partnership has little value as a form of organization. It serves its purpose as long as the partners can profitably pool their resources and abilities to share profits. When the enterprise grows beyond that point, the partnership is likely to become impractical.

The business advantages and disadvantages of the partnership form are shown in the following chart:

Partnerships—Business Considerations

Advantages	*Disadvantages*
Facility of formation. Partnerships are easy and inexpensive to organize. There is somewhat more formality required than in the formation of an individual proprietorship.	*Unlimited liability.* Partners are usually jointly and severally liable for *all* debts of the firm. Generally speaking, the more numerous the partners, the greater the risk of the partner. The larger the scale of the partnership operation, the greater his liability.
Division of profits. Profits may be divided in accordance with both the capital and services contributed. Moreover, each class of contribution may be rewarded separately, *i.e.*, a certain return for capital investment and a different return for services or abilities contributed.	*Impermanency of existence.* Partnerships may usually be terminated voluntarily, by agreement of the parties, or they are terminated involuntarily, by the acts of the partners, by certain events (such as death, insanity, or insolvency of a partner), or by court actions.
Freedom of action. There are usually no limitations on what a partnership may do, other than those self-imposed by the partnership agreement. (Note, again, that local retail licensing requirements, etc., naturally must be observed.)	*Division of control.* Sometimes the majority controls in questions of partnership policy and management. Where that is not true, it may be difficult to achieve harmony among partners on all questions. This difficulty is more pronounced in larger partnerships. Serious disagreement among partners can harm the well-being of the enterprise.
Division of responsibility. The partnership permits specialization in management. Each partner can handle that aspect of the business for which he is best suited by experience and knowledge.	*Lack of entity.* Because the partnership has no entity, each partner generally has authority to act as agent for the partnership. Each might render it liable for damages by his acts. A partner usually can make contracts which, within the scope of the partnership business, are binding on the partnership and the
Flexibility of operation. Since the partnership is a contractual relationship, its objectives, capital, and membership may easily be changed to meet changing needs.	
Increased sources of capital. The resources of several individuals are naturally greater than those of one individual.	

Advantages

As larger capital becomes necessary, partners may be added. Even if this procedure is not practical, the combined credit resources of existing partners afford greater possibility of expansion. The borrowing capacity of the partnership is greater than that of the individual. It may even be said to be greater in proportion to capital than that of corporations, because of the liability for debts which the partners must assume.

Retention of individual control. Even though risk and responsibility are divided among partners, the individual partner retains some control. If he is dissatisfied he can withdraw and thus dissolve the firm; or he can force his partners to buy him out. This is naturally an advantage to be considered by each partner.

Incentive. There is greater inducement to effort and efficiency than where management and ownership are separate.

Personal relationships. The personal relationship of the proprietor to the customer or client is not lost in the partnership form. This is especially important in professional and personal-service organizations.

Personnel advantages. The partnership can offer more incentive to the key employees than can the individual proprietor. Reward for efficiency or excellence of service may be admission to the partnership, either as a general partner, or as a special partner, according to the partnership agreement.

Disadvantages

other partners. Generally a partnership cannot sue, or be sued by, one of its partners.

Capital limitations. Partnerships generally have greater resources than the sole proprietorship. When an enterprise needs large amounts of capital, however, the partnership form is usually impracticable. A partnership with too many partners becomes clumsy.

Ease of disruption. A serious problem in a partnership is the ease with which the whole organization may be disrupted or disorganized. Personality or policy clashes among partners, the death of a partner, dishonesty, or unfair practice may cause difficulties which can be solved only by dissolution of the partnership. Of course, this does not need to mean discontinuance of the venture, but it may have that result. It increases the risk of doing business as a partner.

Limited marketability of interest. A partnership interest is usually not readily marketable. Generally, the partner must sell to a copartner, or to an outsider, only with the consent of the partners.

Difficulty of centralizing authority. It is difficult to centralize or circumscribe authority in the partnership. So far as third persons are concerned, one partner has as much authority as another on each question.

Tax considerations. The tax advantages of the partnership are many. With small earnings the net tax cost is usually less than for a corporation. More important is this: The corporation distributes its profits in the form of dividends after it pays a corporate tax. Dividends are also taxed to the stockholders; so there is a double tax on the same earnings. Partnership earnings are not taxed twice. There is only one tax on each partner's share of the profits. Here are many other advantages of partnerships:

Corporations are sometimes penalized by a special tax if they accumulate earnings and it can be asserted that this is done to avoid taxes upon the stockholders. The partnership can accumulate its earnings at will. Retention of funds for development is thus not limited by tax considerations.

Partners can decide how to divide profits among themselves without regard to investment. Partnership distributions are entirely a matter of contractual relations. As long as there is no effort among the partners to purchase the interest of another partner, they may even determine partners' individual earnings on the last day of the year, rather than at its start. That often occurs in professional partnerships. Earnings are often allocated on the basis of the respective contributions of individual partners to the business for the year. This is not assigning income earned by one partner to another. Obviously this process affords much opportunity for control of a partner's individual income. You might, for example, provide, by year-end arrangements, that nearly all losses are to be borne by one partner. He may well be the person willing to bear them in a given year.

A partnership business loss can be deducted from the individual partner's personal income. The corporation's loss is not a deduction to the stockholder. The partner's loss can produce a carry-over and return of prior year's taxes or reduce taxes for future years.

Dissolution of a corporation results in a tax. That does not happen with a partnership. But if death of a partner or stockholder comes before dissolution of either a partnership or corporation, the result is the same. The estate must include a value of the business property at death.

Partnerships can gain a good deal by picking their first tax year with care. For example, a new partnership might lose money for 3 months and thereafter earn profits. Its first fiscal year can end after the first 3 months. If the partners use the calendar-year basis and expect substantial income from other sources during the year, this process permits offset of partnership losses against individual income. It may also defer the partnership income into the next year, when tax rates may be lower.

Receipts may be exempt to the corporation (for example, proceeds on sale of property below cost, proceeds of life insurance, canceled debts, etc.). But they are fully taxed when the proceeds are distributed to the stockholder. That is not so with a partner. He takes these proceeds without tax.

Earnings already taxed but not withdrawn increase the cost basis of the partner in his company. That is not true of the stockholder. His cost is his investment—even if the corporation has paid all sorts of taxes on its earnings.

If the owner is also employed by the corporation he may have to draw a salary in loss years—in order to justify the salary as a reasonable corporate deduction in other years. Thus, he may have taxed income although the business does not show a profit.

Long-term gains are taxed at only 25 per cent to the partner, and to the corporation. But they lose their identity when paid out as dividends by the corporation. Then they are taxed as ordinary income. That is not true of partnership capital gains.

Capital-gain treatment varies. A partner whose total net income is taxed at income rates of less than 50 per cent will pay a tax of less than 25 per cent on his partnership long-term capital gains. This is not so with corporations. They, at all times, pay a maximum tax of 25 per cent on long-term capital gains. Of course, a partner whose total net income is taxed at income-tax rates of more than 50 per cent will pay a maximum tax of 25 per cent on his partnership long-term capital gains.

There is likely to be difficulty in tradings of any kind between a stockholder and his corporation. We do not have the same problem in transactions between a partner and his partnership.

Partners can deduct the carry-over of partnership capital losses up to $1,000 a year. This is not permitted to corporations.

Partners can deduct their share of partnership contributions up to 20 per cent of their adjusted gross income. Corporations are limited to a 5 per cent deduction. Stockholders get no advantage out of excess contributions. Partners can also take their share of tax-free interest as exempt income instead of as taxed corporate distributions.

* * *

Sometimes *partnerships are termed associations,* and taxed as corporations, unless it is shown that the partners "contribute" to the organization in the form of capital or services. These contributions must be real, though some partners may be inactive. Taxation as a corporation sometimes applies when: profits and losses are not shared on a definite basis; there is not a joint and several liability for debts. Limiting the liability of a partner approaches the corporate form. To avoid being taxed as a corporation, it must also be true—

That the partners' participating interests cannot be sold or inherited. Death must generally end the partnership. Where partnership interests can be disposed of, as can shares of stock of a corporation, the organization may be taxed as a corporation.

That the partners are directly responsible for the conduct of the business, each partner being an agent for the others. The managing partners may be agents, not representatives, of the others (as the directors of a corporation are representatives of the stockholders).

That the partners act really as coproprietors. If there is strong centralization, characteristic of the corporate form, the government will tend to find that a corporation rather than a partnership exists.

* * *

Common trust funds, maintained by some banks, are usually treated as partnerships. So is a *syndicate, pool, or joint venture* if: two or more persons

organize for a limited period; they acquire property for a specific purpose or enter into a specific venture (or own individually an undivided interest in the property or enterprise); they issue no stock or certificate of ownership; they do not provide for transferability of interest. These are approved even if the agreement confers limited powers upon a manager or trustee.

A continuing business enterprise which gives up a percentage of its profits to persons who furnish it with funds might also be a joint venture. Each venturer would report his share of income. The business would regard the share as a distribution of its income.

* * *

If partners in a business want to incorporate, they have no tax to pay if the partnership transfers assets to the corporation *solely* in exchange for the securities of that company. But immediately thereafter the partners or partnership must own 80 per cent of the voting stock and 80 per cent of all other classes of stock of the corporation. If securities go to partners rather than the partnership, they must be substantially in proportion to interests in the partnership before the exchange.

Example. A and *B,* equal partners, transfer partnership property worth $50,000 to *X* Corporation. *A* receives stock worth $25,000. *B* receives stock worth $15,000 and $10,000 cash. Though each received equal values, the *stock* received by each was *not* in proportion to his interest. Gain or loss would be recognized upon the incorporation. Or assume *A* and *B* each transfers property worth $50,000 to *X* Co. As *A* has had more business experience, *A* is given 600 shares of stock and *B* 400 shares. The stocks received were *not* proportionate. Tax would arise. *A*'s business experience cannot be employed as a substitute for the value of the property transferred.

You may complete the exchange in either of two ways. In one, you may dissolve the partnership. The assets are then distributed in kind to the partners, who transfer them to the corporation for its stock. The better way is to have the partnership transfer the assets to the corporation for its stock. The partnership can be dissolved in a few years and the stock distributed to the partners.

This step is used because *there may be considerable change in the tax basis of assets in the liquidation of a partnership followed by the formation of a corporation.* Difficulty arises where some assets are worth more or less than book figures. Or some assets (like goodwill) may not be recorded on the books. Upon the liquidation of a partnership, and the distribution of property in kind to a partner, a reallocation of the cost of each asset must be made. Here is how that is done: Each asset is given its proportion of the partner's cost of his interest based on the value of the property transferred.

Example. *A* and *B,* two partners, originally invested $100,000. An additional $100,000 derived from earnings has increased the basis of the partners' interests to $200,000. The $200,000 is composed of inventory of $100,000, accounts receivable of $50,000, and fixed assets of $50,000. The present fair market value of the inventory is $100,000. But the fixed assets are now worth $150,000, and the accounts receivable $50,000. Under the rule, the cost basis of the inventory would be reduced to one-third of $200,000 or $66,667. That of the accounts receivable would be reduced to one-sixth of $200,000 or $33,333.

If goodwill exists, there would be a further dilution of the basis of the other assets. Of course, the increased basis of the fixed assets would be recoverable through higher depreciation charges. But these might not be sufficient to offset the loss of the cost basis in the inventory and accounts receivable in an example like the preceding.

The trouble with the reallocation can probably be avoided by having the partnership transfer the assets to the corporation in exchange for the stock and securities. The basis of each asset to the corporation would then be the same as it was in the partnership.

But if the partnership distributed the stock and securities to the partners immediately after the exchange, the government might contend that they had transferred the assets. A reallocation of basis might then be required. The stock and securities probably should be retained by the partnership for a year or two before distribution.

* * *

One reason to keep the partnership alive is to pay off contingent or contested liabilities. All assets, except those sufficient to pay the claims, may be transferred to the new corporation, and all other liabilities may be assumed by it. If the new corporation were to pay these contingent or contested liabilities, they would have to be capitalized. Then neither the old partnership nor the new corporation would have the benefit of a tax deduction. If the partnership is kept alive to pay them, the partners will get the benefit of the deductions.

* * *

When changing a partnership into a corporation, experts seek to avoid tax upon as much as 23 months' income upon the individual partners.

Example. *A* and *B* Company, a partnership, has a fiscal year ending Jan. 31, 1950. It exchanges its assets for stock in a corporation on Dec. 31, 1950. *A* and *B,* filing on the calendar-year basis, must individually report their distributive shares from the partnership for the 12-month period ending

Jan. 31, 1950, and for the 11-month period ending Dec. 31, 1950. If the dissolution had occurred in 1951, *A* and *B* would have been required to report only 12 months' income in 1950.

If you organize a corporation out of your partnership, remember the penalty tax for failure of a corporation to distribute sufficient dividends. Experts suggest reducing the transfer of cash or investments to the corporation. They give it only enough for bare operating necessities. Thus they may avoid the penalty tax. If the corporation does not have large sums of money or investments, you cannot be held liable for the tax.

* * *

Sometimes partners agree to pay a tax on incorporation for this reason: they want the corporation to get a *higher basis* than partnership cost for the assets of their partnership.

How is this done? There are four ways to get a *stepped-up* basis:

1. The securities are distributed to the partners in proportions which are *not* similar to their partnership interests
2. Some of the securities are sold for cash to outsiders. Then in exchange for the partnership assets, some of this cash is paid to one partner. The securities are paid to the other partners
3. The partners pay cash for the corporation's securities. The corporation then buys the partnership assets for cash at market value
4. The partners receive *other* property or cash in addition to securities. Otherwise the exchange complies fully with the rules for making the exchange tax-free

If one of these steps is taken, the partners automatically can pay a tax of not over 25 per cent on their long-term profit. This is based on the difference between the cost of their interests and the fair market value of the securities and cash received.

3. The corporation as a business form

Business considerations. The inherent weaknesses of the individual proprietorship and partnership are: unlimited liability and concentration of risk and responsibility in one person or a small group of persons; inability of individuals, as such, to secure large amounts of capital—thus, impermanency of existence.

Sometimes these lead to consideration of an alternative form of business. One such form is the corporation. One of its important advantages is the limited liability of the stockholder.

Liability is usually cut to the amount of stock subscribed or purchased, unless it was originally issued by the corporation at a discount. Often this

advantage accrues only to stockholders of large corporations who are interested in investment. In a "close" corporation owners are, on occasion, made personally liable upon the insistence of creditors. And too, courts sometimes ignore the corporate form. They may hold the stockholders liable as partners.

The existence of the sole proprietorship and the partnership are constantly in jeopardy. The corporation, on the other hand, is usually dissolved only by agreement of stockholders, or some type of legal action.

These and many other advantages have tended to make the corporation the most important form of associating individuals for private gain. But as compared to a partnership, it has many disadvantages. These are shown in the following chart:

Corporations—Business Considerations

Advantages	*Disadvantages*
Limited liability. Liability is usually limited to the amount of stock issued.	*Difficulty of formation.* Forming a corporation sometimes involves considerable formality and expense. The expense is not deductible for income-tax purposes.
Continuity of existence. Change of ownership through transfer of stock has no effect on the existence of the corporate form.	*Control and regulation.* The corporation is everywhere subjected to governmental control and regulation. It may have to file endless reports and tax returns. Attorneys must be consulted frequently.
Continuity of management. Change of ownership through transfer of stock need not affect management.	*Interstate limitations.* If a corporation wants to do business in states other than the one in which it is organized, it must usually qualify in the other states and pay their fees and taxes.
Skill and flexibility of management. The management of the corporation is placed in the hands of a board of directors. The wisest and most skillful directors may be chosen. Their investment in the corporation need not be large.	*Charter limitations.* The scope of activity of the corporation is limited by the purposes set out in the corporate charter. This difficulty may be eliminated by making the original charter broad or by amending it. The corporation's outstanding stock may not be more than the amount authorized by its charter.
Acquisition of new capital. A successful corporation may seek as much capital as it needs. Investors have greater confidence in the securities of a corporation than in those of other forms of doing business.	*Inflexibility of operation.* Certain formalities may have to be observed before many actions. Some types of transactions must be authorized by the directors or stockholders. It may be difficult to get quick action on many important transactions.
Personnel advantages. The corporation can offer more opportunity to the efficient and ambitious employee, and thus secure top-flight personnel. Opportunity to secure stock in the corporation is an incentive to effort.	*Possible liability of stockholders.* The corporate fiction has sometimes been disregarded. Stockholders have been held individually liable where the corporation is used for fraud, evasion of the law, monopoly, or personal gain of a dominant stockholder.
Limitation of power to bind. Any one partner can bind all his partners, perhaps disastrously. Power to bind the corporation is limited to designated directors, officers, and agents.	
Control of minorities. While minorities have adequate representation, dissident minorities are usually not as difficult to manage as they are in partnerships.	

Advantages

Transfer of interests. Interest in the enterprise, evidenced by shares of stock, is readily transferable. Corporate shares provide a means of investment that can be transferred to heirs with comparative ease. A partner's heirs cannot succeed to his status as a partner without the consent of the other partners.

Disadvantages

Division of profits. In a partnership profits can be divided arbitrarily, as desired, in ratio to capital or services contributed. If the corporation divides profits, it must do so in proportion to stockholdings. Profits can be distributed only after a declaration of dividends by the directors. Limitations are often placed upon the amount of distributions. These vary with states. Generally, the laws try to prohibit impairment of capital by the payment of dividends.

Minority stockholders. Minority stockholders sometimes have no means of protection against some acts of majority stockholders.

Separate ownership and management. The divorcing of management from ownership may lead to abuse. Constant change of management is dangerous when continuity of effort is needed

Expansion of capital. Sale of stock on the open market involves highly technical procedures regulated by many laws. It may be an expensive and complicated operation.

Dissolution. Dissolution of the corporation can be an involved process.

Tax considerations. *There are really four taxes on corporations.* One is like our personal income tax, with graduations (lower taxes) for the small corporations.

Another, used in war years or in periods of high defense appropriation, is called an excess profits tax. It attempts to levy on the income in excess of normal profits.

Income for all these taxes is what the law specifically defines it to be. Moreover, this law-defined income differs for the various taxes. In all businesses the income is computed by deducting the losses sustained in both preceding and subsequent years. The law asks for a tax only if there is business income in any series of years. In 1953, for example, the law provides that you may reduce your 1953 income by 1952 losses. And if those are still greater than 1953 profits—you may carry them over to reduce profits of 1954–1957.

The process is called "carry-over of net operating losses." Fundamentally, you pay a tax only if the average over the 7 years is a profit.

The third possible corporate tax is called the *surtax on personal holding companies.* It is covered later. The fourth is called a *surtax on unreasonable*

accumulations. Its purpose is to impose a penalty when corporations attempt to avoid taxes on their stockholders by accumulating profits instead of distributing them. Your corporation is liable for this tax only if the corporation was used for the purpose of avoiding income taxes upon shareholders by not distributing its profits.

The rate of this tax is made high in the attempt to compel corporations to pay out profits to stockholders. It is computed on the same income as is used for the income tax and after deducting the normal tax, the surtax, dividends paid, and other adjustments.

The fact that earnings are accumulated beyond the reasonable needs of the business assumes a purpose to avoid individual surtax—unless you can prove to the contrary. Companies carry the burden of proving the purpose of the accumulation. We have a law in which we must prove that our companies are not evaders. If we cannot do it, the tax is assessed.

The government has apparently advised its agents that they are to consider penalties upon at least the following classes of corporations:

Those which did not distribute at least 70 per cent of their earnings as dividends

All those that invested their earnings in securities or other property unrelated to their normal business activities

Those that advanced sums to officers or shareholders in the form of loans out of undistributed profits or surplus from which dividends might have been declared

Those where a majority of stock is held by a family or other small group

Any others, even if 70 per cent of their earnings were distributed, where the agents can assert that distributions of dividends were inadequate in view of the financial position of the corporation

If you use your funds for the reasonable and current needs of your business you need not worry about the penalty. But you may court trouble if there is not a specific plan, which, in the exercise of good business judgment, demands the accumulation of earnings.

We may also have trouble if accumulations are too large for the fair needs of the business—even though the profits arise out of normal business. So is the fact that stockholders saved a large income tax that would have been imposed upon them had the surplus been distributed.

Certainly this is true: If your corporation intends to retain its earnings, then you must gather evidence justifying the retention. If funds are hoarded for business needs—such as future expansion, protection against increasing costs or inventory price rise, cost of converting to improved products, cost of moving to better quarters or nearer your markets or materials—your

records must be in shape to show your purpose. You have to be prepared to prove that you did have a definite plan.

* * *

The fourth type of corporate tax concerns only what the law calls "personal holding companies." They are also popularly referred to as "incorporated pocketbooks." They may cause a penalty surtax of 75 to 85 per cent of income. A corporation may suffer this extra penalty no matter how honorable or innocent the intentions of its organizers.

What stamps your company with this penalty? Only this: 50 per cent or more of the corporation's stock is owned by five or fewer people; 80 per cent of its gross income is from interest, royalties, security or commodity transaction gains, estates and trusts, annuities, dividends, or personal service contracts, or from rents under certain conditions.

You pay the prohibitive surtax if a corporation meets the tests above. Then its net income is determined under very special rules—quite different from those used to find the income tax. The penalty is on the net income, less the dividends paid and certain other credits.

This penalty is intended: to discourage individuals from incorporating their income-producing properties to avoid their personal surtax; to pressure these companies into distribution of their net income, into dissolution, or into abandonment of their condemned characteristics.

Experience indicates it is usually *not* advisable to incorporate the following types of businesses:

An investor, speculator, or trader (not a dealer) in securities
An engineering or similar partnership, if one of its members is designated to perform a contract
A company that collects for use of its building, equipment, patent, etc., from one of its stockholders whose ownership is 25 per cent or more

Personal holding companies have some advantages; *these often urge experts to use this form.*

One advantage is that the excess of net long-term capital gain over net short-term capital loss is taxed at only 25 per cent. This takes the place of all other taxes on the corporation upon this income. Other companies would still be liable for the dividend penalty tax on this gain. In addition, these companies—

Are exempt from the penalty surtax for failure to pay dividends
Get the benefit of a carry-over for dividends exceeding income. This right is not given to other companies when computing the dividend penalty tax

Figure a deduction for charitable contributions up to 15 per cent to compute the personal holding company's penalty tax. Other companies are allowed an unlimited contribution only when computing the dividend penalty tax

* * *

Some business corporations are partially or fully exempt from taxes. One type is the foreign corporation not engaged in trade or business in the United States. Its entire tax is a flat 30 per cent on fixed or periodic income from United States sources. If residents of the United States own 50 per cent in value of foreign corporations—and if 50 per cent or more of corporate income is dividends, interest, royalties, annuities, or rents—they may be taxed on their annual share of the undistributed income of the company.

Another company getting preferred treatment is one doing business in United States possessions. Another is the so-called Western Hemisphere Trade Corporation—one whose business is done in North, Central, or South America, in the West Indies, or in Newfoundland. They receive a 30 per cent credit of their normal tax net income if: (1) 95 per cent or more of the gross income for the 3-year period immediately preceding the close of the tax year (or for the part of such period during which the corporation was in existence) was derived from sources outside the United States; (2) 90 per cent or more of the gross income for this period was derived from the active conduct of a business. It is sometimes advisable for a company selling in both the United States and other countries in the Western Hemisphere to form a separate corporation to handle only the Western Hemisphere activities. That gets them the 31 per cent credit.

* * *

What are the tax advantages of a corporation—as contrasted with those of a partnership? Whether the net tax paid is lower depends on the dividend policy and the salary payments to stockholders. The tax benefits of the corporation may be listed this way:

It is easier to split into two or more units for greater tax benefits

Stockholders who are employees may be included in profit-sharing or pension plans of a corporation. They cannot be included in partnership plans

Certain corporations (but not partnerships) engaged in foreign trade or in other ventures have special exemptions or tax benefits. Some of that is explained later in this chapter

Intercorporate dividend receipts are now subject to a tax on a fraction of receipts. They are not subject to the full normal tax and surtax paid by partners

Officers, and stockholders employed by the corporation, receive the benefits of social security (unemployment insurance is also available to them). Partners are now covered by social security only

Members of a family may be stockholders without many of the burdens and restrictions of family partnerships

Dividend payments to stockholders can be avoided by companies needing the money for business developments or business emergencies. Corporations can thus be used to pile up earnings, net of a low tax, into huge enterprises. Partnerships cannot do that under present tax rates

Reopening of the individual partners' tax years is possible in the government examination of partnerships. That is a serious disadvantage in a partnership, not usually true of corporate operations

Corporation stockholders can often control the dividend process. They can dictate the year they will get income. They might often select the year most favorable to them. Control of the dividends by corporate holders permits averaging of stockholders' income over a long period. Partners do not have this opportunity. They pay a tax for the year income is accrued

A stockholder can have a capital gain when his corporation is liquidated. He may be able to cause it to liquidate in a year when he has losses to offset the gain from liquidation. Liquidation of a partnership usually gives no loss

If the stockholder dies, his estate can dispose of his stock with no income tax. The value of the stock at his death is its basis to his heirs. Partners' estates may have a tax to pay on accrued income to the date of death

Corporations can get an immediate refund if a net operating loss is sustained. Corporations can reduce the tax due for their prior year if they have losses in the current year. Partners must wait a year to get the same treatment, since they pay as they go

* * *

Which is better as between the corporation and partnership? No rule of thumb can be given. The answer depends on many points. Here are some points to consider in seeking the answer:

Compute the estimated future yearly incomes of the business and the individual. Then figure what salary (to stockholders) and dividends a corporation will pay. Then compute the tax for both the corporation and the stockholder, who may also be an officer or employee drawing a salary. Now figure the tax if the partnership were used. In both cases cover a series of years. Then make comparisons

Remember that future incomes are being estimated. Also that the double tax (on corporate income, and then again to the stockholder when he is

paid dividends out of the corporate earnings) may some day be modified

But note also that a stockholder may often help to control the dividend policy of his corporation. He can also minimize double taxation by liquidating or selling the corporation. Then he would pay only a 25 per cent tax on his accumulations of profits

Remember that if the corporation has a substantial loss and then dissolves, the stockholder may get the benefit of a double "deduction." The loss carry-back may give the corporation a tax refund. The stockholders may get a capital loss on dissolution. If they have capital gains, that can be useful

A business may be growing for a number of years before it attains a normal level of operation, or it may have recurring periods when it needs money for expansion. In these cases the corporation may properly avoid paying dividends. That means, too, that the stockholder avoids double taxation. More important, this can help build up an estate at low tax cost. If he used the partnership form, he would have paid a tax on earnings throughout the entire period

It is not advantageous to use the corporate form where income is largely to be from capital gains or any kind of tax-exempt income. Here is the reason: When this income is distributed as salaries or dividends, it is fully taxed regardless of the origin of the income. But the character of income does not change with a partnership

The corporate form probably should not be used where losses are expected and the stockholder has personal income, or perhaps it should not be used until profits are certain. In noncorporate forms business losses can be offset against personal income

Even if the corporate form is ultimately to be used, consider starting as a partnership if the first months are likely to show a loss. The losses can then be set off against personal income. The corporation can get the use of its losses through the carry-over system. But a more substantial saving results if the individual is in a high surtax bracket. Later the business can be changed to a corporation. That can be done without any tax cost.

Suppose the early period proves the new business to be a "dud," with losses. If liquidated, the individual proprietorship or partnership form permits an individual to offset the entire loss against his personal income. Had he used the corporate form, the realized loss (from a worthless stock or a loss in liquidation) would be a capital loss. That may not give much tax saving.

* * *

When organizing a corporation, it may be advisable to issue bonds instead of preferred stock, together with common stock. You get a deduction for

interest on the bonds. There is no deduction for payment of dividends on preferred stock. The redemption of bonds is not usually considered a taxed dividend. It might be a repayment of a loan. But redemption of preferred stock is often a dividend, up to the company's earnings and profits.

* * *

One form of bond to consider is that with increasing values, paying no interest. Bonds issued with increasing surrender values have many advantages for a bondholder. You may sell a bond for $75 redeemable at a given date for $100. Then your investor—

Pays no tax until he collects the $100
Is taxed only as capital gain—not as ordinary income

At the same time, the corporation may obtain a tax deduction for the $25, spread over the life of the bonds. To get this deduction, however, the bond must be a registered bond, or be issued with coupons attached.

Here is an example of how you can do that in organizing a new company:

Example. *X*, *Y*, and *Z* form *A* Corporation. $400,000 is advanced, of which $100,000 is represented by common stock and $300,000 by debentures. The common stock is issued in equal shares to *X*, *Y*, and *Z* for cash or property. The debentures are sold to *XW*, *YW*, and *ZW*, wives of *X*, *Y*, and *Z*, for cash. The debentures are in registered form. They provide that at the end of 10 years the holder of each $1,000 unit will be entitled to receive $1,415. This is the equivalent of the original investment with interest at the rate of 3½ per cent per annum, compounded semiannually. The holder may surrender them on any anniversary date after 3 months' notice at fixed dollar amounts. That is to be computed by adding to the original cost simple interest at the rate of 3 per cent per annum. There is no provision for current interest. The corporation reports its income on the accrual basis. It is entitled to deduct each year accrued interest computed at the 3 per cent rate.

In a recent ruling, the Treasury indicates that it will restrict the cases in which capital gain can be achieved. So, if the bond does not meet all the requirements, the increment will be taxed as ordinary income.

* * *

In organizing a new company you should use your natural business year as the basis for keeping your books. This gives you the best picture of your business. Your financial statements are then prepared when you have the fewest incomplete transactions. But you may have tax advantages by choosing another year.

If you organize a corporation you may choose the fiscal year that is most

advantageous. Or you may pick a calendar year. Take the one that aids you most. Or you may have a seasonal business. Then be sure you get a period that permits profits to be balanced by losses.

In starting a new corporation, you can start with a short year. If you begin business in July, you might have a 6-month first year. That can cut your tax materially in the first year, when you may need the aid.

* * *

One of the advantages of forming a new corporation is the ability to give it a fiscal period controlling dividend payments. If a corporation has a fiscal year ending after December—for example, January or February—dividends paid in January or February fall into the year after that of organization. Stockholders might get some benefit in postponing the tax.

* * *

Considerable thought should be given with your CPA to the selection of the accounting methods. You are usually bound by the accounting elections you make in your first return. Generally a change is possible only with government consent. Bad decisions in the first year upon inventories, accruals, some reserves, depreciation—and many other elements—can prove costly.

* * *

The tax advantages of first incorporating and then later changing from a corporation to a partnership are many. Accumulated earnings of the corporation can be transferred to the stockholders at a 25 per cent tax. That may be a much smaller tax than the normal and surtax rate on dividends or the tax on partners' earnings.

Important, too, is this: Stockholders take corporate assets in a liquidation at their fair market value. They may pay up to 25 per cent tax to get much higher values than permitted to the corporation. Higher deductions at perhaps much higher rates are thus often available to the stockholders. They get a stepped-up basis at bargain rates.

That may be particularly helpful if inventories have risen in value. The corporation might have to pay income taxes and possibly excess profits tax on all income over cost when they are sold. But the stockholders can get the right to sell them free of tax except the 25 per cent capital-gains tax on liquidation.

The same step may radically increase annual depreciation allowances or the cost of capital assets held for disposal. But, of course, there may also be a step down in a liquidation, if inventory and other assets are worth less than the cost to the corporation. Also important are these advantages:

You secure delivery of the assets to stockholders without tax on the accumulated earnings. In the liquidation, the stockholder pays only the 25 per cent capital-gains tax upon the fair value of the assets distributed —in excess of his cost. He might have paid higher personal tax rates for distributions of cash dividends or upon the same earnings were they held by a partnership.

If a corporation can acquire an income-producing contract which has no market value, then incorporation, followed by liquidation, gives this result: Stockholders are not taxed on the value of the contract when it is distributed in liquidation. They are taxed only when the payments under the contract (plus all other assets received) exceed the cost to them for their stock. And the excess is taxed as a capital gain. Assume a corporation sells all its assets for a percentage of the purchaser's profits. This type of contract cannot be valued. And so the corporation is not taxed. Assume you liquidate and distribute the contract to stockholders. The payments by the purchaser are taxed as capital gain to the stockholders, even though they would be ordinary income to the corporation or a partnership.

What year do your stockholders get their gain or loss on a liquidation? There is loss only in the period when substantially all the corporate assets are distributed, and the corporation has only enough cash or other assets to meet its debts. There is gain only when distributions finally exceed the stockholders' cost basis. That is not true if there is a redemption of part of the stock. You can select the year or years in which your stockholders will benefit most from any kind of liquidation. If you like, you may fully or partially liquidate in the year they have gains or losses to offset the loss or gain from the liquidation.

Liquidation may create a great many other problems. Here are a few points to discuss with your tax experts:

You will lose the advantage of carry-overs of net capital losses, net operating losses, and many other tax benefits. They do not survive to a new owner of the assets. And your basis for depreciation, gain, or loss cannot be given to the purchaser. There are some exceptions to this in a liquidation by a subsidiary into a parent company.

Be careful that you do not expose your stockholders to a short-term capital-gains tax. Stockholders pay a long-term capital-gains tax on the fair market value of the liquidated property over the cost basis of their stock. The later transfer of the assets is usually made at the same price as the value at liquidation. Then stockholders have no further gain. Sometimes there is an interval between liquidation of the corporation and the later transfer of the assets by the stockholders. Then the government may claim the assets increased in value between the time of actual liquidation to them and the date of sale. This can result in a short-term gain to

the stockholders if they dispose of the assets before 6 months. Holding by the stockholders for 6 months avoids this difficulty. Should that be impracticable, you might be able to get competent appraisals of the property to show that value at liquidation and sale dates was the same figure.

Do not conduct business operations if the distributions in liquidation will take more than a year after you adopt the plan of liquidation. The distributions may be taxed as dividends to the extent of accumulated earnings and profits.

Do not distribute income-producing property this year if you have available a loss carry-over from earlier years.

During liquidation, do not pay debts with appreciated assets—the payment is considered a sale or exchange.

You can have a partial liquidation of stock. Pay property to stockholders to redeem their stock. That usually creates a capital gain or less to stockholders. But it might also be an ordinary dividend. If the stockholder does not turn in all his stock he may have an ordinary dividend on the distribution.

If you are going to liquidate, do not pay dividends. Particularly avoid payment of dividends in arrears. Characterize your payments to stockholders in the liquidation as distributions in redemption for their stock. If you pay dividends before liquidation your stockholders have ordinary income. If they are paid off the amount due them in redemption—even if that includes the par value and accumulated dividends in arrears—they have a capital gain or loss.

Your corporate resolution providing for a partial or complete liquidation should specify a distribution in kind. If the resolution can be construed as an obligation payable in dollars, the Treasury may claim a dividend was intended.

If you have unamortized bond discount, retire the bonds before liquidation. The corporation will then get the full deduction for the balance of the unamortized bond discount.

If an unsecured debt is owed by the corporation to its stockholders and the debt's basis to them is less than the face amount, they might forgive the debt before the liquidation. That is considered a capital contribution. Payment of the full debt on distribution might be taxed as ordinary income to the stockholders.

* * *

Time your distributions if you do liquidate to form a partnership. Several points should be watched. If your company has a net operating loss carry-forward, you may want to retain income-producing assets in the corporation. It will get the benefit of all sorts of carry-over. Don't distribute these assets until you have taken all benefits. And note this:

Liquidation can create income that might not otherwise arise until a later date. For example, a company using the installment sales basis may have income at the time of liquidation rather than in later periods. And there are many other similar situations of immediate taxation on income that might otherwise have been deferred

Timing is essential if there is a seasonal business. You might create income to the corporation that would not be taxed if it completed its full year

* * *

Instead of liquidation you might distribute corporate property with an increased value (over cost) as a dividend in kind. There is no tax to the company on the appreciation when this dividend is paid; the stockholder, however, does have a tax to pay on the fair market value of the dividend.

* * *

Continued operation of a corporate business after liquidation risks tax on the continuing entity as a corporation. Calling the new business a partnership, trust, or association does not eliminate tax. To avoid this, organize your partnership quickly after the liquidation.

* * *

What do you do with *life insurance policies on executives' lives formerly owned by the corporation?* If they go to a new partnership, the transfer may be a "transfer for value." This subjects the proceeds to income tax when paid upon the death of the insured. They would not be taxed if held by the corporation until it collected the proceeds.

There is no tax when assets are transferred to a corporation and the transferees remain substantially in control of the new corporation. But this same advantage does not follow corporate liquidation. It is *not* afforded policies distributed to shareholders and assigned by them to a new partnership.

To avoid this result, you might place the ownership of policies in the *insured* parties—rather than place them in the new partnership. Or you can have the insured purchase the policies and own them personally. That is *not* a transfer for value. The insured can collect the proceeds tax-free.

Sometimes it is best for a corporation to surrender the policy. Its cash value so obtained would be distributed to the stockholders among other assets. The stockholder-partners could then get a new policy on the life of the employee.

* * *

4. What about a limited partnership?

Business and tax considerations. Some of the problems of the ordinary partnership may be avoided by the formation of limited partnerships. The business advantages and disadvantages of this form are:

Advantages

Limited liability. Liability is limited to the investment of the "limited" partners. Creditors must be notified of the limited liability provided in the partnership articles. Otherwise they may be able to levy upon all the assets of the partners.

Easier acquisition of capital. Because the liability of the special partner is limited, this form appeals especially to individuals who have money to invest.

Retention of control. The entrepreneur who has ability without sufficient capital can acquire capital through "special partners." He can still retain his managerial control.

Concentration of management. Management may be concentrated in the hands of a small group of able individuals, without the necessity of bringing in general partners in order to acquire more capital. This may be important when an enterprise needs a great deal of capital and already has sufficient and capable management.

Disadvantages

Power of general partner. Do the general partners have too much power? In the absence of fraud the special partners apparently cannot interfere in the management. Thus the special partners' interest may be abused. At the same time it is difficult to withdraw without a loss.

Recording of limitation of liability. The facts concerning the limitation of liabilities must be publicly recorded. The public may not be deceived.

Limited or general partnerships with members of a family may be created. Some partners can be general partners. Wives or children might be limited partners. Each limited partner can be entitled to a fixed percentage of the profits and losses from the operation of the business. Or, the liability of each limited partner can be expressed not to exceed the value of his capital contribution.

Sometimes general partners are given only limited authority to determine whether any part of the annual profits are to be used for additional working capital or for improvements, alterations, or additions to the plant, or are to be withheld for expansion or development. In other cases general partners are given complete management and control; special partners are denied a voice in the operation of the business.

* * *

The tax handling of the limited partnership is like that of the general partnership.

5. *A joint-stock company may be right for you*

Business and tax considerations. The joint-stock company is a mixture of the partnership and corporation. It is different from the partnership in three ways: (1) its capital is divided into shares, which may be transferred by the owner without the consent of the other members of the association; (2) its

affairs may be conducted by a board of managers or directors, who may bind the company when acting within the scope of the business; (3) it is not dissolved by death or incapacity of any member. The business advantages and disadvantages of this form of organization are:

Advantages

Ease of raising capital. It is much easier to raise large capital for a joint-stock company than for a partnership. Capital is raised by the sale of a large number of transferable shares. The investor can sell his shares relatively easily. So he can protect himself to some extent, even when he is liable to the full amount of his property.

Concentration of management. Management is concentrated in elected officers. This permits specialization. It relieves the investor of active supervision.

Limited authorization to bind. Only authorized officers of the company can bind it and the investors. This reduces the risk as compared with partnerships. Shareholders have no power to bind the company.

Permanency. The life of the joint-stock company is limited only by the articles of association. It may not be terminated by the death or withdrawal of a member.

Separation of management and ownership. As with corporations, this may be an advantage or a disadvantage. It does furnish the element of concentration which makes for more efficient management.

Disadvantages

Unlimited liability. The members of a joint-stock company are personally liable for all debts of the association unless local regulations expressly grant exemption.

Delegation of management. There is not the incentive to efficient management that exists when the partners are active managers.

Lack of entity. No separate entity is created, but the joint-stock company may be treated as a corporation when it is to the advantage of the regulating government.

Regulation and control. There is some governmental regulation and control, but not as much as in the case of corporations.

Inability to hold real estate. Normally the association cannot hold title to real estate except in the name of one or more trustees.

* * *

Three tests seem to govern whether a joint-stock company will be taxed as a corporation. These are—

1. There must be two or more persons associated in a joint enterprise
2. It must carry on a business for profit
3. It must resemble a corporation—have the attributes and advantages of a corporation. These are continuity despite the death of associates, limited liability, centralized management, transferability of interests in the association

6. Should you form a trust?

Business and tax considerations. Trusts are usually formed by the voluntary action of individuals through trust indentures, for their own benefit, or for the benefit of others. They sometimes operate business ventures.

In our tax rules, the trust is often treated as a corporation. That is not usually the case with a trust created by a will or a grantor's declaration. In these the trustees take title to property only for the purpose of protecting or conserving it. The beneficiaries of a trust generally do no more than receive distributions. Ordinarily no business is done except to conserve the trust property.

The government distinguishes these from business trusts. In the latter title to property is conveyed to trustees. They hold and manage it for profit. In business trusts the object is not to hold and conserve particular property, as in the traditional type of trusts. Business trusts are really designed to run a business for gains. For example, a trust may be created as a convenient method for several people to be associated in real-estate dealings. These trusts are taxed as corporations. Like a joint-stock company, a trust might be taxed as a corporation if—

It is in effect a joint enterprise for the transaction of business
It continues in existence despite the death of beneficial owners
There is a method of transferring beneficial interests similar to the transfer of stock by stockholders of a corporation
There is a centralized management
The personal liability of beneficiaries is limited

The absence of one or more of these does not necessarily mean that the trust will not be taxed as a corporation. The question is essentially one of degree. If it conducts a business and resembles a corporation, it probably will be taxed as one. One cannot get the advantages of the corporate form without its tax disadvantages.

The purpose of a trust is often found by examination of the trust instrument. If that permits the trustees to carry on a business, rather than to conserve trusteed assets, then a business trust may exist. Broad general powers must be avoided if elimination of the corporate tax is desired.

Business Trusts—Business Considerations

Advantages

Ease of formation. The trust may be formed easily and cheaply. Generally local filing fees or costs are small in comparison with taxes and fees required of corporations.

Limited liability. Limited liability of both certificate holders and trustees may usually be secured by contract.

Corporate advantages. The business trust has many of the corporate advantages without incorporation. It may even

Disadvantages

Loss of limited liability. Beneficiaries may lose their limited liability in some trusts.

Possibility of personal liability. Trustees may sometimes create personal liability of the beneficiaries.

Lack of control. Since the trustees are not agents of the investors, they cannot be controlled by the investors.

Lack of flexibility. There is no flexibility of management in a business trust. After the trust deed is put in force it is

Advantages

deal in real estate and hold stock of corporations.

Separate entity. The trust may usually sue and be sued as an entity.

Continuity of existence. The trust may not terminate on death, bankruptcy, or withdrawal of a trustee or beneficiary.

Centralized management. The trust can afford permanent and centralized management and economy of operation.

Flexibility of operation. Its flexibility can be greater than a corporation's. Its activities are limited only by what is outlined in the trust instrument.

Freedom from regulation. The business trust is usually free from regulation. No franchise is needed. Annual reports are few and of nominal cost.

Interstate transactions. There are usually no restrictions imposed on a business trust when its transactions cross state lines.

Interstate activities. A trust can usually do business in foreign states. It is not necessary for the trust to qualify to do business in the foreign state.

Transferability of proprietary interests. The beneficiaries' shares may usually be transferred, assigned, mortgaged, sold, and otherwise dealt with.

Disadvantages

changed only by the methods described in the instrument—by unanimous consent of all parties. Sometimes this means the business trust is efficient only if it requires little discretionary action on the part of the managers. An example would be the holding and management of real estate.

Lack of motivation. The trustee is bound to take as good care of trust property as he would of his own property. But he usually has no responsibility to beneficiaries. He cannot be removed by them. If he is unskillful, they cannot remove him. If he is guilty of fraud they can resort to law.

7. What to know about a cooperative

Business and tax considerations. A very important business form is the cooperative. It need pay no taxes if it can distribute all its earnings to its stockholders. The distribution need not be in cash. Cooperatives create considerable working funds by distributions in scrip, stock, notes, or other forms that permit full retention of the profits by the organization. These are taxed to the recipient as ordinary income. Thus cooperatives can use all their annual earnings for expansion. The result is that many cooperatives have grown into large, powerful groups doing a great volume of business and owning large amounts of assets.

A cooperative can be an organization of members or stockholders, all desiring to buy or sell something, or to invest money. They form an organization to furnish them with what they wish to purchase, or to sell for them what they wish to sell, or to invest their money. They do it because concerted action will be to the individual financial advantage of the members of the group.

When owned by a group of corporations, cooperatives can split earnings on the basis of sales without first paying a tax. Rebates upon purchases from the central source dealing for the group can be readily arranged.

When used as a common subsidiary the cooperative has many other advantages. It avoids many difficulties encountered when there is a parent-subsidiary, or another related company arrangement. Both of these run the risk that deductions will not be permitted to the parent companies for contributions to the central agency. Income of a subsidiary or common agent might be taxed to it, even if its income is fully paid out to the stockholding companies. Use of the rebating system, based on sales or services, may avoid this risk.

* * *

How does the business cooperative function? It can redistribute profits made from its members on the basis of the volume of business done with them. It can surcharge them for deficits on the same basis. The refund to the members is called a decrease in the cost of goods purchased, or an increase in the selling price of goods sold for members. The surcharge becomes an increase in the cost of goods purchased, or a decrease in the selling price of goods sold for members.

The tax law treats patronage distributions this way: They are mere modifications of the original trading agreement between the member and the association—not dividends. They are permitted as a deduction in determining the net income of a cooperative. That assumes that the patronage dividend is paid under agreements to pay over the profits under a binding contract between the company and its members made before the income was secured.

Surcharges are a deduction to the members as additional cost or reduced selling price, if based on patronage.

How is the business cooperative organized? In order for a cooperative to get deductions for patronage dividends, the membership agreement (or charter or bylaws) must provide for refunds on the basis of patronage.

If it provides that distributions may be made to members on the basis of stock ownership, the organization might be acting as a corporation. Then dividends would be regarded as distributions of profits. They would not be deductible by the corporation, but still would be taxed to recipients.

If deficits are required to be paid by contributions from members on the basis of stockholdings, the organization may also be treated as functioning like a corporation. Contributions would be regarded as contributions to corporate capital. They must be capitalized by the payor.

The name of the organization is not controlling. It may be referred to

as a cooperative. But it may conduct itself as a corporation. Then it will be taxed as a corporation. Its members will be treated as stockholders. If it functions as a cooperative it is given the favored treatment. If it deals with nonmembers, it is regarded as a corporation and profits and losses are recognized. Distributions of profits from that source are regarded as dividends—not deductible by the corporation, but taxed to stockholders.

It is usually assumed that the dealings with members and nonmembers are equally profitable. If members are required to compensate the association for losses from nonmembers—even though patronage is the measuring rod —they may be regarded as capital contributions. They, too, would have to be capitalized. There are some problems in cases of deficit financing of business cooperatives. We may get a denial of the deduction to the stockholder, if payments are based upon stockholdings, rather than service rendered or patronage.

Cooperatives—Business Considerations

Advantages

Diversity of form. The cooperatives may take many forms—stock or nonstock corporations or unincorporated associations.

Limited liability. Liability is limited to the amount of the stock, if the cooperative is organized as a corporation.

Voting power. Each member has one vote regardless of number of shares or amount of patronage.

Small capital investment. Members may make relatively small capital investments.

Revolving capital funds. Members may realize a return of their capital investment without dissolution of the cooperatives and without sale of their shares on the open market.

Economies of a large business. The economic advantages and the management efficiencies that go with large-scale buying and selling are available to relatively small buyers and producers.

Reinvestment of capital for expansion. Patrons' proceeds may be paid in other forms than cash and the cash retained for expansion of the cooperative. Other forms of payment include: certificates of indebtedness, allocation of patronage net margins, and certificates of equity of interest.

Disadvantages

Limited return. The rate of return is limited to a fixed percentage of capital.

Difficulty of raising capital. Large or additional capital may be hard to raise.

Governmental regulation. There is considerable governmental regulation, especially of cooperative marketing associations.

Limited advantage. All the advantages of the cooperative are to the member—not to management or the organizer.

Possibility of regulation. The cooperative movement is just beginning to grow. Governmental regulation may become much stronger.

8. Consider a joint venture

Joint ventures and syndicates are often used for business transactions—particularly when participants share a temporary risk. They have these advantages and disadvantages:

Joint Ventures—Business Considerations

Advantages	*Disadvantages*
Ease of organization. There are no formalities on the formation of a joint venture.	*Unlimited liability.* The members usually have unlimited liability, like partners.
Ease of termination. The venture usually terminates without formalities when its purpose has been accomplished or the time agreed upon has expired.	*No entity.* No separate entity is created by the formation of a joint venture. One member can bind others by his acts done within the scope of his authority.
Binding upon members. A member, unlike a partner, cannot withdraw unless he is able to show a good reason.	*Vagueness of organization.* The joint venture has not a clearly defined standing Usually it is treated as a special form of partnership.
Continuity of existence. Death or withdrawal of a member does not usually terminate the enterprise.	
Pooling of resources. Tangible and intangible assets, like goodwill, may be pooled for the duration of the venture.	
Sharing of risk. All members of the venture share in its risk.	

Economy in selling and benefits that flow from marketing similar or complementary products often motivate business to create joint ventures—for example, a common sales agency to market products. Though economically sound, the arrangement may give rise to tax disadvantages. If the common agency is incorporated, the government may seek to tax it as a separate entity. Then the profits of the agency are taxed twice—once to the agency and once to the manufacturers when the agency's profits are distributed to them. What may be worse is this: If the agency suffers a loss, the loss cannot be deducted by the venturers.

Cooperating businesses can usually avoid the tax dangers by use of the unincorporated joint venture. They usually organize it under the direction of an agent or manager. Profits or losses of the joint venture are then taken up by the venturers upon their respective returns.

Joint ventures may have agents. Assume that a group purchases property. It then designates one member to act as agent in holding and managing the property for the group. Despite that, all payments made for taxes, insurance, interest, and incidental expenses on the property may be deducted by each member in proportion to his interest. Corporations may be used as agents without affecting this arrangement.

Example. A, B, and *C* owned property as joint venturers. It was agreed that *A* and *B* should get a fee for management. The remaining profits were to be divided equally among *A, B,* and *C*. *A* and *B* organized *X* Corporation. The property was transferred to *X* to be held in trust for the benefit of *A, B,* and *C*. *X* conducted the business. The government argued that *X* Corporation should be taxed on the entire income. But a court taxed *X* only on the operating fees it got under the agreement.

9. *Changing the form of your business*

Using single units for a business. Economies in operation sometimes dictate a merger of several units of a business into one. So does control of markets, supplies, customers, and personnel. Combination of parts of a business into one may also be useful to reduce taxes. The advantages might include: greater ability to use losses in some departments to offset gains of others; getting full use of the "carry-forwards" that might not be had by a unit of the whole business with the loss.

* * *

When is centralization best for your organization or a group of your companies? Centralization into one unit may facilitate adoption of uniform policies. It may coordinate activities and permit greater standardization and specialization, with attendant economies.

It usually secures use of a higher grade of personnel because of concentration of functions, greater flexibility in use of existing personnel. It probably permits quicker adjustments to rapid changes in economic environment.

* * *

Centralization vs. separation must be a business decision. If combination is to be accomplished with an existing group, many tax alternatives must be studied.

First—when should you merge? One consideration is in the tax mathematics of the merger. That is easy to figure knowing existing tax rates for the separate and merged companies. Important, too, are the carry-overs of all sorts—credits, exemptions, operating losses with which the law may be studded at a given moment. The general rule is that the dissolved corporation may not be able to carry over its losses and credits into the merged company.

How do you effect the merger? Several methods are open. You can use a direct purchase of assets or you might use mechanics giving tax freedom to the vending company or stockholders.

If you buy the other company's assets, your cost controls the value you

place on assets you buy—not the predecessor's basis. If you wish to take over the assets of another company at their present appreciated value, you omit all compliance with the tax rules that give the seller tax freedom. Assets received in a taxed exchange are then taken over at their present value.

When do you use a tax-free exchange, merger, or consolidation rather than a purchase of assets? Only when you are willing to accept the predecessor's basis. That may be helpful or may hurt you. You might give stock worth $100 for $1,000 in asset cost. Or the reverse might be true. You might gain tremendously or get fantastic losses of value. Work out your new basis in each case.

How do you close down subsidiaries? In planning you must answer these questions: Do you seek a tax-free liquidation giving you the same basis as the subsidiary for its assets? Or do you want to take a new basis following the liquidation? If you do, you must compute gain or loss on the transaction. Do you seek a worthless-security loss on the subsidiaries' demise?

You do not merge an affiliated corporation into your corporation if you want to take a loss of your investment. If you effect a merger, the loss on liquidation of your subsidiary will not be recognized.

If you do not merge it into your company and it ceases business, then the loss on stock in the affiliated corporation may be deducted in full as worthless stock. Loss on bonds, debentures, notes, etc., with interest coupons or in registered form, may be deducted in full as a bad debt, if no part is recoverable.

To make this loss possible, two things must be found: (1) the parent must own *directly* at least 95 per cent of each class of stock of the domestic subsidiary; (2) more than 90 per cent of the income of the subsidiary *for all the years* during which it has been in existence must be from sources *other* than royalties, rents (except from rental of properties to employees of the company in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, or gains from sales or exchanges of stocks and securities.

Here is how to get a tax-free liquidation of a subsidiary. No gain or loss is recognized in complete liquidation of subsidiaries if one corporation is the actual owner of: (1) at least 80 per cent of the total combined voting power of all classes of stock of the subsidiary entitled to vote; and (2) at least 80 per cent of the total number of shares of all other classes of its stock (except nonvoting stock which is limited and preferred as to dividends).

Here is the result of this rule: If you want a loss recognized when you liquidate a subsidiary company into your corporation, you cannot own 80 per cent of the stock. You can sell more than 20 per cent of the subsidiary's stock in a bona fide transaction before liquidation.

If you do not want a gain recognized, be sure you own at least 80 per cent of your subsidiary's stock before liquidation.

If your subsidiary company has contingent or contested liabilities, perhaps you should not liquidate it entirely. Retain sufficient assets to pay off these claims when they become fixed and absolute. Only the subsidiary can take a deduction for payment of these costs.

When liquidating subsidiaries, be sure to deduct in the year of dissolution: organization expenses of the subsidiary; legal and accounting fees in the dissolution; goodwill abandoned by liquidation, if a cost basis exists.

Avoid risk of tax to the subsidiary when you liquidate it and then sell its assets. A parent can be a liquidating trustee for the subsidiary. Its gain on the sale of an asset has been held to be the income of the subsidiary, if the negotiations for the sale were initiated before the liquidation. But the subsidiary is probably not taxed if no negotiations were begun before liquidating a subsidiary, or if the offer of purchase was made after the subsidiary's liquidation and distribution of the property.

You may find it advisable to have the subsidiary pay a parent corporation dividends, instead of liquidating. Only 15 per cent of the dividends a corporation receives is taxed. Here are other cases in which it would be better to take intercorporate dividends than to use other methods:

If you own less than 80 per cent of the stock of a company with large accumulated earnings, you can do this: Have all the earnings declared as a dividend. Then you can liquidate the subsidiary. If you liquidated it first you would pay a maximum of 25 per cent capital-gains tax on your share of the subsidiary's earnings. This might be more than the tax on the dividend.

Even if you can have a tax-free liquidation because you own more than 80 per cent of the subsidiary's stock, it might be better to use the dividend method. The subsidiary's assets may have greatly increased in value. If you liquidate, you take the subsidiary's assets at their low basis. A dividend can push up the value of the assets to fair market value at a low tax cost.

What about mergers of parent into the subsidiary? There are cases where you give the stockholders of the parent the stock of the subsidiary. They may not be tax-free unless a statutory merger is possible. If that cannot be done, there may not be tax freedom, if there is no real transfer of property by a parent company to the merged companies.

But when the parent has properties to be contributed to the merger, we may fairly assume tax freedom. The move is usually made under a plan of reorganization in this way: The parent transfers all its assets except the subsidiary stock and cash to the subsidiary. The subsidiary stock and cash are

distributed to the parent stockholders in exchange for the parent stock. The parent corporation is then dissolved.

Dividing a business into smaller units. Is it advisable to have two or more corporations or partnerships handle your business operations?

Decision to move toward divided entities is sometimes based on the fact that lawmakers favor small enterprises. Sometimes it is chosen to fit into the tax exemptions and credits by which legislation subsidizes smaller companies.

Many business reasons also suggest split-ups. Perhaps it will give the business which is so often developed by smaller units.

But dividing your business may result in the loss of the good features that go with single companies. And it may require more personnel and equipment, thus creating duplication of effort in administration.

Our experiences in many industries often suggest that decentralization allows greater initiative by executives. They know local conditions. They can more readily get major replanning of a business to correct high costs. They may create more sales by adoption of techniques better fitted to local conditions.

Sometimes the split naturally follows the decision to seek a more advantageous economic environment by a division. That is done—

To secure proximity to sales, markets, sources of capital, credit, supplies, abundance of labor, cheaper labor, less unionization, less labor dissatisfaction, greater employee productivity, adequate employee transportation

To make certain of power or water supplies

For less restriction on sales in regulatory legislation, less price control, or less local inspection

To get closer to customers and to cut costs of selling

Or these advantages can be secured by leasing all or part of the corporate assets for part of gross sales, percentage of net earnings, *or* a flat annual sum.

* * *

Normally these steps might be accomplished by a simple division of the business into smaller units. *But tax advantages can make it highly advisable to create two or more companies out of existing organizations.* That may mean two partnerships or two corporations where only one corporation or partnership now exists. This may bring use of the parent-subsidiary company device, or it may be done by having a holding company own stock of another company, or it may be a division of an operating company into two or more parts. Tax considerations cause experts to divide businesses for these reasons:

To claim exemption for some of the tax normally due on certain foreign business. Assume that your corporation does business both abroad and in the United States. Your business abroad is in the Western Hemisphere. If it has gross income from sources within the United States, that prevents it from receiving the tax advantages of a Western Hemisphere company. Dividing your corporation into two corporations will enable one to do all the trading abroad and get the credit.

To save taxes by dividing the income among several corporations. Where earnings are high, a tax saving would result if at least one of the new corporations fits into the favors legislators extend to small companies.

To take out cash or other assets from the corporation. Is all the property in one corporation? Then the liquidation may be costly. If you had your business divided into several corporations you might have an easier time. You could get your property by liquidating one corporation, and pay only a capital-gains tax.

To sell part of the corporate assets. Sale by the corporation and distribution of proceeds results in double taxes. Having the property divided among several corporations might avoid this. (But it is important to avoid a split-up of corporations just before you are ready to sell part of the assets. The transaction might be disregarded by the Treasury as being a sham.)

There is a bar to splitting existing corporations in our present law. Check with your tax experts to find if you satisfy the requirement that a sound business reason warrants the change.

The normal way to split corporations is through use of a subsidiary. But there are other ways to form a separate corporation. One is to create a new company owned by your stockholders in this way: Liquidate part of the property to stockholders so that they may form a new corporation. They pay a tax only upon the fair market value of the property received by them at the time of liquidation. Another method is to pay a taxed dividend in cash to stockholders. It is entirely fair for them to use the cash to purchase assets in an existing company.

Still another method is this: Stockholders have a clear right to use their separate funds to organize a new business. They may even use them to contract with the existing corporation to perform certain services. There is no problem if the payment for services is fair in the light of the previous experience of the corporation. No obligation is on the stockholders to arrange their own and the company's affairs to result in a maximum tax burden.

* * *

What steps should be considered when you form a subsidiary? First is the method of creation. Usually you can create a subsidiary tax-free by trans-

ferring property to the corporation in return for its stock. If the subsidiary needs cash, you can also include it as part of the property you transfer. Or cash could be provided by outsiders in exchange for stock, if you want to bring them in. But if you want tax freedom, check with your experts on the amount of stock the outsiders receive. It must be in proportion to the fair market value of what you and they contribute. Other points to consider are—

The subsidiary can assume liabilities of the parent and still keep the transfer tax-free. (The subsidiary gets no deduction for any of these liabilities it pays.) But the assumption of liabilities must be for a business purpose

The basis for depreciation of assets received from the parent—or to be used in finding gain or loss on a sale—is the same as in the hands of the parent, if the subsidiary is formed in a tax-free transaction

You might hedge against a change in price trend in forming a subsidiary. It might adopt an inventory or other accounting methods different from those used by the parent

You can plan to file a consolidated return to offset a gain of the parent with a loss of the subsidiary—or the reverse. But you would not file a consolidated return if: you and the subsidiary want to use different accounting methods; you do not want to pay the additional 2 per cent tax that consolidation costs

* * *

While thinking of division, note that all transactions between controlled persons in any trade or business get special tax scrutiny. This is to find whether the control is being used to reduce, avoid, or escape taxes. The law gives the Treasury the authority to determine true net income.

Our courts approve the divided companies' activities if their separate books and records clearly reflect the income of the several units. At the heart of many difficult cases seems to be bad accounting. The records should precisely reveal the net income.

The contract between the units must be reasonable. The turning point is the compensation, rentals, or other payments, agreed upon by the parties. They must be arrived at fairly.

In brief, taxes cannot be reduced or avoided by unfairly shifting or distorting income or deductions of either business. That means that sham transactions, or fictitious sales on an artificial basis, should be avoided. Prices used between related companies become very important. Out of our experience come these rules:

The price or fee charged must be the same price that would be charged others for the same service or merchandise

One can make special terms for affiliates only if very good reasons exist, as—

Lack of credit risk

An assurance that there will be no unreasonable return of merchandise

Do not vary the price in proportion to the profits. That prevents the charge of diverting profits. Keep the charge constant

Avoid year-end manipulation of prices or intercompany charges. Have the agreement specific and definite. You can charge each company with a proper proportion of joint expenses like administrative overhead. But this ratio should be consistent and logical. Do not vary the charge with changing profits

* * *

Another point should be stressed concerning intercorporate transactions. If a company expends money for production, promotion, administration, and the like in its own business, it is entitled to a tax deduction. It does not follow, however, that these payments retain their character as business expenses when they are made by the parent of that company. From a common-sense standpoint, there is much to be said for the view that they do retain it. But we are dealing with a technical, arbitrary statute, particularly as to deductions from gross income. We cannot cut corners. The statute requires that expenses be related directly to the company's own business. *We cannot deduct expenses related to some other business, however reasonable that might be.*

Of course, a holding company, having the care of investments and, through voting rights, the control of various subsidiaries, may incur deductible expenses in the conduct of that business. It may make expenditures designed to safeguard its holdings and protect its investments.

If, when paid by the subsidiaries, the expense is of a character to be deductible by them, the deduction is not available to the parent. The subsidiaries are entities distinct from the parent, although their economic advantages redound to the parent's benefit.

* * *

If you have a parent-subsidiary relationship, you may proceed with safety only if the method of business operation is one in which—

Good records are maintained by both companies. The subsidiary squarely stands on its own feet before employees, customers, and creditors

Charges are made by each to the other in exactly the same manner as they would be made to any outsider

The financing necessary to ensure continued operation of a subsidiary is arranged through capital investments

A subsidiary's earnings are regularly distributed as dividends

Tax considerations with any change of form. *Before you make your business change,* you should check with your tax experts to find the present state of the law on this point: Will any successor company pay a tax that would *not* have been paid by the old company?

10. How state taxes affect your business [1]

Any company that intends to do business across state lines at any time in the future must consider new problems. And that means that businessmen will have to do a lot of painful homework in tax law.

The United States, as you learned to say in grammar school, is "one nation indivisible." Generally speaking, that is true. But legally it is not. Taxwise, the United States is a Federal union of 48 sovereign states.

The distinction is important for businessmen. And it is likely to become even more important as time goes on. As a result, a company that does business across state lines does not deal with just one tax authority.

Most companies today think of state taxes as a necessary but comparatively minor business expense. But if present trends continue, state taxes 20 years from now may be as much of a headache as Federal taxes are today.

If that sounds fantastic, stop a minute and think about Federal taxes 20 years ago. Back in the days of the big bull market, all corporate taxes—Federal and state both—took about 14 per cent of total profits. Today, they clip off much, much more.

This comparison suggests to many a state government that it is passing up an easy way out of all its financial troubles. And in the scramble to raise more money, state after state has slapped new taxes on corporations or has tightened up drastically on the application and enforcement of existing tax laws.

Some corporations have discovered recently that state taxes can hit them even harder than the federal levies. This may happen in at least two ways:

1. State taxes on corporate income usually make no provision for a carry-over or carry-back of an operating loss, as the Federal system does. For instance, if your company made $1,000,000 last year and loses $1,000,000 this year, the Internal Revenue Service will let you offset the profit against the loss and claim a refund of Federal taxes on last year's income. But the State of New York will give nothing back on its franchise tax, which is levied against the income earned in any given year regardless of earnings or losses in other years. This rule is particularly

[1] This section is adapted with permission from a *Business Week* report to executives.

tough on new companies. Under Federal law they can carry forward the losses of their first couple of years to offset later profits. Under state law, they can't.

2. As the states scratch for income, many of them are adopting taxes that have to be paid regardless of how the corporation is doing profitwise—for example, taxes on property, gross receipts, accounts receivable, or warehoused goods. Companies will have to scrape up the money even though they are running a deficit.

* * *

It is not so much the rise in rates that makes the state-tax situation dynamite for business. The real threat is the rapid expansion in coverage. And this is doubly dangerous because few businessmen know much about the intricacies of tax law.

If you take a look at recent court decisions in this field, you can see that two things are happening:

1. The courts are gradually widening the definition of what constitutes doing business within a state. And, of course, the more they widen it the more business they bring into the net of the state tax collectors.
2. At the same time, the courts are giving the state governments more and more authority to tax activities that are pure interstate commerce.

As long as a corporation is doing only interstate business it is protected by the charter given it by its own state and by the United States Constitution. But as soon as it starts doing intrastate business within another state it has to come to terms with that state. Otherwise it has no legal standing and lays itself open to a variety of penalties.

All states have legal procedures for giving "foreign" corporations—that is, corporations chartered by another state—permission to come in and do business in their territory. Usually the corporation applies to the secretary of the state, pays a fee, and receives a certificate. This routine is known as "qualification."

After a foreign corporation has qualified in a particular state it has all the rights of a domestic corporation. It can carry on its business. It can use the courts. The state cannot discriminate against it in any way.

The hitch is that the qualified corporation also acquires all the responsibilities of domestic corporations. And that usually means it becomes liable for state taxes.

A good many corporations obviously think that the advantages of qualifying aren't worth the price. They try to set up their operations so that their business will be classified as interstate. The trouble with this is that the

courts have shown a definite tendency to give the benefit of any doubt to the state that says a particular activity constitutes doing business within its boundaries.

Where an unqualified corporation is found doing an intrastate business, it generally cannot use the state courts to collect its debts or bring any other suit that otherwise would be legally all right. Some states hold that contracts made by an unqualified corporation in intrastate business are null and void in so far as the corporation is concerned.

Most corporations would say that getting thrown out of the courts was penalty enough for failing to comply. But on top of that many states slap stiff fines on any unqualified companies that they find doing an intrastate business. State authorities sometimes even have power to imprison officers of unqualified corporations.

Let's say, then, that you don't want to take any chances on doing business within a state without getting properly qualified. How can you tell what sort of activities will count as intrastate business?

Here are some of the things that the courts have held are intrastate business:

Using agents and salesmen who deliver products
Maintaining branch stores or departments in stores
Construction work under contract
Maintenance of equipment within the state
Maintaining stocks of goods (either in your own warehouse or a public warehouse) for shipment to customers in nearby districts
Keeping a stock of repair parts for local customers
Leasing equipment to customers within the state
Aiding local dealers in making sales

You have to remember that state laws are a long way from uniform on this subject. What one tax collector calls interstate business another may say is doing business within the state. And the chances are that both of them can make their rulings stick.

For instance, say that you sell a piece of equipment in a transaction that is interstate commerce in anybody's book. If you then send your men into a foreign state to install the equipment, some will hold that you are doing intrastate business, provided the installation takes no particular skill. Even when the equipment calls for highly technical installation, some will tag it intrastate business if the job requires many and varied operations over a considerable period of time.

Sometimes decisions will turn on points that are so fine no layman can figure them out. Texas courts in one decision held that a foreign corporation which leased shoe machinery was doing business within the state. And

in another case they decided that the lease of voting machines was part of an interstate transaction.

* * *

From a tax standpoint, the distinction between interstate business and intrastate business isn't so important as it used to be. The door is open now for the states to tax activities that are pure interstate commerce. And this is where the state tax collectors are having a field day.

As far back as 1918, the U.S. Supreme Court held that corporations could be taxed, even though they were doing something that did not require them to qualify in foreign states. It ruled that Northwestern Consolidated Milling Co., a Minnesota corporation, was liable to the state of Massachusetts for taxes because the company maintained a sales force in Massachusetts. The salesmen took orders and turned them over to local dealers. The court said that the salesmen were working for the local dealers and that the milling company therefore could be taxed.

That was the beginning. Since then—particularly in the past few years—state collectors have moved bag and baggage into the field of interstate commerce.

* * *

All this means that from now on state taxes will be taking a bigger and bigger bite out of corporate incomes. And as the states move in on interstate commerce, you can expect more and more cases of multiple taxation to crop up. Sales may be taxable in the states where they are made and the revenue from the sales taxed in yet another state where the company has its plant. Or the same piece of property used in two or more states may be taxed in each state.

Corporations will have to get used to the idea of acting as collection agencies for states that levy sales taxes or excises. This means that they will have to pay the expenses of collecting, accounting, and filing the returns.

Even where there is no direct tax liability, states are likely to require informational returns. These may cover such things as withholding taxes on salaries paid by the corporations, payments to individuals for services, and payments to stockholders living in the state.

In most cases, you will find Federal authorities giving the states a hand whenever they can. And the states themselves are beginning to pull together on the problem of tax collection. There is a growing trend to allow the tax authorities of one state to use the courts of another to make collections.

* * *

What can you do about it? The first thing to do is to go into a huddle with your company lawyer. Tell him in detail just how you handle your sales, billing, accounting, and warehousing. Give him a list of all your activities that involve any foreign state even indirectly. And don't leave anything out. Even one trivial activity may make all the difference in your tax liability.

Your lawyer probably will want to make a check with one of the service companies that specialize in the technicalities of this subject. These service companies deal exclusively with lawyers. They maintain contacts in each state, keep posted on legislation and court decisions. The larger ones keep offices in various states to serve as representatives for qualified foreign corporations.

The next step is to take the map of your company's operations and go over it with your lawyer. You can then decide where you will have to qualify for intrastate operations and where you can keep your business on an interstate basis.

Qualification has its advantages. Once you have qualified you have a free hand in the state. You can warehouse goods, make sales, and run your business without worrying about whether or not you are letting yourself in for any unforeseen taxes.

If you have any choice in the way you set up your operations, you may be able to pick states that have a favorable tax system from your standpoint. Nevada, for instance, has just passed what it calls a "free port" law. This practically exempts warehoused goods anywhere in the state from personal property taxes. It is an obvious invitation to corporations doing business anywhere in the West to use Nevada for their warehousing.

After you have decided where you want to qualify and where you don't, you can go over your list of activities looking for chances for legitimate tax avoidance. State laws vary widely. Some are tougher than others. And there are plenty of perfectly proper ways of keeping your tax bills to a minimum.

There aren't any general principles that cover the process of legitimate tax avoidance. Everything depends on the laws of the particular state and the nature of your company's operations.

* * *

Be sure you keep your books so that you know just where to charge all your expenses and revenues. Otherwise you may have to pay state taxes on income that legally should escape. Two cases point up this fact. In one, the court ruled that the tax authorities could not disregard a seller's books and make their own arbitrary estimate of markups; the court said that as long as

the books were there the commission had to follow them. In another, the same court held that Federal income-tax refund claims were taxable assets, when they were shown on the books of the corporation as an asset.

* * *

Sometimes the way you render your bills will make a difference in your tax liability.

In another case, the court decided that where one person sells material and services to another the whole transaction is a single sale and is subject to the sales tax. But if there is a distinct separation on the bill between the amount charged for materials and the amount charged for labor, only the materials are taxable.

In some states where there is no way of ducking the use tax, the only way to protect yourself is to pass the tax along to your customers. Be sure to show the tax separate from the selling price on the bills you send to your customers.

* * *

Double-check all your sales procedures to make sure that they aren't laying you open to unnecessary tax liability. Making all orders subject to home-office approval gives some, but not complete, protection.

Trouble can be avoided, of course, by making interstate shipments directly to customers.

Some states will stick you for unemployment taxes and other levies if you use traveling salesmen who solicit orders, even though final acceptance of the orders comes from the head office. One method of avoiding this type of tax is by limiting your sales in such states to independent agents. But avoid any system that might suggest subterfuge.

If you sometimes send out top executives to clinch big orders, watch your step. The big shot may bring home the bacon, and he may also bring a tax liability along with it.

Conditional sales are another thing to watch. In seven states they count as doing business within the state.

If you sell equipment that requires installation or maintenance, it may be cheaper in some states to turn the work over to some local businessman and let him handle it for his own account.

First and last, remember that the state tax picture is changing. Methods that you have used in the past may lay you wide open to a new set of taxes in the future. The only way you can stay out of trouble is to keep reviewing your operations and changing them as the tax laws change.

Section 2

HOW TO FINANCE A BUSINESS

BY

WILLIAM J. CASEY

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HOW TO FINANCE A BUSINESS

1. The capital structure

The financial requirements of a business will depend upon its scale of operations and its method of marketing. Conversely, the scale of operation of the business and its methods of marketing will be limited and controlled by the amount of financing available to it. Thus the very efficiency and competitive vitality of the business will frequently turn on its financing.

The sound way to develop a business is to get it going on a modest operating scale—enough to achieve the operating economy which it needs to be competitive. Then, after it has proved its right to live, it can be expanded. This kind of a two-step approach will not only minimize risks but enormously simplify financing. Getting the money necessary to launch a new enterprise and getting the money needed to expand a proven enterprise are two very different problems. We shall look at them separately.

Questions which must be answered. In developing any financing plans and seeking financing, these basic questions must be answered to the satisfaction of both borrower and lender—both the person who puts up money and the person who accepts responsibility for using it:

How will the money be applied—to what purpose and on what time schedule?
How will the money turn over, and from what sources will repayment come and on what time table?
Will the use of the money be profitable?
What kind of a return (interest rate or dividend yield or capital depreciation) will it show to the investor?

The first two questions can best be answered by projecting a cash budget. It should be scrutinized carefully to see that all possible contingencies have been considered and allowed for. From the cash budget it can be determined how full repayment will come from amortization of fixed assets, from liquidation of inventory or other assets, and from anticipated profits after tax. Profitability will be shown by a projected-earnings statement—a projection of a profit-and-loss budget as distinguished from a cash budget. The projected profit-and-loss budget together with pro forma balance sheets based

on budget projections will show dividend prospects and potential capital appreciation.

How much financing? An initial budget is needed to show: (1) the probable amount and timing of cash requirements; (2) the kind of balance sheet the company will have on which to attempt to secure borrowed funds as needed; (3) a forecast of the margin required for profitable operations and the probable time needed before the inflow of cash will exceed the outlay, and thus the time needed to repay borrowed funds; and (4) a demonstration that operations will yield profit sufficient to justify the investment.

First, the factual basis for budget projection must be obtained. How long will it take to reach profitable operations—to develop, get in production, and market effectively a standardized product? How long to secure machinery, materials, labor, funds, and sales orders and to organize their flow? What are production and selling costs? What volume is probable—what prices and discounts? A hardheaded investor or lender will dig at all these points and apply a skeptical eye to them. Successful financing requires a conservative estimate of factual factors with strong supporting details, precedent, and comparisons. It is difficult to put forward an exact answer to these questions and to coordinate sales expectations, production runs, the time it will take to lift sales to a point which minimizes production costs, and the rate at which manufacturing, administration, and sales overhead will be absorbed. The difficulties are so great that a high, a low, and a medium budget level may be, and frequently are, developed. The first profitable month and the date of cumulative breakeven can be calculated by drawing up estimated profit-and-loss schedules by month to show how cumulative profits offset cumulative losses.

The cash-requirement schedule is prepared from much the same data. It will show the cash required for capital equipment and improvements, organization expense, acquisition of patents, and such items which do not appear in profit-and-loss schedules. The most important financing function of the cash-requirements schedule is to show the lag or lead on every major item of incoming expense. How soon will customers pay their bills? How soon must machinery be bought, and how soon paid for? How large must inventories run? When must an inventory be acquired, and how soon paid for? How often must payrolls be met? When are insurance or tax payments due? What selling expenses must be incurred before the current sales income materializes? What initial advertising is contemplated, and when must it be paid for?

Careful reflection of these factors in a cash budget may substantially minimize financing requirements or avoid unanticipated shortage of funds. This process must be done so as to determine financial requirements and

to justify a lender or investor in making funds available. The comparison of projected profit and loss in the cash schedule may show the necessity to adapt the operation or its scale so that it will conform with the availability of financing. It may suggest a preservation of cash by forgoing quantity purchase discounts and cash discounts, forgoing the economies of long production runs, holding back on promotion, etc. It will also show how final success creates need for additional financing to achieve profitable expansion. This may have considerable bearing on the character of initial financing, in calling for the holding back of certain stock and collateral for use in raising additional funds later on.

Rule of thumb for estimating financial needs. Carefully worked out budget projections are highly desirable for even the smaller business. Yet rough approximations can be quickly developed from the ratios, profit margins, and turnover frequency which prevail in a particular line of business.

Probably sales volume may be determined from a study of the market. Operating ratios will tell how much net this should yield and how much rent should be carried.

Turnover experience and prevailing markups will tell how much inventory will be needed to do that volume. If the volume potential seems to be $40,000 and in the particular line inventory should turn over four times, money required for inventory will be $10,000 less the trade discount or prevailing margin. If the margin is 35 per cent, $6,500 should acquire beginning inventory. Add to this the rent and operating expenses for a 90-day period, plus the cost of fixtures and equipment.

Another way of going at it is to determine how much profit will be needed to make the business worth while. Determine how much volume that will require. After investigation establishes that the necessary volume can be attained, determine how much inventory and how much equipment will be needed to attain it. If $10,000 profit is needed and the ratio of net to gross is 10 per cent, $100,000 must be grossed and 200,000 units of a 50-cent item must be produced and sold. From there, space, equipment, inventory, and working-cash requirements can be developed roughly. To pin down the flow of cash and other requirements takes one back to budgeting.

What kind of money? In addition to determining the amount of money which is needed, it is equally important to determine what the money will flow into and how it will revolve. Money which will go into buildings and equipment will be fixed capital and therefore will have to come from stock and long-term loans. This money will revolve slowly, and as money invested in fixed assets is turned back into cash via depreciation charges, it can be used to amortize debt or for additional working capital, but always with the proviso that some day it will be needed to replace fixed assets which have

worn out or become obsolete. Money which is required to carry the organization until it is converting money into goods and back again into money fast enough to meet incoming bills should also be part of the permanent capital of a business. Similarly, a reserve of cash to meet emergencies should be part of the permanent capital.

Over and above these requirements is the ordinary daily working capital which the business will need. This is made up of the funds which are put into inventory and payroll, converted by sales into accounts receivable, and then converted back into cash as customers pay their bills.

The importance of adequate working capital is too well known to be labored. It is important to determine how much of the working-capital requirements should be available as permanent capital and how much can be obtained by short-term financing. Where there is a long production or selling cycle and inventory is readily salable, or where there are peak requirements at certain seasons of the year, current financing can be relied upon for much of the working-capital requirements. Where there is quick turnover, working-capital requirements will be lower and a larger portion should come from the permanent capital of the company. There should be careful study, with bankers and other financial advisers, to see that business policies are shaped to bring working-capital requirements in line with available resources and that there is enough permanent financing to sustain the amount of current financing which is anticipated. The amount of capital needed to execute the necessary turnover of the company's operations will depend on how customers pay, on terms set in selling, on terms obtained in buying, on the volume of business and the rate of its expansion, on the time consumed in manufacture, and on the rate at which inventory is turned over. The amount of permanent capital which will provide for safety over and above that needed to acquire fixed assets will depend on how hazardous or how stable the business is and on the practice of bankers in making current financing available to the particular line of business. The planned relationship between permanent financing and current financing, taken together with the way in which money will flow, should be such that the business can be expected to meet the tests which will be applied to determine its credit worthiness when it seeks current financing.

Exactly how these tests will be applied to a particular line of business must be determined by canvassing the outlook with a seasoned banker, but the financial plan must be such that, on the basis of the projection of a cash budget, an income budget, and pro forma balance sheets, it seems likely that they will be met.

The rule of thumb is that the ratio of current assets to current liabilities should not be allowed to fall below 2:1. Where this ratio prevails, liquida-

tion of current assets at 50 per cent of book value will clean off current liabilities. The ratio of current assets to liabilities at 2:1 means that the company, via stock, surplus, or long-term debt, has provided as much of the capital over and above fixed assets as short-term creditors. Thus if a 2:1 ratio is satisfactory in a specific line of business, it follows that to get a specified amount of short-term financing, a business will have to count on having a definite amount of permanent financing over and above that needed to acquire fixed assets.

Then the projection must show that the cash account will bulk sufficiently large compared with total current assets and current liabilities. This again will vary with the type of business, but should not run less than 5 to 10 per cent of current assets. If current debt is to be held at 50 per cent of current assets, cash should run 10 to 20 per cent as much as current debt. There are companies which keep less than 10 per cent cash, and there are companies which keep enough cash to meet current liabilities.

Promoter's interest and control. When a promoter develops a scheme for a new business enterprise, he has three problems which bear on the financing of the operation:

1. He must secure control over key elements needed for the successful development of the enterprise
2. He must secure his own interest
3. He must give sufficient security and income potential to attract necessary financing from investors

In seeking to obtain control over the key elements which the enterprise will probably need, the possibilities are as follows:

Basic idea. Protection of an idea is extremely difficult. It may nevertheless be done through an agreement whereby those who will use the idea deposit cash in trust to be turned over to the contributor of the idea if they exploit the idea within a specified time. It may also be done by an agreement providing compensation to the contributor of an idea if the idea should be exploited, with provision for arbitration of the amount of compensation

Patents and copyrights. Application for a patent or a copyright gives tangible control over an element which may be licensed, or turned in for stock

Options on the acquisition of property, such as a unique location which will be needed by a proposed business. It can be traded in for stock

Leases over real estate needed to develop a proposed business, or an option to lease. These can be traded in for stock

Franchises and concessions from governmental units or private companies

Contracts for the services of individuals with special skill or talent on which a business operation depends

In financing a new business, the promoter may receive stock for his idea, for his services, or for any of the foregoing elements of control which he has been able to secure in lieu of stock. He may prefer to receive an option to acquire stock at an attractive figure. Because of an intimate knowledge of the progress and possibilities of a business, he is in a position to exercise such an option at a time which would be advantageous to him.

In attracting outside financing, those who put up the money are normally given debentures or preferred stock so that they will get the full security available for their investment, so that it is possible to give the promoter a relatively large share of the common stock for his contribution or ideas, control elements, and such managerial skill as he can contribute.

Capital structure. After determining how much money is needed, how it will flow, and the proper balance between long-term and short-term funds, the next step is to determine how money will be raised, the securities which will be offered, and the sources of funds. Many considerations come into play here, and the correct decision will require a judicious balancing of all of them. The final decision is frequently governed by the kind of money which is available and the terms on which it may be had. Nevertheless, it is highly desirable to make a serious effort to formulate the most correct and desirable financial structure. To the extent that the business does not justify the kind of financing thus formulated or that the kind of money needed is not available, the owners of the business will at least know what they want and go only as far from that point as forced by trading necessities. The questions to be asked are—

What financial structure will be most profitable?
What structure will yield the best margin of safety and best provide for future emergencies and possible expansion?
What securities structure will yield the desired control features?
What structure will be most advantageous taxwise?

In most cases the capital structure which shows the greatest profit potential will be least satisfactory as to provision for future requirements. The reverse is also true. This is the kind of balancing which is needed to achieve a desirable financial plan. This balancing should be done even though the ultimate capital structure reflects as much money as can be obtained on a risk basis and as much as can be obtained on a loan basis. Understanding and balancing of these factors are important in selling the investment.

Fundamental economic principles should determine the financial plan. If a plan is formulated which reflects fundamental principles accurately, it will facilitate the obtaining of money from both equity and loan sources. The old rules were that bonds could be issued only when future earnings of a corporation promised to be liberal and reasonably certain; that the preferred stock

would be issued when the earnings were irregular but, over a period of years, promised a fair margin over the preferred stock dividends requirements; that only common stock would be issued when the earnings were uncertain and unpredictable. These principles are no longer automatic, principally because scarcity of equity capital and tax advantages in borrowing have brought about a shift from stock financing to loan financing.

Profitability and capital appreciation. The smallest possible proportion of equity investment (common stock or partnership interest) and the highest possible proportion of debt payable in a fixed amount will produce the highest potential return on capital investment and the largest potential for capital appreciation. This is called trading on the equity. A business borrows money in the hope that it will be able to make that money pay more than the interest rate payable on borrowed capital. Obviously, failure to earn the rate of return higher than interest payable on borrowed money will eat away basic capital and possibly result in creditors taking away the assets of the business.

To illustrate, consider a business with $100,000 in capital stock which can make 10 per cent on capital. If it borrows another $100,000 and maintains a 10 per cent earnings rate on the capital it uses, there will be a 14 per cent return to common stockholders after paying 6 per cent on the borrowed money. If the earnings rate can be kicked up to 15 per cent, common stockholders will receive a 24 per cent return. However, if the rate of earning on the capital employed should decline to 5 per cent, common stockholders will receive only 4 per cent on their capital. If the corporation should earn only 2 per cent on capital employed, 6 per cent will still be payable on the borrowed money and the common stockholders would have their capital dissipated by 2 per cent a year.

Thus we see that the higher the proportion of borrowed capital, the greater the rate of return to equity owners as long as they can make the business show more than the interest rate. As earnings fall below the fixed interest rate, the higher the proportion of borrowed money, the more rapidly the equity owners lose their capital. Increased earning power, inflation, or any other factor which enhances the dollar value of assets will benefit common stockholders exclusively. Owners of fixed-value notes or bonds or preferred stock do not benefit. Thus the owners of the business will profit more from appreciation in value, and lose more substantially and more rapidly, where there is a low proportion of common stock and a high proportion of fixed value obligations.

Safety factors. Maximum safety requires all common stock and no fixed obligations to pay annual interest and redeem loans. Yet debt may be desirable to produce sufficient capital and to maximize income and capital-gain possibilities. A business must therefore determine how far it can go into debt.

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To a considerable extent this will be determined by the caution and prudence of lenders. As a generality, a lender is apt to insist that the borrower have as much money at risk as he has. For practical purposes, this may restrict borrowing to somewhere between 40 and 60 per cent of total capital. Frequently the owners themselves will want to advance money to a business on a temporary basis, and this will make it possible for the proportion of debt to be increased.

The limits of prudence on the proportion of capital to debt will vary with each situation, depending on the stability and prospects of the business and on the experience and financial position of its operators. The following factors will suggest setting a conservative limit to the debt assumed:

Instability of prices and volume
An unusually high burden of fixed costs
A high rate of turnover
A low ratio of profit to sales

By way of illustration, a merchant's business will be well advised to borrow less than an apartment-house venture or a printing plant with a large fixed investment in machinery.

Provision for future requirements. Where a substantial expansion is likely to be necessary or desirable, sound financing calls for a high ratio of stocks to debt to provide borrowing power for future needs. However, should the owners be sure of the prospects and earning power of the business and feel that after some experience and an opportunity to demonstrate profitability they will be able to issue stocks at a higher price, it may be better to hold back as much stock as possible, and to use as high a proportion of borrowed money as is available. Similarly, if a business is successful, capital requirements will almost always increase sharply, and careful consideration must be given to holding back enough stock so that additional stock will be available for expansion financing without too great a dilution of the owner's control and interest.

Control elements. To work out a financial plan that will bring in enough outside money and at the same time maximize control requires careful planning. It is usually accomplished by giving the common stock sole voting power and making the issues small. There is always great danger that control will be lost and the owner's interest diluted when they do not anticipate the scale of financial requirements that successful operation will bring. When those requirements do arise, the owners may have to let go too large a portion of their holdings to satisfy them. A preferred issue is usually used to secure the investor's money when some of the group contribute intangibles in the form of services or special skills or patent rights and are entitled to a

large share of the profits over and above a normal return on tangible cash investment. But here again the owner of the underlying equity stock must look ahead to see that the financial requirements of successful business can be obtained without causing him to lose control and dilute his interest by having to issue so much new stock that his proportionate interest dwindles rapidly. The use of preferred stock permits retention of a more substantial proportion of the common. Later on, when a business has reached a certain size, the issue of additional voting stock may actually strengthen control of the management by making it more difficult for another group to purchase control. (See illustrations on pages 58 and 59.)

2. *How taxes affect financing*

Sometimes wisely, sometimes not, tax considerations have become a dominant force in shaping more and more capital structures. The lower rates applicable to capital gains, the deductibility of interest, the double taxation of dividends, high surtax rates and now the excess profits tax—these are the factors which are steadily increasing emphasis on debt financing. Here's how they operate:

Interest deductibility. In computing taxable income, interest paid out on bonds is deductible while dividends are not. At a corporate tax rate of 40 per cent, $5 must be earned to pay out a $3 dividend. To pay $3 in interest, only $3 must be earned.

Capital gains. In discussing trading on the equity previously, it has been pointed out that maximum gain opportunities result from a large amount of debt and a small amount of equity. The fact that only 50 per cent of a capital gain is taxed at a maximum rate of 50 per cent (a maximum of 25 per cent tax on the capital gain), while tax on ordinary income may go beyond 80 per cent, makes it tempting to risk the dangers in a heavy debt load to shoot for the high capital appreciation which may result from a small capital base. If the owners of a company capitalized at 50 per cent common stock and 50 per cent debt should triple the value of their assets, the value of their equity will be increased by 400 per cent. If they have 20 per cent equity and 80 per cent debt, a tripling of the value of their assets will run the value of their equity up by 1,000 per cent. The fact that this kind of appreciation escapes tax until it is realized and then receives favorable tax treatment has tempted many owners to work on a low ratio of equity to debt capital. The fact that such a low ratio increases the risk of loss and that tax credit for capital losses is restricted severely should work in the other direction, but businessmen tend toward optimism, and the prospect of favorable tax treatment if they win is apt to impress them more than that of an unfavorable tax treatment if they lose.

CAPITAL NEEDS AND USES OF NEW TRADE FIRMS

The U.S. Department of Commerce conducted a survey of retail and wholesale firms entering business in the period 1945 to 1947. Their findings as to the capital required in various lines of business, the sources of capital, the use to which funds were put, and the turnover of investment are highly significant.

Average Initial Investment by Line of Trade * According to 1947 Sales

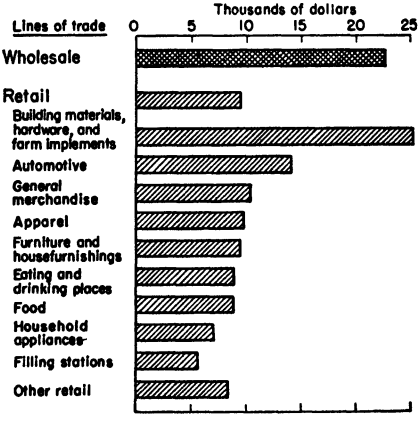


Fig. 1.

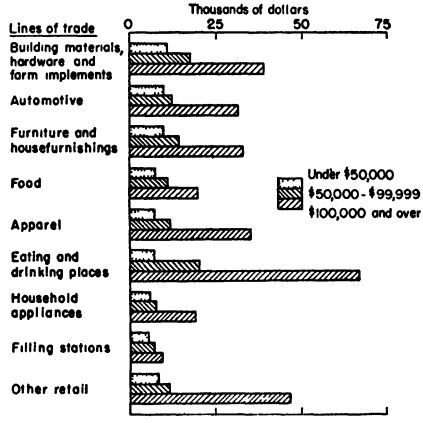


Fig. 2.

* Source of data: U.S. Department of Commerce. Office of Business Economics. The figures for Plant under Uses of Funds include renovation and land.

Among the reporting panel (firms with one or more employees), the average initial investment of renters and nonrenters was as follows:

	Renters	Nonrenters
Wholesale trade:		
Average total investment	$37,200	$114,300
Average plant investment	.....	42,600
Retail trade:		
Average total investment	13,300	23,300
Average plant investment	.....	12,300

As a result of the larger average investment and the additional credit facilities of firms owning plant, nonrenters utilized considerably less personal savings and more bank and mortgage credit than did renting firms.

Sources and Uses of Funds *

Retail

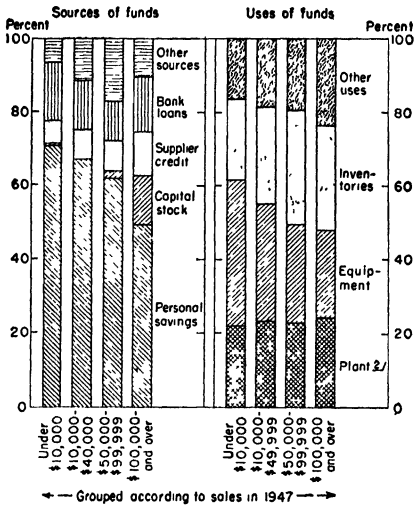


Fig. 3.

Wholesale

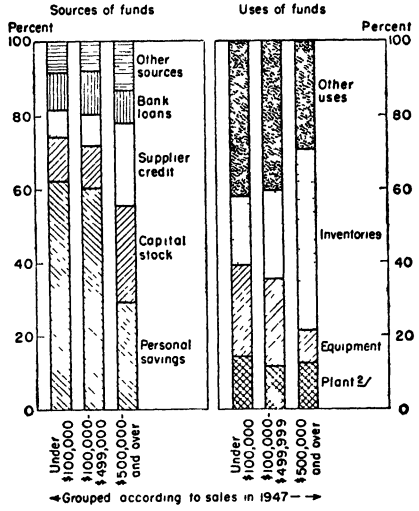


Fig. 4.

* Source of data: U.S. Department of Commerce, Office of Business Economics.

Turnover—1947 Sales per Dollar of Investment

Line of trade	Initial investment			
	All firms		Renting firms	
	Under $10,000	Over $10,000	Under $10,000	Over $10,000
Wholesale	40.0	16.4	40.0	21.6
Retail	9.4	5.6	10.4	6.5
Automotive	18.4	9.5	19.5	13.0
Building materials, hardware, and farm implements	6.3	7.7	6.5	8.6
Filling stations	11.3	4.3	15.3	7.6
Food	12.0	5.9	13.2	7.8
Household appliances	9.7	4.9	11.2	5.3
Apparel	6.5	5.6	6.6	5.7
Furniture and house furnishings	9.6	4.8	9.9	5.4
Other retail	7.4	4.5	7.7	5.1
General merchandise	10.2	3.9	11.0	4.2
Eating and drinking	6.2	2.9	7.4	3.2

Early tax-free recovery of investment. If a business is successful, it can pay off its debt out of earnings after the corporate tax without incurring a second tax on the payment. On the other hand, when a business pays out dividends on common stock and even when it retires a portion of its common or preferred stock by returning the capital which it received for issuance of the stock, the repayment is likely to be taxed to the recipient as ordinary income to the extent that the corporation has accumulated earnings and profits. Debt capital offers much more promise of easy, quick, and tax-free repayments and recovery of the investment than does equity capital.

Debt pay-off saves taxes, builds equity. Double taxation of corporate income—when earned by the corporation, and again when paid out as dividends to stockholders—places a premium on using corporate earnings to build up the corporation's asset value. If corporate earnings are not paid out to be taxed a second time as dividends, the government may be able to impose a penalty tax on the corporation unless the earnings accumulated are required in the operation of the business. Retirement of debt is usually a valid reason for refraining from dividends. Thus the existence of outstanding indebtedness permits the use of earnings to build up equity value by paying off debt rather than for distribution into high surtax brackets.

Relative Cost of Equity and Borrowed Money (1949)

(Cost of $500,000 of new equity vs debt capital)

Capital structure (after flotation):	*Company A*	*Company B*
Bonds, 3 per cent coupon	.....	$ 500,000
Common stock	$ 950,000	450,000
Surplus	50,000	50,000
Total capital	$1,000,000	$1,000,000
Earnings for current year:		
Before taxes and fixed charges	$ 100,000	$ 100,000
Less bond interest	.....	15,000
Before Federal income taxes	$ 100,000	$ 85,000
Less income taxes (38 per cent)	38,000	32,300
After Federal income taxes	$ 62,000	$ 52,700
Less dividends on common stock at 7 per cent	66,500	31,500
Balance transferred to surplus	$ 4,500	$ 21,200
Charges applicable to new capital:		
Interest on bonds	.....	$ 15,000
Additional income tax	$ 5,700	
Dividends on additional stock	35,000	
	$ 40,700	$ 15,000
As a per cent of new capital raised	8.14 per cent	3.00 per cent

Equity build-up via thin corporation. The tax cost of operating a business earning any kind of income as an individual or a partnership is well known,

and there are perhaps few businesses running to any size which are not incorporated. However, as soon as a corporation gets into good liquid shape, the tax costs are apt to be as high or even higher under the pressure of the double tax on corporate profits and dividends, plus the 102 penalty tax designed to force distribution. This can be delayed, and the tax advantage of the corporation can be prolonged, by creating a "thin" corporate structure—one well laden down with debt, so that the corporate funds can be used to build up equity by discharging the debt, rather than distributed at expensive individual tax rates. An article by M. R. Schlesinger, in the November, 1947, *Harvard Law Review,* does a good job of tracing out the financial advantages of a corporate structure laden with debt over one which is debt-free. We quote from the author's comments on an infant corporation with the following opening balance sheet:

Assets		*Liabilities*	
Cash	$ 25,000	Accounts Payable	$ 30,000
United States Bonds	75,000	Miscellaneous Current Liabilities	70,000
Accounts Receivable	50,000	Bonds	150,000
Inventory	100,000	Capital	50,000
Real Estate	40,000	Total	$300,000
Miscellaneous Assets	10,000		
Total	$300,000		

Now we will assume, conveniently, that the neophyte corporation experiences eight years of operations, netting exactly $50,000 in each year, continuing to incur a 38 per cent income tax liability, and realizing after taxes about $250,000. If the taxes have all been paid, and if the noncash assets and the liabilities of the corporation are the same at the end of its eighth year as at its inception, this $250,000 surplus will be reflected by an increase in cash from $35,000 to $275,000.

As the final step resulting from its initial foresight in incorporating thin, the corporation will redeem its $150,000 of outstanding bonds. The $100,000 balance of the $250,000 cash increase will be left in the business, thus replacing, as it were, the $100,000 withdrawn from the business prior to its incorporation. After the bond redemption, the balance sheet will read the same as did the proprietorship statement before any assets were withdrawn from the business, except that the individual owner's capital account will show as corporate capital and surplus:

Assets		*Liabilities*	
Cash	$125,000	Accounts Payable	$ 30,000
Accounts Receivable	50,000	Miscellaneous Current Liabilities	70,000
United States Bonds	75,000	Capital	50,000
Inventory	100,000	Surplus	250,000
Real Estate	40,000	Total	$400,000
Miscellaneous Assets	10,000		
Total	$400,000		

If followed by a period of earnings such as we have imagined above, the thin incorporation will have resulted in two significant tax advantages: (1) the stockholders will have withdrawn from the business $250,000 entirely free of income tax to themselves; (2) the thin corporation may have postponed its day of reckoning under Section 102. The first advantage is based on the premises that both the $100,000 withdrawal from

the individual business and the later $150,000 bond redemption are not taxable income. We shall examine both premises later in this paper and conclude that under certain circumstances these receipts might be taxable. Since these tax possibilities can be guarded against and probably avoided, it may be assumed for present purposes that the $250,000 will be received free of any individual tax burden.

It is revealing to consider at this point how much business a "thick" corporation, originally capitalized for $300,000, would have to do in order to net its stockholder $250,000 in pocket after taxes and maintain its net worth at $300,000. We have assumed that the sole stockholder's salary and outside income bring him $20,000 a year, on which an income tax of $5,890 results. To net him $250,000 after taxes, the thick corporation will have to pay him approximately $1,032,000 in dividends. This assumes that the dividends are paid out at the rate of $129,000 per year for 8 years. In order to pay both that $1,032,000 and its 38 per cent income tax, the corporation will have to derive a net income of about $1,665,000 as compared to the $400,000 required of the thin corporation to obtain the same results. (This does not provide for additional working capital required.)

As the final step in determining the in-pocket advantages of a thin corporation, we may contrast the volume of gross income required of a thick corporation to equal the performance of a thin one. We may assume that the business, once it has attained a net annual income of $50,000, adds to its net income 10 cents of each dollar of added volume. Since the conventional corporation needs $1,265,000 more net income than its flimsier companion, *it will have to gross $12,650,000 more!*

The Treasury is well aware of this situation and is now making substantial efforts to nullify the advantages of heavy debt, particularly where a company is financed with a sliver of equity and a mountain of debt. However, there remain important financial and tax advantages in a capital structure which makes full use of the basic credit capacity to which a projected business is entitled. There are valid reasons for the organizers and owners of a new business to limit their risk by putting up part of the money required as a loan rather than a stock investment. In deciding how far one should go in taking loans from stockholders, care must be exercised not to impair the new company's present and future credit position. The counsel of an experienced tax man should be obtained to be sure that the corporation's capital structure is not being set up in such a thin layer of equity as to constitute an invitation to the tax authorities to question the legitimacy of the debt financing. Mr. Schlesinger's article in the *Harvard Law Review* offers a good picture of the potential complications on this score.

Capital requirements vs. income. From the standpoint of the investor in the corporation, a thin capital structure will offer opportunity to accrue capital gain which need not be taxed until realized, and which when realized is taxed more favorably than dividends received from the corporation. If the corporation is launched with $100,000 of debt, roughly $165,000 can be earned before corporate taxes and used to retire that debt. This will produce a capital appreciation of $100,000 for the investor which will not be taxed until and unless he sells his stock, and then the tax on $100,000 appreciation will not exceed $25,000 under present rules. If the investors are in the 50 per

cent bracket, on the other hand, and the corporation is formed without debt, the same corporate earnings before taxes would be taxed immediately when distributed as dividends to them and the tax would be $50,000 or more. Another way of looking at it is that subsequent earnings would be distributed over a smaller capital base after debt has been paid off, whereas if equity is used exclusively, subsequent earnings will continue to be distributed over a larger capital base. This may make a substantial difference in the values at which the two investments would be appraised over the long haul.

Recovery of capital via bonds vs. stock. A further major reason for putting money into a business enterprise as a loan rather than as a stock investment is that it is very much easier to get the money back when one has made a loan. A stockholder receives repayment of a loan without tax. When even preferred stock is retired, there is grave risk that it will be considered essentially equivalent to a dividend distribution by the Treasury and treated as a fully taxable dividend. Thus a corporation would have to earn $165,000 before corporate taxes in order to return $100,000 of capital to a bondholder. But to return $100,000 of capital to a stockholder in the 50 per cent bracket, a corporate business might have to earn as much as $330,000 before corporate taxes. Again there are technical pitfalls in designing a proper ratio between equity and debt, and in designing the instruments of debt so that they are not likely to be construed as equity. Only experienced tax counsel will afford protection from these pitfalls.

What an investor buys and risks after taxes. In seeking capital with which to finance a business, it is important to understand the psychology of people with accumulated savings, to know exactly what a successful investment will mean to them after taxes, and to know the special significance which a sharply graduated income tax structure gives to the loss of capital already accumulated. The greatest appeal which may be offered to many investors is that of achieving a capital gain which will not be taxed until realized and which then receives favorable tax treatment. The return on dividend income is substantially reduced by taxes, so that in presenting an investment it is important to capitalize the dividend which may be hoped for, and, as suggested above, to offer a capital structure which promises a build-up of equity (by the retirement of debt or otherwise). For example, to a man in the $50,000 surtax bracket, an investment in a corporate business which will earn 20 per cent before taxes will mean only a return of a little over 4 per cent after corporate and individual tax. But it will mean a 12 per cent return before individual tax, and if this can be capitalized at 8 per cent it will mean a 50 per cent capital gain, which will be much more interesting than a 4 per cent annual yield after taxes.

The reduction of reward effected by the income-tax structure has made

Net Returns and Losses of Investors * (1949 Tax Rates)

Net return to an individual from investment in—					Years † it would take to recover the loss from a bad $10,000 investment from the income of a good $10,000 investment in —		
Surtax income before investment	Common stock of corporation earning 10% before Federal tax, %‡	Proprietorship earning 10%, %	6% bond, %	3% bond, %	Corporate stock where 10% was earned before Federal tax, %	6% bond, %	3% bond, %
$1,000	5 17	8 34	5 00	2 502	17 7	18 3	36 6
2,000	5 00	8 064	4 838	2 419	18 1	18.7	37 4
4,000	4 78	7 712	4 627	2 314	18 5	19 2	38 4
6,000	4 56	7 36	4 416	2 208	19	19 7	39 4
8,000	4 34	7 008	4 205	2 103	19 7	20 3	40 6
10,000	4 13	6 656	3 994	1 997	20 2	20.8	41 6
12,000	3 85	6 216	3 73	1 865	21 1	21 8	43 6
14,000	3 64	5 864	3 518	1 759	21 8	22 5	45 0
16,000	3 47	5 60	3 36	1 68	22 4	23 2	46 4
18,000	3 31	5 336	3 202	1 601	23	23 8	47 6
20,000	3 14	5 072	3 043	1 522	24 1	24 8	49 6
22,000	2 98	4 808	2 885	1 443	24 8	25 7	51 4
26,000	2 82	4 544	2 726	1 363	25 8	26 7	53 4
32,000	2 65	4 28	2 568	1 284	26 9	27 8	55 6
38,000	2 44	3 928	2 357	1 178	28 5	29 5	59 0
44,000	2 27	3 664	2 198	1 099	30 2	31 2	62 4
50,000	2 11	3 40	2 04	1 02	31 8	32 8	65 6
60,000	1 94	3 136	1.882	0 941	33 7	34 8	69 6
70,000	1 78	2 872	1 723	0 862	36 1	37 3	74 6
80,000	1 62	2 608	1 565	0 783	39	40 3	80 6
90,000	1 45	2 344	1 406	0 703	42 4	43 8	86.6
100,000	1 34	2 168	1 30	0 65	45 3	46 8	93 6
136,719	1 22	1 968	1 18	0 59	49	50 7	101 4
150,000	1 16	1.877	1 126	0 563	51 1	52 8	105 6
200,000	1 11	1 787	1.072	0 536	53 1§	54 8§	109 6§

* Prepared by the author in collaboration with L Robert Driver.

† The last three columns show the number of years it would take for the income (at rates shown) on a good investment of $10,000 to equal the loss of a similar investment of $10,000 which was lost. Due allowance has been made for the tax saved by being able to charge off $1,000 a year for 5 years.

‡ This is where an individual bought a stock earning 10 per cent on the price he paid before deducting the Federal corporate-income tax. Since the corporate tax is 38 per cent, the greatest gross return the stockholder could get would be 6⅓ per cent. The return in the several columns is the net return after the individual's Federal income tax.

§ The number of years would be more if the investment were larger. The reason for this is that, on an investment of $10,000, the $5,000 which could be charged off at the rate of $1,000 a year is one-half the investment. If we assume that the investment was $100,000, it would take the investor in the highest tax bracket 86.6 years, 89.4 years, and 179.8 years, respectively, to recover the loss.

many people lose interest in risk investment, but a more powerful lever in that direction is the difficulty in replacing lost capital. Thus if a man with a surtax income of $50,000 lost $10,000 in an unsuccessful risk investment, he would have to receive 3 per cent on a good $10,000 investment for over 65 years in order to make up his loss. That is a long sentence, and it will take ingenuity to raise capital for a risk investment in the face of the degree to which the reward is reduced by taxes and the risk multiplied by the difficulty of replenishing loss. The table on page 64 shows how the return and loss factors work after taxes for individuals in the various surtax brackets.

3. *Equity financing—ways and means*

The investment banker. The investment banker undertakes to funnel the savings of the public into productive use. An experienced investment banker will be of great value in developing the most desirable financial structure. In formulating the correct ratio between common stock, preferred stock, and bonds, between long-term and short-term debt, he will be able to contribute seasoned experience in appraising the immediate and future financial need of business ventures and also an up-to-date knowledge of what types of securities and what rate of return will attract public funds.

Ordinarily the investment banker does not invest any of his own funds. He is a middleman or an agent in procuring the funds of the public. He may underwrite an issue, that is, guarantee that it will be sold and that he himself will buy any portion to which the public does not subscribe. On companies which do not have an investment record, it is more likely that he will limit his commitment to undertaking to sell the company's securities to investors, without committing himself to purchase any shares which the public does not take up within a specified time period. In almost every city in the United States there are security dealers who may undertake to sell a new issue of common stock to the local investing public. It is the business of these security dealers to know and appraise companies and their securities and to be in touch with local investors. Most local security dealers do not underwrite or purchase securities for resale to the public. They limit themselves to an agency basis under which they undertake the sale of securities on a best-efforts basis.

Cost of flotation. The cost of selling securities to the public, whether common stock, preferred stock, or bonds, goes up sharply as the issue becomes smaller. The two main reasons for this are that a larger issue absorbs fixed costs such as printing, legal fees, etc., over a larger number of securities and dollars. Also the smaller issues are likely to come from companies whose investment merits are unproved and therefore require more costly and intensive selling efforts. For the three years 1945 to 1947, studies of the Securities

and Exchange Commission show the following percentage costs for floating issues of various kinds:

Cost of Flotation as a Per Cent of Gross Proceeds, Three Years, 1945 to 1947

	Size of flotation, millions								
	Under $0 5	$0 5 to $1 0	$1.0 to $2.0	$2 0 to $5 0	$5 0 to $10 0	$10.0 to $20.0	$20 0 to $50.0	$50 0 and over	All Sizes
Common stock:									
Commission and discount	24 39	15 55	12 30	8 24	6 67	7 64	7.88	..	8 77
Other expenses	4.59	3 01	2 05	1 25	0.91	0 67	0 33	.. ..	1.13
Total	28.98	18 56	14.35	9.49	7.58	8.31	8 21	....	9.90
Preferred stock:									
Commission and discount	...	9.20	8.32	4.59	3 37	2.80	3.15	2 00	3.43
Other expenses		3 04	2 16	1.19	0 88	0 68	0 44	0.25	0 75
Total	....	12 24	10.48	5.78	4 25	3.48	3.59	2.25	4 18
Bonds:									
Commission and discount	4.98	6 44	3 18	1 58	0 98	1 26	1 01	0 65	0 88
Other expenses	1 74	3 58	2 06	1.26	1 06	0.69	0.51	0 43	0 55
Total	6 72	10 02	5 24	2.84	2 04	1 95	1 52	1 08	1 43

Commissions and discount go to pay for the services of the underwriter and his salesman for their time and effort in digging up people with savings to put in a business venture. Principal expense items are legal fees, accounting fees, engineering and appraising, printing and engraving, Federal and state stamp taxes and fees, and payments to trustees and transfer agents.

Securities and Exchange Commission. The Federal Securities Act of 1933 seeks to protect investors by requiring companies which offer securities for public sales to disclose financial and other information about the company's business, its principals, and the securities to be issued. It also prohibits misrepresentation and other fraudulent acts and practices in the sale of securities. Disclosure of information is provided by the filing of registration statements with the SEC and by requiring delivery of an informative prospectus (selling circular) based on the registration statement. Issuance of common stock and other securities may be exempt from SEC requirements if it fits into one of these categories:

Private offerings to a limited number of persons
Offers to the residents of a single state by companies organized and doing business in that state
Offerings not in excess of $300,000 made in compliance with specified conditions laid down by SEC

The fraud provision of the law applies to all sales of securities in interstate commerce or by use of the mails, whether or not they are exempt from registration.

In general, the registration forms call for disclosure of information such as (1) description of the registrant's business and its development, (2) description of the significant provisions of the security to be offered for sale and its relationship to the registrant's other capital securities, (3) information as to the management, how much it is paid by the registrant, and what dealings it has with him, and (4) certified financial statements, including a balance sheet, profit-and-loss statements for a 3-year period, and detailed supporting schedules.

Private sources. Small business needing capital of under $100,000 rarely obtains it by selling shares to the general public, nor is it economical for a small business to seek capital that way. Such enterprises depend to some extent on bank borrowing and trade credits. For the equity money they look to their own personal savings, to friends and relatives, to a limited number of local businessmen who may be ready to go into a new venture, and sometimes to companies which they supply or services to which they constitute an outlet. Companies sometimes get equity money from employees, from their customers, and from dealers and suppliers.

Common stock. The individuals who buy the common stock of a corporation bear the ultimate risk. It is they who will enjoy the major fruits of its success or take the first loss of its failure. An individual bears this risk of buying common stock in the hope and expectation that his investment will be secured by the assets into which his money will be converted and that the enterprise will create enough value to pay him a return on his money. As a common stockholder he gets no guaranty of return or rate of return, and he will not receive anything until interest has been paid to creditors and dividends to preferred stockholders, if any. For assuming the brunt of the risk, an individual putting his savings into common stock usually wants some expectancy that earnings available for common stock will be enough so that, after the enterprise has proved its capacity to earn, less venturesome individuals will be willing to pay more for his stock and take a smaller but now more assured rate of return. That's how capital values are enhanced as earnings mature and the risk is shaken out of an enterprise. That's why an investor

in the common stock of a new enterprise wants to see that the business may be capable of earning more than a normal investment return. That's why, in offering common stock to prospective investors, it is necessary to project a possible and a probable rate of return. A cautious investor will want to see that prior charges will be serviced and that he will get an investment return on his money if the business, for example, operates at from 50 to 75 per cent of its capacity. The working figure will vary with the risk element in the enterprise and the stability of the particular line of business. Such prudent discounting of maximum results should be presented to give the investor some degree of safety. Then, the compensation for remaining risk will have to come from the prospect of substantial profit and capital appreciation, if the business should exceed the discounted level and achieve maximum volume and profit ability. In judging the rate of return which will be attractive to investors, one should compare the probable investment yields with those shown by profitable companies. At a time when going companies with years of successful experience are selling at a price where the established dividend rate yields 8 per cent, it will be necessary to show the prospect of a substantially higher return in order to interest a prudent investor in taking the risk of an unproved enterprise. When securities are selling below their book value and at a price where dividend rates show a high rate of return on money used to buy securities available and salable on public exchanges, it becomes very difficult to raise money for a new company or to expand an existing company without seriously diluting the equity of present stockholders.

Preferred stock. Investors may be more willing to put capital into an enterprise if they are given a prior right to dividends and a first claim on assets if the business should be terminated and liquidated. This is accomplished by issuance of preferred stock. In financing a small company, preferred stock may be particularly appropriate where the individuals who are to be active have put up only a small proportion of the available money. Investors who are not to be active may be given a participation in the ultimate success of the business by buying common shares at a relatively low price and may also be given priority as to the major portion of their investment by the issuance of stock preferred as to dividends and distribution.

There are many varieties of preferred stock. It may be cumulative or noncumulative. If, when a company fails to pay the prescribed rate of dividend on preferred stock, the arrears are accumulated and the accumulation must be paid before dividends can be declared on the common stock, preferred stock is said to be cumulative. If dividends on preferred stock are payable only as earned, and failure to pay the dividend in any one year does not create any obligation to make up the deficiency in subsequent years, a

preferred stock is said to be noncumulative. Preferred stock may be callable or noncallable. If, at a specified time, it may be retired upon payment of a specified redemption price, a preferred stock is said to be callable. If it carries no such provisions, it is noncallable. A preferred stock may be participating or nonparticipating. It is participating if it is provided that after the common has received a specified rate or amount of dividends, additional dividends are to be shared with the preferred on some specified basis. The participation itself may be limited so that after the preferred receives a specified dividend over and above the required rate it no longer shares in profits beyond that point. If the preferred stock is to receive only the specified rate of dividend and that is the limit no matter how high the dividend on the common, then it is a nonparticipating preferred stock. The issuance of a preferred stock may provide that a sinking fund is to be established to redeem the preferred stock. The requirements and existence of a sinking fund usually improve the attractiveness and the value of a preferred stock.

Conversion privileges. If the ordinary limited returns upon preferred stock or upon bonds is insufficient to attract investment money, a further attraction may take the form of conversion features. This privilege permits the holder to convert his stocks or bonds into a stipulated number of common shares whenever he believes that it is to his advantage to do so within specified time limits. Thus, in addition to a prior claim on earnings and assets, the holder of a preferred stock or bond can be given a participation in the appreciation of value which will come to the common stock if the business is successful. Whenever the value of common stock exceeds the rate at which preferred stock can be converted into common, sufficiently to compensate the holder for the priority he gives up, the conversion option will normally be exercised. If a preferred stock has a face value of $100 and is convertible into four shares of common, the preferred stockholders get an extra run for their money because, when the value of the common stock moves beyond $25 and looks as though it will stay there, a profitable conversion can be made. The existence of a conversion privilege is frequently considered a sign of financial weakness. It is an indication that the company could not obtain funds entirely on its own credit standing. On the other hand, when conversions are made, a company strengthens its financial structure because it is relieved of fixed charges and enhances its equity base. Its capacity to issue new securities to meet emergencies and to expand is improved. The trick in using conversion privileges to advantage is to place the price at which the privilege may be exercised low enough to make it attractive, and yet not so low that it will unduly dilute the per-share value of the common stock and so injure the position of the original holders of common stock. The conversion price must be placed somewhat above the market price of the common stock

at the time the new security is being sold. If it is placed too high above the prevailing market price, its value in attracting investors to the new security is diminished. If it is placed too close to the market price, the present common stockholders will share the profits from the risk they have been bearing at too early a date. If a preferred stockholder has the option of acquiring common stock at $50 per share, and the stock appreciates to $80 before any conversions are made, the conversions will dilute the value of the equity and bring the per-share value of the common stock down below $80. Earning power per share will be similarly diluted because a given level of earnings applicable to common will have to be shared with that many additional holders of common stock. The interests of the common stockholders may be protected to some extent by so arranging the conversion privilege that the conversion price will be raised by gradual steps over a period of years.

Sale of additional stock to stockholders. Going concerns generally finance their expansions by offering, at least initially, new common stock to existing stockholders. Most corporations have charters which give existing stockholders preemptive rights on the issue of additional common stock. This is done in order to give stockholders an opportunity to preserve their control and their share of surplus and goodwill. The new stock is offered for less than current market or book value. The technique of offering existing stockholders privilege subscriptions to new stock usually involves the issuance of rights or warrants. Such rights are readily transferable and have a market value that depends upon the spread between the market price of the stock and the subscription price at which the rights may be exercised. An offer of a security by the issuance of rights to existing stockholders may be underwritten by investment bankers. The offering of subscription rights will fail if the market price falls below the subscription price during the subscription period. This risk may be calculated and hedged in these terms:

The issue must be small enough to be absorbed. Existing stockholders are much more likely to absorb another 10 per cent addition to outstanding stock than a doubling of outstanding stock. For this reason, it may be desirable to spread an expansion program over a period of years and offer rights in a succession of small amounts rather than in a single large offering.

The greater the spread between market price and the price at which new stock may be acquired, the greater the chance that the market price will stay above subscription price and that the offering will be a success.

The investment quality of the stock, its market performance of the past, and the general business outlook must be gauged. Finally, the distribution of stock holdings, the kind of stockholders (wealthy, medium, or small; safety-minded or speculation-minded) and the size of their holdings must be carefully evaluated.

Employees as stockholders. There's been a marked revival of stock offerings to employees in big corporations. Dow Chemical, United Air Lines, Westinghouse Electric, Jewel Tea, Sun Oil, and several others have made substantial offerings to employees in the past year. In almost every case there's been real interest and broad participation from run-of-the-mill workers.

The principal motive lies in employee relations; acquisition of capital has been a secondary consideration. Most companies experienced in stock-purchase plans say that stock ownership has developed loyalty, heightened cooperation, and generally increased productivity.

In smaller companies the financing angle may be all-important. Stock sales to employees are often the most convenient and inexpensive method of building up cash funds. Although the money comes in slowly (and technically you're not adding to capital account until each share is fully paid for) your credit position may be strengthened by the fact that a successful plan is operating.

Few people realize the extent of employee ownership in a variety of successful large and small companies. Almost 20 per cent of Sears Roebuck stock is owned by the 81,000 members of its saving and profit-sharing fund. A prominent New England lumber firm, a successful northeastern metal-processing firm, and a large New York commercial laundry have all used employee purchase plans for many years; today the employees constitute the principal minority interest in these companies.

Any plan has to be tailored to individual circumstances, but there are certain features which should be incorporated in any stock-purchase plan designed for broad employee participation:

To be productive from the employee-relations standpoint, the plan must provide for *broad* worker participation. Many companies allow only the executive group to buy stock on attractive terms. While this is a sound way to provide management incentive, it fails to build morale down the line; it can even be a drag on general employee relations.

Eligibility should be limited to employees with reasonable length of service—a minimum of one or two years. It is also well to restrict the amount of stock for each employee, with a maximum such as one share for each $200 of annual earnings. The sour experience of employee stock-purchase plans in the period 1925 to 1935 proves the wisdom of limiting participation to a reasonable portion of the worker's total savings.

The open subscription period should be long enough (at least a month) so that employees can consider the plan carefully. A definite limit on subscription time and amount of stock simplifies bookkeeping and provides an effective control mechanism.

Price should be set at some discount below the going market price or valuation; around 10 to 15 per cent is a sound figure. This makes the offering attractive to employees and actually costs you less than the average public underwriting of a small stock issue.

The plan must allow for liberal installment purchases; payments should be spread over a sufficiently long period so that they aren't burdensome. A weekly payroll deduction of $1 or a monthly deduction of $5 has proved a workable figure. The payment period can be extended to 3 or 4 years, but it's a good idea to require a down payment of a few dollars per share.

It's advisable to credit the employee with a modest rate of interest to put the installment purchase account on the same basis as a savings account. Some firms credit dividends on the number of shares applied for and reserved.

Provide for closing out the account in the case of employment termination. Where the stock is publicly traded there isn't much problem; you can simply refund the balance in the worker's account and offer to buy back the shares already in his name. But in a closely held company the stock purchase application should provide for reacquisition by the company.

Be sure that the offering prospectus points out the risks of stock ownership. Employees must clearly understand that in return for the benefits of ownership they are assuming the normal risks inherent in equity ownership. Some companies even give the employee a period to reconsider his purchase each time a share is fully paid for and ready to be registered in his name; if he wants to back out, his payments are refunded in full.

Stock purchase plans are often tied in with a profit-sharing arrangement, especially in smaller companies. Typically, this provides that a set percentage (around 20 per cent) of net income *after dividends* will be used to purchase stock through an employees' stock-purchase fund. Individual ownership is determined according to a formula based on annual straight-time earnings and length of service. Some plans provide for company participation through direct payments to individual employee accounts ($1 for every $5 or $4 paid in by employees).

Any closely held corporation considering an employee stock-ownership plan must realize that "corporate privacy" will be lost. Outside ownership always raises the possibility that you'll be called on for a considerable amount of financial information on your business. This is true even if the offering is small enough so that you're exempt from formal SEC registration.

Intercompany financing. It is not uncommon for large companies to give financial aid to smaller companies to whom they sell or from whom they buy. The advances of the larger companies in such cases are not viewed as investments that return a yield but as a common-sense method of promoting an

outlet for goods or of preserving a source of supply. In a seller's market the flow of funds is from large companies to small company suppliers. In a buyer's market the flow is from large companies to smaller company customers.

Investors with an interest hope for more than a satisfactory return on their investment. As a rule such an investor looks forward to a long period of mutually profitable trade transactions between himself and the debtor. More often than not, the profit to be derived from these transactions dwarfs the return promised on the investment and renders safety a matter of secondary importance. Back in 1903 a certain large mail-order house advanced $30,000 to one of its suppliers. The eyes of the officials who decided upon this advance were focused not on the interest charged on this loan but on the profits that would accrue to the larger company from the sale of the debtor's product during the course of the next 50 years. An economic by-product of this particular loan was the conversion of a small struggling producer into the world's largest manufacturer in the line. Today the company boasts nine factories and four display rooms. A portion of its product is still marketed through the mail-order house, but it also sells to a large number of independently owned retail outlets, many of whom owe their existence to the aid given them by the manufacturer.

There are three types of intercompany aid:

1. The most common form of intercompany financial aid grows from the practice of selling merchandise on credit. When the seller himself cannot afford to finance the sale, he often takes the buyer's note for discount. In this way his credit standing causes bank credit to be made available to buyers who normally would not be able to demand bank accommodation. Examples of seller financing through intercompany loans are easy to cite. It is common practice in the automobile field. Most of the large trucking companies that exist today started when a driver made a down payment on a truck, agreeing to pay off the balance on an installment basis. Small road contractors frequently purchase equipment in this manner. The chief disadvantage of ordinary trade credit is that, like bank loans, it is short-term credit and must be renewed from time to time. If business activity declines, the supplier of the credit may become alarmed and curtail his aid, and this would deprive a small business venture of credit at a time of its greatest need. The only restraining influence on such curtailments is the desire of the larger company for a continued outlet for its goods.
2. Of much greater value to a small company is a grant of credit by one of its suppliers for purposes other than to finance a sale by the latter and on terms such as do not make it necessary to renew the contract periodically. Examples of such advances are purchases by large com-

panies of the common stock, preferred stock, or long-term bonds of a smaller company. The interest of the larger company in such cases is almost always to conserve or to strengthen an outlet for its own products. Thus in 1939 we find a certain large oil company purchasing $400,000 of the 3 per cent notes of a national trucking company. During liquidation proceedings for a prominent furniture company, it was revealed that a large radio manufacturer (who was a customer of the furniture company) and a certain truck company (who sold transportation services to the furniture company) had jointly advanced the company $950,000 of funds. The pages of Moody's Investment Manuals contain numerous examples of companies that have purchased the stocks and bonds of the smaller companies to whom they sell.

3. It is even more common practice for large corporate buyers to extend financial aid to smaller corporate sellers, the motivating interest of the larger company being to conserve and to strengthen an important source of supply. The effect is often to develop the weaker company into a strong producer. An officer of a large mercantile corporation writes:

Our company has for many years given financial assistance to smaller companies, many of which are our most valued sources. Capital is made available in three ways:

1. Direct lending of money to small manufacturers during their peak production season.
2. Investment of money in factories through the purchase of stock.
3. Arrangements through field warehousing financing companies.

That such aid proves beneficial and is appreciated is obvious from the following comment of the treasurer of one of the recipient companies:

In the early years of our company, some 25 or 30 years ago when our business was very small, one of our large corporate customers did at times render financial assistance to us by advancing sums of money upon request when we were in special need of it In that way they were a very direct assistance to a small struggling company. Although we might have secured funds elsewhere, nevertheless they did give us assistance when the need was great and thereby, no doubt, were instrumental in developing a strong source for the products which we manufacture for them.

I believe that large companies often do just that in assisting their smaller sources of supply, especially in difficult economic times.

Customers as stockholders. Utilities and railroads have sold stock extensively to customers. Distributors have purchased stock in companies making products which they handle. The United Drug Company was financed by druggists who handled "Rexall" products manufactured by the company. Customer stock ownership is sometimes an effective and an economical way to raise capital. It is frequently conceived as a method of tying the customers to the company and ensuring continued business with them. This method may backfire, particularly when the fall in the value of stock creates dissatis-

faction in a customer who may be satisfied with the product and the service he is receiving.

Contract advances. Some companies have been able to do some of their initial financing and expansion financing by getting customers to make deposits or to advance money on contracts. During the war, advance payments on war-production contracts constituted a significant source of finance. Large companies will give this kind of aid to companies which they seek to develop or maintain as supply sources.

Dealers as stockholders. The floating of two new motor companies and one appliance company just after the war involved financial help from dealers and potential dealers. There are a number of ways in which money can be raised from dealers. Stock ownership may be made a requirement for obtaining a franchise. The franchise itself may be sold for a cash payment without the dealer obtaining any stock. As a condition for obtaining a franchise, advance payments may be required against the acquisition of inventories. Payments for a franchise may be in the nature of earnest payments, with the franchise holder given an opportunity to recover his initial payment for the franchise by obtaining a credit against subsequent purchases from the company whose product he is distributing. If he does enough business he recovers the amount he paid for his franchise against the cost of goods purchased by him for resale. The manufacturer gets working capital from the franchise holder, who is then given an opportunity to earn his money back by doing a job in developing volume sale of the manufacturer's goods.

The extent to which financial help can be obtained from dealers is a trading matter which depends on how salable and how profitable the manufacturer's product is judged to be. It was by tapping his dealers for money that Henry Ford retained his ownership of his motor company and was able to expand and meet financial crises without bringing in public ownership through Wall Street.

4. Debt financing—ways and means

Bond issues. Bonds give the investor a fixed claim on assets and a fixed income rate. They give the owners of a corporation financing without diluting their control or ownership. Prevailing low interest rates and deduction of interest in computing corporate tax make bond financing cheap. Bonds carry a fixed charge which may be burdensome in adversity. They also have a fixed maturity value, which gives the equity owners the full value of any increment in value enjoyed by corporate property.

Bonds which are secured by mortgage on the corporation's real property, such as mortgage bonds, or by other tangible property such as equipment trust certificates, or by securities or intangible assets, pledged in trust as

collateral trust bonds, can usually be arranged for longer maturities and at lower interest rates.

Debenture bonds are secured only by the general credit of the company. It may be provided that if a mortgage is issued in any subsequent financing, outstanding debentures will share in the lien equally and ratably with the new financing. In closely held companies, in order to bolster general credit, it is sometimes provided that debentures issued to stockholders will be subordinated to the claims of general creditors. Debenture bonds may be given extra attraction by making them convertible into stock, or by issuing a warrant to each bondholder which gives the bondholder the right to purchase common stock at specified prices. This gives the bondholder a share in the prosperity of the first-risk stockholders, if the company is successful.

Bonds have been issued which give bondholders a right to participate in stock earnings over and above a certain level. This is a doubtful practice. Where it is desired to give bondholders an equity stake, it is probably better to sell them a package with some low-cost stock with each debenture. This permits each bondholder to separate his two investments and sell each off separately and gives the corporation a more rational capital structure.

There are such things as income bonds which require payment of interest only on an "as and if earned" basis. This practice is doubtful because it runs into a question as to whether the securities are really bonds or preferred stock, and whether the payments are deductible or nondeductible interest for tax purposes. It also opens up endless dispute as to whether the accounting, which shows either income or the lack thereof, is valid.

Requiring the establishment and maintenance of a sinking fund to retire a bond issue enhances its value. Financing flexibility is imparted by the provision that bonds may be called before maturity.

Tax counsel must be consulted to assure that bonds are not likely to lose their tax advantages by being treated as preferred stock—

Because the ratio of debt to stock is inordinately high
Because bonds are subordinated to bank loans and creditors
Because interest is contingent on earnings
Because stockholders hold notes in the same proportion as they hold stock

Any combination of these factors makes it possible for the Treasury to contend that the bonds are in fact the equivalent of stock.

Mortgage loans. Long-term mortgages secured by first liens on improved real property are a cheap source of working capital. Current high valuation of industrial and commercial property may allow higher loans and better terms than normal.

Source is principally savings banks and life-insurance companies. Savings

banks will usually advance construction loans if a new building is involved, charging about ½ per cent higher rate until the mortgage becomes effective. They are also more active in smaller types of loans. Insurance companies prefer to have the facilities completed before the advance is made, except in the case of very large loans.

Amount is usually between 50 and 70 per cent of property's appraised value, which is likely to fall about midway between the prewar evaluation and today's abnormally high level.

Maturity is usually 10 to 15 years, going up to 20 years on advances of $1,000,000 or more. Length of the loan available varies directly with the borrower's credit.

Cost. Large prime names have been borrowing or refunding until recently at around 3½ per cent interest cost, smaller high-grade mortgages bringing 5 per cent. Rates have stiffened a full ½ per cent in the past year. Industrial borrowers generally have to pay a higher rate than commercial borrowers because the buildings pledged are seldom of general-purpose type and the location is likely to be in a less stable area.

Amortization is generally required, varying from 100 on small and medium-sized loans to only about 50 per cent on large mortgages. Interest and principal payments are monthly or quarterly in most cases.

Any institution making mortgage loans is likely to impose curbs on operating practices, to supervise financial conditions, and to restrict any other type of borrowing. How such conditions might affect present operations and plans should be given consideration. For instance, liberal credit-extension practices may have to be changed, directly affecting relations with customers. Other borrowing activities may be endangered. By pledging valuable fixed assets, a business automatically becomes a less desirable risk and may find other credit sources drying up.

Term loans. Commercial banks and insurance companies will extend to a company with a good credit rating a loan running for a period of years with provision for amortization or retirement over the life of the loan. Insurance companies have an interest only in loans over $200,000, but recently some companies have consented to participate in smaller loans issued and managed by commercial banks. Such a loan, even if secured, will depend heavily on the lender's appraisal of the long-range expectancy of the company, its earning power, and the quality of its management. Term loans are usually restricted to a business having a sufficiently large organization to preclude the possibility that payment of a loan might hang on the life and talent of one or a few individuals. Stable lines, such as food and merchandising, are preferred, and it is difficult for those in an industry like construction, with sharp ups and downs, to obtain term-loan financing.

The main features of term loans may be summarized as follows:

Term loans may be for short periods and for small sums. The Federal reserve found that 90 per cent of loans in 1946 were small, the average being $3,700

A small term loan is usually secured by real estate or equipment, with repayment on an equal-installment basis and maturity within 5 years

Interest charges run about double the rates for short-term loans. Small term loans will be even more expensive

The lender usually insists that the company agree to follow certain definite operating policies. Dividends and salaries may be limited; subordination of other indebtedness and indorsement of principals may be required; a dollar limitation on capital expenditures may be fixed; a covenant to maintain and repair property may be required

A long-term loan is worked out in the form of an unsecured note, accompanied by a term-loan agreement. The lender simply relies on the general financial strength and the earning prospects of the borrower

A long-term agreement usually restricts the borrower's right to pledge his fixed assets, and also limits any other long-term borrowing. The borrower is required to maintain certain standards of liquidity, and he must provide the lender with periodic financial statements

Sometimes there is provision for lump-sum payment at maturity, but more often the loan takes the form of a group of serial notes which mature at different dates. In many cases, there is a single note which is amortized on an installment basis

Trade credit. Credit granted by the seller to the buyer of materials or merchandise is called "trade credit." It is highly important, particularly for the small business which has difficulty in raising capital from other sources. Granting of trade credit by suppliers of parts and raw materials to manufacturers, by manufacturers to wholesalers, and by wholesalers to retailers is a well-established practice and is at least as significant a source of financing as bank credit. A trade creditor looks at his extensions of credit quite differently than does a bank. Trade credit is considered a requirement and aid to selling. It is usually covered by a profit margin more substantial than usual interest rates. Bad-debt losses are not regarded as net loss until the net-profit margin on the business has been wiped out. A seller may even feel that if he rejects a class of business because of the credit risk, he will lose the contribution that business makes in covering fixed expenses as well as the possible profit margin. Likewise, in extending trade credit the seller is looking forward to establishing a continuing source of repeat sales. Forward-looking companies seek to build up trade customers and their credit rating by extending credit and helping them to merchandise and operate effectively.

Trade credit is normally extended on the basis of the credit reports of

Dun & Bradstreet and other mercantile agencies and credit bureaus. This may be supplemented by checks with banks and other supply sources and credit references supplied by the buyer. The availability of trade credit will vary with the following factors:

The seller's own position will govern his willingness and ability to use liberal credit in his method of selling his goods

When inventories are heavy or moving slowly, and when the price outlook is dubious, trade credit will become more generously available

With the introduction of all products to a new market and of new products to a general market, easy credit terms are frequently used to stimulate sales

Longer credit terms may be expected on merchandise which moves slowly and has a long turnover period. The need to help distributors carry such inventory usually creates a trade practice of fairly long terms. Thus a retail jeweler would expect longer terms than a butcher

Similarly, the more standard the article, the more likely credit terms are to be generous. On novelty items which are difficult to sell, credit terms are held very tight

Customers located a long distance away from a source of supply may be able to get longer credit terms on the theory that they have to stock for a longer period of time

In a general depression, competition tends to extend credit terms and, even though credit terms are used to stimulate sales, to make sellers weed out weak customers and restrict credit to their more stable customers

The cost of trade credit may be calculated in terms of this discount offered for cash. When sellers offer a 30- or 60-day credit term, cash discount is ordinarily allowed for payment made within some specified period of 5 or 10 days. This time is calculated to cover the shipping period and to give the buyer a chance to check the merchandise before making his remittance. Where a 2 per cent discount is allowed for payment within 10 days and the buyer is required to pay the entire bill at the end of the 30-day credit period, he's paying 2 per cent for 20 days of credit if he fails to discount his bill—an annual rate of interest of 36 per cent. When there is a 2 per cent cash discount for payment in 10 days on a bill payable within 60 days, a buyer not taking the discount is paying 2 per cent for 50 days of credit. When the situation is analyzed in this way, most companies will find that bank credit is ordinarily cheaper than trade credit, beyond the cash-discount period.

Commercial paper. Companies which can meet a sufficiently high credit standing can get short-term funds by arranging for the sale of a paper to banks through commercial paper houses. Notes are made payable to order of the issuer and indorsed in blank to make them negotiable. Commercial paper

is sold in large denominations such as $5,000 and $10,000, with maturity normally running from 4 to 6 months. These notes do not bear interest but are sold at a discount on their face value. Commercial paper houses buy such notes from the issuing firms at the going rate of discount, which depends on the credit standing of the firm and the maturity date. A commission ranging from ⅛ to ¼ per cent on the face value of the paper is charged to the issuer. The commercial paper house resells these notes to banks. The commercial paper houses do not guarantee or indorse the notes they sell, and the paper depends entirely upon the credit standing of the issuer. To sell such unsecured promissory notes in the open market, the issuer must have a record of successful operation for a number of years, a reputation for prompt payment, and a healthy current financial position as evidenced by balance sheets. Short-term financing through the use of commercial paper is substantially limited to companies producing standard commodities in foodstuff and textile and dry-goods lines, metal goods such as hardware, furniture, farm implements, drugs and chemicals, steel, and lumber. Producers of specialty and style goods are not likely to be able to sell their commercial paper.

Advantages	*Disadvantages*
Discount rates are generally lower than bank interest.	Inconvenience of numerous inquiries and investigations of those shopping for paper
Maintenance of deposit balances at one or more banks for the purpose of obtaining credit is eliminated.	Relationship is impersonal without the same consideration which a bank will accord to maintain a profitable relationship.
The range of credit facilities is broadened.	Paper must be paid on due date. Renewal cannot be sought.
Prestige and advertising value increase for paper which becomes nationally known and respected. Facilitates a subsequent security issue.	It becomes difficult to sell paper when money becomes tight. Bank credit lines must be kept open for such emergencies.
Local credit standing is enhanced when a company's paper stands up under the test of open-market sale.	

Selecting a bank. The choice of a bank is important in the development of proper credit facilities. The development of a good banking relationship is a matter of time and successful experience. Also a business is in an advantageous bargaining position at the time a bank is seeking its business. These factors make it more important to study the resources and experience of the banks which are suitably located in order to make the right choice as soon as possible.

These are the factors to be weighed:

Size. Does it have the financial resources to satisfy the maximum needed for direct bank credit? Sometimes a business may borrow from more than one bank, but banks prefer exclusive arrangements which facilitate control

over the borrower. Selecting a bank that is larger than necessary may involve a loss in attention of more experienced officers. Also an account may be more important to a smaller bank, which will therefore tend to give better service and perhaps more liberal lending.

Lending policy. Banks differ in policy and standards, and it is important to get the general approach of a bank to determine how much it will lend, for how long, and at what interest rates.

Experience. Is the bank familiar with the specific line of business and its special credit problems?

Officers and personnel. Are they valuable counselors? Do they have close relationships with competing concerns?

Reputation. Ability to borrow from a conservative and well-known bank and to use it as a financial reference may enhance general prestige and credit standing.

Safety. The existence of a satisfactory ratio of capital to deposits and liquid funds to business loans will minimize the danger in suffering loss and embarrassment from bank failure. Federal deposit insurance affords protection only up to $10,000.

Corresponding relationships. Good relations with larger banks may enhance lending ability and provide useful contacts.

What banks look at. A bank loan officer will study a borrower's credit standing by checking with trade creditors, credit bureaus, and other banks and by studying the figures and the past history of the business. The bank will have to make a composite appraisal, reflecting its judgment as to the character and the ability of the principals, and the tangible values, financial resources, and prospects of the business. In looking at a request for a specific loan, the bank officer will have to satisfy himself that the proposed note will be paid at maturity, and that even unforeseen circumstances will not involve the bank in serious loss.

As material for this judgment, the bank officer will analyze

The ratio of current assets to current liabilities, which indicates liquidity
The ratio of cost of goods sold during a year to the average inventory, which indicates turnover
The ratio of customers' receivables to average daily sales, which indicates the rate of collection
The ratio of cash to total current liabilities and to total current assets, which points up the adequacy of cash position

When the so-called "acid test" can be met, a borrower's position is considered very good. This is the ratio of cash plus customers' receivables to current obligations. If this is 1:1, obligations can be paid without liquidating any further inventory. This test is too severe and is not strictly applied

to many lines of business, particularly those of a seasonal character and those conducted on a cash basis where inventory is the largest current asset.

To study the financial soundness of a business and the risk of lending to it more intensively, a loan officer will want to know how the money which the owners have in the business compares with total debt. Then he will want operating ratios, such as profits and key expense elements to sales, the percentage earned on total investment and on net worth, and total turnover of operating assets. He will want to appraise the flexibility of cost elements, and the pressure which price decreases or volume decline would place on margins. Chances for satisfactory bank loans are improved if a borrower is prepared to explain how these tests apply to his business and its outlook, and how the following factors have shaped up over a 3- to 5-year trend.

Is net working capital dropping? Is there a reserve for expansion? What is the current ratio—current assets divided by current liabilities? (Average ratio in last quarter of 1947 for companies of all sizes was 2.67.) What is the quick ratio—cash, marketable securities, and receivables divided by total current liabilities? (Medium-sized firms average 1.2.)

Too high a ratio of fixed assets to tangible net worth compared to past years would indicate a freezing of working capital in fixtures, etc. Banks will compare the ratio with that of other firms in a similar industry.

What is the ratio of net profit after taxes against net sales? In many cases the percentage figure has been sliding while absolute profits are up.

How does turnover of accounts receivable as against net sales compare with the figure in similar businesses? How does the inventory turnover compare with the average? (The figure for medium-sized companies making durable goods is 4.4; in the case of nondurable manufacturers it's 6.6.)

How's the breakeven point? There are no adequate tests for external examination, but a low breakeven point is an arguing point at the bank.

In actual practice, the bank's decision is likely to be based on many considerations other than the factors described above. Be prepared to face such questions as the following:

Is the product an off-brand item which might run into trouble competing with brand merchandise?

How big is the backlog of orders? Have duplicate orders been weeded out of the backlog?

Have any large customers been lost?

How reliable are remaining customers? Are they likely to fade out if conditions should toughen up?

Is the market situation such that buying commitments might turn out to be dangerously heavy?

In organizing your case for a loan for presentation to a bank officer, see that the following points are covered:

Show long-term business prospects. The bank will want to know how the business stands on labor supply, material supply, and demand for its products. It will also be interested in the standing of the industry as a whole.

Describe operating policy during the period of the loan. A sound financial plan for repayment should be prepared, together with a forecast showing how and why payments can be met.

Past financial statements should make up a special exhibit. Banks know that in most cases the main sources of payment are earnings plus funds built up from depreciation, depletion, and amortization charges.

Past earnings should be modified in today's light. New Federal taxes and new interest changes may make old figures meaningless. Similarly, nonrecurring elements of income should be eliminated. Any instance in which past expenses no longer exist should be clearly pointed out.

Revenues anticipated from future expansion should be taken into account, if there exists something of a record indicating how these future developments may pay off.

New sources of income should be pointed out. Sales of assets, money expected from sales of stock, or as a result of changes in business policy (such as cutting out installment selling) should be pointed out.

Line of credit and short-term loans from banks. Short-term bank loans are obtained either by individual borrowing or by obtaining a line of credit against which advances may be obtained. On the basis of a study of the financial position of the company, a bank will ordinarily establish a maximum amount which it will lend and permit the borrower to obtain loans up to that figure without further negotiation. Advances are evidenced by individual notes with short-term maturities, at which time they are reviewed, repaid, reduced, or extended. In extending a line of credit and in advancing money on unsecured notes, a bank is apt to require some combination of these conditions:

Between 10 and 20 per cent of the line of credit or of the loans actually made is to be kept on deposit

Loans are to be cleaned up at least once a year to assure the bank that the business is remaining liquid and to prevent the use of bank credits as permanent funds

Where the stock of the company is largely held by officers, they are required to indorse or guarantee the corporation's notes individually whenever loans exceed a conservative amount

Officers or directors are required to subordinate loans or other claims against the company to bank loans

These conditions are subject to negotiation and may be modified, depending on how good the loan is and how eager the bank is to get it.

In clearing up loans at maturity dates or at year's end, money is frequently borrowed for this purpose from other banks or obtained by forgoing discounts or taking advantage of trade credit. Where this is necessary, it is desirable to accumulate available cash by refraining from dividends and other disbursements. A line of credit is a highly desirable and flexible arrangement, particularly in businesses which are seasonal and which have the kind of inventory turnover which creates peaks of financial need. The availability of a line of credit and short-term accommodations should be carefully nurtured, because instead of fixed credits which call for continuing interest, only amounts of money actually used, plus a small commitment fee on any portion of the original commitment not actually consumed, are charged, which adds up to inexpensive financing.

Miscellaneous bank loans. A commercial bank will make loans on various types of collateral, normally at rates lower than unsecured advances. This of course depends upon the credit standing of the borrower. Here are some of the ways in which banks advance short-term funds on collateral:

Stock-market collateral put up by the business or its owners will almost always justify a loan at low interest

Accounts receivable may serve as collateral

Bills and notes received from customers may be discounted. This type of security is open to the suspicion that such notes represent accounts receivable which have been slow or overdue, or that the merchandise was sold to a weak debtor on long-term payments

Quality merchandise is acceptable as collateral when secured by a bill of lading, warehouse receipts, or trust receipts

A banker's acceptance (a draft by a seller on the customer's bank, the buyer having agreed to pay cash to the bank) is good for an advance of money from the seller's bank

Technique of lending on accounts receivable and inventory and warehouse receipts is highly developed and is discussed more fully under the appropriate headings.

"GI" loans. A veteran who served at any time between Sept. 16, 1940, and July 25, 1947, and was discharged under conditions other than dishonorable after at least 90 days' active service (or for service-incurred disability in less than 90 days) may qualify for a "GI" loan.

Three types of loans are available:

1. To purchase, construct, or improve a home
2. To buy a farm, farm land, stock, feed and seed, farm machinery, and other farm supplies and equipment

3. To buy a business or otherwise to enable a veteran to undertake or expand a legitimate business venture

The Veterans Administration does not lend money to the veteran. He makes his own arrangements for the loan through the usual financing channels. VA then guarantees the lender against loss up to 50 per cent of the loan, with a maximum guaranty of $4,000 on real-estate loans and $2,000 on non-real-estate loans.

The Veterans Administration also pays the lender, for credit to the veteran's loan account, a sum equal to 4 per cent of the guaranteed portion of the loan. This is a gift to the veteran and not a loan.

Farm realty loans may be made repayable in up to 40 years; other realty loans, in up to 25 years, and nonrealty loans, in up to 10 years. The interest rate normally may not exceed 4 per cent a year on the unpaid balance.

Veterans have until July 25, 1957, in which to apply for "GI" loans.

Business loans will be approved when they are to be used (1) for engaging in business or pursuing a gainful occupation; (2) for purchasing land, buildings, supplies, equipment, machinery, etc., for business; (3) for constructing or repairing real or personal property to be used in business; (4) to provide working capital.

There must be reasonable likelihood of success, as indicated by the veteran's ability and experience and the conditions under which he intends to do the business.

Loans for the acquisition of a business. Requirements as to specific type of loan are as follows:

When a veteran purchases an interest in an existing business which interest will constitute security for a guaranteed loan, the bill of sale or other appropriate instrument must expressly provide that goodwill is included, and in the event the business is in a service industry, or where appropriate otherwise, such instrument must contain provisions forbidding or restricting the seller's engaging in a similar business within such period of time and such area as the seller and purchaser shall agree. The interest of the veteran in the business must include such rights. To the extent practicable and legally permissible, all assets of the business so acquired must be pledged or encumbered as security for the loan. However, cash, notes, accounts receivable, and other choses in action not an integral part of the business may be excluded.

If realty is acquired in the transaction, the lien on the realty must usually be a first lien. If personal property is acquired in the transaction, the lien thereon may be a secondary lien, provided the first lien thereon secures an obligation for only part of the purchase price thereof.

If the veteran will not own the entire interest in the property, when ac-

quired, but will own an undivided interest therein, the lien must cover all undivided interests in such property and the owners thereof must join in the mortgage or other security instrument but need not become personally liable with the veteran on the obligation. The maximum maturity of loans for the acquisition of a business may not exceed 5 years.

Loans for the purchase of equipment, machinery, or tools. If the guaranteed loan is to be used to pay the entire purchase price of such articles, it must be secured by a conditional sales agreement or by a first lien thereon. The maximum maturity of such loans must not exceed 3 years.

If the guaranteed loan is to be used to pay the initial payment on the purchase price of such articles, it may not exceed one-third of the purchase price or $1,000, whichever is the lesser amount. Such loans may be secured by second liens. The maximum maturity of such loans must not exceed 1 year for loans of $500 or less or 2 years for loans over $500.

Loans for the purchase of supplies. A loan for the purpose of purchasing supplies may be made in an amount not exceeding $1,000 and for a maturity not exceeding 1 year. Such loans may be unsecured if security is not practicable or customary.

Inventory. Loans for the acquisition of inventory are not covered by the "GI" bill.

Security and repayment provisions. The lender is permitted by agreement with the borrower to take life insurance or other security in addition to the property encumbered to secure the guaranteed loan. Subject to the limitations on maximum maturity of business loans for the various purposes specified above, the terms of repayment of the loan to be guaranteed may be such as the lender and borrower agree on. Such terms should be predicated primarily upon the anticipated earning capacity of the business, the nature and normal useful life of the security, if any, and other material factors that would be considered by reasonably prudent persons similarly situated. Generally such loans should be repayable on a monthly, quarterly, or seasonally amortized basis. An unamortized loan, unless it is a term loan for purchase of business realty, will not be guaranteed. The loan agreement may provide for variable amortization payments dependent upon the earnings of the business, and for such other reasonable protective options as usually are required by prudent lenders of the community in comparable transactions.

Equipment loans. In today's tight capital market, an increasingly popular method of raising funds is to borrow money against machinery and equipment. Manufacturers, service firms, and retail stores may obtain such advances, ranging all the way from $100 to several hundred thousand dollars.

Equipment loans can be based on either existing installations or new pur-

chases, but the items must be general-purpose and removable. Here are some other important conditions to most equipment loans:

Title withheld from purchaser, or lien instrument placed on equipment until loan is paid off
Intermediate-term maturity (1 to 6 years) based on considerably less than *minimum* productive life of equipment
Full amortization by maturity date
Original down payment or equity equivalent to about twice the estimated loss suffered through immediate repossession and sale (15 to 33 per cent, normally)

In addition to banks, finance companies, and factors, many equipment suppliers serve as sources for equipment loans. These companies provide financing accommodation to their customers by taking the buyer's note for a substantial part of the purchase price and then indorsing and discounting the note at their own bank. Suppliers also act as finance companies' agents in offering the latter's installment plans as part of the sales package.

There are two main ways of handling equipment loans. One method is to pledge new or acceptable used equipment to which you have unencumbered title as security for the loan. A formal agreement and note is drawn covering the individual requirements, and you give the lender a chattel mortgage on the equipment. This is the customary bank-type advance and is widely used on medium and large equipment loans. Interest rates vary from 3½ to 5 per cent, depending both on the collateral and on the borrower's credit standing.

The other method of working an equipment loan is via an installment financing plan. The borrower gets physical possession of the equipment, but does not obtain title to it until the loan is paid off. A note and conditional sales contract (chattel mortgage in certain states) requiring passage of charges are added on, and monthly repayment schedule is set up to amortize the total loan balance in equal payments.

Actual cost of installment loans may be a lot more than the quoted 6 per cent rate. Interest is ordinarily based on original loan balance, but periodic payments on principal result in an average borrowing of roughly half the original loan. True cost of any "add on" loan is nearly double the quoted rate.

To finance purchase of new equipment, sound out the supplier. A secured note taken back by him is cheap, and his continuing interest in your business assures a pleasant credit relationship. Even if the equipment is too small or too specialized to warrant this arrangement, it is a good idea to let the supplier handle the installment-financing deal with the finance company.

One machinery manufacturer offers customers a financing deal that costs about 50 per cent less than the outside financing open to purchasers of equipment. In cooperation with a large, national finance institution, this manufacturer of machinery permits buyers to defer payments over a 12- to 36-month period, after an initial 25 per cent payment. The buyer pays 6 per cent simple interest on unpaid balances, which means an average annual interest rate ranging from 3½ per cent for 12 months, to 3.08 per cent for 36 months.

Inventory loans. General inventory loans, aside from the field-warehouse type described later, may solve a financing problem if merchandise or inventory can qualify as collateral. Requirements are stiff, and inventory loans are limited to the following:

Actively traded raw materials, liquor, and a few other items that can be easily marketed. Banks and certain government agencies will make high-percentage revolving loans at low rates (90 per cent advances at 2½ per cent are not uncommon), but the inventory must be secured by public warehouse receipts

General types of raw material and finished goods, if stored in a public warehouse. This is usually impractical (transportation problem, releasing approval requirements, etc.) unless the goods move slowly in and out of the warehouse. Advances vary up to 75 per cent of value, and interest rates depend on general credit standing as well as collateral—3½ to 7 per cent, exclusive of the warehouse charges

Trust-receipt arrangement on new purchases. The borrower gets possession of the merchandise, but holds title jointly with the bank or finance company (and also with the supplier in some cases). Advances are made up to 60 to 70 per cent of the purchase price at interest rates of 4 to 8 per cent. Loans on trust receipts are used principally for individual advances, since revolving credits are difficult to work out

Any loan secured by inventory or commodities solely under the control of the borrower is an exception to standard practice. Banks, finance companies, and factors sometimes do this as a special service, but the accommodation is generally made to cover a season requirement or an unusual purchase and is made only where a close relationship exists.

Field-warehouse loans. One of the most convenient and cheapest ways of raising capital is the field-warehouse technique of borrowing money on inventory—a fairly recent development. Under this scheme the borrower literally brings the public warehouse to his own premises and uses its receipts as the basis for getting a revolving credit from any bank or finance company. Marketable raw materials, component parts, or finished goods can be used.

Marketability of inventory is the big point in field-warehouse loans; the

particular type of stock is a minor consideration. It also makes little difference where or how inventory is stored (stockroom, open lot, storage tanks, etc.) as long as in-and-out movement can be properly controlled. The following list of products gives an idea of the broad use manufacturers and distributors are making of the field-warehouse loan technique:

Agricultural implements	Frozen foods
Alcohol	Leather products
Blankets	Meats
Builders' supplies	Petroleum products
Cord wood	Radios
Drugs	Sporting goods
Envelopes	Wire

Field-warehouse borrowing is ideal for a business subject to major seasonal fluctuations. Production swings can be ironed out by pledging raw materials initially and then replacing them with finished goods as they come through the manufacturing cycle. Also these loans can be used in obtaining quantity discounts, avoiding l.c.l. freight rates, or making advantageous market purchases.

The first step is an understanding with the bank or finance company that certain types of inventory are acceptable loan collateral, if under the control of a public warehouse company. An agreement is then made with a warehouse firm under which it leases the borrower's storage facilities and hires one or more of the borrower's warehousemen. The warehouse company issues its field-warehouse receipts to the lender. The understanding with the bank or financing company is next formalized by a loan agreement, usually accompanied by a demand or short-term note, which sets forth all conditions of the loan and confirms the releasing procedure to be followed by the warehouseman.

Transfer of stockmen to the warehouse company's payroll does not create an operating problem. It is done for the lender's protection and largely amounts to a formality. The additional duties of these employees are minor, and they can continue to spend most of their time handling materials. The warehouse company trains them in required control routines and provides only part-time supervision thereafter.

The lender should issue some type of general delivery instructions to the warehouse company covering release of stock. A specific release arrangement, under which the receipt holder must approve each release, is very cumbersome and involves too much paper work. Most lenders are willing to use delivery instructions specifying that the warehouse firm balance out weekly or biweekly. The borrower is charged for withdrawals and credited

for additional receipts. The lender is paid off directly on periodic settlement dates for any excess withdrawals.

The whole device has important advantages of economy. The cost of field warehousing itself is quite reasonable—appreciably cheaper than public warehousing because existing space and personnel are used and extra handling is not involved. The field-warehouse organization bills back the rent and personnel expense, which only partially represents an additional cost to the borrower. The charge for overhead, supervision, and the warehouse's profit varies downward from 3 per cent on a $25,000 loan to less than 1 per cent on $1,000,000. The bank's charge is usually somewhat higher than rates on unsecured lines of credit, total charges amounting to 5 to 8 per cent on a moderate-sized loan.

A number of companies have found that field warehousing results in improved inventory control. Accurate, complete stock records are a must with warehouse receipt issuers. Their extensive stock-control experience can be of real benefit.

Let the bank or finance company suggest the warehouse organization. On these deals there's always a close working relationship between the lender and the public warehouse. Conversely, where a local lending institution is not interested, contact one of the national field-warehousing organizations.

FHA's nonhousing loans. Few businessmen realize that the Federal Housing Administration guarantees small loans for modernizing, repairing, or building commercial as well as residential properties. Admittedly, FHA has little to offer large companies directly, and small firms in a strong position can get normal private credit. But in the face of tightening credit accommodations, many small businesses can use FHA loan guaranties advantageously.

For modernization and repair, the FHA maximum is $2,500 repayable in equal monthly installments for not more than 3 years and 32 days. The charges are relatively favorable for the borrower: FHA limits the lender to a discount equivalent to $5 per $100, payable in 12 equal monthly installments—roughly 10 per cent a year. FHA is willing to guarantee loans up to 90 per cent of the value of the project.

Comparable terms could be obtained by reputable firms from the local bank, and companies with high credit rating can generally do better on the charges. Granting these limitations, however, there is value in FHA for many firms. For instance, a large wholesaler, though needing no credit himself, may have small suppliers and distributors who are handicapped in making improvements because they don't know of the FHA possibilities. Similarly, many manufacturers today find that their smaller suppliers can't meet contracts or take larger orders because they haven't money for necessary repairs or expansion. In the same way, distribution outlets are often lim-

ited because retailers can't swing new show windows, air conditioning, and other modern promotional aids.

What is true of modernization and repair is also true of new building on a small scale. FHA will guarantee loans for the erection of filling stations, wayside stands, tool sheds, service buildings, etc. Maximum terms are $3,000 and 3 years, which is a favorable proposition for the thinly financed operator.

FHA doesn't guarantee loans for the purchase or installation of machinery, store fixtures, or other equipment. But it does grant loans to strengthen a structure to support heavy machinery.

Accounts-receivable loans. Borrowing against receivables may be the answer for the company that is really hard up for cash. The device is often very expensive, however, and as a general rule other possibilities should be exhausted first.

Commercial banks and finance companies are the spots to go for receivable loans. (Finance companies usually use purchase and sale contracts, but the result is the same.) Under a notification plan, the receivables are pledged and payment is made directly to the lender. The borrower is still responsible. Under the more satisfactory and more commonly used non-notification plan, the debtor pays his vendor, the borrower, who collects as agent for the lender. Terms and policies of accommodation vary widely, but the deal usually takes the form of a detailed agreement, frequently accompanied by a demand or short-term note. All accounts receivable, or a selected group of them, are assigned to the lender as security. In return he agrees to advance funds up to 60 or 80 per cent of the face value of open receivables pledged, usually specifying a dollar maximum which can be borrowed. Periodically, schedules of customer invoices are submitted to the lender to replenish borrowing power—the lender deducts payments as they're received.

Cost of these receivable loans varies widely. Quoted commercial bank rates are 4 to 6 per cent per annum on the balance in the loan account. Some banks add a small service charge to cover the sizable amount of clerical work involved, such as ½ per cent based on total receivables pledged or a flat amount for originally setting up the loan. Finance company charges are higher. They charge from $\frac{1}{30}$ to $\frac{1}{40}$ per cent of the face value of accounts pledged for each day they're outstanding. This may cost you 15 per cent per annum on a loan where the advance is 75 per cent of the face value of receivables.

Keep away from arrangements where it is necessary to get clearance on each individual invoice. Blanket deals are much easier to administer; invoice schedules are simply submitted periodically on accounts the lender has approved, and he worries about individual account limits.

Find out exactly when the lender credits the account for collections turned over to him. Most institutions make up schedules of collections periodically and credit the borrower's account from the schedule. This results in payment of additional interest for the period between the time when customers' checks are cleared and the time when the collection is reflected in the account. Effective interest cost can be increased as much as a third by this delay.

Good control over returns and allowances is important. Lenders insist on prompt and accurate notification of all changes in amounts invoiced. Chances of getting favorable loan terms will be much better if the lender sees this problem is under control.

Certain restrictions (periodic internal checks, preparation of forms, etc.) are unavoidable. The big point with all lenders is that collections are turned over to them *promptly* and in *original* form (customers' checks themselves). Some of these restrictions can be avoided if credit is not needed but one lump sum is borrowed on a batch of your receivables, instead of a revolving credit.

How factoring can help. Factoring receivables is gaining popularity as another new source of working capital. Under this arrangement, a professional factoring house buys receivables for cash without recourse, and customers are notified to remit directly to the factor.

The agreement provides that the factor take over credit and collection functions and stand any losses on bad debts. All customers' orders are submitted to the factor's credit department for approval. After shipment, regular invoices are prepared and duplicate copies with shipping documents sent to the factor, who credits the borrower's account with the proceeds, less his service charge. If the borrower withdraws the funds immediately, he is charged interest to due date on the invoice. Proceeds left with the factor until due date cancel the charge and usually draw interest thereafter.

Factoring has long been used by the textile industry as a means of raising money, but an increasing variety of businesses are finding it a workable solution. Manufacturers and wholesalers of bicycles, floor coverings, furniture, leather goods, lumber, paint, paper products, toys, and many others are factoring their receivables. The type of business is unimportant as long as the following requirements can be met:

Sales are on open account where credit information is available
The annual volume of accounts is over $200,000 and individual receivables are well over $100
The arrangement is to continue for an extended period (is not of only two or three months' duration)

Some companies are wary of factoring because customers must be notified of the arrangement. They fear that this notification gives the customer an impression of financial instability. Actually, such fears are groundless. Many of the soundest textile firms have been using the factoring device for years as a means of finding working capital.

The cost of factoring is composed of two separate items:

1. An interest charge—usually about 6 per cent per annum on funds actually withdrawn
2. A service charge—a fee charged for credit and collection services which is based on volume of sales factored. It varies from 1 per cent on large, prime accounts to over 3 per cent on small accounts involving both risk and volume of detail. It accounts for the bulk of total factoring charges

The service charge is usually offset by savings made in transferring credit, collection, and bad-debt expenses to the factor. Hence, the cost actually boils down to somewhere between 6 and 9 per cent per year.

Example. *X* Company sells its $80,000 receivables for $75,000 cash (factor holds back $5,000 for reserve for returns and allowances). Not only does *X* get the immediate use of funds to pay off liabilities and build up cash, but the company's whole financial position is basically improved.

	Before factoring	*After factoring*
Cash	$ 15,000	$ 30,000
Receivables	80,000	5,000
Inventory	35,000	35,000
Total Current Assets	$130,000	$ 70,000
Fixed Assets	60,000	60,000
Total Assets	$190,000	$130,000
Accounts Payable	$ 80,000	$ 40,000
Notes Payable	20,000	.....
Total Current Liabilities	$100,000	$ 40,000
Net Worth	90,000	90,000
Total Liabilities	$190,000	$130,000
Working capital	$ 30,000	$ 30,000
Current ratio	1.3:1	1.8:1

Almost all the thirty-odd factors have their headquarters in New York, but they have wide field representation. Most local bankers can supply names of factors to contact. The best way to develop a deal is to write and have them send a representative to discuss the possibilities. In shopping around to get the best deal, the factor must be given fairly complete information on the

borrower's business—type, number of customers, terms of sale, collection record, total sales volume, etc.

Caution should be exercised in selecting a factor. He will be receiving a great deal of confidential business information. The wiser choice may be one of the older factoring houses, because their experience outside the textile field is often much broader.

Factoring should be considered when the amount of money needed cannot be accurately forecast, or when periodic requirements vary considerably. The proceeds of factored accounts may be withdrawn at any time without prior notice, and interest is paid only on what is withdrawn.

Credit insurance. Insurance can be bought to guarantee payment of accounts receivable. This assures the flow of funds from sales and may facilitate bank credit. Though more widespread in textiles and apparel than other industries, such protection is available to manufacturers, wholesalers, and jobbers in almost every field. Retailers are not eligible for this type of financing.

While there is no limit on the size or type of business which can use credit insurance, it should not be considered unless a company's loss record is fairly normal. If credit losses are extremely low, it is not worth paying the premium—if they are unusually high, application for credit insurance will probably not be accepted.

Two types of protection are offered by the two companies in the field (London Guarantee & Accident and American Credit Indemnity):

Blanket coverage is the most common form. The insurance company sets limits of coverage by mercantile agency ratings. For example, a table accompanying the policy shows that if there is $50,000 limit of insurance for a certain rating, the insured is covered up to $50,000 of sales on each customer with that rating. The limits vary according to the requirements of the insured, subject to a maximum for each rating.

Where customers have no Dun & Bradstreet or other agency rating, the insurance company makes its own investigation and states the coverage in a rider attached to the policy. Many companies have no ratings, because they do not wish to disclose some of the required financial information.

Name coverage, instead of blanket, is available to those who sell mainly to utilities, banks, railroads, or insurance companies, because these businesses are not agency rated. The insurance company makes its own evaluation, and names the accounts in the policy.

There is a basic charge which depends on the mercantile agency ratings of the different accounts insured. For example, the charge is $3 for $1,000 worth of coverage on accounts with AAA-1 ratings. A small service charge

is added to this, depending on the annual sales volume of the insured. The larger the sales volume of the insured, the lower the service charge. Total premium costs average $\frac{1}{10}$ of annual sales volume. When an account fails and a claim is validated, the insured receives an amount equal to the unpaid purchase price of merchandise shipped and delivered during the term of the policy, less two deductions: (1) amount of risk carried by the creditor as coinsurer, and (2) stipulated amount of primary loss.

Coinsurance requirement usually amounts to 10 per cent of the account for high and good credit ratings, 10 to 25 per cent for fair and limited. This clause is designed to cancel out the difference between the cost of the goods and the selling price. Credit insurance is designed to restore capital, not profit.

Primary loss in a specified amount is usually figured as a definite percentage of gross annual sales. This percentage is based on statistical loss tables and the insured's own past loss experience.

Losses must be legally sustainable. The goods must have been shipped and delivered in the regular course of business, and the claim must have been officially allowed against the debtor or his estate. If the debtor has a valid defense or setoff, or the claim is otherwise unenforceable against the debtor, it will not be provable under the policy.

Though credit insurance usually covers losses arising during the policy year on shipments made in that year, a back-sales rider may be obtained when the policy is renewed. The rider will cover any losses in the past year not arising until after the original policy's expiration.

In weighing the value of credit insurance, consider these points:

It offers protection against unforeseeable losses. This is especially important today, when business weather is uncertain in several fields. Businesses that have been failing in the past several years haven't always been war-born novices, nor those operating on a shoestring—million-dollar failures have been more frequent than in the past. Notable instances are firms in furs, radio, aircraft, cosmetics, metals, and vending machines. Even the best of mercantile credit ratings can lag behind today's fast-changing business conditions. Disastrous write-offs may result unless adequate protection is obtained.

Only the coverage needed is paid for. Companies usually buy insurance to cover their entire sales volume for a year. But if some customers are so well established that their accounts appear to carry no risk, they may be excluded. Riders may provide for various other exclusions and inclusions according to the needs of the insured. Factors perform a function somewhat similar to credit insurance when they buy accounts receivable, since they sustain the losses if the accounts fail. However, they are somewhat more expensive than insurance companies, since

factors perform many other functions outside the scope of insurance—for instance, credit checking, management advice, marketing, etc.

The insurance company helps in gauging the credit outlook. Although the insurance company will not report or make special studies, except for its own use, it watches the credit picture closely. Insurance companies often find signs of weakening in a particular concern, industry, or section of the country, which may otherwise not be noted. This information is used to keep their customers in a safe position.

The insurance company can often salvage more from a failing customer's remaining assets than can the creditor. Insurance companies are on many creditors' committees, hence carry considerable weight in bankruptcy proceedings. They can often use their influence to improve settlement terms. Furthermore, their representatives have close contact with the "grapevine" and can detect and expose unrealistic settlement arrangements.

A policy may be written to cover accounts which are simply past due. A delinquent account is filed with the insurance company, and if the insurer fails to collect within 60 days, the account is provable as a loss under the policy.

Credit insurance may be a great asset in applying for a bank loan. One large bank now requires credit insurance for loans on accounts receivable.

At this time there is a great demand for credit insurance. Insurance companies are limited in the amount they can underwrite and so are very selective in screening risks. Therefore, if credit insurance seems desirable, check the following when applying for a policy:

The credit department must be in good working order. The insurance company will look at the collection record of the prospective insured, its over-all credit policy, and the caliber of personnel in the credit department.

Doubtful accounts must be weeded out. This is particularly advisable if borderline customers are in industries or sections of the country where business has sagged. Accounts with a record of slow payments are also bad risks from the insurance company's point of view.

Credit experience and insurance needs should be discussed frankly with the insurance company. Clauses can be written into a policy to cover a variety of needs and situations. A credit insurance policy should fit individual requirements, and it is the job of the insured to make these requirements clear. Give the insurance company a sharply focused picture, not just some vague notions of what is needed.

Floor-plan financing. Local banks and finance companies will carry the stocks of dealers in automobiles, farm equipment, electric and gas appliances, and radio and television sets. This is an important brand of working-capital

financing for dealers in standard items which run to a unit value of $50 and up. The money advanced to carry inventory on the dealer's floor may be secured by trust receipt, conditional sales contract, or chattel mortgage. Funds are always advanced against, and secured by, a specific piece of merchandise. There seems to be a trend toward having the manufacturer or distributor commit to repurchase the inventory of a distressed dealer. This arrangement reduces interest rates, simplifies the financing, and protects the manufacturers against the dumping of distressed stocks by banks and finance companies. Westinghouse and International Harvester have typical plans. But there is still a lot of floor-plan financing wherein local banks look only to the dealer and the merchandise. Floor-plan financing will be limited to 80 or 90 per cent of the wholesale price which the dealer pays for the merchandise. The term is usually 60 or 90 days, with a 30-day renewal privilege upon a 10 per cent reduction of the loan. The cost of floor-plan financing is usually ½ or 1 per cent for writing the contract and ½ per cent per month (6 per cent per annum) simple interest. On small items, where paper work runs high in relation to the size of the loan, interest rates will run higher. The interest rate may be brought down below 6 per cent where a nationally rated company undertakes to repurchase distress stocks or otherwise underwrite the loan and where the dealer takes over billing, collections, and other paper work.

Financing installment sales. Extending deferred-payment terms to customers is an important selling weapon. Very few businesses can handle any volume on the installment plan without getting their customers' paper financed. Local banks and finance companies will take over installment paper. It is desirable business. Floor-plan financing of dealer stocks is generally unprofitable because of the great amount of checking of stocks and paper work it entails. Banks and finance companies handle floor-plan financing as a method of getting the more profitable financing of the retail customer's paper.

The usual arrangement for financing time sales is for the seller to collect an appropriate down payment and take a note or a series of notes from the customer. The seller may merely act as agent for the finance company, taking the application but leaving it to the lender to investigate and approve credit, hold a lien on the merchandise, and collect payments. Under a recourse plan, the seller indorses the buyer's notes, becomes liable for the unpaid balance in the event of default, and is responsible for repossession.

On retail installment loans there is a limited-recourse arrangement. The bank has full recourse to the dealer for the first 3 or 4 months. If the customer defaults after the critical period, the dealer may buy back the merchandise at a substantial discount from the unpaid balance to cover

reconditioning and selling costs. The bank reimburses itself for the difference from a reserve set up out of the finance charge.

Competition and lending prudence govern the size of the down payment and term for repayment. The American Bankers' Association has made this recommendation:

Guide for Time-sales Financing

Articles costing $2,500 or less

Class of business	*Minimum down payment, per cent*	*Maximum terms, months*
Automobiles:		
New cars	33⅓	24
Used cars—1946 and later models	33⅓	18
Used cars—1940 to 1942	40	15
*New household appliances**		
Refrigerators (gas and electric), ranges, washing machines, and ironers	20	36
Radios, phonograph combinations, and other appliances	25	18
Television sets	25 plus installation costs	18

* Minimum monthly payment, $7.50; minimum down payment, $15.00.

See also table on page 99.

How to get RFC loans. Tighter credit policies on the part of private banks and shaky business conditions are turning many firms to the Reconstruction Finance Corporation for loans.

RFC has something like 1.5 billion dollars available for lending purposes. While most of the business demand is for straight working capital, RFC loans are also available for such varied purposes as replacement or purchase of machinery, the payment of existing indebtedness, and strengthening of cash reserves. In fact, RFC will lend for any purpose recognized by banks and other private lending institutions.

It also makes some loans which banks would not extend on the theory that it is supporting employment or relieving distressed localities. RFC loans are not available without showing inability to get a loan from normal private sources on reasonable terms. The applicant must show that he has tried for a private loan. There must be evidence that the applicant made a thorough and consistent effort, although it isn't necessary to show that he tried a great number of banks.

RFC aid may be in one of two forms. One is a direct loan. More commonly, however, RFC enters into participation arrangements with the banks, usually on a deferred basis. This is a guaranty that, at any time within 10 days after demand by the bank, RFC will put up a specified percentage of

Financing method	Requirements to qualify	Source of funds	Size	Approx. cost, per cent	Term	Amortized	Secured
Purchase-lease	Valuable fixed assets	Life insurance companies, large funds	$100,000 up	4 to 7 *	20 to 35 yr.	Yes †	Outright sale
Factoring	Must sell on open-trade accounts	Factoring houses	$20,000 up (av. advance)	6 to 9 ‡	Revolving arrangement	No	Outright sale
Equipment loans	Productive equipment	Banks, finance companies, factors, plus manufacturers	$100 to $1,000,000	3½ to 10	1 to 6 yr.	Yes	Yes
Field-warehouse loans.	Marketable inventories	Banks, finance companies, factors	$25,000 up	5 to 8	Revolving fund	No	Yes
Mortgage loans	Valuable fixed assets	Institutional investors	$25,000 up	4 to 5½ *	10 to 20 yr.	Yes	Yes
Unsecured bank loans.	Must be well established	Commercial banks	$10,000 up	2¾ to 5	Under 1 yr.	No	No
Term loans	Must be well established	Banks, insurance companies, RFC, reserve banks	$10,000 up	2¾ to 7	2 to 10 yr.	Yes	Varies
Inventory loans	Special types of inventory	Banks, finance companies, factors	$25,000 up	2½ to 9	Short-term or revolving	No	Yes
Truck leasing	Use commercial vehicles	Specialized-truck lessors	No limit	.....	Continuous	....	....
Accounts receivable loans	Must sell on open-trade accounts	Commercial banks and finance companies	$20,000 up (av. advance)	4½ to 15 ‡	Revolving fund	No	Yes

* Plus moderate cost to set up.

† Rent payments equivalent to interest plus amortization.

‡ May include charges for services performed.

the unpaid amount of the loan. On the other hand, RFC may voluntarily purchase its participation at any time this seems desirable.

Generally, RFC won't guarantee more than 60 per cent on loans over $100,000, although it may go as high as 70 per cent on smaller borrowings.

The current interest rate is 4 per cent. This is true of both the direct loan and the portion of participation that is guaranteed. The participating bank, however, may (and usually does) charge up to 6 per cent on its share of the loan.

For obvious reasons, RFC prefers participation to direct loans because it is the bank which makes the initial outlay of cash and does the work in administering and policing.

Security arrangements on these government loans are supposed to vary with the type of risk involved. In general they are at least as stiff as private requirements; a good many businessmen feel that RFC is a tough creditor.

A basic rule is that collateral must be adequate to cover the full loan. But the RFC does have some discretion on the whole question of security, and may give a firm a slight break where community interest is involved.

Generally, acceptable security may be one or more of the following:

A mortgage on real estate, chattels, plants, or equipment

An assignment of warehouse receipts (for marketable stock in satisfactory warehouses)

An assignment of current receivables, or other sound assets

In addition to the type of collateral available, the RFC takes a cold, critical look at many factors of the enterprise. It is particularly interested in management's experience and know-how, the firm's past earnings and outlook, and the long-range chances of success.

It will look at the way the funds are to be applied and how they will come back to return the loan in much the same way as any bank.

Officers, stockholders, and partners may have to accept personal liability. If the borrower has creditors who threaten the priority of RFC, stand-bys and subordinators may be required. Nor is it unusual to specify "no dividends or distributions without RFC consent" as long as any part of the loan is outstanding. Also, if RFC should develop any doubts as to the ability of the management to operate the business and repay the loan, it isn't slow to insist on a shake-up.

There are no general rules about maturity, but these government loans usually run much longer than the short-term arrangements that many banks are now offering. Almost always repayment is made by fixed amount on a monthly basis. In general, RFC has been considerate in staggering payments in a way that won't impair working capital or in any other way interfere with the purpose of the loan.

Here are the basic facts that RFC wants from an applicant: How much money does he need? What does he propose as collateral? What does he want the money for? What banks has he applied to? Why did they turn him down? Are any of the banks willing to make a loan if RFC participates?

The best way to get started is to apply to a local bank, whether a direct loan or a participation is desired. As a rule, the bank will have all the information needed, including the necessary application forms. If they can't give all information desired, bank officers will direct the applicant to the nearest RFC office.

Bank loans must be unavailable, or RFC won't consider the deal. Many businessmen ask: "If I have to furnish adequate collateral to RFC, why shouldn't a bank be willing to lend me money on the same collateral?" Here are some of the reasons for the seemingly paradoxical situation:

Banks shy away from long-term credit without strong collateral and security. The average RFC loan runs 5 to 7 years. Loans for such a term are hard to get from private banks, particularly in the case of the small or newly established businesses

Many banks are reluctant to lend on inventories; RFC will

A bank may consider collateral insufficient because it consists mainly of movable equipment or mortgages and liens on construction work

The bank may consider the loan as of a "permanent capital" type

The applicant may be a newcomer to a community, or just starting in business, without any credit or earnings record to present

The bank may not handle "GI" loans, referring them to local RFC

Some banks are overcautious and refuse credit to any business which can't demonstrate that it would remain solvent with a 25 per cent slash in its volume

5. *Financing by lease and license*

The lease of land, buildings, and equipment and the licensing of patents have become important methods by which a business acquires the use of assets needed for its operations. Leasing and licensing offer an effective way to minimize capital requirements. In effect, a business which obtains land, buildings, machinery, or patents on long-term lease or license is borrowing money from the owner rather than from a bank.

Long-term lease of locations. Securing control of land suitable for business operations by long-term lease is the equivalent of borrowing the value of the land. Although not showing up in the balance sheet, such a commitment represents a fixed charge and has very much the same effect on profitability of the capital structure that long-term debt has. The annual rental should be arrived at by taking between 3½ and 6 per cent of the fair value of the land. Sometimes the rent goes up as high as 10 per cent of appraised

value, but there's room for a lot of negotiating in setting rates, values, and final rents. Bear in mind that the owner of property relieves himself of paying real-estate taxes, which are normally assumed by the lessee. He also converts property into an income producer without going through the process of sale and payment of capital-gains tax. If the property has doubled in value over the owner's cost, he will net more from a 5 per cent rent than from a sale with investment of the proceeds at 5½ per cent. A lessee may be able to minimize his fixed commitment and get some trading value by offering the lessor some inflation protection by negotiating to pay a low basic rental plus a percentage of sales or profits over a specified level.

When land is leased, the problem of getting mortgage funds to improve it becomes much more difficult. This may be overcome by having the owner improve and lease both land and building or by getting the owner to join with the tenant to get a building financed and built. A lessee can trade quite heavily on the fact that he commits himself to improve, or to contribute to improve, leased land, and that these improvements inure tax-free to the lessor.

Sell-lease financing. The newest method of raising working capital is by sale and leaseback of real estate. Under this scheme a company sells its property outright to institutional investors like life-insurance companies, educational institutions, etc. At the same time, a long-term net lease is made assuring continued occupancy. The lessee assumes all the risks, taxes, insurance, maintenance, and other costs of ownership.

The result is a supply of cash which can be turned over in business operations instead of being tied up in real estate. Another advantage can be important tax savings. As long as you *own* the building, only the depreciation on the cost of the building over its life can be charged off against taxes. But as a *tenant* you charge off rental, which includes amortization of *both* land and building. And the charge-off takes place over the term of the lease —normally a somewhat shorter period than the life of the building.

Small as well as big businesses are eligible. A number of life-insurance companies are now interested in purchasing properties worth anywhere from $100,000 up. Moreover, purchase-lease financing can be used for new construction as well as where buildings already exist. The purchaser agrees to the proposition in advance, provided that the building is completed in accordance with prearranged specifications.

Transactions vary, of course, but here are some general considerations common to all purchase-lease deals:

Considerable weight is given to a company's credit standing, earnings record, management ability, and fundamental industry position

General-purpose commercial properties are favored over industrial prop-

erty, with the result that rental costs on factory buildings usually run higher

Location is an important factor. As a general rule of thumb, the poorer the location, the better must be the credit rating of the tenant

There is a preference for buying properties at their depreciated value, eliminating any capital gain to the seller. Also, there is some concern that criticism may develop on sale-lease deals where the seller takes a loss

The lessee usually assumes all cost of operating the property and other charges, including capital expenditures, to keep the property in good shape

Rent covers the required rate of return plus amortization of the purchase price

Leases usually run for an initial term of 20 to 35 years, with renewals for additional periods and rentals to be determined by negotiation

Renewal options at about one-third to one-half the original rate are fairly common

Yearly rental rates vary from 4 to 8 per cent of the sales price; industrial property is often set up on the basis of a declining rental scale over the term of the lease, and the lease tends to be shorter

Assume a purchase-lease transaction in which the company sells its buildings and land for $550,000, realizing a long-term capital gain of $50,000. The lease is for 30 years at 5½ per cent ($30,250 a year). A renewal provision for another 25 years at 2 per cent ($11,000) is also included. Here's how such a deal can work a tremendous improvement in the company's current financial position (note how the proceeds are used to pay off a $350,000 loan and build up cash at the same time):

	Before net lease	*After net lease*
Cash	$ 75,000	$ 275,000
Other Current Assets	700,000	700,000
Total Current Assets	$ 775,000	$ 975,000
Equipment (net)	100,000	100,000
Land and Buildings (net)	500,000	
Total Assets	$1,375,000	$1,075,000
Notes Payable	$ 350,000	
Other Current Liabilities	150,000	$ 162,500
Total Current Liabilities	$ 500,000	$ 162,500
Capital Stock	400,000	400,000
Surplus	475,000	512,500
Total Liabilities	$1,375,000	$1,075,000
Net working capital	$ 275,000	$ 812,500
Working ratio	1.6:1	6.0:1

Now follow through on an earnings basis, assuming that the additional $537,000 working capital will earn 15 per cent ($12,500 of proceeds goes for capital-gains tax):

	Before net lease	*After net lease*
Net operating profit	$250,000	$330,625
Depreciation on building	15,000	.....
Rental charge	.....	30,250
Profit before taxes	235,000	300,375
Federal income taxes, 38 per cent	89,300	114,143
Net income after taxes	$145,700	$186,232
Additional cash available for reinvestment of dividends		$ 40,532

Terms in the above example would apply more to department-store or retail chain property than to factory real estate. On industrial property the initial term would probably be something like 20 instead of 30 years, and the rental rate would be an initial 8 per cent declining to 5 per cent rather than the straight 5½ per cent noted above.

Provision in the agreement for a rejectable offer is probably all right. Such an offer provides that after a period of time the lessee can make an offer for the property at the then unamortized balance of the investment, plus a percentage of that amount as a penalty. If the offer is accepted, the property is conveyed. If the offer is rejected, the tenant has the option to continue in possession or vacate.

But a repurchase option in the lease may be dangerous taxwise. The Bureau of Internal Revenue may hold that the transaction is a loan with title held as security. This decision would result in disallowance of part of the rental deduction. There would then be only a depreciation deduction based on the useful life of the building plus an interest charge. There is also a tax danger in selling at a substantial loss. The Bureau may hold that the value of a low rental lease is part of the consideration for the sale and disallow the loss deduction.

Go slow on purchase-lease financing unless there is a *permanent* need for additional working capital. Otherwise, if there are a few bad years, the device can be just as heavy a load as owning the property under a long-term mortgage. Even though the rental commitment won't show up on the balance sheet (like the mortgage obligation), it will still be a long-term commitment which must be met.

Renting machinery. By renting rather than purchasing machinery and equipment, capital requirements can be minimized. For example, DoAll Company is currently selling contour saws and precision grinders on a plan which splits the sales price evenly into 36 monthly payments. The user of

the machine commits himself to keep it for a year and pays each month in advance. If he wishes to buy the equipment, 75 per cent of all rentals paid will be credited against the original selling price. In some cases when monthly rentals are applied against the purchase price, particularly if full credit is given for all rentals paid, the lessee will be required to pay interest on the value of the machine over and above rentals paid. This arrangement gives the user of the equipment a better expense deduction at rent than he would get as ordinary depreciation if he owned the machine. Under present depreciation practices of writing off a machine in 10 years, a buyer can deduct only $\frac{1}{120}$ of the cost each month. Under the rental plan where $\frac{1}{36}$ of the price is paid each month, that amount can be written off as current expense. Thus, while the cost of renting is higher, the difference is to some extent offset by the lower investment in capital equipment and by tax savings. The Treasury Department has cleared plans for the rental of machinery and equipment but it has also attacked rental plans that have strong sales elements. The Department has stated: "If there is any considerable disparity in the remaining amount to be paid for equipment and the fair market value at the time the option to purchase rented equipment is exercised, Treasury Department policy would be to consider the transaction a sale from the outset of negotiations."

Truck leasing. Companies which use trucks and are in need of cash may strengthen their capital position by leasing instead of owning the vehicles they need. Arrangements are usually made with trucking firms which specialize in leasing vehicles on a fleet basis. The transaction can involve one or two trucks, or a whole fleet.

The contract with the truck-leasing company may be for anywhere from 1 to 4 years. Usually the user furnishes the drivers and gasoline, the lessor assuming all other responsibilities (tire replacement, repairs, lubrication, insurance, washing, and garaging). Most lessors are willing to paint the user's company name and advertising on their trucks.

Truck leasing costs the average company as much as, or more than, the direct costs of operating its own equipment, although some companies claim that it actually saves them money. But consider these indirect advantages, as well as the value of an improved working-capital position:

No time-consuming maintenance

Insurance against breakdowns (the lessor will replace trucks which are out of service)

Peak traffic loads are not an expensive overtime problem, since the lessor normally agrees to furnish extra equipment as required

The best way to set up a truck-leasing arrangement is to contact several truck rental associations (like National Truck Leasing System) and have

them send representatives to study the company's operations and needs and quote a price. Industry prices are by now fairly standard, but it is still desirable to get several proposals.

Contribution and acquisition of patents. A patent, applied or issued, may be turned in for corporate stock or licensed to a corporation. Under some circumstances royalties paid on patents can be made tax-deductible to the licensee and capital gains to the licensor. Where a patent is licensed to a corporation for a percentage of sales or profits, the tax court has allowed the annual deduction as return of capital of the full annual payment called for by the volume of business and the applicable contingent payment percentage. This gives the buyer a full deduction of his annual outlay, while the inventor or author may get capital gain.

A licensor (promoter or writer) can retain substantial protective features and yet make an effective sale which may produce capital gain rather than ordinary income. Thus, where one Hessert assigned patents to Remington Rand, he retained the following protections and still made an effective transfer:

He earned royalties on the sale of consumable supplies as well as on sale or rental of machines covered by his patents

He got an "earnest" payment on execution of the agreement

Patents on inventions or improvements usable in connection with, or in substitution of, Hessert's inventions, discovered by Remington Rand's employees, were to be issued or assigned to Hessert. Remington Rand could, of course, use them under the license, but they would revert to Hessert in the event of default or cancellation

Improvement or substitution patents acquired by Remington Rand would be nonexclusively licensed to Hessert in the event of default or cancellation

Hessert could cancel if Remington Rand failed to carry out any of its covenants, including those for minimum royalties and full exploitation

The inventor could cancel if the licensee became bankrupt, filed a petition, made an assignment for benefit of creditors, or was placed in the hands of a receiver who was not discharged within 6 months

In the event of cancellation the inventor was to receive back, free of liens and claims of creditors, not only his patents but the business developed out of them

In the event of cancellation, Remington Rand agree to go out of the business, assign trade-marks and goodwill to the inventor, and to refer customers and forward orders for 3 years to the inventor or a company of his designation

The strategy in handling investment in development projects is very sub-

stantially influenced by the special tax treatment accorded patents and other assets flowing out of such activity: (1) loss is fully deducted, while gain may be at capital-gains rate; (2) unlike stock, the cost may be recovered by annual depreciation charges; (3) some expenses incident to research and development may be charged off currently; (4) income may be taken at capital-gain rates from an exploiting corporation which can deduct precisely the same payments.

Incorporating the development at too early a stage draws away some of the advantages:

To the extent that early development costs can be expensed, the net after-tax cost to the investor will be increased.

If the patent is ultimately to be sold or licensed, the intermediary corporation may merely set up a double tax liability.

In any subsequent sale of the development, to the extent its value is based on earnings, this will be net earnings after corporate tax. To put it another way, it would seem that a patent drawing off $1.67 might bring more than the stock of a company holding the patent drawing off $1 of dividends. This is by no means a hard and fast rule, particularly where the character of the development is such that the earnings from early operations are to be used in expansion.

Incorporation of the development increases the risk by getting the inventor involved in capital-loss restrictions and deprives him of the personal tax benefit of the depreciation of capitalized development cost. If a top-bracket taxpayer puts $10,000 into an incorporated development which fails, he loses all tax benefits from $5,000 of the loss and is restricted on the balance. If the development is held personally, some $8,000 may be absorbed by reduced tax liability.

If the development is patented, he can charge off $1/17$ of its cost against other income every year until the cost is fully recovered. If he had converted the development into some shares of stock, he can never change off the cost against his ordinary income. He will just have to carry the cost until he sells the stock, and then he gets only a 25 per cent tax benefit out of cost as against tax benefit against ordinary income rates if he can recover the cost in annual depreciation charges. Moreover, he loses the chance to take royalty income, undepleted by the corporation tax burden, out of the development instead of dividend income. Income from a full exclusive license, as explained previously, may be taken at capital-gains rates undiminished by the corporate tax burden, while dividend income is always taken in at full tax rates and is diminished by the corporate tax burden. Even though, at the right moment, he will want to sell to an operating company, there are tax benefits and flexibility in holding an invention or other intellectual property individually in the early stages.

The matter of timing the transfer of a patent or copyright to a corporation is important. The best solution depends on an evaluation of the income position of the owner, the value and income prospects of the patent, and how long it will take for them to mature.

6. *Financing expansion and refinancing*

Financing expansion. Careful study will have provided satisfaction that the reasons for expansion are valid and that the dangers of overexpansion have been appraised and guarded against. Up to a point, the financing of expansion will resemble the normal financing of a healthy and growing business. The usual methods of issuing additional stock and borrowing money from a public or credit institution may be followed. Again, up to a point, expansion may be financed by accumulated profits not distributed as dividends and by growing depreciation reserves. Wise management will look toward long-term growth and, in financing early expansion, will retain their best security for last. They will raise money with stock and debentures as far as possible. To pave the way for later expansion, they will refund bond issues into stock. The desirability of keeping open the way to further expansion and further financing, and of minimizing fixed charges, will have to be weighed against the low cost of borrowed money today, the advantages of trading on the equity and of a thin capital structure, and the requirements of maintaining maximum control. This decision may boil down to a question of weighing the profitability of maximum expansion, conservatively financed, against the profitability of expanding more slowly so as to maintain tax and control advantages without placing too great a risk on equity ownership. The risk of overexpansion is compounded when financed by short-term credit. Income and short-term borrowing may be drained off to build up big assets or expanded inventory, leaving the business vulnerable to the first cold wind of bad times. The nature of the financing used to carry out expansion will also be conditioned by the state of the stock market. If stock prices are high, it becomes possible to sell additional stock without unduly diluting the equity of existing stockholders. If stock prices are low, new stock can usually be sold only at a price which gives away too much of the business. Under these circumstances, such expansion financing as is desirable may best be carried out with borrowed money.

Acquisition of other businesses. The most advantageous type of expansion is frequently effected by issuing additional stock to acquire another business which will expand or diversify existing operations. The fact that other companies can be obtained by tax-free expansion frequently permits the owners of an acquired business to avoid capital-gains tax on their sale, and to improve their liquidity with little if any loss in investment yield.

For example, if stock having a cost basis of $400,000 is sold for $1,000,000, the owners wind up with $850,000 after paying $150,000 capital-gains tax. But, if the deal is a tax-free exchange, the owners wind up with $1,000,000 in securities. Return of 5 per cent on the securities would yield roughly as much as a 6 per cent return on the proceeds of a sale.

The acquiring company builds up its equity in several ways. First, the volume of earnings of the acquired company may be expanded by using the more powerful resources of the acquiring company. Also the established earnings and the method of financing can build up equity by retiring obligations, thereby building up earning power of the remaining stock.

In addition, major benefits may flow when the acquiring corporation has so proved an established earning power that its stock is valued at a higher multiple of annual earnings. The stock of the acquired company would normally be valued at a lower multiple of earnings, and the incorporation of the acquired firm's earning power into the acquiring company's structure will automatically bring about an important increment in value.

Take a corporation whose stock is currently the subject of high investment popularity. Suppose it has 1,000,000 shares of common stock outstanding, backed by $10,000,000 of assets, or $10 per share. Because of its popularity, promise, and earning power, the stock is currently selling for $20 per share. If this corporation acquires a company at a value of one and one-half times its net asset value, acquiring $600,000 net asset value by the issuance of 45,000 new shares, it achieves a 6 per cent increase of asset value for a 4.5 per cent increase in shares, and each share thereby gets a 1.43 per cent enhancement in asset value.

Again, an acquisition deal may be made mutually attractive by the superior credit standing of the acquiring company, which permits it to acquire funds on a low yield basis and to purchase properties of businesses less fortunately situated as to credit standing. The higher valuation set upon the earnings of a large corporation by the securities market means that the acquiring corporation can offer shares that are extremely attractive to the owners of the acquired business, and acquire earnings greater than its own shares are able to report. These earnings are then translated into the higher value for all its shares, including those newly issued.

As an example, take the 1944 acquisition by Coca-Cola of all the stock of the LaSalle group of Midwestern bottling companies for 113,665 shares of Coca-Cola stock. LaSalle's 1943 earnings were $1,200,000. Thus Coca-Cola acquired $10.56 of 1943 earnings for each share of its stock. Its own stock showed 1943 earnings of $5.98 a share. Since Coca-Cola's stock ranged in value from 16 to 30 times earnings in 1943 to 1945, the earning power of the LaSalle business increased the value of all Coca-Cola shares by double

the market price of the 113,665 shares issued to LaSalle stockholders. LaSalle stockholders received ten times LaSalle earnings, which was and is a good price for a small company. They sacrificed one-half of their prevailing level of earnings for the stability, liquidity, and relief from managerial risk and responsibility which ownership of a publicly owned company represents. They sold out at ten times their earnings, without capital-gains tax.

These advantages are quite apart from what a buying corporation can do to improve the smaller company's earning power by use of its financial resources, management talent, distribution outlets, etc., or by way of providing a sure market for the maximum output of the supplier.

Refinancing and recapitalization. The capital structure of a company may be changed by refinancing or recapitalization for the purpose of (1) achieving a more balanced financial structure; (2) paving the way for additional financing; (3) improving the appreciation potential of junior stockholders, the safety of senior stockholders, and the liquidity of both; (4) eliminating arrearages and preferred stock dividends; and (5) saving interest and other financing costs. Such capital changes fall into these categories:

Funding essentially involves the extension of maturities. Short-term debt is converted into long-term debt. Such a move is called for when a balance sheet shows a current liability practically equal in amount to current assets. It's possible only when underlying assets and earnings are adequate to support permanent debt and higher fixed charges.

Refunding involves calling bonds for redemption and paying off with the proceeds of new bonds issued. Such a move is called for to reduce financing charges when either interest rates have dropped or credit position has improved so that money can be acquired at lower cost.

Refinancing debt with stock involves calling bonds or preferred stock with funds realized from the sale of additional common stock. Such a move may be desirable when common stock values are high or when it is important to improve safety or to pave the way for future expansion by removing fixed charges and maturities.

Recapitalization involves revising capital structure by getting holders to exchange existing securities for new securities, on a voluntary basis. Substitution of junior securities for senior securities will improve safety, reduce fixed charges, and pave the way for future financing. Substituting senior securities for junior securities will provide a bigger gamble for those who retain junior securities, and greater safety and liquidity for those who make the swap.

7. *Check list for planning the financing of a business*

Study the business to determine the operating ratios, profit margins, discounts, and rate of turnover which prevail

Determine the scale of operations for which the business will strive. What volume will make it a going concern, and what are the probable and desired stages of growth?

Determine how much will be needed for plant, machinery, fixtures, and such fixed assets

Project a cash budget to determine the probable amount and timing of cash requirements and a profit-and-loss budget to determine the extent to which prospects justify the risk of capital

Start fitting the capital requirements, as determined in the first four steps, to the availability of capital to the owners. This may mean revising the scale and projected growth of operations

Determine how much capital can be raised by investment in equity (common and preferred stock) and how much it is desired to spread ownership

Set aside enough of this amount to cover promotion and early development costs and to provide a fund for contingencies and a cushion over and above short-term working-capital requirements

Determine how much long-term loan financing (mortgage, equipment, term) will be justified by the remaining equity and the collateral value of assets needed

Determine how inventory, payables, and receivables will turn over and explore ways and means of carrying these assets—advances from customers and trade credit, bank loans, inventory loans, loans on receivables

Determine desirability of leasing or licensing rather than owning assets such as plant, trucks, machinery, patents

Look around for trouble. What would be called for if expansion ran ahead of available capital? What would happen if necessary volume were slow in developing? Draw off pro forma balance sheets from budget projections and test them to see how credit worthy the business promises to be at selected intervals

Test the capital structure indicated by the availability and desirability of different forms of capital against tax factors

Section 3

HOW TO ORGANIZE YOUR BUSINESS FOR MORE EFFICIENT MANAGEMENT

BY

EDWARD MCSWEENEY

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HOW TO ORGANIZE YOUR BUSINESS FOR MORE EFFICIENT MANAGEMENT

Organization is the art which multiplies a one-man business enterprise into a large-scale, coordinated undertaking. Without organization—the controlled and directed teamwork of other people—there are distinct and rigid limitations on what one man can do.

It always takes *people* to grow. The difference between an independent grocery store grossing $800 to $900 a week and a supermarket grossing $5,000 to $6,000 is largely a matter of organization. The merchant who personally unpacks shipments, stacks goods on shelves, wraps packages, and acts as cashier has that much less time per day for waiting on customers. But one *manager,* plus an organization, can handle thousands of transactions daily.

The corner newsstand operator expands by "putting on" delivery boys. The garage man sees a step ahead and adds a wholesale department to sell parts and equipment to other garages. The village upholsterer starts selling furniture, in addition to repairing it, and winds up on a main highway with several floors of merchandise, including floor coverings, radios, and appliances. And now he has *people* selling goods for him, *people* delivering his wares in trucks, *people* installing television sets and air conditioners. Lacking organization, he could not function effectively.

Lester Jones and Wallace Smith both start out in comparable lines of business. Jones is a near-genius in his field, and he quickly outstrips Smith, who is a plodder. But Jones "does everything important" himself and reaches a point where, for lack of hours in the day, he can go no further. Smith, on the other hand, gradually acquires, trains, and organizes personnel. Eventually he passes Jones and keeps on forging ahead. Paradoxically, the bigger his business grows, the more time he has for creative forward planning. In short, he has an organization, and has multiplied his effectiveness manyfold.

Hiring people is only part of the organizing process. They must be welded into a unified whole, freed of overlapping and conflicting functions, held together by a common bond or morale. History abounds with instances where organizing genius triumphed over numbers—the Greek phalanx against the Persian hordes; the Roman legions against numerically pre-

dominant Goths and Gauls; the few hundred Spaniards, under Hernando Cortez, who conquered Mexico. Time and again, a handful of trained, disciplined, coordinated men have overturned an empire.

Procurement for war has always stimulated the organizing process among civilians. It was George Washington's compelling need for muskets, for example, which spurred Eli Whitney into mass-producing flintlocks on an assembly line—the world's first employment of interchangeable parts as a basis for production. In recent times, the race for the atom bomb involved the largest and costliest scientific organization in the world's history.

The next great advance was stimulated by the Second World War. The war developed many improvements in technology, but one of its greatest contributions was in the development of business organization. Time was vital, and war production could not wait on decisions from above. Consequently, top management rapidly extended the delegation not only of tasks but also of authority and of responsibility for carrying them out. At the same time, the war draft required an analysis of what each man was doing and a classification of his job. And the wartime wage regulations required a statement of his authority and responsibilities.

The outcome was a highly developed system of job analysis and delegated authority, which had the advantage of freeing top management to deal with the shifting wartime emergencies of materials, labor force, transportation, taxation, and finance.

Though 15,000,000 people were lifted out of the labor force of the country for the armed forces, our war industrial production was multiplied two and a half times in 3 years.

To the businessman, the reasons for organization should be self-evident. Organization not only multiplies his capacity to produce and distribute. It gives him access to others' capital, thus providing financial sinews for growth and operation. It frees him from slavish devotion to detail and enables him to work at his highest skill—managing his business. And it means that after his death or retirement the business will continue, with all that holds for his associates, employees, and dependents.

The process of organization may be classified as a science because it depends so much on precise definition of function, authority, and responsibility. The process of management which directs an organization may be considered an art, because it depends on human reactions, which cannot be relied upon to be always sternly logical.

1. The principles of organization

Organization is the management tool which enables the owner or top executive of a business to coordinate the "four M's"—Men, Money, Ma-

chines, and Materials—retaining control over their use and performance, so that all factors in the business move ahead according to plan. It is the key to eliminating waste and lost motion—and also the means of expanding opportunities for employees and executives. The business which does not meet these tests is not yet fully organized.

Defined in still another way, organization is the wedding of authority and responsibility, because, in its essentials, it consists of assigning specific functions to designated people or departments, with authority for them to be carried out, plus accountability to management for the results obtained.

Each of the following steps in setting up an organization involves a major principle:

Determine objectives. "What are we aiming at?" is the beginning of wisdom in organizational planning. The aim is not merely to make money, which is the first essential. Is it to capture a *measurable,* larger share of the industry's business within a certain area? Is it to introduce a new or improved product within a definite period of time? Is it to purchase and merge another company? Or to launch a subsidiary to engage in some particular line?

When specific goals or targets of this nature have been defined, only then is it possible to weigh their feasibility; to see if they are in harmony with the organization's other goals, and to estimate what may be required in terms of financing, facilities, and personnel in order to accomplish each objective.

Formulate policies. Administering a business, like administering a state, depends for continuity and consistency upon the *policies* prescribed. The constitution, laws, and court decisions, plus the regulations of administrative agencies, provide the great body of policies and precedents in the field of government. In business, policies are made or confirmed by the board of directors and carried out by the management. Through practice and precedent, the latter also builds a policy structure no less important than that of the directors.

Here are a few typical questions, the answers to which become a part of management policy; they must be answered before subsequent steps can be taken in setting up and administering the organization. The best procedures for developing the correct answers to most of these questions are discussed in other chapters:

How should additional capital be obtained, if needed? Through the sale of shares? By borrowing? By converting other assets into cash?

Of the company's borrowed capital, how much should represent long-term, how much short-term, debt?

Should distribution of the company's products be direct, or through job-

bers, selling agents, etc.? Should dealerships be exclusively franchised? Should resale prices be fixed through fair trading?

Should the company make or buy parts or other components? Should it own or rent the facilities for manufacturing, warehousing, the office, etc.?

Where should specific executive jobs be placed on the organization chart? In all cases where the question is applicable, should the particular executive's function be "line" or "staff" (operational or advisory)?

Should certain functions of the business be carried on by departments, divisions, or subsidiaries?

How much information should be supplied to stockholders, and what should be contained in the annual report?

What research projects should the company engage in? How much should be spent each year for this purpose? Should it be done by company specialists, by outside laboratories, or jointly with a college or the Federal government?

It is the nature of business policies to be *cumulative.* If arrived at after mature reflection based on all considerations, one policy supplements another. The existence of this corpus juris (body of law) greatly expedites future decisions. It also enormously diminishes the hazard of conflicting verdicts and incompatible, ill-assorted ventures.

Classify or functionalize operations. There are four major, or "basic," groups of functions in a manufacturing organization: financing, production, marketing, and accounting. With the exception of certain advisory functions —personnel, law, economics, public relations—practically everything a company does can be allocated to one of these four functions. For example, taxes, payroll, insurance, etc., would normally fall under accounting; product design, purchasing, safety, plant layout, and maintenance would come under production; market analysis, advertising, sales management, dealer relations, etc., would be classified as part of marketing; the raising of funds and the conservation of assets would clearly belong under financing.

Departmentalize. Once the separate functions become clear and their relations with others clearly understood, it is possible to set up departments to handle particular functions. In addition to a major function, each may have one or more related, minor functions. Where the volume and nature of an erstwhile "minor" function justifies, it can be given department status. For example, in many larger companies, internal auditing has become a separate function, no longer tied in with accounting. The internal auditor—who performs for the management what the certified public accountant does for the stockholders and directors—usually reports directly to the president.

When organizing departments, due consideration should be given to

administrative ease and control. Anything which needlessly increases the volume of reports, or which adds unnecessarily to the number of executives having direct access to the top official, impairs—rather than improves—business efficiency.

Centralize control. The man at the top of the organization should *hold the reins* or else have them held by someone under his direct supervision and control. The control function, which will be enlarged upon in subsequent portions of this section, is largely a matter of records (plus interpretation) based on standard of performance. Devising such standards, and providing for their proper use, is of major importance to top management.

Recruit and train personnel. The procurement, selection, and training of personnel—both executive and rank-and-file—are vital factors in building and maintaining an organization. Obtaining the right people is only part of the job. The training responsibility is far greater, because it is training which makes an employee invaluable, once he has been properly selected. Training is not just a personnel-department responsibility: it should continue, at all times, through all levels of the organization. Ideally, every job should be regarded as an apprenticeship for something better. The department head who is not training his subordinates to undertake higher responsibilities is failing in his duty to them and to the firm.

In short, policies and provisions for the selection and training of future executives and other personnel should be part of the organizing process.

Ensure coordination. Cooperation and teamwork, both within and between departments, are essential to the success of any organization. These cannot be left to hit-or-miss efforts but are the fruit of continuous and constant application of management policy. Communications and meetings are two dependable instruments, but even the best of these will fail without positive backing from top management, which, through its powers of delegation and control, can coordinate activities.

Coordination is increased when the organization chart provides for executives with *coordinating powers.* A director of advertising and sales, for example, can dovetail these two realms more expeditiously than can coequal advertising manager and sales manager.

Top management must be free to manage. A chief executive whose day is uncluttered with details—especially details not of his own choosing—can be truthfully said to head a "good organization." He must be free to devote his full time to management functions—to administer, to trouble-shoot, to create new ideas, to plan for the future—unencumbered by operating details. Whatever *can* be delegated *should* be delegated, always assuming clear-cut responsibility and tight control.

2. *The two prime objectives of good organization*

The two most basic, fundamental objectives of good organization are (1) to permit delegation of authority, and (2) to exert control. In other words, they provide answers to the questions, "Who is to do this work?" and "Is it being accomplished correctly, at the right cost, and on time?"

To permit delegation of authority. When a problem arises, management's first task is to evaluate it, *i.e.,* project it against the organization chart and see if it is "routine" and therefore referable to a given department or executive. If not, the problem must then be broken into fragments, and each piece assigned where it logically belongs, with provision for assembling the solutions.

For example, fault is found with a price. Was it properly computed? Did *accounting* accurately evaluate and assign the elements of cost? Is it a *cost-reduction problem,* which might involve *production* economies, or even research and an improved design? Is the cost too high because of uneconomical marketing? If so, *sales* may have to come up with the answer.

A problem of a different sort might be that of establishing a pension fund for employees. To *accounting* fall the details of the plan—as to whether, for example, a trusteed or an actuarial plan appears best—and also the computing of probable cost to the company and to the employees. *Personnel* or *industrial relations* must weigh the plan's impact upon the workers, including collective bargaining connotations. To *public relations* may fall the task of selling wide acceptance of the plan.

Delegation, of course, takes place at all levels. The foreman or supervisor who "gives orders" also endows the worker so instructed with some of his own delegated powers. He is *authorized* to proceed along a given course of action. Every step in the chain of command, from the board of directors down to the individual worker, involves a greater or lesser right to delegate responsibility and the authority to carry it out.

Much of top management's direct delegation is concerned less with the day-to-day functioning of the business than with the collection and interpretation of *facts* to use as the basis of planning.

Consider, for example, the fact finding which must precede decision making in regard to a new plant. Where should it be located? Are transportation facilities adequate? Is new construction more advantageous than buying and modernizing an old building? Is it better to borrow new money for the purpose, or use cash (to the possible detriment of dividends) or, perhaps, let an insurance company build and own it, with the manufacturer taking a long-term lease? Will the local labor force be adequate without "importing" others? What group of seasoned, trained employees, supervisors, and execu-

tives should be transferred from an existing plant to provide an expert nucleus? How much additional business must the company handle each year in order to absorb the various outlays and justify the expansion?

When the head of an effective organization needs facts like these, he usually delegates someone (say his executive assistant) to investigate all angles and submit a report with recommendations. Sometimes an outside consulting organization is retained to make a study, working in close liaison with an assigned executive of the company. Either way, the delegation carries with it authority to obtain facts and figures from all departments and individuals possessing them.

One would think, from reading material printed on the subject, that delegation normally originates with the top executive. This oversimplifies the process. More typically, it is an act of *confirmation,* carrying with it authority which sharpens in detail as it proceeds outward from the top administrator.

Here is an illustration. A report from the controller or chief accountant reveals that sales in a certain market are decreasing in relation to those of competitors. The general sales manager, when acquainted with this condition, decides after investigation that more intensive direct mail will help recapture the market. The advertising manager is brought into the picture and instructed (the first true delegation) to map a test campaign. From this point on the delegation spreads—to the advertising-agency account executive, from him to the copy chief and art director, and eventually to the printer who produces the literature.

This simple illustration shows that delegation is not a magic process, with the president sitting somewhere on Olympus, dreaming up ideas and pushing buttons to translate them into action. Rather, it is a process of stimulating others to think and communicate their ideas to management, which acts upon them. In short, delegation is a two-way street.

To exert control. Control is the obverse side of delegation. The larger the organization and the more far-flung its activities and personnel, the greater is the need for formalized control, which is another name for being kept informed about all aspects of the business. The pilot of an airplane has automatic instruments which tell him at a glance his altitude, speed, stability, fuel consumption, direction, wind resistance, and other vital factors. The controls which the head of a business organization exercises play a similar role. They tell him where he is and how he is proceeding, so that he can see where he is heading.

The president who says to an operating executive, "Do such and such, and we'll go over it on Wednesday," is exercising control in its simplest form. By fixing a date for the completion of the work and providing for his inspec-

tion of the results at a particular time, he has made what businessmen would call a "tight delegation." It is "tight" because it includes the measures for control. A follow-up file of dated reminders is another rudimentary example of control.

Organizationally, the control function is related to that of accounting and records, which explains why, in the larger companies, the controller is the chief accounting executive. In small and medium-sized firms, the top executive acts as his own controller, guided by the reports and records prepared and submitted by the accounting department.

Control, which might also be termed "evaluation," because one of its major purposes is *measuring results,* gives management a reasonably automatic check on all aspects of the operation. Without adequate controls to keep him informed, the head of a business cannot effectively "hold the reins" on his organization. More on this subject later.

3. *The three major functions of organization*

A business organization has three major functions: planning, operation, and control. Without the first, it grows haphazardly, if at all. Without the second, the real base of any business, organization is meaningless. Without the third, it is headed for the shoals of loose administration.

The planning function. Planning is the translation of objectives into concrete procedures and assignable responsibilities, determining what shall be done and who is to do it. It represents the generalship of business, including both strategy and tactics. It has long-range and short-term connotations, and it is successful to the degree that it is kept balanced and elastic.

The legendary autocrat who growled, "I'll do the thinking around here!" is the polar opposite of the more enlightened businessman whose organization provides the plan, probably with alternatives from which he can select the course best suited to his purpose.

Forecasting and budgeting are two specific instances of high-level business planning. The first step in forecasting is *appraisal* or *review.* What was our performance in the period just ending? How did it compare with that of comparable firms in the industry? What can we reasonably expect to do in the period to be covered by the forecast? What depressing or stimulating factors exist or can be anticipated in the general economy? What do we have to go on, in the sense of materials on hand or arranged for, work in process, inventories, plant and equipment, cash resources?

As a rule, the sales forecast is the foundation of the over-all prediction. Because sales are usually equivalent to gross receipts, most other factors in the business forecast are related to the anticipated volume of sales. But the sales manager's opinion alone does not suffice. He is expected to look on the

bright side of things, to minimize obstacles, and to reflect in his forecast an optimistic and enthusiastic point of view. Organization provides the needed checks and balances—from the "figure men" or accounting-minded executives, and from those concerned with production and procurement difficulties, who visualize the bottlenecks, internal and external, which may restrain the flow of goods into the market.

Great strides have been made in the art of business forecasting during recent years. Business cycles are better understood. Economic facts are more readily available, through the statistical services of trade associations and the Department of Commerce. Furthermore, business organizations themselves possess a greater store of past-performance data.

The techniques of budgeting have also advanced conspicuously. Few companies of any size, for example, make one rigid budget any longer. The growing practice is to make not one forecast but two or more, with a budget keyed to each. Then, if the lower volume of sales eventuates, there are budget categories to fit, without the need for complete rebudgeting. The so-called "flexible budget" has many advocates. Under this method, outlays are automatically reduced in proportion to periodic drops in sales.

This section is not concerned with the merits of any particular type of budget, but rather with the forecasting-budgeting process as an example of good organizational planning. Instead of being "masterminded" at the top and imposed on those below, it flows from the department heads themselves, and is accepted by them as a democratic device to facilitate their operation —and cooperation.

Forecasting and budgeting, of course, are only two aspects—albeit vital ones—of planning. Research, marketing, advertising, production, purchasing, personnel, training, compensation of executives and employees—all require planning. But the applicable techniques are all the same. Regardless of the particular problem involved, the organizational approach is the best for any business to follow.

The operational function. The operational function of organization is to eliminate the need for intervention in the operating process by those who constitute top management. The goal is to make the business *run itself* so far as possible, and limit management's intervention to improving methods, *i.e.*, further organizing operative details, whenever this seems advisable. Only to the extent that this goal is attainable can management be really free to manage.

This objective is achieved by routinizing operations via the establishment of systems, and by safeguarding their performance with controls. Standards are set up for every task, and records provided for, so that results will be measurable and subject to check. All operations are conducted within a

functionalized framework of executive and supervisory personnel, to whom appropriate delegations of authority have been made.

The requisitioning of materials constitutes a simple illustration. Only in the smallest shops does a workman have to go to the boss for what he needs. All others have a system of forms and authorizations which ensure a ready flow, combining records and control. The separation of toolmaking from production machining is another case in point. This simple, practically universal idea is management's assurance that (1) enough taps, dies, drills, files, etc., of the right type and variety will be on hand at all times; (2) all tools will be kept in top condition; (3) production machine operators will not waste their time sharpening or adapting tools, with the concurrent risk of spoilage. In short, the supplying and maintenance of tools has been *organized.*

The extent to which operations have been organized is apparent in many ways, from every perspective. To the rank-and-file employee, it shows up in such terms as convenience on the job (plant layout); lack of delays due to hitches in the flow of work from machine to machine or department to department; protection against accident, injury, and other health hazards; a clean and attractive workplace, with adequate wash-up and toilet facilities; a formalized grievance procedure; helpful and understanding supervision; a compensation method which he understands and accepts; and a feeling that he is being regarded and appreciated as an individual, rather than a machine or just a number on the payroll.

To the customer, a business is well organized if deliveries are made on time; if the company's salesman calls at regular intervals; if invoices are accurate and submitted in time for discounting; if the goods themselves are up to standard; and if, when occasional things go wrong, remedial steps are promptly taken.

Suppliers have kind words for their customers' organization if orders are clearly stated, shipments promptly accepted, bills paid on time or discounted, requirements estimated far enough ahead to keep "rush" requests at a minimum, etc.

Stockholders, bankers, investment counselors, and others whose concern is financial also have criteria for judging a company's management and ability to organize. Regularity of earnings, health of growth, cash position, debt management, treatment of reserves, depreciation policy, executive continuity (ability to attract and retain the services of competent people), freedom from proxy fights and other disputes over control, the absence of litigation or controversies with government—these are among the signs that the financial community goes by in evaluating a business organization.

The best systems for obtaining these desired results are not haphazardly

conceived. As a rule, each is the result of considerable study and actual test, plus regular revision and overhauling to keep in step with changing requirements. And when things go wrong, organization-minded managers ask, not "What's wrong with the man?" but "What's wrong with the system?"

The chief auditor of a large company recently remarked that a cash defalcation on the part of an employee is as much an indictment of the firm as of the embezzler. It raises the point, "What is wrong with our controls if they tempt—and permit—one to steal?" The same philosophy applies to waste of materials, accidents, absenteeism, and other drains on efficiency.

Almost all contemporary concepts of operating organization stem back to F. W. Taylor's discovery of "scientific management," which combined at every point the following conditions:

Standardization of the operation, including machines, tools, and methods
Selection and training of the right individual to perform the job
A cooperative spirit on the part of the worker

None of these three conditions is *static*. Standards for even the more elementary jobs require constant revision, because of improvements in machinery, changes in materials, changes in other jobs related to the first, etc. And, as has been remarked many times over, the human element is one which requires constant attention. The quality of supervision, plus the general level of human relations prevailing, is a basic factor in keeping systems operating with maximum efficiency.

The control function. Positive, centralized executive control as a function of management is a relatively new concept. Prior to the thirties, few companies numbered a *controller* in their list of key executives. The control function, in other words, was divided among several people, from the president down. The trend today is to concentrate the various aspects of control in one executive or department. An idea of what "control" involves can be gained from the following summary of the duties and responsibilities of a controller:

Determination and promulgation of accounting policies and procedures
Office management and office services, including standardization of office machinery, equipment, and forms; provision for central filing; and supervision of certain office service
Maintenance of the accounting records of the company in adequate form to disclose all needed information
Determination of income, costs, and profits of the company from its various activities, including all necessary preliminaries, such as taking and valuing physical inventories, classification of receipts and expenditures, allocation of costs and income as between accounting periods, etc.

Preparation and interpretation of financial and statistical reports of the company, including government reports and forecasts of probable results in coming periods

The making of recommendations for suggested executive actions indicated as necessary by the reports or forecasts, *i.e.*, in conjunction with other officers and department heads, to initiate and enforce measures and procedures whereby the business may be conducted with the maximum safety, efficiency, and economy

Administration of control practices and procedures with respect to assets, receipts, and expenditures, including budgetary controls

Preparation of tax returns and the supervision of all matters relating to Federal income taxes, social security taxes, state income and franchise taxes, etc.

Administration of internal audit procedures, including the continuous audit of all accounts and records of the corporation, wherever located; the verification of the company's securities and other property; the verification of the adequacy of insurance carried, etc.

The organization of the controller's department is as important in setting up the over-all pattern as is the organizing for production and sales. As in these other instances, functional lines are followed. The organization chart for a small or medium-sized company would probably show two executives reporting directly to the controller: the office manager and the plant accountant. The former would have authority and supervision over receipts and disbursements, general accounting, and budgets, while the latter would be in charge of payrolls, plant accounting, production and shipping, and costs. The functions of auditing, taxes, and so forth would be performed by the controller himself, or by an assistant controller.

In a larger, more involved establishment, the controller might be aided by three or more assistants—say one in charge of manufacturing accounting, to whom the plant accountants report; a second in charge of sales accounting, to whom the office managers of the various branches report, and a third in charge of general accounting, assisted by an accounting director for general accounts and an accounting director for taxes. In still larger setups, there are divisional controllers who report, as a rule, to the general manager of the division.

Although the title of controller is rarely found in small companies, the idea of centralizing records, accounts, and controls under one executive is rapidly spreading. Even where no such office exists, the fact remains that the controller's functions still have to be performed, and it is better organization to concentrate them in one department than to leave them scattered across the board.

4. How to develop a pattern of organization

Define responsibility by preparing job description. As previously stated, having people working for one is not the same as having an *organization,* with all that the word implies. The first step in converting a relatively unorganized group of employees into a real organization is obvious: to find out what they are doing presently, so that their duties and responsibilities can be defined and realigned. This calls for a *job description* of each function. When these descriptions have been written down and examined, it is possible to reassign duties on a more efficient, more logical, and more equitable basis.

Delegate authority sufficient to handle responsibility. Hand in hand with the redefining of the job should go the delegation of authority sufficient to discharge the duties. It is unfair and impractical to assign responsibilities without delegating the powers which go with them. It is inefficient and confusing to have authority and responsibility divorced, but this does happen in industry—most frequently at the supervisory level. The foreman who has no right to hire, fire, or discipline, who is by-passed in the grievance procedure and overshadowed by the union shop steward, does not have authority in keeping with his responsibility.

When defining jobs and delegating authority, it is important to avoid or eliminate overlapping. A delegation is effective only if it is clear-cut and if its scope and definition are known to others in the organization. Limiting authority is as important as imparting it. In short, the executive should know how far he can proceed without trespassing on another's territory.

Some businessmen who are good in every other sense make two cardinal errors in this regard: (1) they prefer to let authorities be implied, rather than stated; (2) they do not respect the boundaries which they themselves have laid down, but feel free to "cut across channels" whenever they so desire. Such actions are subversive of an organization, and are the frequent cause of resignation, frustration, and resentment on the part of executives so treated. To the organization, the cost is paid in terms of waste, lack of cooperation, and impaired control.

Compensate fairly. *Compensation* is of supreme importance in reorganizing a business or setting up a new one. The salary paid to a specific executive must be in line with those paid for comparable jobs in the company, in the area, and elsewhere in the industry, and it must fairly reflect the nature and scope of his responsibilities. A salary is significant not only in terms of the purchasing power and living standards which it represents to the person receiving it, but also as a measure of his importance and prestige.

An executive's salary should be sufficiently larger than that of his best paid subordinate to substantially reflect the difference in their ranks. It is a mis-

take, for example, except under abnormal conditions, for a company to pay supervisors less than the workers under them receive. Such a condition was prevalent during wartime, when production employees' pay was swelled by high piece rates, shift differentials, and overtime. As a result, the foreman's status was badly undermined.

No one—employee or executive—should have his responsibilities increased without receiving a comparable increase in pay. The stabilization rules of the Second World War took this into account, and one dependable way for an employer to win approval of a wage or salary increase was to demonstrate an increase in responsibilities. Incidentally, this rule stimulated the healthy practice of job analysis, job description, and job evaluation as a basis for fixing compensation. It also caused widespread adoption of job classification—the setting of a range for every job, from the minimum or starting wage to the maximum for that position. Many companies which lacked such classifications went to work and installed them, and a few months' trial sufficed to prove the value of the innovation as a permanent device.

Length-of-service increases, within the range set for the particular job, were also recognized in the wartime regulation, and were generally adopted and retained by employers.

Of course, once a maximum has been set for a particular position, the question arises of what to do with the employee who has achieved the maximum. One cannot go on increasing the maximum; this would not only upset and confuse the compensation schedule, but would also lessen the employee's incentive to take on additional or higher responsibilities. The way to meet this difficulty is through a policy of promoting individuals to higher jobs and training them to move ahead.

In the more important positions, the value of salary increases as incentives has been greatly impaired by income taxes. The same is true of a bonus, which is treated as taxable income by the Treasury, and the tax treatment of stock options to employees has also deprived them of their former importance as incentive rewards.

Some companies have partially overcome this condition by granting special privileges to executives in lieu of substantially higher pay, once the tax "bite" becomes confiscatory. These range all the way from more luxurious offices and more assistants to longer vacations and larger personal expense accounts. Everything possible is done to increase the individual's feeling of significance, as in encouraging him to take a larger part in trade association activities, allowing him to speak for publication, giving him greater opportunities for travel, admitting him to the inner councils.

Retirement pay is an important part of the compensation problem, especially in regard to higher executives. Again, tax restrictions interfere with a

company's right to determine retirement payments, and few pension plans give an adequate retirement allowance to the higher-paid executives and officials. This has been met in some quarters by *not retiring outright* the victims of this discrimination but giving them responsibilities of an advisory or consultative nature, which do not take up all their time but keep them "on call" when the need for their help arises. Such duties, of course, must be tangible, because otherwise the Federal tax authorities would disallow the expense of such salaries as not representing services rendered.

The so-called "fringe benefits"—vacation pay, hospitalization, health insurance, employees' pensions, etc.—are becoming more and more a regular part of the compensation plan. Economists estimate that from 5 to 20 per cent of the payroll is for such benefits, and that the burden will increase, rather than diminish. Obviously, a company is not prepared for future contingencies unless it has made tentative provision for this "hidden payroll." Social-minded government combines with aggressive labor-union leadership to impose these costs upon industry.

Evaluate progress at stated intervals. Another "must" to keep in mind is to evaluate progress at stated intervals. This includes not only the progress of individual employees, as measured by merit rating, but also that of departments and of the company as a whole. A business should grow, on the average, 20 per cent a year. No company stands still; it either grows or shrinks. Therefore it is important for the organization to include provision for periodic reviews and soundings to show which way the firm is heading.

One way to keep growing is to keep the individual employees and executives adding to their stature. If their progress is regularly checked and recorded, a basis is provided for recognition of their growth. This keeps the organization "on its toes," and passes the benefits down the line.

Select carefully and train thoroughly. Whenever and wherever new personnel is required, the emphasis should be on careful selection and thorough training. If jobs have been properly analyzed and standards of the right sort devised, the personnel department will be guided in its choice of applicants. Final selection, of course, should rest with the department head to whom the new employee must report.

Training should be dynamic and long-term, rather than haphazard and confined to learning the immediate job. It has been wisely said that "authority to supervise includes responsibility to teach." Unfortunately, as a recent study proved, there are many high executives in industry who never had supervisory experience and who are equally unprepared to train and teach. The facts regarding such conditions should be known to management, which then—and then only—can take steps to supply the deficiency. A program

combining attendance at outside institutions, plus appropriate on-the-job training, will go far to remedy such a situation.

There is another corollary, which holds that no employee is fully trained for a given position until he is able to supervise others in doing the work. It follows that employees who show any promise at all should be early instructed in the art of supervision.

Training also involves indoctrination in the company's policies and procedures, acquaintance with the rules and regulations surrounding various jobs and departments, plus knowledge of its products and of its position in the industry and the community. The preparation of an employee manual, so that a copy can be given each new recruit, is a constructive step in this direction. Needless to say, it should be graphically attractive and up-to-date, and not just one more piece of dry-as-dust "literature" to be put away and forgotten.

5. The levels of organization

Any organization can be broken down into levels of delegated authority and responsibility. These levels of organization are important only in checking actions to make certain that they are being handled at the right level. The majority of decisions will fall under these levels of organization:

Policy decision
Planning and recommending techniques
Supervision
Detail work

The actual working of these levels of operations is covered so thoroughly in the other parts of this section that they are being listed at this point simply for checking.

6. The growth pattern of delegation of authority

Most business organizations are the result of an expanding pattern for delegating authority. The process starts with the original "one-man" business. The proprietor begins organizing when he engages an assistant, to whom he delegates a portion of the work. As business increases, he adds additional assistants, and they, in turn, acquire personnel to help them. In time, the assistants become heads of departments and report to the owner.

As the business becomes more complex, outside services are retained: a public accountant, who for a time provides all the accounting services required; legal counsel; an advertising agency; public relations and management counsel, etc. Often outside services fill an awkward gap, because the business is still too small to justify full-time specialists on a salaried basis.

Gradually the business acquires a full-time staff. Accounting detail has grown and the need for audits and reports has sharpened. So the rudiments of an accounting department appear. The volume of advertising has also grown to a point where someone must keep in constant touch with the agency, so an advertising manager is engaged. Technicians of various kinds, depending on the nature of the business, are added to the payroll, which by now also includes an office manager (who probably doubles as chief accountant), a purchasing agent, and a sales manager.

By this time, the need for capital in keeping with the enlarged scope of the business has made it necessary to sell securities to the public—which in turn has resulted in the election of an active board of directors. The owner has now become the president, and at the directors' insistence he rounds out the organization, so that he can function as an administrator, effectively carrying out the policies of the board.

As one of the major steps in completing the structure, the company obtains a controller, whose function—besides managing the accounting, tax, and related departments—is to keep the president informed where the business is, so that he can see where it is heading.

7. *The importance of controls*

In order to function properly, the head of an organization must retain control over key activities, including—

Budgeting and control of funds and expenditures. The company budget is the basic instrument of such financial control, supplemented by daily balances of condition, summaries of receipts and disbursements, etc. Before any check is signed, the payment is checked against the proper budget category, as are authorizations to commit the company to buy in excess of certain amounts.

Materials en route and in process. A control is kept on all such items, so that warehousing costs, material prices, demurrage on freight, and other losses are kept to a minimum, and so that production stoppages are not caused by delays in arrival of materials at the plants.

Plant and equipment. These are under constant and positive check as to their adequacy, depreciation, maintenance, comparative production costs, etc. The newest and latest devices for materials handling, inspection, speeding up and improving quality of output, and so forth, are studied and tested.

Resources and suppliers. The quality of materials received is established by test, and the dependability of one source as against another is kept a matter of record. Such matters as labor stability and financial and credit status are studied from time to time, and any development which may affect the supplier's delivery capacity or credit is quickly investigated. Otherwise

employment in the organization's own plants may be unstabilized, with a consequent impact upon employee morale and customer satisfaction—not to mention profits.

Personnel. Personnel here includes employees, consultants, and agents. The entire field of employee relations, including collective bargaining, morale building, promotion, and training, should be subject to periodic surveys and examination. Never as intangible as they first appear, these relations are measurable and definite. Just as the military commander's first thought is for his men, so does the happiness and prosperity of his employees loom large in the top manager's thinking.

Outlets and markets. Control in this sense over outlets and markets greatly exceeds mere credit management, which is only one of the factors to be considered. A good organization is "choosy" about those to whom it sells. Price cutters, chiselers, and others of that ilk may have the best of credit, but the firm may suffer from doing business with them. Care is also taken not to overreach into distant markets, where the cost of doing business may exceed the total volume from the area.

Control of marketing must be positive as well as negative. The wide-awake organization constantly surveys new markets, as well as restudying those already established. It never lacks the facts on which to base its decisions regarding territories, consumer demand, etc., and is ready on short notice to "move in" and capitalize on any favorable situation.

8. Basic helps

There are a number of basic devices which top management can use in building and administering an organization. Here are some which have proved their utility:

Separation of functions. As previously stated, functions must be clear-cut and sharply delineated if delegation is to be clear. Otherwise those who perform the functions will be "fuzzy" in regard to them and to their own measure of authority and responsibility. Under such conditions, efficient administration is impossible.

Organization chart. This is a means of defining functions, job titles, and their relation to other functions and other jobs. It is the nature of organizations to keep developing and changing, so the charts which portray them must also be kept fluid. Books have been written on the subject, and there is much to be learned from perusing them.

Clear delegation of work and authority. This has been dwelt upon before, but is an absolute essential, and hence worth mentioning again and again.

Budgets and accounts. These are management's keys to control, the basic instruments in keeping a business concern a going (and growing) concern.

Accurate costing and forecasting. Without these, budgeting cannot be accomplished, which would rob top management of its most essential controls.

Reports to management. These include control reports and summaries, trend and analytical reports, financial reports, etc., as well as special studies made at the request of management or the board. The facilities for gleaning information, making comparative studies, etc., are of vital importance in conducting an organization and keeping it moving ahead.

9. Errors to avoid in building an organization

In building a business organization, certain mistakes are possible—even probable, under certain conditions. The most commonly made include:

1. Excess personnel and resulting high cost of management. It is human nature, under pressure of time and necessity, to *add people* to the organization, rather than restudying the setup and seeing how *change,* rather than expansion, will enable it to absorb a higher load. It should be remembered that while some functions wax, others wane, and this in itself provides a certain elasticity.
2. Confusion over line and staff functions can be bothersome and exasperating. The "line" executives and departments are those in the direct chain of command from the top executive; they carry out and execute orders, with the authority and responsibility implied. "Staff" executives and departments, on the other hand, are those with a purely advisory function, except in regard to their own department personnel. Accounting, auditing, public relations, etc., are staff, rather than line, activities.
3. Loss of initiative at the top, especially in the formulation of policy, is bad for any organization. When moves and decisions are *forced* "by conditions beyond control," management to that degree has lost its ability to manage.
4. Too great a burden of reports, interoffice communications, and so forth is deadening to the people who must read and act upon them. The effort should always be to diminish, rather than increase, their volume, and to require summaries, rather than detailed reports, whenever abridgment and condensation are possible.
5. The fifth great fault of management is to place undue emphasis on some one particular activity—accounting, production, sales, research, and so forth. Organizations thrive on *balance* and are bound to suffer in effectiveness if the direction at the top is one-sided. After all, one of the primary purposes of having an organization is to permit it to move ahead on all fronts.

10. How to check your organization efficiency

The top-management search for organization efficiency is a continuous examination of how your organization is doing what it is supposed to do. The following headings are suggested as major checking points for such an examination. Obviously, they are not all the points that must be checked, but if you look for improvement in these areas, you will undoubtedly identify the special points at which the efficiency of your own particular business organization can be raised.

Organization. Have you an organization manual, defining functions, authority, and responsibility of your personnel? Is the organization charted for easy grasp by all involved? Have standard practices been reduced to writing? Are the manual, the chart, the standard practices maintained on a current basis? Are they circulated?

Personnel. Have you a policy and a program for selecting, placing, and advancement training of all personnel? Are salary and wage rates, from common labor to top management, established by job evaluation? Is an individual history and job record of each employee kept up to date? Are salaries and wages increased only under pressure? Or by seniority? Or on performance?

Product. Do you ensure market acceptability of your product by close cooperation with your sales division? Is your engineering aimed at a competitive cost? Are engineering and merchandising research looking for product improvements and for new products?

Production. Is your production completely planned and scheduled to control the economical purchase of raw materials, to progress the work through modern machinery, processes, and layouts, to utilize labor under efficient supervision and incentives to cooperation, to gear the inventory of finished goods to the sales requirements and manufacturing capacity? How much attention is given to maintaining the effectiveness of equipment and the quality of product?

Distribution. Do you determine your customers' needs by market research and current sales records? How closely do you follow the efforts and results by salesmen, territories, customers, and products? How alertly is your sales force directed? How well is it compensated? How does your delivery system meet customers' requirements competitively?

Planning. How much of the volume and nature of your business is based on guesswork and impulse, and how much on data and the judgment of divisional heads? How much attention do you pay to your progressive position in the industry, and the position of the industry in the economy, and the state of the economy as a whole? Are your plans definitely stated

and understood by those who are to carry them out? Do you participate in trade and business associations? How are your public relations?

Financing. Do you forecast and schedule your money requirements for the business volume you have decided to undertake? Do you budget your intake and output and reserves to keep your capital continuously at work?

Control. Do you recognize that control figures are the checkup on current efficiency—the road to prompt corrective action under a forward-moving plan? Does your accounting supply you with daily, or weekly, or monthly reports on the performance of all departments, showing you what was planned and how the plan is working out? How is departure from the plan signaled and how is the necessary correction determined? Do you get enough control reports and not too many? Are they on time? Do you need better accounting equipment and personnel? Does your accounting secure the necessary data on costs and variations without encumbering operations with forms?

Another check list to help you. *Practical Management Research,* by Alexis R. Wiren and Carl Heyel,[1] has this check list of advanced management (quoted by permission), a sort of composite indicator of the best of what the best companies are doing. A draft of these points was sent by the authors to representative executives in leading companies—specialists in various fields, such as production, personnel, and finance—so that a reasonable approach to comprehensiveness could be attained. The authors note that

> . . . this check list is idealized; no one company will want to conform to it in its entirety, and details on certain items would have to be expanded to fit individual situations. In most companies, because of size, type of operation, type of employees, type of ownership and control, and the like, many of the items need not be considered at all. The list should, however, serve as a useful management yardstick.

A Check List of Advanced Management Practice

I. Administration
   1. Development of company, industry, and general economic indices and "danger signals"
   2. Analysis of *actual* lines or organization and authority, as distinguished from the nominal ones; development of sound lines of organization, and clear-cut delineation of responsibilities and authorities; putting the organization plan on paper in the form of an organization chart or manual, and provision for a regular review through an organization planning or research unit with top management backing
   3. Development of a statement of long-term company objectives, and plotting out basic lines of investigation bearing upon them
   4. Use of committees, carefully selected, as a means of coordinating administration activities

[1] McGraw-Hill Book Company, Inc., New York, 1945.

II. Personnel and industrial relations
   1. Comprehensive job analysis, for—
      a. Use with a job-evaluation and employee merit-rating program, in the development of a scientific wage-payment plan
      b. Use with job specifications in selection and promotion
      c. Job breakdowns in developing job manuals and training programs
      d. Use in drawing up promotion charts, showing logical promotion sequence from one job to another
   2. Job tests, and aptitude tests and other psychological and psychiatric tools, for—
      a. Over-all selection
      b. Specialized duties in connection with placement and promotion
   3. Careful planning of the interview for selection, placement, difficulty adjustments, and exit
   4. A formalized induction procedure for new employees (orienting the new employee may well include written and oral data on company history, products, and policies; a trip through the plant; and introduction to the persons with whom the new employee will work)
   5 Organized training programs; supervisory and job training; use of training manuals, job breakdowns, and other forms of standardized instruction; use of motion pictures and sound-slide films in training
   6. Periodic detailed discussion of the employee's rating with him
   7. Development of personnel manuals and written statements of labor policies
   8. Periodic checkup to see if union contracts are understood by the supervisory group
   9. Use of employee counselors—people to whom employees can talk with the knowledge that something may be done about their problem, but that in no case will what they say be used to their disadvantage
   10. Organized safety programs; development of safety manuals with the help of employees on the job; adequate first-aid facilities; good heating, lighting, etc.
   11. Organized employee recreation, and recreational facilities
   12. Employee cafeteria; help and advice on employee nutritional problems
   13. Group insurance and employee benefit plans—sickness, death, old age, unemployment, hospitalization, severance, employee loan service
   14. Adequate personnel records, including statistics on turnover, absenteeism, accidents, etc.
   15. Formalized, liberal, vacation and leave-of-absence policy
   16. Employee suggestion system
   17. Employee publication

III. Production
   1. Development of production standards and standard costs; periodic discussion meetings of department heads to analyze reasons for variations from standards
   2. Use of visual controls in planning and scheduling work
   3. "Work simplification" programs, to assure continuous awareness of the "why" of operations, and to assure performing them with minimum motions and materials; use of motion- and time-study techniques
   4. Analysis of plant layout for best utilization of space, location of service facilities, etc.; use of flow charts to examine internal travel, transportation, and handling to provide best plant layouts
   5. Scientific inspection procedures; use of statistical techniques
   6. Programs for dramatizing quality and control of waste to employees
   7. Scheduled inspection and maintenance of equipment and facilities; development of maintenance budgets

8. Periodic studies of all paper-work routines (in recent years, paper work has crept into production processes to the point where the ratio of nonproductive labor to productive labor has increased enormously)
9. Formalized procedure for review of new equipment, and its possible application
10. Formation of factory "councils" or boards, composed of executives and department heads, for "consultative management"

IV. Sales, marketing, and advertising
1. Sales forecasting and sales budgeting; development of economic information as yardsticks for sales forecasting and performance
2. Development of statistical information on the sales performance of the company's products against competing brands
3. Use of consumer panels for pretesting of new products and checks upon existing products
4. Use of test stores or other devices for sales testing of new or changed products, preevaluation of displays and dealer helps, etc.
5. Development of procedures for accumulating *promptly* sales data for analysis of performance and potentials by classes of accounts, territories, products, sizes, and the like
6. Liaison between sales and production, to iron out production peaks wherever possible, and to take full advantage of by-product possibilities and new-product ideas
7. Periodic analysis of packaging, from point of view of shelf appeal in competition with scores of other products, convenience of use by customer, efficacy as a container, etc.
8. Study of salesman turnover; use of special aptitudes tests and other selection procedures for the sales force (organizations having large sales forces may find it advantageous to have a separate sales personnel section)
9. Sales training and salesman-development programs
10. Adequate procedure for handling customer complaints, and for analyses of them to prevent recurrence

V. Financial control
1 Coordination of departmental budgeting work, and development of over-all budgetary control for—
   a. Sales
   b. Production
   c. Plant and equipment
   d. Purchasing
   e. Administration
   f. Personnel budgeting when advisable
2. Periodic, well-organized inventories, with an adequate system to control supplies and equipment between inventories
3. Periodic checkup on the adequacy of insurance coverage
4. Periodic analysis of working-capital position, and probable future requirements, to determine—
   a. Future needs for cash
   b. Dividend policy for board of directors
5. Study of financial markets to test adequacy of the company's present financial structure
6. Analysis of all activities and expenditures from the standpoint of tax effects, and provision in the organization for centralization of tax work
7. Preparation of annual and periodic reports in a form to be intelligible to stockholders and employees through the use of charts, illustrations, interpretations in nontechnical language, etc.

VI. General office
1. Establishment of production standards wherever possible; especially, establishment of standards of promptness in dealing with current matters
2. Procedure manuals for branch offices
3. Review of office supervisory methods, and establishment of training methods for office supervisors (to bring the office, in this respect, up to the plant's foreman-training methods)
4. Periodic review of office forms, to take advantage of possible modernization or revision for economies in production and use
5. Examination of centralized operations, to see whether centralization has gone so far that operational difficulties are encountered
6. Establishment of scientific filing procedures; systematic review and destruction of obsolete records in accordance with a formal record-retention schedule
7. Application of "work simplification" and motion- and time-study thinking to office operations, to save motions, steps, material, or the time of other departments
8. Analysis of methods in the light of modern equipment, to see whether certain manual operations should be done automatically; periodic review of equipment newly placed on the market for possibility of laborsaving use; regular examination of equipment to avoid reduction in "turn-in" values because of obsolescence
9. Periodic review of all statements and reports to see whether some should be eliminated, combined, or reduced in distribution
10. Formation of office "councils" or boards, composed of executives and department heads, for "consultative management"
11. Scheduled talks by the office manager with individual employees

VII. Purchasing
1. Use of market forecasts for advantageous placing of orders
2. Standardization of items and written specifications to prevent avoidable variations
3. Periodic examination of standards of quality and other specifications to reduce possibly excessive requirements
4. Physical laboratory or testing facilities for the development of purchase specifications as well as for testing incoming materials and supplies
5. Use of "contract orders" under which the supplier is authorized to have at all times a definite quantity of materials or supplies in stock to be drawn against, the supplier storing the bulk of such materials and thus decreasing the storage problem
6. Use of blanket contracts with price adjustment clauses
7. Analysis of usage, so that related orders can be combined and placed at longer intervals, instead of a larger number of separate purchases of individual items, requiring separate bids and separate handling
8. Periodic checks with suppliers, to see whether changes can be effected in specifications which would permit decreases in their costs, with corresponding decreases in prices
9. Maintenance of multiple sources of supply, particularly for key items, to guard against the failure of any one
10. Adequate procedure for prompt payment of bills, to permit taking advantage of all trade discounts and, where possible, "anticipation discounts" periodic review of terms

VIII. Receiving and warehousing
1. Establishment of minimum stock on hand for automatic reorder, in conformity with possible seasonal variations

2. Periodic review of procedures to improve inventory control and reduce paper work to a minimum
3. Review of slowly moving stock to permit intelligent disposal of obsolete items
4. Examination of layouts and usage, to keep handling at a minimum in the distribution of materials and supplies to consumption points
5. Adequate marking of lots, so that purchase order and supplier can be determined readily
6. Advance planning for special space required by seasonal peaks
7. Requisitioning procedure which permits adequate control but reduces paper work to a minimum

IX. Packing and shipping
1. Periodic analysis of shipping containers and packing and shipping methods, in the light of technical developments
2. Development of sound traffic methods; analysis of warehousing and distribution centers from the point of view of customer service and transportation rates

Section 4

HOW TO AVOID THE RISKS IN BUSINESS

BY

ROY A. FOULKE

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HOW TO AVOID THE RISKS IN BUSINESS

1. *Trend in business failures*

Since 1900 there have been three peaks in the broad cyclical fluctuations in the number of business failures: [1] 22,156 in 1915, 23,676 in 1922, and the all-time high of 31,822 in 1932. Similar peaks in the failure rate [2] per 10,000 of listed business concerns occurred in these same years although there has been a fluctuating upward trend in the number of listed business concerns. The failure rate was 133 per 10,000 listed businesses in 1915, 120 in 1922, and 154 in 1932.

In 1945 business failures reached an all-time low of 810, or only 4 failures per 10,000 listed concerns. Since 1945 the number of failures has increased each year, 1,130 in 1946, 3,476 in 1947, 5,252 in 1948, and 9,247 in 1949. The failure rate increased at the same time, 5 failures per 10,000 listed concerns in 1946, 14 in 1947, 20 in 1948, and 34 in 1949. Nothwithstanding this steadily upward trend over the past 4 years, the number of failures and the failure rate for 1949 were both strikingly low. This fact is evident from the following comparison of the average number of failures and the average rate of failures for successive decades from 1900 to the present time:

Year	*Average number of failures*	*Average failures per 10,000 concerns*
1900 to 1909	12,020	90
1910 to 1919	14,530	90
1920 to 1929	20,443	98
1930 to 1939	17,736	86
1940 to 1949	5,919	26
1900 to 1949	14,130	78
1949	9,247	34

[1] Business failures are largely commercial and industrial enterprises which have discontinued operations following assignments, voluntary or involuntary bankruptcies, and such actions as executions, foreclosures, or attachments where losses to creditors have resulted, or where the concern withdrew voluntarily from active operations leaving unpaid obligations; also enterprises involved in court actions such as receiverships, reorganizations, or arrangements which may or may not lead to discontinuance of operations; and enterprises reaching voluntary compromises with creditors out of court.

[2] The index of business failures for any one year represents the number of business failures in the calendar year for each 10,000 business enterprises listed in the July *Reference Book* of Dun & Bradstreet, Inc., for that year. There were 5,252 business failures in the United States in 1948 and 2,550,000 business concerns listed in the July, 1948, *Reference Book*. These figures give an index of 20 failures per 10,000 active listed concerns for that year.

The 9,247 failures which occurred in 1949 were materially lower than any of the 10-year average failure figures from 1900 to the present time with the exception of the current decade of 1940 to 1949; they were 23.3 per cent lower than the average from 1900 to 1909, 36.5 per cent lower than 1910 to 1919, and 55.0 per cent lower than 1920 to 1929. Moreover, the failures for 1949 were actually 34.8 per cent lower than for the 50-year average of 1900 to 1949.

A comparison of the failure rate for 1949 with the averages for these earlier decades is even more impressive. The 1949 rate of 34 failures per 10,000 listed concerns was 62.3 per cent lower than the averages for 1900 to 1909 and 1910 to 1919, 65.3 per cent lower than 1920 to 1929, and 56.4 per cent lower than the 50-year average of 1900 to 1949. From 1900 through 1941 there were only 5 years in which there were less than 10,000 failures. For 1949, failures were 7.9 per cent below that figure. From 1900 through 1942 the lowest failure rate of 37 per 10,000 listed concerns occurred in 1919, a rate which was somewhat higher than that of 1949.

2. *Causes of business failures*

Business failures, it is said, are the result of many divergent factors such as incompetence in one form or another; inexperience; lack of working capital; the increased intensity of competition; changes in the technique of production and distribution; changes in styles, fads, and habits; the introduction of substitute products; disasters, such as drought, severe windstorms, and fires; overtrading and undertrading; the personal extravagance of officers or partners; and, last but not least, the greatest overlord of all of the masters, "general business conditions." Failures have been attributed to every reason under the sun and also to some reasons under the moon, the stars, and the planets.

Fundamental importance of management. The factor that has caused more business failures than any other single factor has been considered by many diligent students to be the lack of working capital. This cause has been singled out, emphasized, and delicately played upon, in contrast to many other causes, including incompetence, mental inertia, and inexperience on the part of those guiding the affairs of a business enterprise. Four examples will indicate the moral that the finest plant, the most meritorious product, the greatest potential market, are liabilities under poor management; that management and not the multitude of collateral factors is fundamentally responsible for the success or failure of the business enterprise. Other factors help or retard progress in a competitive economy, but they are, in truth, on a secondary plane of importance.

Lack of working capital. If a business enterprise to manufacture a line of folding card tables begins operations, for example, on a net working capital of $20,000, when a minimum of $50,000 is essential at a particular location, is not the very organization of that concern with insufficient working capital the result of incompetence, inexperience, poor management, and a lack of financial knowledge regarding the minimum amount of working capital needed to start operations with a reasonable expectation of success? On the other hand, if the business begins operations with a net working capital of $50,000 and in 3 years such losses have been assumed that the excess current assets have been reduced to $20,000, are not those losses fundamentally the result of inefficient or incapable management somewhere along the line? The lack of working capital in either instance is but an outward expression of the inexperience or the inability of those who have charge of the welfare of the particular business concern.

Extreme competition. Failures are often said to be due to the increased intensity of competition. With hundreds of thousands more concerns in business today than ever before, we are in for a period of bigger and better competition—and that is as it should be. If the effects of competition are actually beyond the control of business management, fatalism would need to be the philosophy of business operations. The expenditure of thought, energy, and conscious effort would be largely superfluous!

Just consider this matter of "extreme competition" for a moment. Suppose that there were 59 motion-picture-theater supply houses in the United States and that each dealer handled a wide variety of supplies for the typical motion-picture theater—projection machines, seats, curtains, carpets, sets, projector repair parts, lamps, accessories, and carbon. Suppose competition became keener and keener, and prices were cut—first on one product such as carbon, and then on others such as projector repair parts, lamps, and accessories. Profits are turned into losses as the gross margin on carbon is cut from 30 per cent to 10 per cent, and the gross margins on other important items also are materially reduced. First one concern and then another liquidates its affairs, pays its bills, pays the wages of its employees and its rent, pulls down the shades, and closes up shop. Finally, 39 remain. How did that happen? Why were not the entire 59 concerns forced to liquidate under a condition of extreme competition? Why only 20?

Obviously, the 20 which felt the results of the keener competition were the marginal concerns. The managements of the liquidated concerns had lacked the aggressiveness to hold old business and had failed to acquire new business on more profitable collateral lines, such as radios, television, air-conditioning equipment, and sound equipment which could have been sold to clubs, schools, and churches. The weaker financial businesses often become

stronger and finally work into healthy shape under the stress of intense competition, because that very stress often breeds aggressiveness and a will to go after and acquire sales on a profitable basis. We are now entering a period of competition the like of which we have never before seen in our country. Management with the greatest ingenuity, keenness, and foresight will survive, and those which lack the competitive instinct, the will to work, and ability to create a hard, tight-functioning organization will be the first to hit the sawdust.

Only where the management is incompetent does a concern go under, so is not a business failure which is said to result from intense competition generally caused by poor or misguided management, where inertia has finally played its last leading role? Perhaps the financial condition of the concerns liquidated was not strong enough to stand up against the strain as long as the others. Then, that financial condition again had been brought about by mistakes in policies, by inertia, by unskilled management guidance. If a particular business was started with too little funds, that again can be laid only at the doors of the owners; and if it became weak financially as a result of operating losses, the management again must accept the ultimate responsibility.

Changes in technique of production. Here is a concern which has been engaged in the manufacture of electrical washing machines for many years. The plant is an old-fashioned one, operated in an old-fashioned manner, congenial for the employees when there are profits, and paying low wages when there are no profits. A close personal, but hardly efficient, relationship exists between the owner and the men who put the hundreds of parts together to produce the final product.

Competitors have up-to-the-minute productive methods so that the work flows in one steady assembly line through the factory, each worker carrying on a limited number of operations in which he has become expert. As a result, three times as many washing machines are turned out with the same number of men as in the old-fashioned enterprise. The change in production technique is surely a tribute to the live operating management in one case, and an indication of sleepy unawareness in the other.

Changes in styles, fads, and habits. Even failures which are said to be the result of such factors as changes in styles, fads, and habits may be laid nowhere except at the doorstep of the executive staff. There is no one policy to which the real executive gives more serious study and attention than just such changes. An aggressive, wide-awake management generally realizes that changes are taking place behind the scenes many months—and, at times, years—before they come to light. Consequently, improvements and changes are made in the product well in advance of actual need. Studebaker went

from wagons to automobiles, Curtiss from motorcycles to airplanes, and Cluett Peabody from collars to an entire line of haberdashery, the management of each concern thereby removing itself from a declining industry.

Less awake executive staffs would have watched their sales shrink to the vanishing point and then, when it was too late, would have placed the onus on the "changing times." Every manufacturing or wholesaling business enterprise, and most of the larger retailers which have been in existence 25 years or more, have had to meet and overcome changes in the demands of customers, in manufacturing processes, and in methods of distribution. A constant change is in process, a change which is quietly taking place in the method of operation of all concerns whose managements have a firm grasp on reality. A business enterprise is the reflection of a guiding hand, just as much as a painting is of the artist, a book is of the author, and a building is of the architect. Furthermore, the business enterprise may be fully as much a work of art.

3. Basic classifications of failure causes

This discussion of the causes of business failures indicates that most of these causes, whether they are said to be beyond the control of management or not, are largely subdivisions of management experience and skill in one form or another or the lack of experience and skill. Only in rare instances is management not to be scored because of a particular financial embarrassment. With this emphasis on the extreme importance of the knowledge, skill, experience, and aggressiveness of operating managements, the principal causes of failures fall under two basic classifications: those which are manifestations of managerial ineptitude, and those rare, occasional instances in which the skill of the management plays little or no part.

Every policy and decision of an executive staff has its reflection somewhere in the assets and liabilities of the balance sheet, the surplus account, or the profit-and-loss statement, and consequently it is disclosed by the healthy or the unhealthy proportion of the various assets, liabilities, and expenses of a business enterprise. The causes of business failures which are manifestations of managerial ineptitude may be evidenced by inability to avoid conditions which result in heavy liabilities, excessive inventory, top-heavy fixed assets, excessive receivables, inadequate sales, heavy operating expenses, poor location, or competitive weakness. These conditions are fundamental expressions of managerial inefficiency, mental or physical inertia, or ill-considered judgment. Each of these conditions, in turn, may be brought to light by one or several secondary factors or symptoms, such as poor business conditions, changes in the accepted technique of production and distribution, changes in budgetary and accounting controls, and fluctuations in wholesale com-

modity prices. These factors are not basic causes, but they tend to emphasize the effects of first causes and bring them out in bold relief. At times, they are the background against which the initiatory principles of business management stand out.

Excessive liabilities. The most obvious manifestation of managerial incompetence, inexperience, or neglect is the growth in the liabilities of a business enterprise to a point where they have become distinctly excessive. A business becomes financially involved when its liabilities are top-heavy, when invoices cannot be paid according to terms, when the interest on a funded debt cannot be met, and when the current or funded debt cannot be paid or refunded at maturity. Because these definite financial obligations cannot be met, a compromise settlement is reached, or a petition in bankruptcy is finally filed either by the management of the business or by its creditors.

The history of all such cases would show that the liabilities had become heavy because of some one or several management decisions, or because of the lack of aggressiveness or preparedness to meet competitive conditions and practices. Possibly the management in immediately preceding years had drawn excessive salaries, permitted excessive dividends or withdrawals, operated at a loss, speculated in merchandise, or had top-heavy funded debts and excessive fixed charges. In other words, along with excessive liabilities, there would be found underlying managerial decisions which had brought the enterprise to its final resting place.

Top-heavy fixed assets. The second manifestation of managerial incapacity is found in top-heavy fixed assets. This condition, at the same time, indicates a lack of net working capital, and burdens the operating account with more than its normal share of yearly depreciation. Such a condition in a manufacturing enterprise results from the desire of the management to expand the capacity and the facilities of the concern, generally during a period of good business. When the business cycle turns, the concern is distressed by idle plant capacity. Such a situation is doubly dangerous when new construction and additions to plant capacity are financed with borrowed funds.

The same situation occurs with retail establishments when large sums are spent to improve the front or the inside furnishments of a store, when an addition is made to an old store, and when new units are taken over either by the purchase of the properties in fee or under leaseholds. This condition may also be brought about by continual heavy losses, withdrawals, or dividends for several years by the management of a business which at an earlier date had maintained a satisfactory relationship between its fixed assets and its tangible net worth.

Excessive inventories. The third important manifestation of managerial incompetence is found in excessive inventories. This condition may be

brought about by the manufacture or distribution of too many products or lines for the size of the business; by speculation in merchandise, that is, by buying heavily in anticipation of a rise in prices which often fails to materialize; by poor judgment in future markets, that is, by overbuying; by the production or handling of a product which is off-style or not in public demand; by unknowingly having prices which are competitively high; and by not keeping the inventory neat and up to date.

An executive who would speculate in merchandise, who would purchase heavily in excess of his reasonable needs, and whose business would subsequently become bankrupt in the ensuing drop in wholesale prices, would certainly lack both knowledge and foresight. The drop in wholesale prices would not have been the cause of the failure, but merely the means through which the inexperience of the management became evident. The fundamental error was in deciding to pile up a heavy inventory, far in excess of reasonable legitimate needs.

4. Understanding figures is essential to avoid difficulties

For the successful operation of commercial and industrial business enterprises, the fundamental, clear, definite understanding of three sets of figures is positively essential. This does not mean that a business executive, a commercial or an investment banker, an investor, a speculator, a business counselor, a mercantile credit man, or a financial analyst must know how to prepare these three financial statements; trained accountants are available in every city in the United States for that purpose. But the unchallenged ability to interpret these three sets of figures intelligently and accurately is essential to an understanding of the operations of business enterprises in a highly competitive profit economy. These three financial statements are the *balance sheet,* the *profit-and-loss statement,* and the *reconciliation of surplus.*

When gross profits and net profits are decreasing, or when black figures have turned into red figures without professional legerdemain, the active management of the typical business enterprise generally follows two policies simultaneously: sales are pushed just as hard as the aggressiveness, the energy, and the ingenuity of the organization will permit; and the amount and the percentage of each expense item in the profit-and-loss statement are compared with the amount and the percentage of the corresponding item for the previous fiscal period to ascertain where expenses may be reduced radically. The emphasis is primarily on increased sales and on decreased expense. It is a natural and logical emphasis.

Over a period of years, the author has found that the typical business executive knows his profit-and-loss statement forward and backward. He can always find some place where expenses may be cut, perhaps the advertising

budget, perhaps salesmen's expenses, salaries, wages, telephone, or postage. Probably not more than one business executive out of 10 gives the slightest particle of intelligent thought or analysis to the balance sheet of his business. If he recognized the implications in the relationships between items in the balance sheet as clearly as he sees the implications of the relative size in individual items in comparative profit-and-loss statements, he would realize the effect that operating policies which anticipate profits and losses have upon the future financial condition. With this understanding, he would be more careful in making decisions which so often result in anxiety, sleepless nights, and the necessity for the subsequent study of the income and expense figures.

Here are examples. If receivables are heavy and include a large number of past-due or questionable accounts, a charge-off for bad debts that is greater than usual will make inroads upon subsequent profits; if the inventory is top-heavy and prices should happen to fall, nothing can stop a write-down, generally to that well-known accounting convention of "cost or market, whichever is lower," which will reduce or possibly wipe out net profits; if fixed assets are excessive, the annual depreciation charges will represent an overbalance charge to expense; if a large funded debt exists, the interest will eat into net profits. These conditions become evident from an analysis of the balance sheet. Skilled management realizes the intimate effects of these unbalanced conditions upon a future profit-and-loss statement, and so determines and follows financial policies that prevent such unsound conditions from arising in the first place. To do so, however, the individual must know what represents sound and unsound relationships in a balance sheet.

Therefore, the fundamental importance of understanding the delicate shades in meaning of balance sheet proportions must be emphasized. If a balance sheet is out of line in any important respect, intelligent operation and consistent, sound, financial policy are essential to bring affairs into a healthy condition over the years. No balance sheet will recover its health by itself; the management staff must guide the business consciously. Too many business enterprises are constantly adrift, blown by the variable winds of the season, and the conditions of their balance sheets are the unfortunate results of extraneous influences instead of conscious managerial direction. *Every managerial policy, or absence of managerial policy, is reflected somewhere in the figures—in the balance sheet, in the profit-and-loss statement, or in the reconciliation of surplus.* The extension of credit to customers in excess of their reasonable needs will be shown in excessive receivables and a heavy collection period; the purchase of merchandise in excess of reasonable requirements, because an executive officer is "sure" that prices are going up,

will be shown in a larger inventory and a slower turnover; and expansion in plant facilities, home offices, or retail stores will be reflected in a large proportionate investment in fixed assets. The payment for an insurance policy will appear in the expense account, the return of merchandise will be evident in the profit-and-loss statement, and the payment of dividends will show in the surplus account.

5. *Organizing to avoid the risks in business*

This entire handbook is concerned with intelligent management to avoid the risks in business. If you know the risks, perhaps you can organize to avoid them. For example, *if you face* [3]—

Catastrophes, fire, floods, earthquakes, hurricanes. Keep your plant out of areas where such catastrophes are likely to happen. Insure yourself against these possibilities

Migrations of population or industries with or without government instigation. These do not happen suddenly. They can be anticipated if you study the political and economic scene

Government fiat. Watch social trends: anticipate laws (police laws, health laws, zoning regulations) that may put you out of business

Cutthroat competition by monopolies. Tie up with other independents (in union there is strength); call on government for aid; sponsor legislation remedying situation

New legislation, such as tariff-law changes, wage and hour and labor laws, industry regulations. You must anticipate these social changes by keeping informed as to trends. Join with others to see that these laws are fair and not discriminatory

Competition from new sources that have better products. Recognize the change, and make the more accepted product. You should try to be the first to develop such products. Consider merging with the powerful competitors

Foreign competition. Seek legislative protection; meet the competition with better product or lower cost

Shifts in consumer demand because of population decline, change in taste, changed standards in living, wider knowledge. Watch trends. Anticipate these social changes; improve your products or make new uses

Fluctuations in business. Anticipate them. Know when to expand and to contract. Timing is important

Poor management (failure to plan or budget, lack of definite policy). Know what to do and how to do it. You must plan for the long term and budget for the short term. You must guide your factors of sales and production and hold the reins of your business. You must fulfill and consummate your plans. Get vital information currently from your

[3] List prepared by J. K. Lasser.

accounting and statistical departments to prevent lack of efficiency, spoilage, waste, theft, and embezzlement and to detect high costs

Corrupt management. Get responsible management whose personal interests do not conflict with business aims, including profits for owners. Watch especially when there is absentee ownership. Use internal checks and controls. Have internal and independent audits; also professional surveys

High costs. Remedy this by such steps as: new equipment if this means lower costs after deducting interest, maintenance, and depreciation cost; check on relative costs of laborsaving equipment and equipment-saving labor; check on idle plant capacity—perhaps you can dispose of such plants and eliminate high depreciation charges; check on plant location to see if that should not be changed; often you can write down the plant valuation to meet the true situation, and your current costs are not too high after all; slough off "deadwood" personnel; check on your techniques and modes of operation—are they obsolete? ancient?

6. *Check list of the risks in business*

The editor of this book once compiled a list of the many risks faced by business. Study of these may be useful in the effort to organize for profits. Risks include [4]—

1. *Internal difficulties*

You might have unusual, temporary depressions due to—

Dissension and quarreling among management
Theft and embezzlement
Crippling or unusual litigation
Excessive waste and spoilage
Revolutionary changes in price policy and managerial policy

Your organization may include personnel who are incompetent, inexperienced, or neglectful, reflected in poor promotion, poor selling, inferior product, poor location, or unreasonable moving costs, too little mechanization, deferring repairs

You might suffer because of failure to maintain properties in periods of earnings, or to maintain research and proper market analyses

Difficulties may also be caused by bad credit policies such as overexpansion and speculation, high rate of losses, or incompetent or possibly too harsh handling of customers

Unreasonable losses may occur where there is investment in undesirable or uneconomical property causing excessive financing charges or excessive depreciation to be absorbed

Unexpected financial difficulties may arise from improper financing, inefficient budgeting, expensive floating of working debt, encroach-

[4] List prepared by J. K. Lasser.

ments on working capital, inventory accumulations, inability to get usual financing, stockholders' insistence on dividends

2. *Accidents and unexpected events*

Your product suddenly may meet with public disapproval, as has happened with foods, beverages, patent medicines, etc.

Your product may develop unexpected deficiencies causing loss of customers, and it may cost much to meet complaints and returns

Your supply of materials may change in quality or quantity, as in one case where severe deterioration in quality of a product with consequent loss of market was caused by an undetected change in the quality of the water supply; in another, the tanning formula ceased to work, and many hides were ruined

Unforeseen personnel difficulties may arise, such as illness of important persons; inability to get employees, due to market conditions; accidents; occupational diseases

Location problems may be caused by movement of customers to other districts or changes in sources of supply

3. *Sudden and revolutionary changes*

A new invention may render your highly specialized plant, equipment, or product inadequate

A new type of competition may arise, such as electric power made available by the TVA, which brings new competition, advantageously located near water power, to your mill

Sudden closing of banks, preventing credit and stopping normal flow of business, may make it necessary for you to cease production

Accidents, injuries, epidemics, strikes, or other physical interruption or diminution of activities of other persons or industries; local prosperity; marriage rates, birth and death rates; migrations or immigrations in certain communities

Some businesses face unfair and ruinous competition and practices—for example:

- Price wars and similar practices
- Unfair labor practices of competitors
- Labor pirating
- Infringement of your patent, copyright, trademark; pirating
- Theft of secret processes
- Secret rebates

Some face such pressures as—

- Consumer leagues' pressure
- Dictations from monopolistic groups (suppliers, customers, transporters)
- Sanctions by religious or other pressure groups
- Temperance groups
- Organized labor pressures; boycott

Picketing
Gangster coercion

In some businesses physical interruptions or economic distress to others may mean economic depression to you—for example:

When your source of supply, upon which you are dependent, is temporarily and unexpectedly cut off or diminished, as where your supplier suffered a physical interruption

Where other essential services, such as transportation or power, are similarly cut off or diminished

When any of the depressive influences throughout this list destroy your sources of supply, market, credits, customers

4. *Profits too long deferred*

For example, consider the business that must finance itself to—

Overcome "buying resistance" to an entirely new and unproved product; time is required to develop the market; advertising and missionary work are necessary for buyer acceptance

Overcome competition of manufacturers or resistance of labor organizations and others who see in the new article a threat to their investments or jobs

Overcome the inertia of society and condition the people to innovation, as in the case of the institution of international airways

Create new fabricating techniques and new skills necessary for new products (new plastics, rubber substitutes, drugs)

Age or season its product, as in whisky distillation, natural seasoning of lumber, "natural drying" of fruit, fish, where a basic stock must be built up before business can hit its normal stride

Get labor and equipment to the source of raw material, as in the case of new mines discovered in out-of-the-way places, distant exploratory ventures

Mature orchards, nurseries, rubber plantations, quinine and cork development, where time must elapse before a normal operational level can be reached

5. *Sales market too capricious or uncertain*

Businesses in which acceptable styles and public demand depend on unpredictable public taste

Businesses heavily influenced by occasional best sellers (books), styles (novelties, jewelry)

Businesses whose sales prices are depressed intermittently by foreign dumping and similar gluts

Specialty businesses such as those which depend on public "crazes" and "crushes" that are unpredictable

The manufacture of games, puzzles, and similar articles that "take" at irregular intervals

Businesses in which the volume of sales and profits depends on the

stimulus of the occasional new discovery, invention, or innovation in production, sale, or distribution—for example:

Specialty businesses

Businesses that are new and in process of rapid evolution (say electronics), where continuous and recurring spurts of invention would affect profits, until the whole industry could catch up

Businesses in which climate or weather must be recognized as a primary and uncertain influence—for example:

Companies whose profits depend on the concurrence of a good crop, a good catch, a rich vein, and a good market; therefore, they may be intermittent and sporadic:

Farming, horticultural, agricultural, and livestock; corporations which plant and harvest variable crops, and also those which raise livestock

Canning corporations—fruits, berries, vegetables

Fisheries and canners in the fishing industries

Some mining and shipping industries

Industries that make products the demand for which rises with weather conditions (umbrellas, raincoats)

Resort hotels, furs, summer and seasonal clubs, open-air restaurants, theaters geared to the weather and season

Beverage sales, such as soft drinks

Industries in which deterioration or spoilage due to weather conditions is a material factor (some chemical industries and food industries)

6. *Businesses not following general business prosperity*

Industries whose sales are to persons other than the ultimate consumer. Production in these tends to fall off sharply when demand for consumption goods declines relatively lightly. That is sometimes due to accumulated inventories available to meet the lessened demand without reordering from primary producers. When the inventories are low and the recovery phases begin, the reverse processes take place. A small increase in consumer demand sets off a hasty expansion by primary producers eager for speculative profits while costs are still low

Industries making products that have a long life—durable goods—and hence being likely to have a profit cycle different from the general business cycle. Purchase of such goods can be deferred for relatively long periods, and consequently during bad times the production drops sharply and stays at a very low level. When business improves and the recovery phases get under way, these durable-goods industries become exceedingly active. These are often called "prince or pauper" industries

Industries producing luxury goods—they are likely to have to wait

before the recovery phases of a cycle catch up with them, and when business begins to show a decline, the producers of luxury items find that their sales slow down and their volume drops more precipitately than in general business

7. *Legal difficulties, burdensome obligations, political or legislative problems*

These sometimes arise with restrictive or indiscreet contractual obligations, such as—

Restrictions against sale in certain areas; certain articles

Restrictions imposed by contracts with unions, competitors, etc.

Long-term leases based on sales or purchase contracts at high prices

Long-term sales contracts at too low a price

All, of course, face unusual problems because of lawsuits, injunctions, patent problems that disrupt business, stockholders' actions for accounting that prevent normal business activities

Or there may be unexpected forfeiture or foreclosures

Conditions may be changed by new governmental regulations, for example:

Tariffs, excessive hauling inspections

Prohibitions, local options

Price-control legislation

Unequal tax burdens (usually local, as a tax on chain stores)

Health laws, quarantines, police and fire laws, injunctions or foreclosures

Introduction of government competition into your business

Local option and other restrictive legislation that seesaws according to the group in power

Public controls of operating or selling conditions, etc.

Legislative control of wages, selling prices, terms, etc.

Enforcement of local laws with oscillating rigidity and laxity

Section 5

HOW TO START A BUSINESS

BY

D'ALTON B. MYERS

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HOW TO START A BUSINESS

You have turned to this chapter because you want to check your thinking before you start to set up a business of your own.

You have been asking yourself, "Can I make a success in business for myself?" Perhaps two or three of you are talking over the prospects. Or it may be that several of you are planning to launch a medium-size corporation —a manufacturing or wholesaling concern. Regardless of the size, type, and scope of the contemplated business, now—before it is started—is the time to stop, read, and check.

We could do a much better job of helping you get the answers to all the questions that are flooding your brain if we could talk them over together. That is out for the present; so condensed into this short chapter are the high lights of hundreds of talks with men and women who have asked the same question. Regardless of whether they were production engineers with large manufacturers, buyers or merchandising managers for large department stores, salesmen, office managers, Army and Navy officers, government workers, secretaries, or GI's; whether they were experienced business managers or novices; whether they had $500 or $50,000 to invest, the conferences invariably started with, "I am thinking about going into business for myself. Do you think I should?" Or "A group of us are considering starting a new corporation. I'll be one of the owners and managers. What do you think of the idea?"

The answer to the first question involves you and what, where, how, and when. Answering the second question increases in difficulty in more than direct ratio to the number of men who will participate in the management of the proposed company. It is a safe assumption that the success of the venture and your participation in it rest to a great degree on how well your group probes into the abilities and temperaments of the members and is able to integrate them into a working team.

The same general problems face all businesses regardless of their type and size. However, the fact that these problems may be dealt with differently in the various types and sizes of business tends to increase or to lessen their importance in any specific case. In the small one-man business all problems must be handled by the owner-manager. As businesses increase in size, more

and more problems must be dealt with by division heads and other subordinates. Only major problems reach the top management.

Similarly the questions that should be thought about before starting a business will vary in importance with the size and type of the venture; nevertheless they remain basically the same. The larger the business, the more detailed the advance consideration must be. This is not so much because of the increased size of the financial risk, but rather because the larger the organization, the less flexible it tends to be in adjusting quickly to new and unforeseen developments—of which any new business will have plenty.

But to get back to the first question, "I am thinking of going into business for myself. Do you think I should?" In this chapter we will subdivide your question that involves you, what, where, how, and when, into six. Two questions I will ask of you; four you will ask of me:

1. Do you really want to start a business? (And this includes buying an established business.)
2. Are you prepared to start a business?
3. What about my business? (Most people start the conversation with a specific community in mind.)
4. Where should I start my business? (Some people will move to any community that looks good for their business.)
5. What are my chances for success?
6. Should I start my business *now*?

1. Do you really want to start a business?

You will have to answer this question objectively and completely before we can get down to a sound discussion of your particular business. Most likely if we were talking this over, you would be able to convince me of your earnestness in a few moments and we could move right on to the main topic—your business. These are the points that I would raise with you:

Have you analyzed carefully the security provided by business ownership and compared it with that possible if you remained an employee?

Have you compared earnings and salaries of business owners with the wages and salaries of workers?

Have you carefully considered the negative aspects of business ownership? The dangers of losses? The "mortality" or failure rate of business?

What is driving you toward business ownership? Need to earn more? Desire to be independent? Wanting to be the "boss-man"? Dissatisfaction with present job or work?

Here are some facts and opinions on these points:

Business ownership and security. Security is not guaranteed by business ownership—neither immediate job security nor that for old age and retirement. In fact, the "mortality" or discontinuance rate of businesses is so high

Length of Life of Enterprises Established between 1844 and 1926 in Poughkeepsie, N.Y.*

(Counting change in proprietorship as a new enterprise)

Years of life	Type and number of enterprises					
	Wholesaling 183	Manufacturing 1,194	Retailing 5,567	Craft 1,423	Service 2,855	Total 11,222
	Per cent					
1 or less	22 4	24 0	32 5	31 9	32 9	31.5
2 or less	32 2	37 1	45 8	46 2	47 2	45 2
3 or less	43 7	49 8	55 0	56 5	56 8	55 0
5 or less	57 9	63 2	66 2	68 1	69 0	66.7
10 or less	74 9	78 6	80 7	81 9	83 4	81 3
Over 10	25 1	21 4	19 3	18 1	16 6	18 7

* *Dun's Review*, June, 1939, p. 13.

Life Span of Retail Stores in 207 Indiana Towns, 1930 to 1937 *

Retail trades	Per cent entering business, 1930	Percentage of stores which started in 1930 discontinuing in—							Per cent still in business, 1937
		1st year	2d year	3d year	4th year	5th year	6th year	7th year	
Groceries	100	22 5	16 4	10 3	8 1	5 4	4 5	2 7	30.1
Shoes	100	23 9	21.7	13 0	4 3	....	2.2		34 9
Hardware	100	11 5	16 4	9 8	3 3	1 6	6 6	4.9	45 9
Garage and auto sales	100	30 5	19 9	11 9	6 3	5 7	5.7	3 4	17.4
Department stores	100	30 3	27 3	9 1	6 1	3 0	.		24 2
General stores	100	24 3	18 9	14 9	6 8	2 7	4 1	4 1	24 2
Drugs	100	14 0	14 0	6 5	5 4	2.2	5 3	2 2	50.4
Restaurants	100	33 1	20.4	8 4	11.3	5.1	4 4	1 8	15.5
Men's clothing	100	17 3	16 0	11 1	12.3	6 2	1 2	1 2	34 7
Women's clothing	100	21 9	21.9	6 1	5 3	6 1	4.4	2 6	31.7
Furniture	100	20 0	18 2	5.5	3.6	5.5	12.7	5 5	29 0
Total	100	24 9	18 4	9 9	7 6	4 9	4.8	2 7	26.8

* *Dun's Review*, January, 1940, p. 27.

that authorities state that out of every 1,000 new businesses started during a year 250 disappear before the end of the year. By the end of 5 years, only 350 remain; and no more than 190 of the original 1,000 start their eleventh year. These figures apply pretty much to all types of businesses. The tables on page 161 show the results of two comprehensive surveys—one made in Poughkeepsie, N.Y., covering the 82 years, 1844 to 1926, and the other made in 207 Indiana towns for the period of 1930 to 1937.

Business ownership is synonymous with risk taking—at least it should be. Risk taking involves both the possibility of profit and that of loss; if the unprofitable operations exceed the profitable, closing up the enterprise is just a matter of time.

By placing this emphasis on the mortality rate of business there is no intention to deny that in this country today there are tens of thousands of smaller businesses that produce good incomes for their owners—or rather, it might be said, that enable their owners to earn good incomes by capably managing them.

Business ownership does offer a particular form of security: security against arbitrary and sudden dismissal. Perhaps this is one of the reasons you have for wanting to start a business. If so, good; but the way may be long and hard before you can get your enterprise to the point where the security begins to mean something tangible.

The question of security should be at the bottom of the list. But because so many people talk about it first, I have considered it early in this chapter.

Too much emphasis on the security possibilities of business ownership can easily get you on the wrong track in starting a business. In the final analysis the only real security for the individual rests in his making himself more and more qualified for the job to be done. If he is an owner, it means running a business that so pleases the customers or clients that they will support it or buy its products. And, of course, that is what so many men mean when they talk about the security of business ownership. They feel that they can produce, and they do not want to be blocked by some boss who has unsound business policies or uses out-of-date business methods.

The fear of insecurity has kept many people from launching businesses for themselves. Perhaps you have been asking yourself if you shouldn't stay on your present job—if you are not foolish to venture into the unknown. If your friends and relatives know that you are considering starting a business, the chances are ten to one that they are saying, "Don't be foolish. Stay where you are."

If the fear of insecurity is holding you back, or the desire for security urging you on, then I think you had better ask yourself the question, "Do I really want to start a business?" If the desire for security outweighs all the

other reasons for starting or not starting, then, in my opinion, you are not mentally or emotionally prepared for business ownership.

Jobs with big corporations provide very little in the way of real job security. Even men in the top positions are subject to sudden and arbitrary dismissals by boards of directors or controlling interests. Face-saving letters of resignation are accepted, but the results are the same. All you have to do to check on this phase of insecurity is to watch the shifts in management of well-known corporations. For example, in January, 1950, Charles Luckman, president and "wonder boy" of Lever Brothers, resigned his $300,000-a-year job after a two-day conference with the real heads of the soap empire that has 500 subsidiaries scattered throughout the world.

The insecurity of key executives in our large corporations was impressed on me several years ago when I listened to a series of sales talks designed to recruit salesmen for an insurance company. They had been put on seven double phonograph records; 14 sides in all. Two records were devoted chiefly to case histories of former business executives who had found real economic security only after they had set up their own insurance offices. In each case, the man had held an important position with a big corporation, had drawn a good salary, and had thought he had security. Then there had been a sudden change in management or policy, and the man had been let out. If the facts given were accurate—and they must have been, for names of companies and individuals were stated—they would certainly dispel the idea that top jobs in large corporations provide security.

Business ownership and income. Many people who claim that they want to go into business for themselves point to large earnings of businessmen and to the fact that they can pay themselves large salaries, that is, draw out a lot of the earnings for their own living expenses and personal investments. You most likely have heard stories of men who started a few years ago in their own businesses and today drive around in Cadillacs, own swanky homes, and always seem to have plenty of the folding green stuff—certainly far more than they would ever have had "working for someone else." Many of these stories are true, although perhaps a little exaggerated, but they do not tell the whole story.

The facts are that, on the whole, the range of incomes of the owners of unincorporated businesses or of closely held corporations is about the same as the range of the earned incomes of wage earners and salaried employees. In other words, lots of business owners do not draw out of their businesses any more money for their own use than the average full-time worker draws in wages. The majority of retail stores and service businesses in the United States do not take in enough money each year to provide their owners with more than $200 a month for their own use.

On the other hand, there are business owners whose share in the profits, withdrawn in cash, will run into hundreds of thousands of dollars each year. But it is also true that the top employees in some of the larger corporations draw similar amounts.

Maybe you have convinced yourself that, because someone is paying you a salary or wage, he is making a profit on you which you could keep if you were your own boss. Perhaps you are right, but you had better check your thinking once more. No general rule holds true in all cases. In some cases you are valuable only as a member of a team, and the so-called profit of the owner is on the work of the team as a whole, not on the individual members. The minute you leave such a team, your value drops, even to yourself—that is, until you are able to form another team that is just as efficient. Perhaps the business principle that it is not good business to begrudge the other man a reasonable profit—even on your efforts—should be applied more often.

Your business proposition may be just the opposite; that is, highly individualistic. Perhaps it is similar to the case of the young European who evaded the Iron Curtain, got into this country, and wanted to get started in the importing business. All he had was his knowledge of materials and a list of contacts with whom he had previously done business. My advice to him was to start his own business immediately. For personal reasons he felt that he had to get on a payroll, so he spent several weary weeks calling on importers, trying to sell them on hiring him for what and whom he knew. He could get no bona fide offers from reputable companies, so he finally launched his own company. Today he is on the road to success. My reasoning was that it was he as an individual who was valuable. Being a member of a team would not add one iota to his worth to any company. Apparently this was obvious to all the businessmen he interviewed, for each figured that, since whatever they paid him during the early months was being staked on one person, not on building a team of workers, the possible returns had to be very high. Furthermore each implied—some even asked—the question: "If you are worth the salary and expenses you ask us to advance, why don't you go it on your own?"

If it is the envy of someone else's making a "profit" on you that is causing you to want to start your own business, why not talk it over with your boss and tell him of some of your ambitions? This assumes that you are currently working for a smaller company, which is all the more reason for considering such a move. If you start the same type of business as you are now working for, you will have to build it into more than a one-man enterprise. That is, if you want it to grow, you will need an organization. Perhaps your present boss has some ideas along the same line. Therefore, unless you have some very valid reasons for not doing so, I would talk things over with him. But do not be surprised if at first he takes a negative view of the whole idea. It

is my observation that most small businessmen are immediately suspicious and resentful of employees who approach them with the idea of getting in on the ownership of the business. It is a perfectly normal reaction, so recognize it as such. Word your proposition so that you do not have to consider his first reaction—if he is opposed—as a turndown, but rather as the basis for further study of the idea.

Recently during a talk on business management I urged the small businessmen present to start building organizations in their firms by taking their employees into their confidence and giving them as much responsibility as possible. In the question period following, one man challenged the idea. According to him, I was all wrong. "If you let an employee learn about your business, he will quit as soon as possible and start up for himself." I asked him why *he* had gone into business for himself. He replied, "The guy I was working for wouldn't give me a chance to become part owner. He wouldn't even let me learn the important parts of the business." I felt that he was helping me make my point very clear, so I asked him if he would have left his old boss if he had been given such an opportunity as I now urged him to give his employees. My point was made!

Let's ask the basic question in another form: Why do you want to start a business? This, of course, includes buying out a business as well as acquiring part interest in a going concern.

The specific answers that men give to this question are manifold. It is my observation that if you can get your real reason out in the open where you can analyze it thoroughly, you will be taking a long step toward getting launched in a successful business, or avoiding a false start.

Profits are supposed to be the prime reason why men go into business. If you mean by *profits* the difference between the sum of money a business takes in during a year or any other period of time and what it pays out during that period (including what the owners get, what is set aside to replace the equipment when it wears out, and what it has promised to pay later on), then, in my opinion, it is safe to say that the majority of businesses are not operated at a profit. Actually most of the so-called "profitable" businesses produce for their owners no more than reasonable salaries plus a nominal interest on their investments.

Self-expression through business ownership. As previouly implied, I do not think that many men or women become business owners because of the possibilities of big earnings or because they see real security in it. It is my opinion that they become business owners because they see, or think they see, an opportunity to create something—an opportunity for self-expression. Isn't that the basic drive that is behind your thinking about starting a business? The "grand openings" of markets, retail stores, theaters, factories, and in fact

all types of businesses are not just advertising stunts; basically they are a desire to present the new business, just created, in all possible glory. I have seldom met a man who could any more conceal his pride in a new business than he could his pride in his first-born son. And the men who seem the proudest to become business owners invariably are former executives of big corporations. They are like an acquaintance who telephoned wanting to see me for a few minutes. For years he had held important positions in one of the largest rubber companies, and he just wanted to stop in to tell me that he was now in business for himself. I had never seen him so happy or so proud, despite the fact that *his* company would not do as much business in a year as the big corporation he had just left would do in half a day.

The desire for a better income from business ownership is a perfectly legitimate justification for wanting to go into business. Perhaps it is your desire; perhaps, the wife's. The latter is just as good; many a man who claims to be self-made is actually wife-made. But if the desire for profits takes precedence over that of making your business render a real service, it is my opinion that your chances for success are definitely lessened.

American businessmen are often kidded about their ideas on *service*. Businessmen in many other countries scoff at the idea and think the Americans are either naïve or hypocritical. But we seem to have learned that service pays dividends. "Rendering a service" is just another way of saying "solving a problem." And that is just what most businesses do for us day in and day out. The fact that we create many of our problems does not alter the situation, nor does the fact that we are frequently talked into having problems by high-powered advertisements.

It has been said that if you can find 30 people who have a common problem, or who can be convinced that they have, you have the basis for starting a business. You can think of hundreds of businesses that will illustrate this point. I always think of diaper laundries. We had been having babies for a considerable number of years and the home washing of their diapers had always been a burden, but in spite of this it was not until 1932 that the first commercial diaper laundry was started. It had taken businessmen a long time to see this problem and do anything about it.

The problems that businesses are set up to solve may range from the simple to the very complex. They may be problems that are causing serious losses and great worries, or they may be problems whose solutions just simplify life, make it more enjoyable, and give people more time to do all those things they really like to do.

Let's take a simple situation that may illustrate not only the problem-solving role of business but also the relationship of profits to service. A chap

with less than $1,000 of capital came to a California town where he wanted to live and where he wanted to start a business. The businessmen in the town had lots of problems, but one that seemed universal was the distribution of handbills. The high school boys they hired were usually too careless about where they stuck the handbills; sometimes they even put them down the storm drains to speed the distribution. In a few days the newcomer convinced enough merchants that he could solve this problem for them, and he was in business for himself. It was profitable right from the start. The merchants appraised the service in terms of the increased effectiveness of their handbills plus their savings in money, time, and worry. They wanted him to make a profit and to stay in business as long as he solved their problem.

Businesses that solve one problem frequently create whole series of problems the people will want solved. The automobile industry is a well-known example of this. Even after 50 years of the motor car, companies and individuals are still solving the problems of motorists.

Perhaps you are starting your business because you want to be the "bossman," or because you would rather be the big toad in a small puddle. That is very understandable and, if kept within bounds, perfectly all right. The danger in this approach to business ownership is that it overlooks the fact that many workers do not care to work in so-called "one-man" businesses where their interests are likely to be at the mercy of one individual's whims. Rightly or wrongly, labor today wants to broaden the area of its interest in the management of businesses. More and more, professional managers of businesses are recognizing the value of labor-management teamwork even on such matters as sales and advertising programs, production costs, the introduction of new laborsaving machinery—questions that a few years ago were strictly management's job to solve.

If the drive to be boss is at the top of your list of reasons for starting a business, ask yourself if you would want to work in that kind of business. If it is not good enough for you, it most likely will not be good enough to attract capable workers. It may be hard to build business teams, but when you can get a good one going it certainly pays off. Being boss does not need to mean that you have to "lead the band and play all the instruments in it." On the contrary in some well-managed and profitable small businesses the boss is the least conspicuous. Before you start your business you may want to answer very thoroughly the question: Can I build a real business team?

Larger ventures. The larger the business-to-be under consideration and the more owner-managers involved, the more important it is that you discuss the basic problems of ownership and the questions of security and income to

achieve a meeting of the minds regarding them. Not only the basic policies for the business must be agreed upon but also the objectives of the owners of the enterprise. Let me illustrate:

Recently I watched a sound business break up and disappear—not because of lack of orders or of capable operating management. The break-up was due solely and entirely to a conflict among the owner-managers over top policies and the main objectives of the concern. Some of them felt that security and income—that is, their personal security and income—were furthered by keeping the business relatively small. Others felt that growth provided the most security and that income—that is, their current incomes —should be restricted in order to help the business grow.

The damage done by this cleavage was irreparable. The records revealed that this basic policy had never been explored prior to starting the business. Each man had entered into the deal with his own preconceived ideas as to the objectives of the enterprise.

The variation in the Federal personal-income-tax rates is another reason for achieving agreement on the business policy affecting security and income. This is particularly true in those cases where some of the owner-managers of the enterprise have sources of personal income other than the business in question, while others are dependent solely on it for their total incomes. The problem is complex and no single general advice can prevail. Help of experts should be obtained when the problem is under discussion—that is, before you start.

All that we have been doing so far in this section is to get you to check whether or not you really want to go into business. If you are satisfied that you really do, we can move on to the next question from me to you. But before we do, you may want to make certain that you have the facts which will justify the following statements by you:

I want to go into business [1] because—

I believe there is greater security for business owners than there is for job holders.

I believe my average profits over a given period of years will greatly exceed my average wage or salary income for the same period.

I believe I can develop a business that will prove to be a genuine service to my customers and will solve one or more problems for them.

I believe that I can build an organization in which others will enjoy working. In short, I believe that I have qualities of leadership and am justified in my desire to head an organization.

[1] If your business is to be a partnership or corporation, substitute "we," "our," and "us," for "I," "my," and "me" in the above statements and similar ones that appear in subsequent parts of this section.

2. *Are you prepared to start a business?*

Whether or not you are prepared—that is, adequately prepared—to start a business depends, of course, to a large extent on the kind of business you are thinking of starting.

There are fields of business you cannot enter unless you pass professional and/or technical knowledge tests and are granted permits or licenses by governmental or other agencies. Pharmacies, beauty parlors, and plumbers are typical examples of businesses in this category. But actually such businesses are very few and in most of them it is an individual, not a business, that needs the license. Such men can be hired as skilled workers in many cases.

I am assuming that the business you are considering is either one whose legal requirements you can meet or one for which there are none.

Similarly we will skip the question of whether or not you are financially prepared—that is, whether you have adequate resources. During the past few years this aspect of business ownership has received a lot of attention. In part this situation was due to the fear that many men and women would try to start businesses without a full appreciation of the financial problems and would go broke. Writers who got their information from credit managers, bankers, and government officials tended to stress the amount of money that it takes to get established in a small business. It is my opinion that not enough stress has been placed on the need of being prepared for financial management of business. The amount of money you have is not nearly as important as how you use what you have. Understanding how to use money—your own and that which you can borrow—is a key point on which you should be prepared. Are you?

Financial management. Preparation in financial management is all-important—unless, of course, you conceive of your business as one that will remain relatively small, a sort of shop. If you have visions of its growing into a large concern you had better be prepared in financial management or make haste to become so prepared. Borrowing money—that is, using one's credit—is not all there is to financial management, but it is an important part of it. This is especially true today, for the business owner never knows when he must either expand rapidly or lose out to his competitors. The superabundance of investable funds and the thousands of men and women who are looking for business opportunities are constant threats to existing businesses. It is estimated that at least 25 billion dollars out of the 250 billions of individuals' savings is available for investment.

Human relations. Perhaps the most important question under preparation is: Are you prepared in human relations? This is a term that is usually

applied to relations between management and labor or between boss and workers. But in a broader sense adequate preparation in human relations means that you know how to work with people, deal with people—in short get along with your fellow human beings as equals. No one is ever fully prepared on this score. Most of us bat only about .200 at the most when we come right down to it, but if we recognize the importance of good human relations, there is much that each one of us can do.

You can get lots of help in becoming prepared as far as human relations are concerned. There are many excellent and well-written books on the market. You will find them very readable, and they can help you acquire a scientific basis for most effective dealing with your customers, the people you buy from, the people who work with you, and your fellow businessmen.

When you check into what is adequate preparation in human relations, you will see that it is chiefly *you* that is involved. It is the way you act, what you say, and even how you think that determines what the other fellow does or says. You can't make people buy from you, but you can so conduct your business that they will want to buy from you. You can't get loyalty from your workers and associates by command, but you can earn it by your understanding of them, their ideas, their hopes and aspirations, and their problems.

Let me illustrate by a couple of short stories from real life. Both happened in a Midwestern manufacturing company whose top management has a keen appreciation of good human relations.

The first involves Joe, a janitor, and the building of a second-floor addition to the main office building. It was not much more than a routine construction job to provide more space for the engineers, draftsmen, and general office force. As such it didn't seem that it would be of much concern to the rank and file of the workers. But the general manager knew that Joe, like most of the employees, lived with his family near the plant . On Sundays now and then he had seen Joe with his two small sons walking past the plant while Joe, the big shot in their eyes, pointed out things of importance. The general manager could foresee the questions they would ask just as soon as construction started, and he could sense Joe's embarrassment and hurt if he were unable to tell his sons what *his* company was doing in this latest development. So on the bulletin boards were posted the details of the expansion, complete with blueprints, architect's sketches, costs, and explanations of the need for the expansion and just what it would mean for each department. Joe and the other working fathers were never embarrassed for lack of information about *their* firm.

The second story involves supervisors and the difficulties of really getting to the root cause of a problem. According to this company, supervisors or

foremen find it hard to understand and to apply good human relations. And the more recent their promotion to the supervisory positions, the more trouble they seem to have. One such supervisor complained that one of his men, Brown, continually ignored instructions and did work below the standard acceptable in this plant. Reprimands were of no avail, and finally it reached the point where Brown's dismissal was being considered. His production record made such action possible under the terms of the union contract. When the case reached the general manager, he urged that shop friends of Brown find out what had happened to him during the last six months. Word came back promptly that Brown had lost his hearing and was afraid that he would be discharged if his deafness was discovered. The general manager allayed his fears and pointed out that several of the executives wore hearing aids. Brown immediately acquired one, and the problem was solved. But the real pay-off for the company resulted from the better understanding by the supervisors of what really constitutes good human relations.

Perhaps we can restate the question for this part of the section: Do you consider that you are temperamentally and emotionally prepared for business ownership? I am not trying to scare you away from business ownership, but I do think that you must answer that question frankly and honestly to your own satisfaction. And your answers must be made with present-day business conditions in mind. Competition is keen, business as a career has attracted many of the country's most able men, labor (for the most part) is well organized, and customers are well informed.

If your business venture is to be a partnership or corporation—that is, a medium-size or larger small company—then the question is: Is each member of the group of owner-managers adequately prepared in human relations?

The relationships among the owner-managers of businesses of these sizes must usually be very close, and it is vital that each man in your group be able to bring emotional maturity and judgment to the problems of the business.

You can help develop sound human relations if you are party to developing an organization in which the responsibilities, duties, and authority of each member are clearly defined and in which each feels that there is confidence in his ability and integrity.

If the need for these is not clearly understood by each member of the group or if there are conditions existing in their private lives that would prevent or retard the development and continuance of sound human relations in your group, then no further action should be taken until this problem is satisfactorily dealt with.

Good human relations among owner-managers of a concern do not require that discussions and arguments be avoided or that they agree on all matters.

On the contrary, desirable human relations develop best under conditions that bring up problems for frank and open discussion and, in the event that unanimity cannot be reached on important policy questions, provide for arbitration of the disputed points. Excellent work in the arbitration of business matters is being performed by the American Arbitration Association, whose services are available to all businessmen.

Experience. I have left *experience* as the last factor to be discussed under preparation because, frankly, I think that is where it belongs—at the bottom of the list. As with training (and it is really only a phase of training) experience is absolutely necessary in some businesses. There are some things that can be learned only by doing; for example, the short cuts, the so-called tricks of the trade, and the establishing of the many personal contacts so necessary in all types of businesses.

The Second World War dispelled a lot of the myths about the need of experience. We discovered that jobs which workers had formerly claimed required many years of experience to learn could be mastered in a few weeks. Men moved into important jobs in industry, government, and the armed forces in which they had absolutely no experience and did remarkably fine work. But we will most likely go back to putting a high—perhaps too high—premium on the repetition aspect of experience rather than on the ability of human beings to learn very rapidly when properly motivated.

Another reason why I put experience far down on the list is that it tends to put the stamp of approval on what has been done in the past or on how people are doing things now, and to avoid the question of how things can be done better.

All this boils down to the observation that experience is a great teacher provided that what experience is teaching is the best that can be taught. As far as this applies to your preparation for business ownership it means that you have to check your experience against the best in the business. For example, if you are considering the restaurant business, your experience should be measured against that obtainable if you worked for the most efficient and profitable restaurant in the class you are considering starting.

Your experience as a user of a product or service is frequently more important than your experience as a producer. Many of the most successful hotels, motor courts, restaurants, service stations, and even manufacturing and retailing businesses have been started by men and women whose only claim to experience was that they knew "a good one when they saw it." Many had never actually operated a business of any type, but they had been keen observers of what the buying public likes and will support. To people with enough brains to observe accurately, the problem of learning efficient operating management of most businesses is relatively simple. They are usually

better qualified than the ex-GI who claimed he wanted to start a cocktail lounge. He stated he was experienced, so I asked him where he had worked. And he replied, "I have never worked in one, but I hang around them every night." Since at that time a lot of fellows were dreaming of getting rich by serving drinks, I had made a point of talking with a number of bartenders and cocktail-lounge owners myself. So in a few minutes I was able to get the ex-GI to realize that even his experience as a consumer was not teaching him very much about the business.

You will be better qualified to answer my question as far as experience is concerned if part of your experience has been in the role of an observant user of the product or service you are going to deal in. You can get a form of this experience from reading magazines published for the many types of businesses. There is practically no business for which a trade magazine is not published. If you do not know the titles for your business and cannot find out from your local public library, then write to the Office of Small Business, U.S. Department of Commerce, Washington, D.C. They will be able to help you without charge.

There is just one other phase of preparation that I want to ask you about, and this assumes that you are married. Is your family prepared for you to start a business? This applies particularly to your wife, for without her understanding of all that is involved, your chances are considerably lessened. The importance of this part of preparation for business ownership will, of course, vary with the kind and size of the business, its location, and the personalities involved; but for many men considering business ownership, it should be the first question under preparation, not the last.

Before we move on to questions about your business, the following list may help you to evaluate your preparation for business ownership:

I believe that I am prepared to start my own business because—

I possess the necessary skills and can obtain the required permits and licenses. I have made arrangements to employ men having those I do not possess or cannot obtain.

I understand the importance of financial management and the need for being ready to increase the size and scope of my business.

The experiences I have had with my kind of business have made me familiar not only with all phases of it but also with the reactions and opinions of its customers and clients. I know how the better businesses of its kind are managed.

I get along with people. I know how to work with customers, employees, suppliers, and fellow businessmen for the most mutually satisfactory results

My family—and particularly my wife—approve of my going into this business.

3. What about my business?

You most likely have a specific business in mind; also a specific community where you would like to start your business. Most people do, when they ask whether or not they should go into business for themselves. Obviously in this section or even this entire work we cannot talk in terms of specific enterprises. What we attempt to give you are facts, ideas, principles, and techniques that are applicable—more or less—to all businesses. Another thing that we should like to do is to stimulate your imagination and broaden your vision as to the possibilities in business. So in answer to your question, "What about my business?" I am going to talk about business opportunities.

Have you ever been curious about how men got started in the businesses they are in? That is, why they selected a particular type of business? I believe that if you asked businessmen why they chose the businesses they did, you would be intrigued with the discovery that many, if not most, just landed in them by chance. Sometimes luck is with them and their careers get written up as "success" stories in later years. But that only proves the hazards of relying unnecessarily on chance to determine your fate.

Specialization in business. No one has ever made satisfactory descriptive lists of all the different kinds of businesses in the United States. Even if one had been made (and one is highly desirable), it would have to be added to almost daily because new businesses or new forms of old businesses are being set up constantly. A great deal of specialization is taking place in the business world. In many cases the specialized businesses are actually new types of enterprises, although they may be classified under a common term. The diaper laundries are a perfect example. Although technically listed as laundries, the service they were set up to render is so unique that they should be considered as a separate kind of business. In retailing, the specialty store is very common, particularly in women's wear; but even in men's wear we find stores devoted exclusively to the sale of such items as neckties. Frequently these stores will specialize in merchandise at one price only. Specialization in manufacturing and processing is even more pronounced. Companies not only specialize in products, but in many lines they specialize according to prices, types of materials used, styles, sizes, and other factors. For example, in the women's dress industry, a successful company does not just make dresses—it makes dresses to sell at certain prices or for certain sizes of women.

Specialization is one of the earmarks of an advanced business economic system. You seldom find specialized businesses in so-called "pioneer" or primitive communities; there the general store is most common. Usually it is

not until a considerable volume of trade has developed that people set up stores, shops, or factories to sell or produce just certain things.

The demand for specialized businesses is far greater than most people realize. In fact it is in the performing of special services or in the providing of special goods that are to be found, according to some authorities, the greatest opportunities for business ownership.

One way to stimulate your imagination as to all the different kinds of specialized businesses is to get a directory of businesses—for example, the classified section of a telephone directory—and study all the various types of activities and enterprises that are listed.

Of course, specialization can be carried too far or may be attempted in a town or area where the people are not ready to support it. To find out those specialized businesses that the people in any community will support calls for some real checking, some real market research. But if you can find that the people of a community are saying that they would certainly like to have a particular type of specialty store—for example, a bookstore—you have something to work on. Of course, you have to make certain that their demand will be large enough and steady enough to support your venture. This is just another way of saying that if you can discover a problem which a number of people have in common and can set up a business to solve it, you have at least laid a good foundation for future success.

Strange as it may seem, I have found that many people want to start businesses and sell things which they personally like but which their customers do not like. I do not mean that your likes and tastes are not important; they are. But I do mean that they had better be secondary to those of your customers. I saw a perfect example of this when a former secretary decided that she and her husband would start a restaurant specializing in well-balanced meals, with vegetables and salads. Nothing I could say would stop them. They located near a group of municipal buildings. Because of their location and the general surroundings, their main patronage came from clerks and office workers. This was as they had anticipated, but what they had not anticipated was that their customers did not want to have their dietary habits changed. For two months they struggled to get the clerks and secretaries to take their well-planned and balanced meals, but to no avail. The last time I saw them they were dishing out the fats, starches, and sweets. The vegetables and green salads had all gone by the board. And they were looking for a buyer for the business.

If you say that only a greenhorn would do such a thing, let me remind you that Mr. Childs, founder and developer of the Childs chain of restaurants, tried to force his dietary ideas on his customers. The results were disastrous.

Even Henry Ford had to lose many millions before he was convinced that the public no longer wanted his idea of motor-car transportation—the Model T.

The business population. Right now you are concerned chiefly with one business, the business that you are considering starting. That is as it should be. But I have been trying to get you to compare or check your business with other possibilities that are open to you. Maybe you already have the perfect business in mind. If so, fine. But the chances are that you can afford to take one more look before you leap. The following statistical information is inserted here to give you an idea of the size and characteristics of the American business population.

About 4,000,000 business firms make up the business population in the United States. That means approximately one firm for every 38 persons. The number of firms has gone up and down during the past hundred years, but the long-time trend has been for the number of firms per thousand of population to remain fairly constant. During the last 20 years the number has fluctuated rather violently. The depression of the thirties wiped out a large number of businesses. As the economy recovered, many new businesses were started; and in 1941, there were approximately 3,400,000 firms. Of these, 560,000 disappeared during the Second World War, and in December of 1943 we had about 2,840,000 left. Since VJ day there has been a rapid growth in the business population, according to the U.S. Department of Commerce. Figures for the recent years are shown in the accompanying table.

Business Population, 1941–1948 *

Industry	Number of firms, thousands			
	Sept., 1941	Dec., 1943	Dec., 1946	Dec., 1948
All industries	3,398 0	2,835 6	3,644 6	3,919 4
Mining and quarrying	23 4	26 0	28 0	31 6
Contract construction	243 8	147 1	247 9	311 5
Manufacturing	225 8	227 6	307 8	319.8
Transportation, communication, and other public utilities	209 2	187 9	222 6	234 7
Wholesale trade	146 2	114 0	307 8	186 2
Retail trade	1,620 8	1,318 0	1,674 1	1,778 0
Finance, insurance, and real estate	285 0	267 5	298 5	306 8
Service industries	643 8	547.5	696 6	750 7

* U.S. Department of Commerce.

This table breaks the business population into eight major categories, and it is interesting to note the different rates at which the various groups shrank and grew. The greatest increase in number of firms since December, 1943, has been in retailing, which accounts for about 460,000 out of the total increase of approximately 1,100,000 firms. But the greatest percentage increase has been in the contract construction industry, which has more than doubled. The growth of the number of service businesses means that we, as individuals and in our businesses, are more and more getting other people to do for us work that we formerly did for ourselves. They include not only such businesses as beauty parlors, dry cleaning companies, repair shops, and laundries but also those less well known such as mailing-list companies, freight forwarders, customs brokers, building-maintenance companies, check-cashing and bill-paying offices, and scores more. The list is growing every day.

The average number of employees in the 4,000,000 firms in the United States is about 12. Most people will hardly believe this to be true in a land where big corporations are so common. Of course, it means that the large majority of firms hire far fewer than 12 workers. In fact, according to the U.S. Department of Commerce, 87 per cent of the retail firms and service businesses in this country employ fewer than four workers. Even among manufacturers, 75 per cent of the firms employ fewer than 25. The Department states that 92.5 per cent of all businesses in the United States are small firms.[2]

Sources of information. There are many sources of information and suggestions as to different businesses that you may want to check in comparing your proposed business with other possibilities. I have mentioned telephone and business directories; also the U.S. Department of Commerce (particularly their Office of Small Business). The best procedure with the latter is to visit one of their 44 field offices. Do not overlook chambers of commerce, power and light companies, banks, local newspapers, and other organizations interested in the development of their communities. Several of the states have good industrial development commissions that can be very helpful. In some communities labor unions are becoming increasingly aware of the need of encouraging new companies. Do not think that the emphasis is on helping just the large concerns. More and more communities are realizing that 50 companies hiring about 50 employees each make for more stability than one company that hires 2,500.

[2] The Department of Commerce classifies the following as small business:
1. Manufacturers employing less than 100 people
2. Wholesalers having net annual sales of less than $200,000
3. Retailers and service enterprises having net annual sales or receipts of less than $50,000

The time and energy which you will expend in starting your business will most likely be many times more than you anticipate. Once launched in the enterprise you will be unable or reluctant to change, for you are making a long-time contract with yourself—maybe a lifetime contract—when you start a business.

Your decision in the selection of your business is so important that one more "I believe" is offered for your guidance:

I believe I have selected the kind of business that is best for me because—
- I have carefully surveyed the business world as to types of business opportunities.
- I have chosen a business in which I can happily and sincerely cater to my customers' tastes and requirements.
- I have chosen a business in which I can be of real service to my customers in the solution of their problems.

4. Where should I start my business?

The answer to this question, as with the previous one, depends in most cases on the type of business you have in mind and on you—your personal likes and dislikes.

The vast majority of people who start businesses are as much interested in where they will live and work as they are in the type of business. Top managers of larger corporations, when they are selecting sites for the relocation of their plants or the setting up of branch plants, tend to attach primary importance to such factors as the availability of raw materials, power and fuels, water, transportation facilities, and access to markets Usually they live away from the community and are not so personally concerned with local conditions, other than making them as clean, sanitary, and comfortable for their workers as possible. They know that workers—professional, technical, and skilled—will move to jobs even where conditions are not to their choosing. But the owners of smaller businesses usually live or want to live in the communities where their businesses are located; therefore they frequently tend to give only secondary consideration to strictly economic factors of business locations.

Checking communities. You can get a great deal of published information on how to choose a location for a factory or wholesaling company from the U.S. Department of Commerce, from state industrial commissions, and from textbooks on business organization and industrial management. Check with your local library. Numerous special studies have been made. One of the best and most recent is *Why Industry Moves to the South,* a study of factors influencing the recent location of manufacturing plants in the South, published by the National Planning Association.

Statistical information about communities is also available. The Department of Commerce has compiled data on most of the 3,300 counties in the United States and on 225 of the larger cities. From these you can get the facts about population, tax rates, bonded indebtedness, number of workers, incomes from manufacturing, wholesaling, retailing, agriculture, etc., educational backgrounds of citizens, purchasing power, and a score of other things from which you can begin to evaluate and compare communities.

Statistical facts are seldom enough to give the whole picture. There are some things that you can learn only from a personal check of local conditions. Communities of the same approximate size vary tremendously as to their possibilities as locations for businesses. Sometimes it is very obvious why a town is exceptionally good or bad as a business center; in other cases it is not easy to put your finger on the real cause.

It has been my observation that the first thing to check into is the community government; that is, discover who actually runs the town or city. If you find a broad and democratic participation in the government by all groups—including labor, businessmen, professional men, women's groups, and public employees—you will most likely find the community a good location for your business. If the leaders in business and labor have sincere mutual respect for each other, if industry is diversified (not concentrated in one or two large companies), and if the surrounding agriculture is supported by good soils, you have found a good place.

Any community that depends on one industry or resource is in a vulnerable situation, and so is the businessman who locates in it. Industries are continually migrating, and individual companies usually have to follow the trend in order to keep in line competitively, regardless of their feelings in the matter. There are literally hundreds of "ghost towns" in the country, the results of the sudden and wholesale migration of one industry, the depletion of a basic resource, or the development of a new source of supply or substitute. It always seems that in these cases it is the homeowners, the merchants, and other smaller businessmen who suffer proportionally the most.

This does not mean that you should never select this type of community for your business. It does mean that when you do, you should understand fully the hazards involved and should plan your operations accordingly.

Most of the material written about locations for businesses is directed toward manufacturing companies, mainly the larger ones. Regardless of how well it is prepared, it is my opinion that if the smaller businessman follows it uncritically, he may overlook a number of excellent communities as possible locations for his business. Perhaps this will illustrate:

A Brooklyn manufacturer of leather goods wanted to move his business to California and made a trip to pick a location. Santa Barbara appealed to him as a place for his home, but when he talked of locating a manufacturing business there everyone was shocked. The standard remark was, "Santa Barbara? Why, that's a millionaire's town. You'll never find workers for your plant there." But he was fairly sure that the clerks he had seen in Woolworth's and the other chain stores were not debutantes working for the fun of it. So he started asking these same clerks if they would like to work in a leather-goods factory when he started one. In less than an hour he had assured himself of an adequate labor supply.

The larger the business and the greater its normal marketing area, the more important is the role its location plays in making it a success. So if your venture is on the larger side you will undoubtedly want to give more consideration to the economic aspects of communities than to your personal preferences.

The following are the main factors in selecting plant location as incorporated in the check list used by the National Planning Association in its study:

I. Raw materials
   1. Immediate or potential availability
   2. Assembling costs
   3. Raw material reserves
   4. Quality of raw materials available
   5. Disposal of raw-material by-products

II. Power and fuels
   1. Immediate or potential availability of electric power, coal, gas, oil, coke, wood, and waste fuels
   2. Power and fuel costs at the plant
   3. Disposal of fuel by-products

III. Water
   1. Immediate or potential availability of adequate supply of proper quality water
   2. Water costs

IV. Transportation
   1. Availability of water, rail, truck, and air transportation with relation to plant site
   2. Costs of transporting raw materials
   3. Shipping costs to markets
   4. Possibilities for arranging special commodity rates
   5. Local transportation facilities for material and personnel
   6. Adequacy of highway facilities for company's own transportation

V. Labor
   1. Immediate or potential supply of labor
      a. Total labor force within commuting distance
      b. Availability of required skills
      c. Male-female supply
   2. Facilities for training personnel
   3. Wage rates and labor costs
   4. Extent and character of unionization
      a. Local history of labor relations
      b. Labor attitudes to technological changes
      c. Community attitudes
   5. Extent of labor-market domination by other industries

VI. Financial
   1. Availability of local capital
   2. Adequacy of local banking facilities

VII. Management and technical
   1. Availability of management and supervisory personnel
   2. Availability of technical personnel
   3. Availability of testing and research facilities
      a. Business institutions
      b. Educational institutions

VIII. Marketing
   1. Economic relation to market or main marketing center
      a. International
      b. National
      c. Regional
      d. Local
   2. Future trend of markets in relation to location
   3. Availability of marketing services and specialists
   4. Relation to competitors
   5. Geographical location and pricing pattern

IX. Relationship to established concerns
   1. Relationship to other plans of same company
      a. Ability to integrate plant into company production pattern
      b. Possibility of interchanging personnel and materials by company
   2. Relationship to plants of other companies
      a. Availability of other companies as source of materials or as outlet for production
      b. Economies of specialized service owing to existence of manufacturers locally within same industry
      c. Domination of community by some established concerns
   3. Corporate interrelationships

X. State governmental influences
   1. Tax structure
   2. Minimum wage and hour laws
   3. Workmen's compensation
   4. Laws of incorporation
   5. Incentives to new industries
   6. Attitude of legislators and government

XI. Community influences
   1. Housing
   2. Local government attitudes and local business attitudes
   3. Physical attractiveness
   4. Fire protection and insurance rates
   5. Social structure
   6. Recreation facilities
   7. Community spirit and progress
   8. Special inducements

XII. Building
   1. Costs of new construction
   2. Use of old plants

XIII. Site
   1. Costs of building
   2. Space for expansion

Business population shifting. The center of our business population, just like the center of the population, has been moving toward the West and Southwest rather consistently during the past fifty years. This trend, which was intensified during the Second World War, has continued unabated during the postwar boom.

The selection of the location (the community) for your business is closely associated with the selection of the site or actual spot where your business will be housed. Care in both selections is an important factor in the success of your enterprise. Methods for choosing the most desirable sites will be discussed in Section 11. For some kinds of businesses, site selection has been reduced almost to a science, but when it comes to the selection of the community for a new and smaller business it is invariably the personal desires of the owner that prevail, and strictly economic factors are given secondary consideration. For this reason, it is all the more important that you stop, check, and consider once again the community you have selected. Does the following coincide with your observations of your community? If so, it should be a good location for your business.

I believe I have selected the right community for my business because—
There is a wide diversity of industry for the size of the community; *or,*
industry is concentrated in a few companies, but I have checked care-

fully and found that these companies are well managed, have stable employment records, and are well financed.

There is a good wholesome democratic spirit among all segments of the population and a sharing of the responsibility for solving the community's civic problems.

Labor has a fair cooperative attitude toward the industries, and this is reciprocated by management with the development of fair, workable labor-management programs.

The natural resources of the surrounding territory are being developed and used soundly, particularly fuels, water, and soil resources. The farmers are progressive; crops are diversified.

The materials, supplies, and labor I will need are available.

The community is in line to benefit from recent shifts in industry and commerce.

5. What are my chances for success?

If the answer to this question is to be based strictly on the statistics of business successes and failures, it must be admitted that your chances for success in any new business are not very good. As already stated, 25 per cent of new businesses disappear before the end of the first year, and only a handful survive for 10 years.

But one of the chief reasons for the high mortality rate among businesses is that the vast majority of them are started by men and women who do not check thoroughly into the things we have been talking about so far in this discussion. In my opinion, the very fact that you are trying to evaluate your personal capacities and ambitions and to compare the opportunities afforded by various kinds of businesses and locations puts you in a class apart from that of most people who start businesses. So, assuming that you have the skills or techniques that are absolutely necessary for the day-to-day operations of your business, I would say that you have already increased your chances for success several fold. But in the final analysis your chances for the successful development of your business will depend on you and your managerial ability, particularly your capacity to inaugurate sound business policies and to carry them out.

In this part we discuss six conditions relating to management and the making of policy decisions. We ask that you use these six as a check list against which to measure your present ideas regarding your role as manager of your business.

Time for decisions. The making of sound policy decisions is without doubt the most difficult task in business. As a general premise it may be said that your ability to make such decisions increases in direct proportion to the constructive time and energy you can devote to them.

One of the main deterrents to the growth of the average small business is that the owner fails to realize how much of his time will have to be devoted to considering, evaluating, and selecting policies. Invariably he becomes so involved in performing the daily operating tasks of the business that he has no time to contemplate and to study some of the long-range possibilities of his business.

Planning for the most effective use of your time in the business is a job that only *you* can do. When you are your own boss, no one can force you to plan and no one can compel you to reserve time and energy for this type of work. If you now realize how important it is for you to have time to devote to the formulation of policies and to what are frequently called the problems of top management, you will have placed another strong foundation stone under your business.

Organization essential. The second managerial prerequisite to success is a good organization, for without this you cannot be free to function effectively in your key position of top management. Your ability to build an effective organization will depend on your capacity to delegate responsibilities, to encourage initiative, to permit self-expression, and to create an atmosphere where in the eyes of all concerned the enterprise becomes "our business."

The questions you need to ask yourself at this point are: Do I have the know-how for building an organization? Can I develop good human relations in my business?

Multiplying yourself. Third on the list of managerial skills essential for success I list the ability to multiply oneself. By this term I mean possessing both the willingness and the capacity for making known to all members of the organization the policies and decisions that have been made.

Here is a very simple illustration of what I mean by multiplying yourself. The sales price you set on a piece of merchandise or a service to be rendered requires a decision. You, or someone to whom you delegate the responsibility, has to say such-and-such will sell for so much. Now if every piece of that same merchandise is marked with the price, if every clerk or salesman who has to sell the merchandise is told, preferably in writing, the price and special points about the price, then you and your decision have been multiplied effectively.

If all the decisions that you and your associates make relative to hours of work, the vacation and holiday schedules, overtime, etc., are reduced to writing and made available to all, you have multiplied yourself and simplified your personnel problems. Likewise if your decisions regarding the granting of credit, the delivery of goods, the cashing of checks, and the acceptance of returned merchandise have been reduced to writing, and the procedures for dealing with them clearly stated, you have multiplied yourself.

Failure to grasp the importance of multiplying oneself and to learn the techniques is another reason many businessmen fail to expand their businesses. The block to progress and growth is the boss himself. How many times have you gone into a store, liked something you saw, tried to find the price on it, asked a clerk who did not know, and then finally found the "boss" who had to look it up in a little notebook that he kept tucked away in a littered drawer of his desk?

Yours has to be the decision as to whether you are going to be a *multiplier* and help your business grow or be the *indispensable man* who makes all the decisions and makes them over and over again. The tools of multiplying are simple and readily available: manuals, price tags, instructions, directives, staff meetings, illustrations, and, as your business grows, slide films and movies. The determination to use them must be yours.

Financial management. You have already been asked, in connection with your preparation for starting your business, to check yourself as to your ability in financial management. We are again bringing up the question, but this time with particular reference to the role of financial management in the successful expansion of your business. We are emphasizing this point because the importance of the know-how to successful financial management is not understood or appreciated by the majority of men starting in business.

There are many definitions and interpretations of the term "financial management," but in this section I refer to ability in financial management as the ability to obtain control of the other man's money and resources and to use them effectively. It means much more than keeping an accurate set of books, or paying your bills promptly, desirable as these may be.

Perhaps you do not like the expression "use the other man's money." Perhaps it implies sharp practices or even dishonesty. Or perhaps you are like so many smaller businessmen who say that they never want to go into debt. If so, all right; but your chances of heading up a growing dynamic business are considerably reduced and your chances for survival lessened.

Here is why:

Businesses get money for growth from two sources: earnings and investors. Taxes, particularly the Federal income tax, reduce considerably the amount of earnings that can be retained for expansion purposes. The ploughing back of profits, one of the methods by which many businesses grew from small companies to large corporations, does not provide an adequate method for meeting the growth requirements of smaller companies which frequently find that they must expand or lose out competitively. It is even doubtful that granting special tax exemptions on the earnings of smaller companies would solve the problems of financial management associated with growth.

This means that, more than ever, expanding businesses must depend on

investors as the source of funds for growth. It is particularly true in those instances where mass advertising and the public's acceptance of the product or service create almost overnight a sudden and heavy demand. This creates a sort of business vacuum into which will flow money and resources.

If your business is of this type, you will not be able to stop the flow of money and resources from investors. The question will be whether you have the ability in financial management to induce people to place their money and resources at your command rather than to start competing companies which may soon dominate the market you have developed.

This problem is intensified by the fact that savings of individuals and corporations are at an all-time high (estimated at $250,000,000,000 to $350,000,000,000 by various authorities). Interest rates are low, and the owners of a considerable portion of these savings are continually looking for better or more remunerative places for them.

On the other hand, the superabundance of funds means that the skillful manager has innumerable sources of money to tap. It should never be forgotten that using the other man's money is synonymous with providing him with an opportunity for investment or speculation; also that to the extent that your use of his money is based on sound judgment, effective business policies, and honesty, an investment in your enterprise will be desirable from his point of view. If you have the ability to understand and appreciate that borrowing (or creating a need for more capital) and investing are two sides of the same coin, it is one of the signs that you know the importance of financial management.

Management tools. The fifth factor that will enhance your chances of success is your understanding, appreciation, and use of the tools of management. These tools for planning the operations of a business and for controlling those operations have increased both in numbers and accuracy dur ing the past few years. By tools of management we mean not so much the mechanical devices and equipment that have been developed and improved but the accounting systems, budgetary methods, stock and inventory controls, production controls and cost accounting, and statistical methods that are now available to businesses of all sizes. Today, the business owner has no valid excuse for not knowing at all times the exact condition of his business. In many progressive, well-managed businesses the men and women responsible for the top-level decisions know at the start of each workday morning just how things stood at the close of the previous business day. Are you satisfied that you are qualified in this area?

Customers and competition. The customer is the real imponderable in business. You might almost call him the great unknown. Psychologists have studied the reaction habits of consumers. They know quite accurately

the colors, and the words, and other factors that encourage people to buy. They have taught advertisers a great deal concerning the instinctive and conditioned reactions of human beings. All this has tended to make selling and advertising more "scientific," but the fact still remains that people are individuals, and no two human minds work exactly the same at all times. This, plus the increasing keenness in competition, is the reason why top management in the larger corporations is more and more actively concerned with customers. It is likewise the reason why it is so important that you build the type of organization and use the techniques of planning and controlling which will leave you free to work on the customer problem.

When you talk about customer relations, selling, and advertising, the question always comes up: What about competition?

You will have plenty of competition. And if you do not, you had better find out in a hurry just why it is absent. The question is not one of competition, but of the type of competition that you will encounter.

When discussing locations and sites (or spots) for businesses, potential business owners often say that they are picking particular places because there is little competition. What they all seem to want is a nice little monopoly, although they are not thinking in those exact terms. To get them thinking straight about competition, I frequently ask them where they go fishing. When they tell me, I ask if other people fish there also. If it is a popular spot, I ask them why they do not go to some other spot where there are no other fishermen—and usually no fish. So it is with competition.

It is not the number of competitors, but the number of actual and potential customers in relation to the number and size of your actual and potential competitors that you should study. If your business is based upon rendering a real service, if it is well planned, and if its policies are consistent with the desires of reasonable customers, you should never find yourself in an unfavorable competitive position, provided you are not the victim of unfair or concealed competition or monopolistic practices by other businessmen.

Unfair methods of competition vary considerably in their frequency and intensity among the different types of businesses. Some industries are practically free from them; others are continually plagued. On the whole, the American business system is conducted on relatively high standards of conduct. You, undoubtedly, have sought to avoid, in your choosing, those businesses where unfair methods seem to be prevalent. But if you do encounter what you consider to be unfair methods, you can get advice and assistance from many different agencies. Locally there are usually Better Business Bureaus, Fair Trade Committees in Chambers of Commerce, and neighborhood business groups that are working on this problem. A number of states have boards or commissions that will assist you. The following Federal

agencies and offices are interested in various aspects of the problem of unfair methods of competition, particularly as they affect the small businessman: the Federal Trade Commission, the Department of Commerce, Senate Sub-Committee on Small Business, and the House of Representatives Select Committee on Small Business.

Competition that is concealed is harder for you to deal with. In connection with financial management I have already mentioned the competitive threat from the large amounts of savings in the hands of potential businessmen. Actually, when competition is concealed, it means that the businessmen engaged in the practice are trying to eliminate competition as far as they are concerned. If they are powerful enough to create a monopoly or even to concentrate control in a few large companies so that your access to raw materials, goods, services, or markets is restricted and your competitors favored, then you are definitely up against an impossible competitive position and need to turn to the government for assistance.

Another type of competition that is extremely hard to meet exists when a group of businessmen operate one business on a breakeven or loss basis solely to provide them with the opportunity to carry on a second and *very profitable* enterprise. There is nothing illegal about this method of operating; but if you are in competition with their breakeven business, you may find it very tough going. Let me illustrate:

The consumer-credit or small-loan business has been very profitable. The big problem and cost in this type of business is getting the loan accounts "on the books." People will borrow money for many reasons: to pay hospital bills, take trips, etc. But some businessmen believe that the best way to get people to borrow is to sell them something in return for a small down payment and a promise to pay at terms that are very favorable to the businessman. They are willing to split even on the sale of merchandise, and make their profit on the financing charges. If you have to make *your* profits solely from the sale of the same type of merchandise, your chances for successfully competing with them and staying in business are considerably lessened.

The larger the business you are planning to start, the more important it becomes that the six conditions discussed in this section be understood by the owner-managers and provided for.

In launching a full-blown business of medium or large size—that is, one employing 250 or more workers—all the problems of a new business are intensified. However, such businesses are usually undertaken only by experienced men who thoroughly understand the importance of the six conditions. Many of the most successful launchings of such enterprises have been directed by large, experienced, and successful companies either as subsidiaries

or as semi-independent companies. This is particularly true in industries where the investment in the plant, machinery, and equipment is heavy and where a relatively large volume of production is needed in order to compete effectively from the start.

The production of men's work clothes as compared with that of women's sport clothes in the garment industry provides a good example. Men's overalls and work shirts are so closely priced that a plant must be able to produce several hundred dozen garments per day and operate at near-full production every day if it is to make a profit. Women's sportswear, on the other hand, in which style and design are the important factors, can be produced with a profit in relatively small factories. As a result, most new factories for work clothes started during the past 15 years have been branch plants of large established operators, who were able to provide production and marketing know-how right from the start. On the other hand, in the women's sportswear industry hundreds of small independent companies have been started. Quite a few, despite the inexperience of their founders and their limited original resources, have developed into profitable enterprises.

The financial problems of a new business tend to be intensified when you start a business in an industry such as men's work clothes. Operating expenses can consume working capital very rapidly during the initial period, and if it is ever reduced to the point where the company is unable to avail itself of every possible financial gain such as the discounting of accounts payable, the chances of successful operations and survival are virtually ended.

To summarize: Your chances of success to a large extent depend upon *your* managerial ability. If your chances of success are to be well above the average, you must be able to subscribe honestly and fully to the following:

I believe I will succeed because I understand how to—

- Provide time for me and my associates to make sound policy decisions.
- Organize my responsibilities and those I delegate so that I can function effectively as the top manager of my business.
- Multiply myself by the use of proved techniques so that my associates can carry out my decisions efficiently.
- Use my own and investors' funds to expand my business operations as the growth and success of my enterprise necessitate.
- Use such tools of management as accounting systems, budgetary methods, stock and inventory controls, production controls, cost accounting and statistical methods; and to make top-level decisions based on the facts provided by these tools.
- Develop sound customer relations in the competitive situations existing in American business today.

6. Should I start my business now?

Most questioners have the booms and busts of the business cycle in mind when they ask this question. They have decided on the type of business and the location, and they feel that the situation within the industry or trade is favorable. But, they say, what about business conditions in general? Are we likely to have another depression? Are we likely to have inflation?

When you reach this question, you are right down to the point of paying out your money and assuming many financial obligations. You have passed through the thinking and planning phase and are entering that of action.

The fluctuations of the business cycle have, in the past at least, been the hazards or risks of business ownership most difficult to deal with. In fact it is doubtful if there is any adequate method by which the individual can protect his business against them. The ordinary methods of risk shifting by insurance or hedging are not applicable, nor can one truthfully say that efficient management contains the answer. American business provides too many case histories of well-managed businesses that were forced to close their doors by causes beyond their control. There was nothing their managements could have done that would have saved them.

Generalizations as to the desirability of *any time* being the time to start a business or not to start a business are dangerous. So much depends on you and the kind of business. Even the normally sound advice of "Don't start a business at the top of a boom!" does not hold true in all cases. Sometimes it is only during booms that you can get the customers and financial support needed to justify your starting the business.

Basically it is the rapidly changing value of money during the various phases of the cycle that causes the trouble. Many business transactions and contracts require businessmen to make "dollar commitments"—that is, to agree to make payments in fixed amounts of dollars regardless of the value of the dollar in terms of other commodities and labor. When prices drop drastically in a depression, these dollar commitments can take such an unduly high percentage of business income that heavy losses and failures are inevitable. This was the situation in the early 1930's.

As a result of these experiences, businessmen try to avoid fixed commitments and seek to make contracts in which the number of dollars to be paid during any period can be adjusted to meet the changed conditions. Real-estate leases that call for monthly or yearly rentals figured as given percentages of net sales are examples of this type of contract. In the same category are salary and wage contracts, long-term purchase agreements that contain clauses to keep these fixed expenses in reasonable ratio to income during any future periods of national depression. Frankly, because yours

will be a new business, it is doubtful that you will be able to obtain this type of "depression relief" clause in most of the longer term contracts you have to enter into in starting your business. But the more you can, the more you shift the risks of the fluctuations of the business cycle.

Their experiences during the past depressions have convinced many people —including a large number of businessmen—that it is impossible for the majority of individuals to cope with the forces of uncontrolled economic fluctuations. This belief has led to the demand that the Federal government act to prevent violent ups and downs and to produce a relatively stable but expanding economy, one in which both the fear of depressions and that of inflation are reduced to the minimum.

Whether violent fluctuations in the business cycle can be eliminated by governmental policies and actions remains to be seen. Much appears to have been learned during the past 20 years of the fiscal policies and monetary controls which seem to ensure against violent downswings. But the effectiveness of governmental controls against booms—particularly inflationary booms —is not so clear.

The answer to your question is further complicated by the fact that any attempts at the control of the business cycle become involved in national politics. To some people government actions affecting business inevitably produces statism, the welfare state, or socialism; all of which, according to them, would mean the end of the present American business system. To others, government actions including those taken to prevent or lessen the fluctuations of the business cycle are steps that must be taken if we are to preserve the system. Regardless of the correctness of either point of view, it cannot be doubted that the American people believe in action by the Federal government when their economic well-being and interests are at stake and that no political party will remain long in office if it permits uncontrolled fluctuations in the business cycle and the value of money.

I am not sure that from your point of view as a potential business owner seeking the answer to the question, "Is now the time?" this discussion of the business cycle is specific enough. The question has to remain unanswered, for no honest answer is possible. However, this discussion of your question will have served its purpose if it has caused you once more to stop, read, and check:

Am I certain that I really want to be a business owner?
Am I prepared for business ownership?
Have I selected the business with the greatest possibility?
Have I selected the right community?
Do I have the essentials for success?
Is *now* the time?

7. *A check list*

When you are thinking about starting a business or joining with a group to set up a partnership or corporation, you need to consider hundreds of things; you are about to make an important decision. Careful thought in advance will prevent many mistakes and will go far in assuring the success of your venture.

The following check list will suggest some of the questions which you will want to ponder seriously and investigate carefully. As you read them, you will note that they probe into personal attitudes, basic policies, and business philosophies rather than the details of getting a factory ready for production or a store ready to open its doors to customers. These details are dealt with in various sections. You should consider this list only a starter—a stimulator of your thinking. It will help you most if you will not only go through it question by question but also add questions that have occurred to you while reading and discussing this section.

	A check or notation in this column will show you have considered each point
Personal attitudes toward business	
Do you feel that you have a clear-cut picture in your mind regarding the possibilities and hazards of business ownership?	_____
Have you checked the records of success and failure in business?	_____
Do you have a definite personal objective in starting a business? Is it psychologically sound? That is, do you see in business an opportunity for service, or are you just using it as a means of escaping from an existing unpleasant situation or job?	_____
Do you consider that business ownership assures you security?	_____
How do your present earnings compare with the incomes of men in the type and size of business you plan to start?	_____
Can you stand the emotional and financial strain of an irregular income? (Relatively few new businesses are able to pay their owners steady incomes.)	_____
Does your wife understand that your income may be very irregular? Does your family?	_____
Have you sought to participate in the ownership of the business where you are now employed?	_____

A check or notation in this column will show you have considered each point

Have you analyzed carefully your reasons for wanting to start a business? Do you think they are reasons that increase your chances for success? _____

What problems of other people will your business solve? _____

Do you think your personal attitude toward business is such that people will want to be in your employ? _____

Have you and your associates-to-be discussed the problems of business ownership? Do your attitudes and objectives seem to be compatible? (There are few human relationships, except those of husband and wife, in which mutually determined objectives are more important than those existing among owners of smaller business organizations.) _____

Personal qualifications

Do you possess the professional or technical skills needed in your business? If not, can you hire them? _____

Do you believe that you can meet all the problems of financing the business? _____

Have you tried to foresee the problems—particularly the financial problems—you may experience if your business starts to grow rapidly? _____

Do you consider that you have had sufficient experience and training in human relations? _____

Do you believe that you have the capacity to build an efficient organization? _____

Have you ever supervised people? Have you ever conducted training programs? Have you ever hired people? _____

Do you rate your experiences as being those that would best qualify you to start and operate your type of business? Do you really know the best managerial policies and methods? _____

Are you thoroughly satisfied with the qualifications and personal attributes of your partners-to-be? _____

A check or notation in this column will show you have considered each point

Have you discussed and agreed upon with your partners the major objectives and policies of the business? _____

Do you understand the techniques of getting your policies and decisions over to your employees and associates? That is, do you know how to *multiply* yourself? _____

Do you consider yourself adequately skilled in the use of the tools of management? Do you understand accounting, budgeting, purchase and production controls, and statistical methods? _____

Have you checked carefully into the type of competition you will encounter? Do you feel that you have the ability to compete effectively? _____

Do you appreciate the need for your having time for the study of your business problems and the making of policy decisions? _____

The business and location

Have you compared the possibilities of your proposed business with others you are qualified to start? _____

Have you carefully analyzed the needs of the community for your business? _____

What problems of consumers or other businessmen will your company solve? _____

Is the demand for your type or kind of business on the increase? _____

Have you checked carefully to determine that you will like to serve the types of customers who will normally patronize your kind of business? _____

Have you and your partners-to-be discussed the project with businessmen and others qualified to advise you? _____

If your employees will be union members, have you discussed your ideas with local union officials? _____

Have you considered the growth possibilities or limitations of your business-to-be? _____

Are you satisfied you have picked the best location for your business? _____

	A check or notation in this column will show you have considered each point
Have you considered all the major economic factors of the community, or are you selecting strictly for personal reasons?	
Have you checked carefully the local ordinances and regulations?	
Are you satisfied that you have selected a progressive community? Is it efficiently managed? Is it new-business-minded? Does it encourage the newcomer?	
Does your community have a sound economic base? Are its industries diversified? Are its natural resources long lasting? Is farming diversified or is it confined to one or two crops?	
Have you checked carefully general trends in locating your type of business? Is the industry shifting geographically?	
Are you satisfied that now is the time to start your business?	
Are you satisfied that the costs of starting now are not so high that you would be at a disadvantage with your competitors?	
Have you taken any precautionary measures against a drastic decline in business activities and prices?	
Have you investigated thoroughly all the various types of competition that exist for your type of business?	

Section 6

HOW TO BUY AND SELL A BUSINESS

BY

J. K. LASSER

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HOW TO BUY AND SELL A BUSINESS

HOW TO BUY A BUSINESS

1. Get a great deal of information through your CPA

An intelligent buyer uses his CPA to get a great deal of information. Certainly he seeks an independent audit of the seller's earnings and balance sheet. Beyond that, he might want this:

How do the seller's figures compare with those in the seller's industry—or the buyer's ratios, if he is in the same business?

What will happen to the seller's profits when the buyer takes over the business, if he is in the same industry? (Base this study on the buyer's overheads, wage rates, and other cost ratios.)

How do the seller's sales prices compare with those of competitors? What will be the effect of adjusting them to competing levels? Does the seller really get his published sales price, or are there a lot of special deals, rebates, or allowances that cut the price?

How do the seller's sales prices and sales terms compare with those charged by the buyer, if he is in the same business?

What is the organization chart of the seller and what is each executive's pay, age, and length of service?

How good is the accounting system? Does it develop accounting procedures that will give information to all executives swiftly, continuously, and accurately? Is the cost of operating it reasonable, or is there too much duplication, red tape, and accumulation of useless data? Does it furnish comparisons to executives which accomplish business objectives? Most important, does it aid an efficient sales policy by clearly showing the more profitable products, territories, and dealers or lines?

How good is the cost system? Does it furnish an accurate cost of jobs, parts, articles and assemblies? Or does it compare present costs with previous experiences or standards? Does it completely analyze the operating efficiency by furnishing regular comparative data, detecting quickly any unjustified increase in elements of cost? Is it cheap to operate or full of red tape? Does it show up excessive wastes, spoilages, or bad production?

How good are the budgets? Are they used to coordinate all activities of the business, to ensure considered planning before acting, to give management a yardstick with which to check results against expectations,

to make the most effective use of resources with minimum costs, to reduce waste, to fix responsibility, to restrain unwise expansion, and to establish proper relations between income and expense? Does experience show they are used when actual results are checked periodically (to concentrate on the weak spots showing need of attention)?

How much employee plundering exists? What about the cashiers, mail openers, salespeople, credit men, collectors, purchasing agents, storeroom clerks, and receiving people? Is the internal system good enough to catch their frauds, kickbacks, and collusions?

How much personal expense is charged or absorbed by the business? How good, for example, is the control of salesmen's costs? Is there a policy about what is to be paid, and then a rigid audit of expense reports against call reports and reasonable expenses for the trip?

Is there a control of paper work and business forms? Does it seek what is essential, what can be cut out, what is duplicating other effort, what use is made of the copies prepared, whether there are unnecessary frills, what combination of forms can be made, whether more copies can be made at one time, whether copies are necessary, what writing can be eliminated by checking or crossing boxes? Are forms studied to see if they are wasting more time to keep than the record is worth?

Is there an equipment record for insurance and to tell the buyer what it costs to maintain various types of machinery? Does it show manufacturer, serial number, model, cost, date of purchase, location? More important, is there a record of maintenance costs, dates of inspections, and repairs?

Is insurance adequate? What precaution is taken to have it written at the lowest possible cost for needed coverage?

How good is the credit checking? Is there a sound policy, rigidly adhered to by all employees? Are losses reasonable, or is there too much speculation? Or are losses due to harsh handling of customers? Has the seller's internal system speeded up collection?

How expensive has the financing system been, particularly when sources other than a bank were used?

Is turnover of inventory reasonable? Is inventory timely and modern? Is it standardized and simplified as much as possible?

How good is the purchasing? Does the system get competitive bids? If the buyer is in the same industry, how do the prices and terms compare with those he gets?

How good has tax management been? Has it taken every permissible advantage? Are there errors the buyer can correct—to his advantage—if he buys?

All these are vital to your study of the business. They tell you what you can do to reorganize it if you take over. They may tell you, too, how much bad management, theft, waste, and spoilage have helped to lessen profits.

You should always audit the seller's balance sheet and operating statements.

Get a competent accounting firm *that knows the business* to do that. Or at least get a CPA who knows the business to guide your own CPA. Why? Those who do not know an industry may not catch a lot of seller's tricks in—

Building up fictitious sales
Paying expenses out of his own pocket or out of another business. (CPA's serving a lot of firms in an industry will know what costs *should be*)
Making all sorts of private deals with salesmen, suppliers, and even customers—deals that distort operating figures
Padding a balance sheet
A lot of other devices used by crooked sellers to build up a property before a sale

Ask for sufficient detail to uncover the weak spots usually obscured by generalities and broad classifications.

Be sure the CPA gives you comparisons with profit-and-loss and operating statements of several preceding periods. You want to discover trends—to determine the causes for the operating changes. Be sure, too, that your CPA compares the seller's figures with the following (many are readily available):

Industry statistics of income, expenses, and profits
Wage rates in the industry
Balance sheets of comparable companies
Industry turnovers and other important ratios

Remember that many essential facts do not customarily appear on the seller's financial statements. Your CPA's job is to—

Find out what purchase commitments the seller has—both at or above the market prices. You want to know what you must take over
Discover all claims that affect your future. Lots of them may be contingent, or not on the books
List all the restrictive or indiscreet contractual obligations. That might include: restrictions against sale in certain areas or certain articles; restrictions imposed by contracts with unions, competitors, etc.; long-term leases based on sales or purchase contracts at high prices; long-term sales contracts at too low a price; etc.

* * *

When you get your CPA's report, ask him to discuss it thoroughly with you.

Here is the sort of thing to look for on the balance sheet study.

All that is labeled "cash" is not always usable. Inquire if "cash" items such as i.o.u.'s, payroll advances, and loans to officers and employees are

included in what is represented as "cash on hand." Is the money on deposit with a bank that also carries an outstanding loan of the business? Is it encumbered to the extent of that loan? How much of the available cash is earmarked for more or less immediate payment of wages, dividends, bonuses, loans coming due, and purchase commitments or expansion programs? Is the cash really available or is it held by subsidiaries, affiliates, trustees, or agents? While you are at it—

See if the cash position is adequate for your anticipated business requirements

Check on unusually large cash balances to see if they are indications of inefficient use of capital

Study the *accounts receivable* to see what they are worth. First ask your CPA to state them by age groups. Then compare them with what the seller publishes as his credit terms. What portion of the receivables are good? Which can be counted on for payment when due? Which are bad? Which accounts are past due? Why? Have the auditors checked to find the accounts sold or assigned? Did they eliminate accounts for goods shipped on memo or consignment? These are not proper receivables. What about goods shipped to branches? They should be shown as inventory, rather than as a receivable from the branch. Find, for several periods, the ratio of sales to accounts receivable. An increasing return may reflect a favorable business trend.

Inquire, as to *notes receivable,* what portion is fully negotiable and what portion is restricted. What notes are worthless? Is the practice to hold notes until maturity? Or is it to discount or sell them? With notes discounted or pledged, ask what the pledger's contingent liability amounts to, because of indorsements or other forms of guaranties. Are notes from officers and employees clearly shown separately? Are any notes for unpaid stock subscriptions? Is the presence of notes receivable usual in the business? Or is it indicative of laxness in collecting, or indicative of bad accounts? Are *trade acceptances* segregated from notes?

You need a lot of study of *inventories* with your CPA. Have they been kept under control by accurate stock records? Do they guard against including goods received on consignment? Are slow-moving, obsolete, or shopworn items eliminated? Have all been billed and paid or included in the accounts payable? Have all that were sold or billed, but retained for customer disposition, been omitted from inventory? Are any pledged or encumbered? Here are some common problems:

Merchandise in hands of a processor. These are inventoried by owner when goods are to be returned in kind, for example, goods to be dyed.

But when a new product is to be returned, for example, refined copper for ore, or flour for wheat, these are not inventoried

Goods under contract of sale but not yet segregated and applied to the contract. These are included in the inventory of the seller. Exclude them from inventory of the buyer

Goods under a noncancellable contract of sale, segregated and applied to the contract. Only the buyer includes these in his inventory

Merchandise, title to which has passed to the buyer. You exclude this from seller's inventory. Include in buyer's inventory even if goods are in transit or buyer does not have physical possession

Goods, including shipping charges, sent c.o.d. You ordinarily include them in the inventory of the seller until payment and delivery are made

Goods shipped on approval. You include them in the seller's inventory until they are accepted

Sale by sample, subject to inspection and rejection within a given time. Usually included in inventory of seller

Goods rejected because of defects. Usually included in inventory of seller

Goods sold and found unsuitable by buyer, and then resold to him in the following year with concessions from the original price. You exclude these from seller's inventory from the first year when originally sold

How were the inventories valued? Many methods do not value an inventory at present market prices. You need to know the difference. And you should estimate the liquidity of the inventory in view of business conditions, seasonal selling, and many other factors.

Talk valuation with your CPA. You can easily be misled by inventories valued *at cost* (rather than the lower of cost or market) or *at retail values* (when full markdowns to reflect current sales condition are not recorded). Problems can also come if the seller has used a *last-in–first-out* or a *first-in–last-out* method, or any one of a dozen other normally acceptable schemes. No matter what the seller has done, your CPA must tell you if the price used is no higher than the present market price, less the cost of selling and distributing. Then, in order to understand an inventory, do at least this:

Compute the significant industry ratios: turnover, inventories to current assets, to total assets, to sales, to receivables, and to purchases

Compare these to the corresponding ones of prior periods; get the reasons for any considerable variation

Make comparisons with averages for successful firms in the industry

Don't assume all *investments* are cash. Go over the detailed schedule of the investments and their current market values with your CPA. If the securities are not quoted in the local exchanges, you will probably have to discount their value. And they should not be shown as current assets. Segre-

gate investments in subsidiary or affiliated companies. These are not current assets, no matter how marketable. The intent is probably not to market, but rather to hold for control. You cannot include a company's own shares in its current assets. While you are at it, do this, too:

Examine the investments to see if they are speculative
Check current yield on cost and on market values
Are any pledged? Find why they have been held
Calculate the ratio of investments to total working capital
Determine if funds are tied up when they should be put to use in the business, rather than in someone else's business

Is the investment in *real estate, furniture, fixtures, and plant equipment* proportionate to the size of the business? Are fixed assets kept in good serviceable condition through adequate repairs and maintenance? Are unpaid taxes or assessments shown in the statement? If there were recent improvements, are there any mechanics' liens? How much are the assets really worth? Your CPA can tell you this much:

Their cost less fair rates of depreciation
Their age—by classes
How much they are insured for
The local assessed value
Any record of recent appraisals by the seller
Any government appraisals to find a basis for ratios or depreciation

But that does show *value to you in a going business*—or value for a disposal by you if you buy them. Use competent appraisers to get that.

Be cautious, too, in valuing *patents, goodwill, franchises, rights, trademarks, etc.* Their real worth is only in their future earning power. That may have no relation to the cost or book value.

In your study of *mortgage indebtedness* ask your CPA whether the mortgagor is "on the bond" and has "personal" liability to pay. If not, only the encumbered property can be looked to for liquidation of the debt. Study the release clauses, contingent modifications, and, of course, date of maturity, interest rate, and amortization provisions. They tell you what you are assuming. Ask how outstanding *bond issues* are secured. Some may mortgage future income.

Get all the facts about these agreements creating debts. They inform you of the income you may have to put aside or pay out, your sinking-fund provisions, and possibly any conversion privileges. Often these make a sizable dent with what the seller offers as your equity in property purchased.

Your CPA will be cautious of "contingent" liabilities. You should study them with him. Some will become actual debts when the contingency occurs.

Often you will find these are not adequately disclosed in the seller's financial statement:

Indorsements or guaranties of obligations of others—perhaps negotiable instruments sold or discounted

Damage claims and lawsuits, often not recorded on the books until adjudicated

Liability on a mortgage bond—where the mortgaged property has been sold to others subject to the mortgage

Indiscreet contracts with salesmen or suppliers or for bad leases which will make high costs after your purchase

Severance or vacation pay, or employee-retirement agreements not recorded—or possibly bonus agreements with executives

Tax disputes on which interest is piling up

Rebates due customers

This part of your CPA's audit requires full knowledge of the seller's industry. He must bring you the full history of contracts and commitments to customers, suppliers, employees, and creditors. From that you can judge whether the burden you assume is worth while.

2. Get a great deal of information through your lawyer

You need competent counsel to check a good many points. You can help his work considerably with your notes, or the CPA's notes, as he studies the seller. Here is the sort of thing you want to know:

Has the seller good title? As to real property, there should be a check to see if there are mortgages, liens, judgments, easements, water rights, restrictive covenants, unpaid taxes, assessments, pending actions, or other encumbrances on the property. As to personal property, there should be a check to see if any items are sold, or if there are chattel mortgages, conditional bills of sale, or other evidences of lack of full title

All the terms and conditions of leases. Has the seller the right to assign or sublease? Are there renewal provisions or an option to buy?

What are the patent arrangements and registration of patents, trademarks, formulas, and copyrights? And what about franchises and their transferability?

What about zoning restrictions—particularly those which may come into effect for the first time with change of owner? Is the area restricted to residences or as to any type of building material?

What are other restrictions on the property? Counsel must check possible public use of property for a street, alley, highway, etc.; renting regulations; smoke-nuisance legislation; other building regulations—sprinklers, fire escapes, roofs, and sidewalks; whether you have the right of way over someone else's land to get to your property; rights to oil, gas, minerals, and timber and quarrying rights

Are there local labor restrictions and local health laws, such as workmen's compensation law liabilities; local health and inspection laws?

What of local laws that may force you to have a license to start business, restrict your hours of business, restrict your place of business, control your prices and methods of selling?

What about local regulations and your sales methods? Do any favor a competitor's product, restrict classes of merchandise that may be sold, prohibit you from acting as a wholesaler-retailer or some other combination, not permit your proposed type of distribution (for example, canvassing, itinerant vending, peddling, vending-machine or other mobile merchandising), make chain-store or supermarket operation difficult?

3. *Study the internal operation of the business*

The price you can pay must be based upon what you can earn from the seller's property.

All-important, therefore, is a careful check of how the seller has functioned.

One study is always advisable. See if you can really find *what prompts the seller to make the deal.* Buying a going business has many advantages. One reason for buying is that you can get a bargain. For example, tax considerations for the seller or buyer often give unusual opportunities.

Buying a going business also may give you the benefit of the knowledge and experience of the seller. You get customers—a certain volume can be accurately predicted. To that extent the risk is reduced.

Stepping into a going business can give you benefit of a running start. But all these benefits may be offset by disadvantages:

It may be that sufficient business (warranting the price you must pay) cannot be developed regardless of your ability

Buying a going business may result in saddling you with your predecessor's mistakes. Only your study of this will tell you whether you can make a fair profit

You do inherit certain customers—but potential customers may have formed a habit of *not* trading with the seller. It may take too much investment to get them acquainted with your new management

All-important, therefore, is this: Can you make enough out of the business to get a fair return on your investment?

Seek here: Can you do the job as well as or better than he? Can you make as much or more money out of the business?

Where do you get this information? All-important is the report of a CPA who knows the seller's industry, and your lawyer's analysis. What they should tell you is covered elsewhere. But you have many other sources: the seller's

banks, his customers, and suppliers, plus your own careful check of all he has been doing.

Out of this kind of a review, you begin to ask yourself a lot of questions: What about the seller's organization and his costs? Will you make a fundamental change in the business? Does it need a major replanning to correct high costs? Does it need new management? Can you provide that? Or can you engage key personnel to furnish new impetus to its important income-producing elements?

What about moving the business to another location to secure a better economic environment? Will moving—

Get you closer to customers, markets, sources of capital, credit, supplies, abundance of labor, cheaper labor, less unionization, less labor dissatisfaction, greater employee productivity, adequate employee transportation?

Make certain of power or water supplies?

Get added prestige or advertising value?

Get less restriction on sales in regulatory legislation, less price control, or less local inspection?

One essential is in a study of facilities. Can you make more money with new equipment? You can, if it will give you lower costs after deducting interest, maintenance, and depreciation cost.

Checks here also should consider idle plant capacity. Perhaps you can dispose of these plants.

* * *

What about working capital? Has a lack of it hindered sales expansion? Can you furnish what is needed? Or can you get it by a fundamental change in financial policy, such as—

Abandoning the policy of selling wholly for cash and selling exclusively on long-term credit, or vice versa

Arranging factor sales

Converting retail business from a credit and catch-and-collect system to a vigorous cash-and-carry, cut-rate business.

Converting privately owned business into a "mutualized" or "cooperative-like" business, by making your customers profit-sharers, investors, and, in a measure, coowners

Having merchandise suppliers finance the business by means of cash, long-term-credit, profit-sharing arrangements, or use of the consignment system

* * *

Can you improve the production methods? Perhaps radically different or new manufacturing processes can be used, or maybe you can substantially alter the techniques or create a vastly different sequence of manufacture to achieve product improvement. What about these steps?

Can you adopt better control of wastes, spoilages, and sale of by-products?
Can you introduce raw-material changes (plastics for metals, etc.)?
Are machinery changes needed—to make possible specialization of labor, use of unskilled labor for skilled labor, or less labor?
What about adoption of modern planning, scheduling, or routing techniques? They help cut wastes
Can you use an incentive payroll system or profit-sharing plan—if it will get more productivity of labor? That often gives increased efficiency, less deadwood, less labor turnover, less spoilage, and greater employee loyalty and effort
What about better health and accident-prevention facilities? Medical care, better heating, ventilation, illumination, sanitation, fire prevention, and similar protection often reduce turnover and absences
Should parts or assemblies formerly farmed out to others be made by you or parts made by you be contracted out to others?
Can you establish more effective personnel training systems for workers?
Does the inspection routine need an overhauling to secure control of quality?
Is there opportunity for cost reduction in better control of stores and supplies—and in harmonizing purchasing activities with production?
What can you do to cut maintenance and repair costs?

* * *

Can you improve the selling mechanics? Are the prices too high or too low? Should you eliminate unprofitable lines, products, markets, or customers? Can you get a better coordination of sales and production by better forecasts of volume? Should you concentrate on the most profitable lines—cutting the variety and number of products marketed? And which of these can you do better than the seller has done:

Developing methods to teach old consumers new uses of existing products
Securing markets not before attained for the product
Developing a whole new class of customers by such services to them as taking smaller orders, giving greater discounts, longer credit terms, premiums, generous return privileges, unusual guaranties, unusual deliveries, concessions on freight delivery charges, or unrestricted service after sale
Developing and patenting new products through research
Selling products by employing new marketing methods (for example, developing dehydration in a canning business)

Getting more distribution for the product (agents, jobbers, brokers, door-to-door selling, mail order, exclusive sales agencies, or factory branches)

Formulating more advantageous sales presentation, and better promotion and advertising methods to aid that distribution

Better stimulation of sales by the development of sales training programs for salesmen, modern sales compensation programs, and full use of work stimulators

Changing packaging, packaging design and construction, or design and construction of the product itself to: get better protection in transit; make it more suitable to the purchaser and distributors—thus reaching new markets never before attainable

Changing product design to make it clear, immediate, distinctive, visible on shelf and counter and in show window, so as to secure sales not previously attainable

Changing labeling to eliminate returns and complaints, or make it more helpful to salespeople in procuring sales not previously attainable

Changing customer service, customer credits, and other customer relations, to enhance profits and eliminate abuses

Organizing for most efficient, economical delivery methods by ascertaining the best process of shipping—for greatest convenience to customers, protection against damage or loss, speeding collections, suitability to size and weight of normal shipments, adaptability to shipping emergencies, competitors' practices and customers' desires

* * *

You should get a full record of the *labor relations* of the business—particularly the government agencies to which it is subject, plus—

The record of compliance or violations of Federal and state labor laws, etc.

Union contracts in force, the previous labor disputes, present relations with the union

Wages, hours, and working conditions

Abundance of labor may warrant investment. Scarcity of labor may mean trouble. It might pay to substitute machinery—if that is possible.

The degree of labor unionization may affect the cost of production and the availability of skilled labor. Labor leadership can also control production, jurisdictional strikes, employee dissatisfaction, and employee productivity.

* * *

What can you do to improve the seller's reputation as a good company to work for? That may mean finding whether: it has stabilized employment as

much as possible; it has kept abreast of employee attitudes. They change frequently. Check these points to find what you can do. Has the seller—

Discussed and explained company policies, trends, and management problems through a company house organ or bulletins, to promote loyalty by making employees all feel "part of the company"?
Aimed at stabilized employment (workers want that more than anything else)?
Revised incentive and compensation plans to stimulate complete cooperation?
Encouraged or sponsored group activities—musical organizations, bowling leagues and other athletics, public-speaking clubs, annual stage shows, hobby exhibits, dances, etc.?

What about the way the seller has hired people? Has he employed an experienced personnel director? Does he maintain files showing the experience and qualifications of employees? Has he used modern testing procedures? Does he accord all applicants considerate and careful treatment; fill vacancies by promotion and transfer whenever possible? Does he acquaint employees with opportunities for promotion? Can you improve that?

Are wages comparable with those paid in the industry? Are working conditions at least as good as those in other jobs that might be offered? Is there a program for job evaluation? (If properly done, this increases understanding, promotes fairness, and improves morale.) Is there a periodic rating plan? Has the seller put his best foot forward in telling what the company can offer in the way of stability of employment, job security, disability and death benefits, and other benefits?

Has the seller given attention to the little things that show consideration? That might include—

Good lighting and other fatigue-reducing measures
Facilities such as washbasins, drinking fountains, lockers, toilets, and other employee needs for personal comfort, etc.
Modern safety aids
Industrial-health plans, that eliminate worries and reduce doctor expense
Group life insurance, sickness and accident benefits, hospitalization, and pensions

Has the seller been careful about dismissal procedures? Has he used well-thought-out methods for interviews upon dismissal? Does he have dismissal compensation? Has he given reasonable notices of termination?

Your study of all this tells you what you can do to improve employee relations.

4. Consider the risks in the business

If you are already in the industry—or know it well—you can usually compute estimated sales and profit. When you know the internal operations of the seller, it is possible to tell roughly how much more—or less—you can make than he does.

Intelligent purchasers who know an industry always do this: Find what they can make, after they know all about the seller's business. That tells them what they can afford to pay.

If you do not intimately know an industry, what special factors do you study to find your chance for profit? It might cover some or all of these:

The trends in the industry in sales, costs, and profits
The size and number of competitors, and the opportunity for breaking into the industry
The seasonal variations and cyclical fluctuations in the industry—and what it costs to finance them
The long-term demand for the product
The methods of distribution used in the industry—dealers, wholesalers, syndicates, jobbers, or salesmen. How they can be altered by newer methods used today
The distance of the business from the consuming public; the problem of transportation
The labor market available—labor troubles and wage rates in the area
New technological trends in the industry; how they will affect you

Your study always involves a review of the risks found in the business you are considering. Stop a moment to study the usual risks of business, which are listed in "Check list of the risks in business" in Section 4.

5. Select the time to buy

When should you buy a business? Tax advantages sometimes govern. That subject is covered in the next part of this section. In the preceding parts we have tried to explain how you find the profit you will make. Study, too—

How many others are entering the same business to capture your proposed market?
What new inventions or technological changes threaten the product or its method of production?
What about the local political scene—will impending changes alter your labor, production, or sales methods? And on the state and national scene—what new laws are pertinent to the business?
What about Federal and state tax laws? Will they permit you to get a

decent return on your money? Will you earn enough *after taxes* to pay off what you must borrow to make this deal? (Much of this section is about these points.) If you can't get a good return, should you try some other way to get the property? Maybe you can lease it

Often the decision to buy—or to stay out of the market—is based on two things:

1. *Does the price have some reasonable relation to what your money is worth to you?* You find a fair price only if you know what net earnings after taxes will come to you out of the property; then you must compare the net return with what your money can earn by other investments.

2. *What is the business weather ahead?* That concerns an intelligent check on the normal business barometers. Many published business barometers (like those in *Business Week*) help a great deal in business forecasts. You or your experts can often use these to budget what is ahead of us. They are valuable because history tells us all business cycles are composed of the following phases:

1. The crisis—sharp drop in business, prices, and employment
2. Downswing and the decline—falling off in business and prices, a spiraling downward, falling prices, production, and employment
3. The depression—a period of stagnation, prices low, inventories gradually consumed
4. Upswing and recovery—a gradual expansion of business followed by rise in prices and employment
5. Creation of the boom—a period of rapid expansion anticipating demands, followed by speculation; prices rise more rapidly than production or employment

Buying just as we are coming out of a depression, or at the beginning of an upswing can be very profitable. Prices will be lower. Certainly you want to try to do it. The business should have a low price if you must bear the burden of the crisis or depression.

Caution: Estimates by forecasting are never more than the probable course of events. No one can accurately measure the new elements that may change expected results.

But forecasts can be invaluable aids to tell you how much you can pay for a business.

6. Buy tax-wisely

Should you buy the stock or assets of a business? Assume you agree to buy all the stock of a corporation. Also assume that the price of the stock reflects the higher market values (over corporate costs) of inventories and real estate.

When these assets are sold, both the corporation and you (when dividends are distributed) will pay a tax on the book profit.

The result: your dividends are really a return of your capital. Can your buying plan avoid that penalty? To do it, seek a purchase of assets; or get price adjustment for the extra tax you are assuming.

For example, when you buy corporate stock, your price may reflect the existence of the corporate surplus. Say your stock will cost $100. The company has assets which cost it $50, but which are now worth $100. If it sells the assets for $100, and pays dividends of $40, you will have to pay a tax on the ordinary dividend income. You really should get no income until you have recovered your $100.

But some deals to buy stock can give you a very great tax advantage. Assume you pay $100 for stock of a company whose assets cost it $1,000. They are only worth $100 now. Then you may get a depreciation deduction on the $1,000—and a sale at $1,000 gives no tax to the company.

* * *

The seller may insist on selling the stock of his corporation. But you may want to buy the assets for the reasons we have just covered:

Your purchase price exceeds the cost price of the assets to the company
You want to avoid being taxed for dividends when you sell corporate assets for the price you paid for them

You may want to buy assets for many other reasons—for example, you may not want to take over the seller's undisclosed debts or his contracts. You just want to buy his assets. If that is your position, you can insist that he liquidate his corporation and sell its assets to you. If that is not possible, perhaps he will agree to pay you any tax due to your liquidation of his corporation after you purchase the stock.

As we have pointed out, some stock deals can give you large gains; some are costly. You get one chance to pick the way to proceed. That comes when you acquire the property. At that time, you select the future tax basis of your property. Here are the rules:

If you use cash (or its equivalent) to buy assets, the price you pay usually sets the value you will use later in depreciating or in selling
If you buy stock for cash, then the seller's cost basis of his assets governs in finding a gain in sales or for depreciation
This last rule also usually holds if you give stock for stock. Sometimes you may use your stock or securities to buy assets and still get the seller's cost basis, if you can adopt and follow the highly technical exchange provisions of the tax law

Should you preserve the seller's tax advantages? When you buy the stock of a business, you may gain far more than the tax basis of its assets. If you buy assets for cash, your sales price fixes your tax basis. But you may lose many other benefits. Here is the reason: a successor company may have to pay a tax that would *not* have been paid by the seller on the following:

Income from the same assets offset by prior years' net operating losses, unused capital loss carry-overs, and unused excess profits credit carry-overs

Gains that might be offset by liabilities—assumed by you, but incurred by the seller if they were contingent or indefinite at the time of conversion. Only the seller may have the deduction for expenses incurred during its operation

Some income can be taxed to you, the successor, that would not have been taxed to the seller. Or you will not get many deductions that might have been given it. For example, tax refunds and recoveries of bad debts, where the seller took a deduction but obtained no tax benefit, or some life-insurance proceeds.

And some deductions will be denied—for example, unamortized bond discount on bonds continuing to remain outstanding; unamortized capitalized expenses of issuing bonds, mortgages and other obligations; unamortized capitalized leasehold costs; depletion based on discovery value. These deductions are not available to successors, nor are many types of debtor's taxes and interest. They may be deductible only by the company liable for the tax. They may not be deductible by the successor.

If you are considering replacing the seller's company with a new one, remember this: Losses sustained during your first years of a new company's operations will *not* get you a refund of tax paid by the predecessor. He would have gotten the refund. That is one of the greatest dangers in changes.

No matter how simple the change, a new company usually loses all the benefits of carry-overs of the old company.

If the successor company may not have the deductions, what can you do to avoid the loss when you purchase a company? You might contract to keep the old company alive. It can retain enough assets to pay its debts. Then it might use the deductions to get a carryback and a refund of taxes for your benefit.

Sometimes the incident of the conversion creates a tax that might have been deferred. Income may be created that might not otherwise arise until a later date. For example, a company using the installment sales basis may have income at the moment it stops business, rather than in later periods.

Perhaps you ought to retain installment obligations in the company taken over and keep that company alive for your benefit. It may then report the income over a period of years and pay taxes due on the prorated profit.

And see if it is wise *not* to transfer life-insurance policies. Perhaps you should hold a purchased company alive to collect proceeds that might not be taxed.

* * *

How do taxes affect the price you should pay? Assume you have decided to buy all the assets of a business, and not its stock. You will generally get your greatest tax advantage by this: Insist that your written contract with the seller allocate as much as possible of your purchasing price to the assets giving you your greatest tax deductions. Do that even if you decrease the price paid for assets giving you capital gain on disposal.

Assume you can arrive at a total or bulk price. In that process, you do not try to find individual asset values.

Now it becomes very important to do it.

This sounds like double talk; let's see how it works out in practice. Here are the assets that should be *valued at high and low figures:*

Asset	*Why Value HIGH?*
Merchandise inventory, stock in trade...	A high cost will reduce your profit on its sale. Your cost is fully deductible.
Supplies and similar items not used in the manufacture of the product.	These supplies will be used as expense items in the ordinary course of the business. Your cost is fully deductible.
Accounts receivable	Loss from bad debts would be fully deductible.
Machinery, equipment of short life.....	The short span of depreciation gives you a quick deduction, and a loss on sale or abandonment is fully deductible.
Life-insurance policies	Proceeds at death are ordinary income to buyer. They might *not* have been taxed to seller. But a resale is given capital-asset treatment. If you plan to resell you can value low since you can get the 25 per cent maximum tax. The only exceptions to the recognition of gain to the buyer are when the buyer is the insured or when the buyer is a transferee in one of the possible tax-free reorganizations.
Patents, copyrights, franchises, etc., amortizable intangibles *if remaining life is short.*	You recover deductible cost rapidly by getting reduction of income over the short period left for amortization, but value these at low figures if life is long, or if you propose to sell the asset. Then you may get the 25 per cent rate on long-term capital gains.

Asset	*Why Value LOW?*
Buildings, building improvements; machinery, equipment *of long life.*	Too long a period of depreciation is needed to recover cost. The loss on the sale or abandonment is fully deductible. Gain is taxed at 25 per cent.
Land	There is no deduction for depreciation to recover cost. Gain would be a capital gain—taxed at 25 per cent. Loss on sale or abandonment is fully deductible.
Stocks, bonds, and securities	Gain would be taxed at capital-gain rates —a maximum of 25 per cent. Losses can generally be used only to offset gains.
Goodwill	You recover your cost only through the sale of the business. (Be sure to place some value on goodwill.) Any profits in a sale would be capital gains—taxed at 25 per cent. Abandonment gives an ordinary deduction

The government will not ordinarily disturb the contract prices fixed in arm's-length deals.

* * *

Some purchasers lose assumed tax benefits. The tax regulations try to prevent one company from reducing its taxes by another company's operating loss carry-overs, or other allowances.

The law aims especially at abnormal transactions. And so it condemns two types of purchases:

1. *X,* a corporation (or *A,* controlling *X*) has large profits. *X* (or *A*) acquires control of *Y*. *Y* has current, past, or future credits, deductions, net operating losses, or other allowances. *X* (or *A*) then takes steps to balance its income against the allowance
2. *X,* a corporation, acquires property (not stock) in a way giving it a cost basis materially greater than its fair market value. *X* does this in order to utilize the property to create tax-reducing losses

These rules affect you only if you are buying control of a corporation, or buying property of a corporation for your corporation. Even then the penalty applies only if you become entitled to use the cost basis of the old company in your business.

Moreover, you can lose *only* if the evasion or avoidance purpose outranks any other one purpose. Suppose your motives are in part tax avoidance, and in part some good business purpose? You seem to carry the burden to show how much weight was given to the tax-saving motive. You probably will gain approval *if* a realistic eye does not find the transaction an affront to

common sense. Otherwise failure will result. And that comes despite letter-perfect compliance with the language of the rules.

Caution: This rule places the burden on all corporate purchasers (of control or of property) to maintain a new type of record. They should be able to show their paramount intent was not to evade taxes.

* * *

There are other tax essentials to study on buying. One is this: You may get a better tax buy if you pay a lower purchase price for a business—but undertake to pay annually for a "noncompete" agreement. These are usually *ordinary* deductions if paid to the individuals who are very important to the business. Their receipt is ordinary income to them.

To get the deduction for this cost, your contract with individuals should fix the sum for their agreement not to interfere with you. It should be separately stated from the prices of the other assets or the price for the business itself. It should run for a limited number of years. Then the payment can usually be deducted over the stated period. If the period is indefinite, you may be denied a tax deduction for that cost.

Sometimes the seller's business has been successful because of the personal efforts of some of the principals in that company. It may be advisable to employ these principals. Their compensation gives you a full tax deduction. Perhaps agreement to employ them at a reasonable compensation will give you a reduction in purchase price.

Will a long-term lease—instead of a purchase of the assets you seek—be just as good for you? Here is the tax result: You get a deduction for your rentals. And you can get a deduction for depreciation if you agree to replace asset losses, caused by depreciation or obsolescence, or if you agree to return the property in as good condition as when it was delivered to you.

Are you going to buy a business building with the intention of demolishing it? *Caution:* Neither the cost of the building nor the expenses of demolition are deductible. They are added to your land cost.

If you buy intending to use the property, but later decide to demolish, you do get the loss deduction.

Interest payments to a seller give you a tax deduction. Deferred or installment payments are often involved in a sale. Should you decrease your price and increase the interest rate to make up the seller's loss? That can give you greater tax deductions.

Example. A flat price of $12,000 for a depreciable asset gives a purchaser (say) $1,200 a year for 10 years as depreciation. A price of $10,000 payable in four equal installments with $500 per year interest would give the pur-

chaser a $1,800 deduction for the first 4 years, and $1,000 for the next 6 years.

Mergers, rather than purchases, may be a better way to acquire assets.

* * *

How do you buy real estate tax-wisely? It is common practice when buying business real property to take title in the name of a corporation. This may not be good practice if you intend to sell the property. If the corporation sells, it pays a tax on the gain. Then the stockholders have to pay another tax when the corporation distributes the proceeds to them. Even if you distribute the property first and then sell, the government might try to say that the corporation actually sold the property. Don't use the extra corporation. Or if you do, insist on a sale of its stock. Then you pay only one tax.

This rule does not hold if you organize a dummy corporation only to take title to the real estate. If it does nothing but hold property, you may avoid the double tax. But, according to one case, if it negotiates a loan on the property, it may have to pay the corporate tax. What you must do is this: After title has been taken by the dummy corporation, all acts in the management, conservation, financing, negotiation, and operation must be done in your name. The way to use a dummy corporation is illustrated by one case.

Example. *A* and *B* transferred property to a new corporation in order that it might make a sale. Under the written agreement between them and the corporation, it was only to make the sale and pass on to them the proceeds. The government tried to tax the corporation. But the court held that they had created a mere *conduit* for the profit.

A buyer should try to close title immediately *before* the current real-estate tax is assessed and before it becomes a lien on the property or personal liability is imposed on seller. Then you can deduct the tax on your tax return If you acquire title *after* assessment or after taxes have become a lien or personal liability, then the tax is part of your capital cost. It is not deductible. Only the seller gets the deduction—even if you have to pay the tax to him. Check with your lawyer before you buy properties to see how this works in your state.

If you buy a ground lease with an option to purchase the property, here is a warning: If you exercise the option, and specify what part of the payment is for canceling the lease, that will give you a deduction. Failure to do this may mean that the entire payment is added to the cost of the land.

* * *

The buyer should help the seller in his tax problems if he can. A seller has a great many tax-saving opportunities. The usual conflict of interest with the buyer is this: The seller will seek a capital gain to get the lowest possible tax on his sale; the buyer wants all possible ordinary tax deductions for his payments. Tax experts sometimes make both possible. One way is illustrated by this case:

Example. Four people sold patents to a company. It agreed to pay them 80 per cent of its gross income from its licenses of the patents for a definite period. This secured the sellers a capital gain on all payments. The patents were amortizable purchases. The business was entitled to recover its cost (all the 80 per cent payments) over the life of the patents. Cost was not fixed until payments ceased. A reasonable allowance for depreciation of the patents was held to be the actual annual cost paid for them.

HOW TO SELL A BUSINESS

This section starts off with the assumption that you want to sell. Your problem is *how* and *when* to do it to get your greatest return, *net of taxes.*

If there is any question about selling, you want to read all we have urged upon buyers. Maybe the same kind of a study of your business will change your mind. We have known many sales to be discarded upon intelligent study of business potentials.

This is the kind of a problem that needs full discussion with your CPA, your lawyer, your bank, and perhaps management experts.

7. *Should you sell?*

Selling your business is not always advisable. There are many other ways of achieving a divorce from full management and operation of a business. Consider these:

Leasing your stock or assets. Check the tax problem with your tax advisor as to the tax implications. If you lease, you can spread the income over many years. But this becomes ordinary income, and you may lose the advantage of the capital gains rates. If you lease property and the tenant is required only to keep the premises in good condition, you get a depreciation deduction. But if you insist that he replace losses and turn the property back to you in as good condition as when delivered, then you get no depreciation

Sale of your stock to your own company. We generally have a capital gain if the sale (even if on an installment plan) removes you as a stockholder. In other cases it may be a taxed dividend. That should not concern you if your company has a deficit. All dividends (up to your cost of stock) are merely a nontaxed return of capital. Incidentally,

installment sales plans of stock to your own corporation need not be for a fixed price. You can use a percentage of its net income or its sales for a definite group of years

Sale of a large interest in your company to an investor. Perhaps you keep all the preferred stock, and let him have the common stock

Sale of most of your common stock to partners—or perhaps your associates or employees—who will take over. This may be advisable even if you have to help finance the deal for them. It may give you capital gain, rather than ordinary dividend income

Merging the business with another firm—taking its securities. That still leaves you in business.

* * *

The net operating loss tax carryover may urge you not to sell. You may have a carryback giving you a refund of prior year's taxes if you have a loss this year. Perhaps that suggests reorganization of business operations may be undertaken with government aid; perhaps it urges development costs be undertaken in order to build up earnings. Perhaps this may be a year to take this sort of action:

Make needed repairs and maintenance previously deferred

Spend money to get new markets and new products

Settle for bad contracts or leases—if that gives you a deduction this year rather than in a later year

Clear out defective and obsolete inventory at the best price you can get

Sell out obsolete or inferior equipment

Under this rule losses can be undertaken, if sound business policies dictate, with the certainty of quick refunds of taxes previously paid. Taxes can often be recovered speedily enough to aid in the financing of the business loss.

And this is true too: acquisitions of profitable business departments can be had by a company losing money, or having a carry-over, with the certainty that part of the investment will be returned through government aid.

8. Sell tax-wisely

You have made up your mind to sell. Can you reduce the tax on your sale? How do you get the best tax result? Let me first explain the rules. Here is how the government treats sales of business assets held for more than 6 months:

Sales of capital assets never give a tax of more than 25 per cent, if you are not a dealer in these assets and they are not your regular stock in trade.

Capital assets are any of the following:

Stock, bonds, and other securities of your business

Land, buildings, and other property *not* used in your trade or business

Investments in undeveloped land, etc., including interests in partnerships and other ventures

Many other assets used in your business, for example, goodwill and nondepreciable investments or securities

Patents, copyrights, etc., *not* used in your business

If you sell land, buildings, and depreciable property used in a business, you compute a preferred tax position this way. If the total gains are greater than the total losses, you then treat the net gain as a *capital gain.* If the losses are greater, the net loss is treated as a *fully deductible loss.* Check with your tax advisor to see how this rule changes if you had any gains or losses on involuntary conversions (through seizure, destruction, or fire)

Special capital gains and depletion problems arise with the sale or assignment of a gas or oil lease. Consult the following table for the rules:

If you dispose of the lease this way	*You are taxed this way*	*Deduction for depletion belongs to—*
By sale after holding for more than 6 months and you are not a dealer.	Capital gain.	Buyer.
By sale and you developed the property. Its chief value results from your discovery efforts. It makes no difference whether or not you are a dealer.	Surtax cannot be more than 30 per cent of the sales price.	Buyer.
By sublease	Entire payment is ordinary income.	You (the assignor) get the deduction for depletion on the interest you subleased.

It is obviously very important to determine whether your transaction is a sale or a lease. The test is not whether title passed under the state law. Payments due you under your assignment (after the initial cash payment) may be a fraction of the entire production for its full duration. Then they are payments under a lease and you get depletion deductions on them.

Sale of timber may produce favored treatment by observing the following rules:

If you sell timber—	*How you are taxed*
Standing or cut, owned for not more than 6 months.	Gain is fully taxed. Loss is fully deductible.
Standing, owned for more than 6 months.	Gain is taxed as capital gain. *Loss:* Fully deductible—if you are in the business. Capital loss—if held for investment.

If you sell timber—	*How you are taxed*
Cut, owned for 6 months before beginning of this year or have a contract to cut it.	*If you elect:* Gain or loss is determined at the time of cutting timber. This is the difference between its basis for depletion and the fair market value of the timber on the first of the year in which the timber is cut. The election is made on the tax return. It is applicable for this and later years and to all timber for this and later years and to all timber you own or have a right to cut except timber that is not cut for sale or use in your business or is held for not more than 6 months before beginning of this year. Gain is taxed as capital gain. Loss is fully deductible. *If election is not taken:* Gain is fully taxed. Loss is fully deductible.
Under any kind of contract under which you retain an economic interest in the timber held for more than 6 months.	Gain or loss is determined at the time of the contract. This is the difference between the amounts received for the particular timber in any year and its basis for depletion. *If you are in the business:* Gain is taxed as capital gain. Loss is fully deductible.

* * *

Should you sell for installment payments? If you sell any of the assets listed above *at a profit,* you may gain by having the payment made in installments over a period of years.

Assume that you sell the stock of your company for $100,000 at a profit of $20,000. The $20,000 would be taxed income in the year of sale, if the $100,000 is received then. Under the installment rules, you cannot receive more than 30 per cent cash, or $30,000, in the year of sale. If you took $30,000, you would report only $6,000 profit in the year of sale—*i.e.,* 20 per cent of $30,000. The balance of the profit, $14,000, would be reported as the balance of the cash is collected.

You may use the installment method in any *casual sale of personal property, of more that $1,000.* The initial payment made to you must be 30 per cent or less of the sales price.

It may be to your advantage if the sales contract does *not* provide for interest on the payments. Instead you will gain, taxwise, if your sales price is increased. Interest is fully taxed. The gains are taxed at a maximum of only 25 per cent.

Assume your first year's payments are over 30 per cent for a group of assets, like the inventory, accounts receivable, and equipment of a business. Maybe separate bills of sale and separate transactions will bring you into an installment transaction on at least part of the sale. You might, for example, contract to sell the inventory and receivables at once. Then you might have a separate sale of the equipment. But you may *not* allocate part of a grouped sales price when you sell a going business in order to use the installment basis.

Do not assume you can split the sales price into two parts, attributing, for example, a full cash payment to the inventory and the remaining cash to the other items of the sale in order to bring that amount below 30 per cent. It will not meet with government approval. Split your deal to get your tax saving.

If you have deferred the reporting of income this way, you should not sell your installment obligations. If you do, you will be taxed on all your unreported profits on those obligations.

* * *

Timing your sale is a problem of understanding both the tax rules and the market conditions. The best date of sale is when your best judgment tells you when you can get most (net of taxes and costs) for your property.

Timing has much to do with a many-sided tax result. For example, a sale that will deprive you of a tax recovery due to unused carrybacks may be very costly.

The tax you will pay on a sale may depend on the date you sell. The period during which assets are held fixes the amount of the tax due. The rule differs for assets held more or less than 6 months. An error of one day may convert a short-term loss into a long-term loss. In computing the period, the day the asset was acquired is excluded; the holding period starts on the following day. The day on which the asset was sold is counted as the last day of the holding period.

The holding period is easily determined for property directly acquired and held in the same form since acquisition. In some other situations, study with your CPA may be required.

* * *

Can you use the exchange rules to avoid a tax in a sale? You can avoid all tax in a transfer if you will strictly conform to the exempting provisions of the law. Check with your tax experts to see if you can deliver your business in one of these tax-free transactions:

Solely for voting stock (however small) when you give up 80 per cent of the total number of all other classes of stock of your corporation

Solely for voting stock (however small) when you give up substantially all the properties of your corporation. In this, the fact that liabilities are assumed, or that the property is taken subject to liabilities, is disregarded

For any securities, from one corporation to another, for all or a part of the assets—but immediately after the transfer, your transferring corporation, or its stockholders, or both, must own 80 per cent of all stock of the transferee

For stock or securities delivered to the exact individuals or corporations transferring the property if two conditions hold: (1) they thereafter own 80 per cent of all classes of stock of the transferee; (2) the securities given each are to be in proportion to value of what is delivered. If liabilities are assumed, they are considered securities received by the transferring persons

* * *

When can you defer the tax from a sale to a year later than the sale? Your ability to do that may have some bearing on the way you make your transaction.

Generally, you are taxed in the year when title passes. But you need not pay a tax if you cannot determine the market value of the payments with fair certainty. Some types of deferred payments get in that rule, if you cannot find their market value. These are not a basis for tax until your consideration is actually collected.

Example. For your assets your buyer agrees to give you 5 per cent of his sales, or 10 per cent of his net profits, or all the profits after he earns $100,000. These are not fixed payments. You pay no tax until you collect.

Yet this method of selling is very popular today. Why? It is particularly helpful for sellers who are unable to get all they think their property is worth.

* * *

Sales of property may also be encouraged by proving that receipts are not income, because proceeds are restricted in the year of the sale. When does that occur? Study the following rules to see if you can fit your sale into them:

If securities or other property received are nontransferable for a specific term (say 5 years), the restricted property has been held to give no present income

If property taken has no value now, but has the possibility of developing into greater value later, you pay no tax *now*

If the buyer's payments are escrowed, to be delivered to you only on clearance of substantial encumbrances, you await release of the funds before you owe a tax. The same would be true of escrow payments to cover the substantial seller's warranties. The rule also applies to escrowed monies held pending clearance of litigation or government approval of the transaction. These are not actual payments until the monies are released

If property taken is merely a contract to receive payments when, as, and if profits or sales arise, it may have no fair market value now. You pay a tax on those receipts, when you get them or when the profits or sales are determined. In these cases you may postpone the tax because you cannot judge with a fair degree of accuracy how much (if any) will actually be received

Where the buyer gives you his note or bond and the obligation has no fair market value because payment is conditional, or because the payment is contingent or uncertain, you owe no tax when these obligations are received

Title does not pass as a result of a contract to sell; or if the buyer can return the property in a reasonable time and get his money back

* * *

When should you postpone a sale? Do not sell depreciable business properties, one at a gain and the other at a loss, in the same year. The profitable sale is taxed at 25 per cent. The loss sale in another year is fully deductible. But if both are effected in the same year, one offsets the other.

Example. X Company owns a building and a lot of equipment. It sells the first at a profit of $1,000 and pays a tax of 25 per cent. In the following year it sells the other at a loss of $1,000. The tax saved may be as high as $470. The net gain for the 2-year period is $220. If both sales were made in one year the profit of one offsets the loss of the other with no tax advantage.

If both assets *must* be disposed of in one year, you can still avoid the offset. If you *abandon* the loss asset you get the full deduction. An abandonment loss does not offset a gain on the sale of depreciable property.

* * *

Sometimes a sale is not necessary to get you funds. Assume that real estate or other property cost $20, but is now worth $100. A mortgage or loan is negotiated for $90. Nothing has occurred which would subject the holder to tax on the entire transaction. But he may have benefited far more than in a direct sale of the encumbered property.

* * *

Sometimes a trade or exchange is better than a sale. It avoids the tax on a transaction. The disadvantage may be a loss of increase of basis to you. If you have a fully depreciated machine and trade it in for a brand new machine, there is no gain. But your cost basis is the same as the old machine —zero.

If you sell the old machine and use the cash to buy a new one, you have a gain. It may be taxed at only 25 per cent. And you get a new cost—your cash cost of the new machine. You get one chance to cut your taxes when you elect the kind of deal you will make.

To get out of tax on trades, you must observe these three rules:

1. Property exchanged must be "solely for property of a like kind." The words "like kind" refer to the nature or character of the property, not to its grade, quality, or use. Thus, an exchange of an old truck for a new truck, an old passenger car for a new passenger car, or trading of work horses, would be exchanges of "like kind." Trading a farm for city property, or a trade of unimproved real estate for improved real estate, or of a rental house for a store building, although dissimilar in services or use, are still classified as exchanges of a like kind
2. The property exchanged must have been "held for productive use in trade or business or for investment." And the exchange must be made for similar property. This excludes trades of property used or to be used for personal purposes. An instance is an exchange involving residential property
3. The exchange must be even—that is, no cash can be involved. If cash is taken, then you are taxed up to the amount of the cash. The gain beyond the cash would *not* be taxed. If cash is given, no loss can be taken. This is regarded simply as additional investment in property of the kind exchanged

* * *

When selling real estate, tax gain or loss takes place in the year in which title passes, *not in the year of contract for sale.* That is not true if possession, with its benefits and burdens, passes to the purchaser before title passes.

A danger looms when a seller attempts to stretch his holding period beyond 6 months, in order to get a long-term gain in a sale. The following device is sometimes used: The contract of sale fixes the date for passage of title beyond the 6-month period. This method usually provides for closing adjustments to be made as of an earlier date, within the seller's 6-month holding period. In this, the government may hold the earlier date as the "sale date"; thus it taxes the seller for a short-term gain.

Perhaps a better way would be to give the buyer an option to buy, after the 6-month period, with a heavy down payment to ensure his performance.

How do you get the best price—taxwise? If you are selling individual business assets, not your stock, you will want to get the largest amount of capital gains (taxed at 25 per cent) and the smallest gain on other assets.

The interests of the buyer and seller are often miles apart. Allocation of any total price paid for all your assets is very important. Here is the way the seller should attempt to allocate:

Value at cost or high—*accounts receivable and supplies not in inventory and not entering the product.* A gain is called a capital gain by some authorities

Value low—*merchandise inventory,* stock in trade held for sale to customer in the ordinary course of business. Remember this: Any loss (due to low value) is an ordinary deduction to the seller. Any profit (due to high value) is fully taxed; it is not a capital gain. You want to accept a low value if it will permit you to raise other values on assets that are subject to a capital gains tax

Value high or low—*insurance policies, stocks, bonds and securities* held over 6 months. If you have a gain, and you can agree to high values, so as to reduce the selling value of other assets, do it. Your maximum tax is 25 per cent of gains. But if you have a loss, seek your cost or a low value. The loss does you no good unless it can be offset against other capital gains. If the assets were held for *less* than 6 months, seek a return of your cost. Short-term gains are taxed at ordinary—not capital-gain—rates. Short-term losses are of no value except to reduce other capital gains

Usually value high—*machinery and equipment, land and buildings used in business* held for more than 6 months. Profit is a capital gain if the asset was held over 6 months and losses are ordinary deductions. If asset was held for less than 6 months, seek a return of your depreciated cost

Usually value high—*patents, copyrights,* and other amortizable assets. Same reason as above: you have a capital gain on profits and an ordinary deduction on losses

Usually value high—*goodwill, undeveloped land not used, land and buildings not used* in business and business interest in other ventures. You have a capital gain on a profit if the asset was held over 6 months. But if you have a loss, you have a capital loss. It is no good unless you have other capital gains. That may mean you should seek a return of your cost if you do not get a gain

* * *

If you are about to sell your business or a business asset, see if you can avoid a double tax. That comes when your corporation sells its assets—and then liquidates the proceeds to stockholders. If a corporation sells first it pays

one tax on the profit. The later liquidation of the proceeds can produce *another* tax for the stockholder.

Of course, this might be avoided if the stock were sold instead of the assets —or if the company was first liquidated and then a sale made of the assets.

The sale of stock followed by immediate liquidation may be attacked by the government. But you are safe if the corporation *in reality* did not make the sale. The stockholders should conduct the negotiations on their own behalf. This method can be used when you want to sell part of the assets.

Example. Corporation *A* owned a valuable contract. Corporation *B,* the other party to the contract, wanted to cancel it and was willing to pay a substantial sum. *A* transfered all its assets *except the contract* to another corporation owned by its stockholders. Then *A*'s stockholders sold all their *A* stock to *B*. *B* then controlled the contract. The court said this transaction involved only the sale of stock. It was not a payment to *A,* and there was no double tax.

Any liquidation followed by sales is suspect if there were any negotiations by the corporation for the sale of the assets preceding the dissolution. The government may say that you have a sale by the corporation, and therefore double taxes.

Cases in which the stockholders and *not* the corporation have been held to have sold the assets include these: negotiations were carried on with one purchaser, but the sale was to another; negotiations were started after the corporation was already in dissolution; a minority stockholder carried on the negotiations before any dissolution; stockholders contracted to sell the property in the future, when they got it upon dissolution.

These rules force you to make sure that the documents relating to the transaction are clear. If more than one construction can be put upon the instruments, the government may hold against you.

You need to keep a full written record of all the steps taken. This is important as evidence if the transaction is attacked. Documents describing each step in the transaction should be prepared when the step is taken. Many cases might have been decided differently if there had been documents to spell out each step of the transaction.

Sometimes the corporation should welcome the double-tax system. If there are assets in a corporation that are to be sold at a loss, a double deduction will be obtained if the corporation sells at a loss and then liquidates. The stockholders, in turn, may realize a loss on the liquidation. The carry-back provisions may even get the corporation a good return of prior year's taxes. Liquidation has many problems.

Instead of liquidation followed by a sale of assets, you can consider alternative methods of getting the corporate assets you want to sell—

By distributing the property as a dividend
By using a partial liquidation

You might distribute property with increased value out of the company by a dividend in kind. There is no tax to the company on the appreciation. The stockholder does have a tax to pay on the fair market value of the dividend.

Or you might have a partial liquidation of stock. Pay property to stockholders in redemption of their stock. That might be a capital gain to them. But see your tax advisor to find when it might also be an ordinary dividend. If the stockholder does not turn in all his stock he may have an ordinary dividend on the distribution.

In both these methods you have only the one tax. The corporation has no tax to pay. The stockholder pays a tax only on receipt of the property. When he sells it, unless the value has changed between the receipt from the corporation and his sale, he has no other tax.

The danger of changing values after these transactions must be remembered. The holding period starts with the distribution. If values increase, you may have a short-term gain or loss by a sale before the end of the 6-month period following the distribution.

* * *

How do you sell partnership property? Consider selling your partnership interest rather than the partnership assets. Sale of a partnership interest is probably a capital transaction. If it was held over 6 months, it may not be taxed at more than 25 per cent.

The sale of a partnership asset may or may not be a capital transaction. That depends on the asset involved. Tax advisors sometimes urge that we place values *on each item* contained in a bulk sale, when an *interest* is sold. That may avoid difficulty if (as some assume) we get a reversal of present trends, holding sales of interests to be capital gains.

Before you consider sale of partnership property or partnership interests, study the advantages to be obtained by these various methods:

Sale of a partnership interest may be a capital transaction. Retirement from a partnership (or joint venture) where the continuing partners (or joint venturers) are members of your family denies you a deduction for any loss arising from the retirement. The consideration is not of consequence

Distributions in kind to the partners and then sale by them of assets may get a totally different result from sale by the partnership. That may give you a tax loss or an economy. To get the cost of an asset received you do this: Allocate total cost of a partnership interest between what a

partner gets in such a distribution and what he has left in the partnership—both being figured at market values. That allocation gives him the cost of the assets received. Under the first of the rules above you may reduce the amount of taxed income by distributing appreciated assets to the partners. Have them take the profit. That follows because a new cost for the distributed property is fixed in the distribution

Example. *A* and *B* have a capital of $80,000 in a partnership. All its assets are now worth $200,000. It paid $60,000 for certain stocks which are now worth $100,000. If the partnership sells these stocks, each will be taxed on $20,000 capital gain. But if the partnership distributes these stocks to *A* and *B*, and they sell them, each will be taxed only on $10,000 capital gain. The basis of the stocks to each is stepped up to $40,000.

$$\frac{\$100,000}{\$200,000} \times \$80,000 = \$40,000$$

Sale of property after a partnership liquidation may be complicated by the rule that requires apportionment of basis when distribution in kind is made. If it doesn't make much difference taxwise, you can avoid this complication by having the partnership sell the assets and then distribute the proceeds to the partners.

Sale of a deceased partner's interest may mean that the surviving partners pay a tax on the income used to dispose of deceased's interest. Or they may avoid it by contractual relations approved by the decisions.

Where some parties put property into a partnership and others put in cash, you have opportunity for considerable tax loss or tax control. That is because the basis to the partnership for the assets (which it probably took in at the fair market value) is the *cost to the contributing partner.* You do *not* use fair market value of assets when contributed. Then gain or loss in the sale of these is required by the regulations to be prorated on the basis used in the partnership agreement.

If partnership property is purchased by one of the partners, this is in reality nothing more than one partner buying the interest of his partner in the property. In effect the property in question is liquidated in kind pro rata among the partners. Then one partner buys the undivided interest of the other partner. The gain or loss to the partner who sells his undivided interest is measured by the difference between the cost of his interest in the property and the proceeds from the sale of his interest. The partnership interest may be sold for part cash and part distribution in kind. You do not realize a loss until you sell the property received. But the basis of the property is adjusted to reflect the loss. The purchasing partner does not realize gain or loss upon the liquidation of an undivided interest in the property in kind or the purchase of the other undivided interest in the property.

If a partnership interest is sold to an outsider or to the remaining partners, recent cases say we have a capital gain or loss. The basis is the cost of the interest, including all undistributed profits of the seller upon which he has paid a tax and those from the last accounting period of the partnership to the date of selling. A loss sustained by a partner upon withdrawing from his partnership is a capital loss.

By contributing property to your partnership and then selling your partnership interest, you can get another advantage. You can extend the holding period of your assets. When a partnership interest is sold, the length of time you held that interest fixed your holding period. It is not measured from the time you (if you contributed the property to the partnership) or the partnership acquired the particular assets in the partnership.

Example. You and *A* organize a partnership on Jan 1. You buy *X* stock on Jan. 1 of the following year. On Mar. 1 you contribute this stock to the partnership. On June 30 of the same year you sell your interest in the partnership. You have a *long-term* capital gain. Your holding period is determined from Jan. 1 of the first year.

By contributing a noncapital asset to your partnership and then selling your partnership interest, you can convert ordinary income to capital gain. The sale of a partnership interest is a capital gain. The type of assets composing your partnership is unimportant.

Example. You contribute merchandise inventory to your partnership. Later you sell your partnership interest. Your gain is capital gain even though your partnership interest is represented by noncapital assets.

* * *

How do you sell a sole proprietor's property? A sale of a sole proprietor's business is treated as a sale of each of the assets involved. Thus there are really many sales. The selling price is apportioned among the assets sold. The nature of each asset must then be considered. That is to determine whether the gain or loss from its sale is capital or ordinary. Whether you have an ordinary gain or loss, or capital gain or loss, depends on the nature of each asset sold. Capital assets—subject to a maximum tax of 25 per cent —are the following:

Customers' accounts
Stocks and bonds held as investments
Land *not* used in business
Goodwill and nondepreciable franchises
Assignable liquor license
Life-insurance policy

You get a full deduction for your loss on a sale, but pay no more than 25 per cent tax on your long-term gains in sales of: machinery, building, and any other amortizable capital assets used in your business operations; land used in business.

How can a proprietor selling his entire business get a full capital gain? One way may be to transfer all noncapital assets to a corporation in a tax-free exchange for its stock. That converts ordinary income to capital gain upon later sale of the stock. Further, you may have the benefit of a long-term capital gain. The holding period of the stock includes the period you held the assets.

Income from a joint venture is taxed as ordinary income. But you can get the benefit of a capital gains rate by selling your interest in the joint venture. You can very often use that method (sale of interest) to avoid the tax due by you on the ordinary income.

Example. *A* and *B* engage in a joint venture. When there are earnings, each is taxed in full on his distributive share. But if *B* sells his interest before the income is secured, then he has only a capital gain.

* * *

Should a parent company sell a subsidiary's stock—or sell its assets? Sometimes it is better to have a parent sell a subsidiary's assets. It can take over the subsidiary's assets in a tax-free liquidation. Then it can sell them, using the subsidiary's cost to find its gain or loss. Possibly the gain or loss will help the parent more than the subsidiary.

* * *

Loss upon sales to relatives or your own corporation may be denied. No matter how honest or above reproach a loss on the sale of property is, the loss is not allowed if you entered into the sale with: a member of your family; a corporation 50 per cent of the value of whose stock you directly or indirectly owned; the trustee, if you are grantor of the trust, or the grantor if you are the trustee (the same rule holds for sales or exchanges between trustees where trusts have the same grantor); the trustee of a trust if you are a beneficiary, or the beneficiary if you are a trustee.

In counting what stock you own, add your proportionate share of: stock held by a corporation, partnership, or trust in which you are a stockholder, beneficiary, or partner; all stock held individually by your partners; and all the stock owned by your "family." "Family" has a wide scope; it includes brothers, sisters, husband or wife, ancestors, and descendants.

You never benefit by selling property at a loss when you are dealing with

the classes listed above. The aggregate taxes may be more by the time the property sold finally gets out of the related group.

The limitations apply here *only* to losses. They affect the sales of *all kinds of property.* The rule is not restricted to losses on sales of stock.

If you sell at a loss and come within one of these limitations, then *not only* are you denied the deduction, but your purchaser's cost is limited to his cost. The result is that part of your original basis is never recovered by way of tax deduction.

If you must deal with a related company or person, sell only the exact properties that can be sold at a gain. Sell the others (where there is a loss) to others.

9. Discuss essential steps with your counsel

There are other essential steps in a sale. If you have decided to sell, your stockholders, partners, or creditors may have to approve what you are doing. You must have counsel on how to get their approval.

If you are going to sell personal property (merchandise, stock in trade, fixtures), check with counsel on: how to comply with your state bulk sales act; how to satisfy any chattel mortgages, liens, and conditional bills of sale. If you are selling real property, check with counsel on these points:

Find out whether you are to give a full covenant and warranty deed. You will be liable for any cloud on the title

Consider having the buyer assume the mortgage, so that he will be responsible for the payment of interest and amortization. Perhaps you can be released

Provide for the risk of loss between the period of the contract and closing, in the event of a fire or other casualty

Make sure you get adjustment for all your payments of land taxes, water rents, payments to mortgagee, utility services (electric, gas, telephone, etc.), insurance payments on policies of fire, casualty, plate glass, etc.

* * *

Your obligations to your employees should be fully met. This includes all wages, salaries, commissions, or bonuses. If you have a pension plan or profit-sharing trust, ask counsel what happens to it in a sale. And check your union contract for severance pay.

Make certain that all your accounts receivable will be paid. To ensure this you might: assign them to the buyer for collection, paying a fee for the services; sell them outright, the buyer doing the collecting; sell them as part of your business; sell them to a similar business.

You want to adjust all your uncompleted contracts and commitments.

Study your deals with unions, sales, service agencies, contractors of every kind, insurance companies, or creditors.

If you have inventions, patents, or copyrights or are operating under licenses, be sure you get a release from your obligations under the license agreements.

Notify all governmental agencies, insurance companies, and utilities with which you have had transactions—for example, the Social Security Administration, unemployment insurance companies, or Workmen's Compensation Insurance Board.

If you do sell, see if you want an option to repurchase. The sales date is the best time to get an option, if you might wish to return to the business. But, if you take an option, be sure your tax people explain the tax implications.

Section 7

HOW TO MARKET YOUR PRODUCTS

BY

MARION HARPER, SR.

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HOW TO MARKET YOUR PRODUCTS

Introduction

Technology has now advanced to a point where it can be said that almost anything can be made for which a market exists or can be created. Since the Second World War, markets have expanded greatly as population and wage payments have increased. At the same time, rising costs have forced break-even points higher and profitable operation has become more and more dependent upon the function of marketing.

Marketing embraces every step in the distribution process from factory door to ultimate consumer. The complete function makes use of many diverse talents and skills. Some of these are highly specialized.

As markets have expanded and the need has become more acute for a rising volume of sales, the marketing of nearly all commodities has become more competitive. This more active competition has tended to emphasize the need for more dependable facts about markets and more skilfully planned and executed sales strategies. There is an increasing awareness on the part of manufacturers of the need to reduce costs of distribution.

In this text much emphasis will be given to the importance of formulating a well-charted course based on marketing facts as opposed to haphazard decisions and procedures. The methods employed in market and sales analysis and the more common procedures used in marketing research will be outlined so that they may be used intelligently either in person or in the direction of others.

Nine fundamental elements which are essential to a successful marketing venture provide the framework for this section. Each of these elements will be discussed in such a way as to impart a working knowledge of the subject and to stimulate further study should the solution of specific problems require it. Collectively these nine points should provide a practical and conservative formula predisposing the marketing program to success.

This section is designed to provide practical help and guidance to the marketer of a new product whose plans are still in the formative stage. It should be helpful also to the manufacturer whose distribution is now local or regional and who is planning expansion into other markets.

Need for a marketing program. Optimism and enthusiasm are necessary ingredients of a successful selling operation. They can, however, greatly

handicap a new product during the preliminary stages if they are allowed to influence its marketing prematurely or in a haphazard fashion.

In the normal course, a new product is well out of the development stage before formulation of a marketing plan is seriously undertaken. Planning is time-consuming. So when the product is ready, there is a natural urge to get it into distribution. Sales are being lost. Why wait?

These words of caution may be useful to such new marketers: In marketing new products, there are more failures than successes. And among companies having well-established products, it is said by a research authority that 42 per cent of all decisions involving marketing are wrong.

These are forceful arguments in favor of proceeding in accordance with a soundly conceived marketing program, even though so doing may involve some loss of time.

When finally formulated, the marketing program should be reduced to writing. It should be complete. Statistical findings should be interpreted. Their significance should be crystal clear. Product tests and initial marketing tests should be provided for. The plan should be geared to a time schedule. It should be approved by company management and responsibility for its execution placed in the hands of a single individual.

Once the program is adopted, all personnel having any part in its execution should be thoroughly indoctrinated in their respective activities.

Nine basic points that predispose a marketing venture to success. A complete marketing program has a number of different parts. These are interrelated and interdependent. Like the holes in a golf course, each part has its hazards which, if misjudged or slighted, can endanger the whole selling program. It may not seem important to have a sales policy that is defensible to all customers until you have to justify the refusal of a price concession to your largest buyer. But in that interview you will either gain or lose an important customer.

Study each element in your marketing program with thoroughness. Endeavor to be objective in your thinking about it. Obtain as many facts as are available. Anticipate the difficulties and obstacles which you may encounter. Have sufficient flexibility in your plan so that you can meet and overcome them.

Building a workable marketing program need not be a complicated procedure if its various parts are considered individually and in logical order. Here is a check list of the nine basic points that should predispose your marketing plan to success. This chapter will be devoted to development of the subjects suggested by these essential points:

1. Analyze markets thoroughly
2. Be sure your product is right

3. Allow sufficient profit margin for adequate promotion
4. Adopt a selfishly sound but defensible sales policy
5. Know your competition, its pricing and sales policies
6. Set up simple but workable sales controls
7. Limit marketing objectives; sell intensively
8. Advertise to build product familiarity
9. Research continuously to improve product, to expand sales, and to lower selling costs

1. Thorough market analysis

Establishing the sales target. The first requirement of a workable marketing program is the establishment of a clearly conceived sales target or objective. Start with your product: Does it represent an idea now unfamiliar to those who may buy it? Will its acceptance require a considerable amount of educational spadework or practical demonstration?

Or is the product merely an improvement on other existing products which perform the same function? If an improvement, is this improvement clearly demonstrable either on sight or in practical use? Can the improvement be copied quickly by competitors, or are other improvements possible which may nullify your otherwise temporary advantage?

How extensive are your aims for the new product, and do you have the capital to match competition and win your objective? Is your aim market leadership, or are you merely shooting at what you consider a "reasonable" share?

Is the product to be a leader in a line of products bearing a family identification, or is it to be one of a line already well established in certain markets?

Do you now have a sales organization that can handle the product? If not, how large an organization will be required? What steps will you take to build a functioning sales force? Or will you make use of the services of brokers?

Will it be more profitable to enter only selective markets which offer maximum sales opportunities or to aim for country-wide distribution?

These and many similar questions must be answered as part of the procedure of setting up a clearly conceived sales target.

Study and analysis of markets. The first step in compiling factual data for the marketing plan should be aimed at determining the size of the total market and its geographical and customer distribution. This involves obtaining answers to these simple questions:

How many buyers are there?
How much do they buy?

Where are they located?
How is the market divided among principal competitors?

When these data have been compiled, it will be possible to estimate the market potential for the new product and to set a definite sales objective for the first selling period.

This sales objective then becomes the "budgeted volume of sales" and provides the basis for territorial, branch-office, or dealer quotas. When used in conjunction with available selling costs per unit of goods sold, it may also be used to calculate the budgeted amounts available for direct sales and advertising expense.

In obtaining answers to the first three questions relating to size of market, use is made of available published sales statistics and government reports. This is called the "direct data" method.

When consumption or usage data are not available from these sources, it may be possible to make use of "related factors" which will indicate the size and extent of the market. For example, an automobile-appliance manufacturer might use automobile registrations as a base; wired homes might provide the base for a marketer of electrical household appliances.[1]

Manufacturers of industrial products may find it more difficult to estimate sales potentials than marketers of consumer goods. The industrial marketer's sales opportunity may be measured in terms of factories, shops, assemblers, or distributors. Such data are available in the Census of Business. More specialized data on specific industries frequently are compiled by the trade publications covering those fields.

To obtain completely reliable and useful data, the industrial marketer may find it desirable to undertake a special study of the market for his products.

Many trade associations compile periodic data on the total sales within a specific industry. Examples are the Radio Manufacturers' Association and the Vacuum Cleaner Manufacturers' Association. *Selected Trade Associations of the U.S.*, published by the Department of Commerce, will provide a list of these associations, their addresses, and the names of their secretaries.

The following list, while not complete, will suggest sources of a wide variety of data useful in determining the extent of markets:

Government publications:

Decennial Census of the United States
Census of American Business[2]
United States Census of Manufactures

[1] American Management Association Marketing Series 71, *Getting and Using Market and Business Data*, 1948. 50 cents.

[2] "Business Can Use the Census," from American Management Association Marketing Series 63, *Modern Market Research Procedures*, 1946. 75 cents.

Federal Reserve Board Bulletins, published monthly at Washington, and locally by the several Federal Reserve Districts

Publications of the U.S. Department of Commerce:

Consumer Market Data Handbook
Industrial Market Data
State, Regional, and Local Market Indicators
Survey of Current Business (monthly)

Other sources:

America's Needs and Resources, edited by J. Frederick Dewhurst and published by Twentieth Century Fund. $5
Business publications
Consumer magazines and newspapers (in principal markets)
Market Guide, *Editor & Publisher,* Times Building, New York. $5
Survey of Buying Power, published annually by *Sales Management* magazine, New York. $3
Consumer Markets Analyst, published monthly by Standard Rate & Data Service, Chicago. $10 a year
Consumer Markets, published annually by Standard Rate & Data Service, Chicago. $5

Detailed county data, extracted from the 1940 U.S. Census, are carried on punch cards and low-cost tabulations are available on special order from Bureau of Advertising, American Newspaper Publishers Association.

Marketers of grocery and drug products may obtain useful data on the distribution and movement of principal brands in selected markets, based on store inventory studies maintained by a limited number of metropolitan daily newspapers. A list is obtainable from Bureau of Advertising, American Newspaper Publishers Association.

A smaller number of daily newspapers operate consumer panels and issue periodic reports on purchases of grocery and drug products by panel families representative of the market populations. This is a partial list:

The Chicago Tribune
The Times, Los Angeles
The Press, Cleveland
Commercial Appeal-Press Scimitar, Memphis
News-Sentinel, Knoxville, Tenn.

A consumer panel is a representative group of families who report their purchases of certain products weekly or monthly along with other information relating to price and place of purchase. Consumer panels provide the means for the study of purchasing and usage habits of the same group of

families over long periods. From such studies many useful data may be obtained on brand switching, brand loyalty, average purchase per family, and frequency of purchase. As the characteristics of each participating panel family are known, the data may be analyzed by sex, race, economic and employment status, size of family, etc.

It is sometimes desirable, for example, to classify purchasers of a product into groups of "heavy users" and "light users," and to determine the characteristics of the families composing each group. It is in such definitive studies that the consumer panel technique makes its most important contribution to the marketing specialist's knowledge.

Reports based on data from a national consumer panel are available to subscribers to the service of Industrial Surveys, Inc., New York. The A. C. Nielsen Company, Chicago, supplies bimonthly reports based on inventories and purchase records from a representative group of food and drug stores. These are available to subscribers to the Nielsen Food Index or the Nielsen Drug Index.

From the sources listed, the marketer should make a selection of those data that will be most useful in planning the marketing of his specific product. When compiled, the data should be classified, typed, and incorporated in a ring binder. With the addition of other basic data as planning proceeds, this volume ultimately should grow into a most useful source of facts about your marketing problems.

Here are some of the most common uses of the data described in the preceding paragraphs:

To determine total market and "potential" market for the specific product
To determine the location and number of users
In the establishment of sales territories
As a guide in fixing territorial, dealer, and salesman quotas
In the selection of markets for concentration of sales effort
As a guide in the formulation of sales and advertising budgets based on potential or actual sales

Quantitative market analysis as an aid in selective marketing. Markets vary widely in their capacities to absorb sales of any given product. This is true of markets which appear to have like characteristics. So, almost from the beginning the new marketer will face the problem of market selection.

If the product is a new one, certain markets will be selected for initial test purposes. This will be followed by a further selection of markets in which to expand selling activity.[3]

If the product is well established, selection will be necessary (1) to take

[3] American Management Association Marketing Series 75, *Sharpening Sales Effort through Market Research,* 1949. 50 cents.

advantage of more favorable sales opportunity, (2) to push sales in high per capita consuming areas, or (3) to attempt the development of subnormal markets.

This selection will require the use of an index of some sort which will indicate with reasonable accuracy the relative importance of markets. The selection should never be made on "hunch" or by some random method making use of unrelated or incomplete statistical data.

Much experimental work has been done in the field of index formulation. The new marketer is cautioned against attempting to formulate such an index for his company unless the nature of the product is such that none of the available indices are useful.

The index most widely used by marketers is the index contained in the Survey of Buying Power, compiled and published annually by *Sales Management* magazine. In developing this index, the editors assign 5 points to "per cent of U.S.A. effective buying income," 3 points to "per cent of U.S.A. retail sales," and 2 points to "per cent of U.S.A. population." The claim is made by the editors that:

> This "per cent of U S.A. potential" [the index] figure can be used without change by national marketers in setting up sales quotas on a fair and equitable basis, in dividing up sales territories, in setting reliable goals for distributors, by advertising agencies and advertising departments in breaking down their appropriations and in deciding where to put added pressure.

In addition to the index, the Survey contains, for all cities of 10,000 population or more, data showing the most recent estimate of population, of retail sales of foods, drugs, and general merchandise, and of effective buying income for the previous year.

In summary form, other data deal with population, income, net farm dollars, and effective buying income for the 200 top-ranking counties in total population.

Marketers of certain products may find it desirable to employ county data in their selection of markets. The 1940 Census shows 318 counties of a total of 3,071 which accounted for retail sales of $20,000,000 or more. These "key" counties were credited with 72 per cent of the country's retail sales. The same counties contained only 59.5 per cent of the families. These counties were well above average, therefore, in retail sales per family, had a relatively higher concentration of population, and had retail outlets which were susceptible of development with the least sales effort.

The marketer of a new food or drug product who decides to make use of county data as a basis for his selection of markets should by-pass such extremely large markets as New York, Chicago, and Philadelphia in his initial marketing plans. These are difficult markets in which to pioneer

because of their size, mixed populations, racial differences, and diversity of advertising mediums. To exploit these markets profitably requires an immense amount of capital and continuity of effort. Many national marketers of consumer goods have inadequate distribution in the New York market, for example, but are unwilling to make the investment required to develop the New York market at a possible sacrifice of sales in other well-developed areas.

In the selection of "test" markets, a good rule to follow is: Select markets which are in the 100,000 to 200,000 population group and which are isolated from the influence of other marketing centers. Test markets for consumer packaged products will be more representative if they are both industrial and farm supported.

Uses of marketing research. Marketing research is a useful tool of management in finding solutions to a wide range of business and marketing problems. In its broadest sense its purpose is to provide a factual basis for decisions. In aiding in the solution of marketing problems, marketing research makes use of the techniques and procedures of many sciences, adapting these to its specific needs.

Only a few of the very largest manufacturers find it profitable to engage a sufficiently large staff of research technicians to undertake marketing research on their own account. A somewhat larger number employ a research director and depend upon commercial research organizations for planning and execution of their marketing studies.

Although many large and successful companies have made increasing use of marketing research in recent years, many businessmen are reluctant to enlist the aid of an outside organization in the solution of their problems. Some of these question the ability of "outsiders, unfamiliar with their businesses" to turn up new and useful information. Others are unwilling to invest sufficient money to assure the employment of a recognized research organization whose work will be useful and dependable. As a result, business as a whole underspends for research in relation to expenditures for advertising and other sales promotional activities.

The limitations of this text preclude the inclusion of a comprehensive summary of the techniques of marketing research. But every marketer should have a working knowledge of research methods in order to deal intelligently with those entrusted with his work.[4]

Here are some suggestions that will prove useful:

Sufficient time should be allowed to complete the work in an orderly manner

[4] See *Marketing and Distribution Research* by Lyndon O. Brown. Ronald Press Company, New York, 1949. $5.

It is a mistake to invite bids from several research organizations of unequal experience or reputation. You will get about what you pay for

Provide sufficient funds for the use of an adequate sample

Refrain from incorporating questions of little consequence in the questionnaire; the chances favor more accurate responses if your ballot is not too long

See to it that the questionnaire is pretested, that it elicits the kind and quality of information you are after

Marketing research requires a combination of technical training and business experience; try to find both in the organization you employ

Marketing research employs three principal methods: (1) the survey method, (2) the observational method, and (3) the experimental method.

The survey or questionnaire method is most useful if the response involves a simple statement of fact. The respondent acts as a reporter of his own acts or of conditions with which he is familiar. Direct answers are sought to simple questions. The method requires extreme care in questionnaire phrasing. The question "What brand of coffee do you usually buy?" if rephrased to read "When you last bought coffee, what brand did you buy?" for example, may bring forth a quite different response.

The consumer-panel technique, previously described, makes use of the survey method by seeking direct answers to such questions as "What brand did you buy? When did you buy it? What did you pay for it? Where did you buy it?"

The observational method relies entirely on the reporting technique. Research workers who collect the data frequently are unidentified and ask no questions. They simply report what happens under certain conditions in a uniform manner so that results may be measured and analyzed statistically.

Gasoline and oil marketers, for example, check the services afforded by filling-station employees by the observational method. Observers drive into stations with low gasoline tanks, underinflated tires, and dirty windshields. They report on the extent to which routine service measures are performed.

A distiller was able to obtain an accurate measurement of the extent of substitution for his brand when it was ordered by drinkers at bars. Observers, stationed in bars long enough to witness 10 transactions in each place, reported the brands ordered by drinkers and the brands they were served.

Observers stationed near the checking stands in supermarkets reported on the frequency of purchase and distribution of purchases among the various brands of a frequently bought food product.

Pantry checks and distribution checks also use this method.

The experimental method is sometimes used to test store promotional

schemes and the effectiveness of advertising themes or package presentation. The theory requires the matching of several test areas with an equal number of control areas. In practice, sales in each group of stores are carefully checked by the inventory and purchase method and comparisons made for some specific time period.

The weakness in this method springs from the chance of the intervention of some set of influences which will affect sales in one group of stores but not in the other group.

The method is especially useful for testing store displays and packaging changes. Two matching groups of stores are selected and different displays installed in each group (or no displays in one group). Sales are checked carefully for a period; then the displays are reversed as between the two groups of stores and again checked for an equal time period.

The use of "open end" or "why" questions in connection with the survey method, although not uncommon in practice, is open to many opportunities for error. These dangers are double-edged. On the one hand the respondent may not clearly understand the precise type of information that is sought in the question, but since it has been asked, she feels constrained to give some sort of answer. And again, the reasons for her attitude or for her action may not have been clear to her at any time, so she finds it difficult to describe the reasons now at the time of interview.

Finally, such questions always result in many responses which are difficult to categorize and the sense may be changed in editing as a preliminary to tabulation. This can lead the analyst astray and result in conclusions which are at best suspect.

Questions dealing with attitudes and opinions should not be incorporated in questionnaires under the survey method unless phrased by an experienced technician. Even then they should be carefully pretested.

Pretesting of marketing procedures. Every marketing procedure requiring the expenditure of a substantial sum should be tested thoroughly before being given broad application. It is seldom good judgment to rely upon an executive's own observations, since he may be influenced strongly by his contacts with larger customers. This is most frequently true of decisions affecting price and advertising appeals.

The sales manager of a company producing a household appliance that was sold from door to door found that sales were being impeded by a partial-payment plan which was no longer attractive. He instituted five tests of different payment plans in as many sales areas by telephone. By maintaining close telephone contact with field offices, he was able at the end of a week to proceed confidently with a new payment plan which was successful in all parts of the country.

Large marketers of packaged consumer goods have a routine practice of pretesting advertising copy, store promotion plans, and premium and contest offers before making important commitments in sales work or advertising.

Frequently the need for immediate action prevents adequate pretesting. This can be overcome only by advance programming and by having in reserve certain pretested sales devices with which to meet competitive emergencies.

Advance planning does not pose an insurmountable problem. One of the largest marketers of soap products schedules sales activities in behalf of more than a score of promotional brands 1 year in advance. The program requires skillful coordination of brand and display promotion by salesmen and the company's various advertising agencies.

In pretesting sales-promitional devices it is important to keep in mind the need for adequate control procedures in order that reliable and objective comparisons may be made.

It would be of little value, for example, to run a test of store displays if sales were recorded only for stores in which displays were made. The natural expectancy would be for sales in these stores to increase.

Some of these increases might come, however, at the expense of stores without displays. The only way the advertiser can determine the net change is through a comparison of sales in two groups of stores.

Common marketing errors. The almost unlimited opportunity for application of marketing research to business problems may be more clearly understood by examination of a list of the most common marketing errors recorded over a 3-year period by the A. C. Nielsen Company.[5] This company has an unusual opportunity to witness the sales strategies of many of the largest companies in the grocery and drug fields and then, through the Nielsen service, to observe results. Nineteen common errors are listed:

1. The average executive overestimates his company's percentage of the total market. Perhaps it is natural to belittle one's competitors.
2. The average executive greatly overestimates the percentage of prospects who—
   a. Have heard of his product
   b. Understand its virtues
   c. Believe the claims made for it
   d. Are using the product
   e. Have found the product satisfactory
3. The average executive overestimates the importance of his competitors as a sales obstacle and underestimates the opportunity for creating new business.
4. The average executive thinks his product suffers a good deal more from price resistance than it actually does.
5. The average executive underestimates the virtues of his competitors' sales policies.

[5] F. K. Leisch, A. C. Nielsen Company, address before American Management Association (American Management Association Consumer and Industrial Marketing Series C.M. 24).

We usually find that competitors are using methods which get results, but which our client has assumed are "all wrong." There is a strong tendency to credit the competitor with less brain power than he actually possesses.

6. The average client has an exaggerated conception of his standing with the trade. He is usually surprised at his low percentage of displays and special sales.
7. The average executive fails to gauge accurately the relative values of various sales and advertising appeals. This results in the frequent use of weak appeals and the overlooking of appeals that have the power to increase sales.
8. Overestimating the success of a deal.
9. Overestimating the success of a new product or size.
10. Unsound distribution of effort—
    a. By city-sizes (*e.g.*, neglect of small cities)
    b. By seasons
11. Unwillingness to allow sufficient time to really complete a testing operation. Feeling that it is necessary to meet promptly some competitive campaign, but realizing that the best method has not yet been determined by testing, the management often proceeds halfheartedly—on too small a scale to produce satisfactory sales results. We recognize that there are some situations that really demand prompt action, but there is a solution for this problem. Start testing in advance, before the need for a new campaign becomes acute.
12. Testing the effect of displays or other merchandising operations by measuring sales only in the cooperating stores. These stores may make their gains at the expense of neighboring stores, in which case the manufacturer gains nothing
13. Placing too much reliance on the executive's own observations—failing to realize that these observations may not be wide enough in scope to be representative. A good example is the average price to the consumer, which is almost always estimated too low, because the average executive has more contact with the chains and the price-cutting independents than with the average store.
14. Refusal to face the facts promptly when sales decline.
15. Unwillingness to study and dig—to analyze complex statistics. The head of one large business asked us to summarize the results of a $20,000 survey in two or three sentences. It takes an average of 4 hours for a group of executives to absorb the important facts in each bimonthly Index report Some companies have 15 executives present at each such meeting—including the president and four vice-presidents. Attempts to oversimplify are often fatal. *Marketing is no longer simple.* While one simple idea (*e.g.*, halitosis or B.O.) may sweep all before it and win big success regardless of attention to details, these occurrences are rare. The executive who counts on finding such a cure-all is likely to find himself face to face with the sheriff.
16. Tendency of each department or function to claim all the credit for sales gains and blame the others for declines. Our data show that making a profitable sales volume is a cooperative job, to which many factors contribute. It pays to spend less time protecting your own position and concentrate on getting the facts and applying them to increase profits.
17. Failure to meet competitive increases in advertising. Maintenance of your percentage of the total market requires maintenance of your percentage of the total promotional expenditure—barring some definite improvement in the effectiveness of your work. To protect against this danger, measure the expenditures of competitors and calculate every month your percentage of the total expenditure.
18. Refusal to admit the high percentage of error in executive judgment on marketing questions. Our records, based on tests made over a period of years, have proved that the average executive is right, or substantially so, in only 58 per cent of the cases. The lowest record made by any company is 42 per cent and the highest is 72 per cent. The 42 per cent erroneous decisions place a staggering financial bur-

den on any business. No wonder there is so much complaint about low profit margins!

19. Refusal to spend enough money for marketing research. Authorities state that business spends $200,000,000 annually for production research but only $5,000,000 for marketing research, in spite of the fact that marketing is further from perfection and hence might justify more research.

2. *Be sure your product is right*

Preliminary considerations in new product development. Preliminary to entering into the formulation of a new product marketing plan, several fundamental questions should be answered. These are not directly related to the characteristics of the new product but rather to the effect of its introduction upon the business as a whole.

Assuming other products already are being sold and the new product is an addition to the line, consideration should be given to these points:

What are the profit possibilities if the same expenditures were to be applied to more intensive promotion of existing products, *i.e.*, increased advertising and sales pressure?

Will the introduction of the new product tend to lessen interest and sales effort on established products?

Can the new product be sold through the same distribution channels as our other products and by the same sales organization?

Rather than to add a new product, might it not be more profitable to simplify the already established line (elimination of slow-moving designs, colors, or sizes) and to increase the promotion of demand items?

If the new product represents a new marketing venture, then serious consideration should be given to the ability of the new product to carry all selling costs. Unless the unit selling price is high and affords a substantial margin, it may be necessary to find some way of selling the product other than through your own sales organization. Few packaged consumer products, for example, afford sufficient volume alone to carry the expense of a sales organization.

This may make it desirable to sell through sales agents, brokers or distributors, or to effect a selling arrangement with another manufacturer.[6]

If introduction of the new product involves the entry of an established company into new and unfamiliar channels of distribution, how will the product be sold? If it is planned to use an existing selling organization, its adaptability to the new trade channels should be appraised. Consideration should be given to an arrangement which will employ salesmen who are familiar with trade practices in the new field.

[6] "Wholesaling in Our American Economy," supplementary issue of *Journal of Marketing* sponsored by the National Association of Wholesalers.

New product development check list. If the questions raised in the previous paragraphs have been satisfactorily answered, a check list should be prepared specifically for the new product to make sure that every essential point has been covered by your preliminary research.

Answers to many of the questions suggested by the check list will come from internal sources. Others will require reference to some of the statistical sources previously listed. Some of the points can be developed only after surveys have been conducted among users and the trade. These surveys need not be elaborate but should be sufficiently extensive so that dependable conclusions may be reached.

This check list, while not all-inclusive, will be useful as a guide. Revisions and additions may be made to adapt it more specifically to the new product:

Estimated costs of development
Estimated manufacturing cost
Factory selling price
Spread available for selling costs
Factory inventories and warehousing
Completely manufactured or assembled
Advantages over existing products
Are advantages easily demonstrated?
Does it represent good value?
Can you dramatize its sales appeal?
Does it meet present market needs?
Comparison with competing products
Does product capitalize on company strengths?
Standing of company with trade and consumers
Standing of principal competitors
Extent of profitable markets
Location of principal markets
Channels of distribution
Sales potential for industry
Sales potential for new product, total and by markets
Is your consumer price psychologically sound?
Can this price be maintained?
Production cost data at various levels of output which might affect pricing policy
Are your discounts designed to encourage support from distributors?
Are quantity discounts defensible, if used?
Trade practices in industry
Advertising required in introductory stages
Advertising budget first year
Budget of selling costs
Estimated profits at various sales levels

Servicing requirements by factory branch; by distributors
Selling aids to distributors and dealers
Visual aids to salesmen
Integrated merchandising plan in field
Advertising theme
Proper distribution of advertising to profitable markets
Sales quotas by territories
Field sales supervision

The product: its design and package. A good product affords the greatest security against competition. It should give satisfaction and bear out the claims made for it. It should have eye appeal and look like good value. These qualities should be quickly apparent to consumers and to those who sell the product if it is to enjoy volume sales and low promotional costs.

In readying the new product, the marketer should be conscious of the possible repercussions from incomplete or inadequate planning and product testing before putting the product into distribution.

Many product deficiencies do not develop until some time after the product goes into use. If such deficiencies prove to be serious, it may be difficult to regain the confidence and support of dealers or retailers after corrective measures have been taken. Almost certainly it will be necessary to pick up goods and make refunds to dealers for all defective or unsatisfactory merchandise.

Assuming the essential preliminary research of products and markets has been completed, there are additional steps which may be taken immediately before and during the design process which will help the manufacturer avoid some of the more common mistakes. These steps are:

Make certain that sufficient market, consumer, and design facts are at hand before too many dollars have been spent on development work
If the product is to be designed outside the company, hire good firms to do the work
Design or develop a product fitted to consumer needs and desires
Test the product in a laboratory and on consumers under actual use conditions before placing it on the market [7]

A thorough analysis of all factors affecting the problem should be made before engineering design and development work are undertaken. Information can be collected and assembled through a search of patents, technical and trade literature, and government reports and studies. This preproject investigation is important because it may produce—

[7] Gustav E. Larson, *Developing and Selling New Products,* Chap. 3, U.S. Department of Commerce, Washington, D.C., 1949. 25 cents.

Data, or methods of attacking problems
Information relating to previous attempts to develop a similar product
Expired patents which could not be developed previously but which may now be practicable because of technological advances
Information about new materials, processes, or theories which can be applied to product development

If a design or product engineer is engaged, his work will be greatly enhanced if the manufacturer provides the most complete facts available relating to the proposed product.

In addition to the data which will come from the types of market analysis previously described, it will be most helpful if throughout the designing and engineering period, specialized guidance can be obtained from purchasing agents, supply houses, and manufacturers' representatives who are familiar with the needs of the market.

Patent and legal matters should be treated as important preliminaries to be handled by competent legal counsel.

If the new product is a packaged food for human consumption, the package label should conform to regulations of the Food and Drugs Act. These, in general, require a proper description of the product and a list of its ingredients. Since the labeling of the product may be closely associated with the advertising claims which are to be made for it, it may not be amiss to make a search of recent rulings of the Federal Trade Commission respecting related products. A drug product may require certain clinical tests, for example, to support advertising claims to be made for it.

Here, in capsule form, are the principal stages in the development of a new food product: The new-product idea is developed experimentally by the research laboratory or the product-engineering department or both. Small sample runs are made to show the variations possible in the finished product. These differences may relate to taste, appearance, or cooking qualities. These samples are then tested in a kitchen laboratory, where it is possible to simulate home conditions. At this stage the most promising samples are returned to the research and product engineering departments for further recommended changes, and the series of tests repeated.

When a satisfactory product emerges, the market-analysis department initiates studies to determine necessary facts relating to competitive products, potential sales volume, etc.

A next step may take samples of the product into other laboratory kitchens such as Good Housekeeping Institute or the Herald Tribune Institute where other cooking experts pass judgment upon them.

Finally the product will be tested either by a consumer jury or by placement of the samples in representative homes. These tests generally employ

two samples, one of the new product and one of the largest selling competitive brand. These are packed in plain packages designated only by letters or other symbols. Housewives are asked a series of questions designed to develop their opinions rather completely about the two products.

If no changes are indicated by this consumer research, then the product is put into limited distribution in a few cities or in a limited sales area. Introductory advertising is scheduled, store promotions are arranged, and sales and inventories are checked in a representative group of stores. Later on, a sample of consumers may be interviewed to obtain data on the opinions of users.

If the product successfully passes all of these tests, plans are then completed to place it in the line in general distribution. Such plans will incorporate the experience gained in marketing the product in the limited test area.

It is of the utmost importance that sufficient time be allowed to afford complete pretesting of any consumer product under actual use conditions in the homes of unbiased users. The collection and interpretation of data bearing on these tests should be left to a competent research technician.

Packaging the new product. No single element in the marketing plan deserves more care and study than the selection of a successful package design. The package design is the product's best advertisement, since it can and will sell without the direct aid of other advertising media. As a means of speedy brand identification it says "Here I am" to the shopper who has already been influenced by conventional forms of advertising.

Package design has two important aspects. One is primarily functional: protection for the product, ease of handling and storing, and convenience of mass display. The other has to do with sales appeal and makes use of color, shape, size, and arrangement.

Both aspects of package design demand studied consideration of the steady growth of self-service and "open mass display" merchandising. In grocery, drug, variety, and even department stores new techniques are constantly being developed to encourage the public tendency to buy an ever-widening variety of merchandise on "impulse." The purpose is to move goods toward the consumer by the speediest and most convenient means and at lowest cost for clerk hire. Selling under conditions of "automatic" mass merchandising demands a package that will stop shoppers, stimulate their interest, and encourage them to buy.

Package design therefore parallels product development as one of the important decisions for top management.

The following summation of the means by which package design builds sales is quoted in substance from a bulletin of the Department of Commerce.

It will provide a useful check list for the appraisal of package design in the consumer-goods field: [8]

The package must attract attention. It must compete effectively in the all-important split second to catch a prospective purchaser's eye and hold it. Color, design, shape—all are major tools in accomplishing this end

The package must tell the product story (informative labeling). What is it? What size? How much?

The package must build confidence. Is it the quality wanted? Is its maker reliable? Is it fresh? Is its original quality fully protected? The quality product must look its worth

The package must look clean and sanitary. Shoppers are becoming more sanitation-conscious

The package must be convenient to handle, to carry out of the store, and to use. Improved opening devices and reclosures on packages are examples of satisfying the public in this direction

The package must look like good value. Housewives are finding that their dollars will not go as far as before in buying food and other commodities. The package that looks like "full money's worth" is likely to do a real job in clearing up doubts

The package must look like a fast seller. The shrewd retailer knows that fast turnover is one of his principal assets. His past experience concerning which types of packages sell and which do not will be drawn on in making his decision whether to stock the packaged product you are offering him

The package must deserve a preferred display. Every retail store has its choice spots—the place where things sell rapidly. The package must so impress the dealer that he just naturally gives it a chance to go to work

The package must minimize the clerk's time. The package that answers questions and tells its story quickly means faster handling

The package must be convenient to stock and display. Packages that topple over, that will not stack, or that roll around are troublesome and need improvement

The package must prevent spoilage during the selling period. The product may be good when it leaves your plant, but what is its condition when it goes out of the store and into the home? This determines the degree of protection needed

The package must resist soiling. Dust and handling are constant enemies attacking packages that were once clean and attractive. How do they look out in dealer's stores?

[8] L. B. Steele, address before National Packaging Exposition, sponsored by American Management Association (Packaging Series 19).

Manufacturers should bear in mind that the housewife is interested in the functional performance of the package in the kitchen as part of the housekeeping operation. *Sales Management* magazine asked 455 women in 10 cities for their opinions about food product packages. The findings, in condensed form, established that women are influenced in their preferences and dislikes about packages from six angles:

1. Is it easy to open?
2. Is it convenient and sanitary in storage when partly empty?
3. Does it function correctly in the cooking operation? (For example, if it is a product like baking powder, is it convenient to measure?)
4. Does it make purchasing easier, faster, or in some other way more satisfactory?
5. Is the container reusable?
6. Does the package in any way save time or labor in the kitchen?

A leading package designer classifies package evaluation into three phases:

The first considers broad consumer preferences. There are "bathroom" and "kitchen" colors, "industrial" and "ethical" colors, age and income preferences, regional influences. We know that low-cost kitchen items move most rapidly in bright red, and that food packages with realistic illustrations of the contents outsell those of abstract design. These and countless other generalizations are observations of wide market preferences gleaned from practical experience and augmented every day by further marketing surveys and consumer research.

After masses of preliminary sketches are prepared a choice is made among preferred designs and we enter the second phase. Comprehensives are prepared. These are dummies painted to appear exactly like production packages. The choice among these is then narrowed down even further by small consumer panels representing a balanced cross section of the market for a specific product. Though not always conclusive, the reactions of consumer panels can be indicative of what may be expected in a larger market.

There are also instruments that measure the eye movements of an observer of a proposed package. By recording how the eye scans a package, we can tell what parts of the package contain greatest interest, what elements are seen first. These and many other means are used to help package evaluation at the comprehensive stage. It is important because changes at this stage are inexpensive; after distribution, costly.

The third phase of evaluation (probably the only conclusive means) lies in actual test sales. The proposed design is put in limited production, sold in test areas, and checked against known norms. If sales increase, the package has found new customers. If sales remain increased, the new package has proved its merit. Test sales also afford an opportunity to prove the functional aspects of a package.[9]

Since the package assumes such importance as a self-selling device, skillful labeling offers wide opportunities to tell the consumer how well it is made, how to use it to achieve best performance, suggestions for multiple uses and, if it is a food product, a limited number of tested, foolproof recipes.

On the other hand, the two sides of the package which will be exposed to view on the retailer's shelf should be simple, easy to read and uncluttered.

[9] *Marketable Packaging*, Lippincott & Margulies, New York, 1949.

A good package design should reproduce well in either black-and-white or color advertising. Similar attention should be given to the reproductive qualities of the package when televised.

3. Pricing the product

Assuming that your marketing plan has now developed to the stage where it is possible to estimate with reasonable accuracy the product's sales potential, you will have obtained from the production or engineering department schedules indicating "prime costs" at various volume levels. Under normal operating conditions these should be the most stable components of your selling price to trade and consumer.

The next step in determining selling price will require a budget of selling costs. This should be based upon a volume of sales which is attainable under normal conditions. Such a budget will include supervisory and field selling costs, advertising, special promotional expense, transportation and warehousing, other miscellaneous items of fixed expense, and budgeted profit. The unit cost or "cost of sales" will be the sum of all of these.

Using "cost of sales" per unit as a base, the usual trade discounts current for the distribution channels through which the product will move are next added, one by one. The resulting figure should be the final selling price to user or consumer.

Comparisons can now be made with the prices of competing brands of similar merchandise by reference to the analysis of markets. Such comparison may suggest the need for cutting costs somewhere along the line.

It is not always necessary or desirable to have a lower selling price than competitors. If your product has some demonstrable advantage which represents a "plus value" and a higher price can be obtained without sacrifice in volume of sales, then your selling price should reflect this value.

In a product used by industry such "value" may consist of laborsaving characteristics or of opportunities for improved production methods which justify the higher price. Consumers are sensitive judges of "value," and since they have access to a large number of different brands, selling price is very likely to be influenced by the sales activity of the fastest selling brands.

In building the sales budget and in setting a schedule of selling prices, the following check list may enable you to by-pass some common errors:

Allow usual and adequate discounts for distributors, wholesalers, and retailers, or for whatever type of seller is essential to your plan of distribution. This is essential even though all of the discount may not always be retained if the item is a popular, fast seller. A "free market" is desirable up to the point that price-cutting causes a product to lose the support of important sellers. For example, for many years the lead-

ing brand of coffee was handled by New York grocery wholesalers and retailers at a markup of ½ cent a pound, or six cents a case, when the normal discount to jobbers amounted to more than 50 cents. Consumers were able to buy the product at about 10 cents a pound less than the price which would have resulted from a normal markup by jobbers and grocers. Demand was so heavy and turnover so rapid that the manufacturer suffered no loss of trade cooperation.

Price your product so that you can remain competitive. This does not mean that you must have exactly the same selling price as your principal competitor. Determining whether you are competitive requires a keen sense of what constitutes "value" to the purchaser. A soap manufacturer, for example, might offer a slightly larger package at a higher price than competitors but at a lower price per ounce of product and be actively competitive in the judgment of housewives.

In pricing consumer goods a "psychological price" is of marked advantage, even for merchandise of quality appeal. Most people have well-conceived ideas of what they should pay for merchandise. Try for a retail price of $4.95 rather than $5, or 95 cents rather than $1; or have a single unit price which suggests multiple selling at a special price such as 15 cents (two for 25 cents) or 9 cents (three for 25 cents). The sales volume of a well-known gelatin dessert was doubled in 3 years by a decline in manufacturer's selling price from $3.03 to $2.53 a case. Independent grocers had sold the product at 15 cents or two for 25 cents when the cost per package was 8½ cents. The lower price induced retail prices of 10 cents or three for 25 cents in independent stores, and even lower prices in chain stores. A distiller enjoyed a tremendous volume of business on straight whisky at 95 cents a half pint; at $1.10, necessitated by a higher tax, sales plummeted and the product was removed from the market.

Manufacturers' selling prices should allow an adequate margin for consistent advertising plus a calculated "reserve" with which to match or offset special promotions by competitors. The existence of a budgeted reserve fund makes it unnecessary to obtain executive approval when emergency measures are necessary. Failure to institute competitive measures decisively and promptly may mean loss of volume and prestige.

If your pricing schedule provides quantity discounts to large customers you may be required under the Robinson-Patman act to prove that lower quantity prices are justified by selling economies. Some manufacturers sell direct to large retailers at prices comparable to those obtained from wholesalers if buying is on a volume basis. If volume is the criterion for placement on the "direct" list, the Robinson-Patman act may apply. If your marketing plan offers cooperative or other advertising, display or promotional allowances to volume purchasers, similar smaller scale plans must be made available to smaller volume purchasers.

Adhere rigidly to your price list. Customers exchange information rather freely. Nothing breeds distrust and encourages price haggling quicker than a rumor of a special "deal" or price advantage obtained by another customer.

It is best not to put a product under "fair trade" until such action is dictated by ample experience. Then the seriousness of the problem will have to be appraised by the affected manufacturer. Be on guard against aggravated need for such action based on reports of salesmen in the field. Among merchandisers there are two schools of thought relating to "fair trade." A "free market" is generally preferable up to the point at which price cutting causes widespread loss of dealer cooperation.

It is desirable in establishing both sales and advertising budgets to use a fixed sum per unit or case in determining amounts of expenditure. If sales exceed budgeted amounts, then advertising expenditures should be increased. If sales are being made profitably, selling costs per unit should tend to decline as volume increases.

In most decisions as between a lower selling price and no advertising or promotional expense, and a normal selling price and adequate promotional expenditures, security over the long haul will favor the latter course.

4. Have a defensible sales policy

A manufacturer will build either a good or a bad reputation with the trade primarily through his sales policy. It is, in substance, a declaration of business principles. It should be selfishly sound for the manufacturer but fair to all his customers. It should be defensible by all members of the sales organization to customers of every size and classification.

A soundly conceived sales policy should be sold to company salesmen and to customers as a means of stimulating confidence, a cooperative attitude, and wholesome respect.

Such a policy precludes the negotiating of special "deals" with large customers. On the other hand it is defensible to classify customers by size of order or annual volume of purchases and to sell outlets of every type that can and will qualify.

The manufacturer of consumer goods can no longer afford to sell his goods only through those outlets which traditionally have been his only source of volume in view of the development of giant retail outlets which sell many classes of merchandise.

This suggests the classification of customers by volume of sales. If special allowances are made for drop shipment, pool-car shipments, or special cooperation, these should be made available to all customers on the same terms within the same territory.

Uniform policies should be established with respect to returned or unsold goods.

Merchandise should be regarded as "sold" only when it has moved into the hands of the user or consumer. While in the hands of jobber or retailer it stands as a liability of the manufacturer, blocking future sales.

5. Pricing and sales policies of competitors

It is essential to know who your important competitors are, their sales policies, the selling methods employed by their men, their promotional inducements, and their price lists. To a successful sales manager such knowledge is like a football captain's knowing the weight, speed, and passing capabilities of the opposing team.

Many buyers and purchasing agents consider it legitimate to pit one manufacturer against another in an attempt to obtain some price advantage. Salesmen of competitors are constantly trying to wean away from you your most important customers.

In judging the validity of reports of competitive activity originating with your salesmen, the facts about your competitor and his policies are important. Much of this information can be obtained from your customers.

When your salesmen lose orders, try to find out the reason objectively. Your competitor may have a better salesman calling on that buyer.

One of the most common explanations advanced by salesmen and territorial sales managers for a sales decline is the activity of "cheap competition." Companies which have priced their products well above competition are especially sensitive to this line of reasoning. The remedy generally discussed is a "price reduction."

Price reductions react unfavorably on profits unless such price declines result in large increases in dollar volume. It is not wise, therefore, to jump to the conclusion that volume is being lost to lower priced competition without adequate facts.

A high-priced consumer product can suffer from a shift in economic conditions. If it is sold in only one size, the demand may have a tendency to shift to the smaller size unit of a competitor. Competition may be outadvertising and outpromoting your product in volume markets. Rely on research to get the facts.

The local or regional manufacturer or packer of food products frequently maintains his volume in a limited market through his ability to price his product enough below the products of competing national advertisers to make his price attractive to consumers. Coffee is a good example. In many important markets there are local or regional brands which outsell the national brands for this reason.

Most of these brands owe their early growth in popularity to the "price umbrella" of the national brand which could not adjust prices, market by market, to meet local competition.

It is of course illegal to conspire with your competitor to fix or control prices. But there is no objection to your discussing with him such matters as trade practices and the idiosyncrasies of customers and markets.

Two leading food manufacturers had succeeded in developing complete dominance for their respective brands in two widely separated geographical areas. Every year manufacturer *A* would release an extravagant, high-cost promotion in manufacturer *B*'s pet territory, using "loading" deals, excessive sampling, and large-space newspaper advertisements featuring consumer inducements. As regularly, manufacturer *B* would retaliate with a similar costly promotion in *A*'s highly developed territory. Neither gained any competitive advantage.

Finally the two sales managers were brought together over the luncheon table. They agreed good-humoredly that their mutual efforts had been sterile and decided to stop the practice. Stockholders of both companies benefited by many thousands of dollars annually, yet normal promotion of both brands was unaffected. There was no legal violation, as consumer prices were not involved in the understanding.

It is important to bear in mind that most successful businesses are that way because of sound selling policies, good customer relations, and hard work—not because of cut prices or special inducements.

6. Sales analysis as a means of control

Whether you sell regionally or nationally, in the industrial or consumer field, a simple, practical, and dependable plan of sales analysis is the only means of avoiding a hit-or-miss sales operation. What is meant is an analysis based entirely on data from internal sources, primarily sales records, as differentiated from marketing research of product or market.

Such an analysis will provide a solid background of fact for management decisions affecting purchasing and production. It will point the way to intelligent and effective distribution of advertising and promotional work among your markets.

Here are some of the more important types of information which sales analyses should provide:

Geographic distribution of products by sales areas
Product sales trends by sales areas
Sales performance, by products, by sales areas, and by salesmen
Development of potential sales (by comparison with an "index"), area by area
Existence of weak and strong sales territories

Continuous sales analysis need not require a large staff. An analyst and an assistant who is adept at operating a calculating machine will suffice for most organizations. If the company makes use of tabulating equipment in some other department, use of this equipment will make the analysis that much easier.

Some modification may be necessary to adapt the following outline of procedure to your specific selling operation. These modifications will be dictated by your type of distribution, the number of your products, and their ultimate usage.

Step 1: Select a unit of control which is to become the basis of your control system. This can be a sales territory, a trading area, or a county. The "control unit" should be self-contained and as small as possible.

Step 2: Allocate total sales to the various products in the line. These sales may be shown in percentages. If your line of products is a long one, the small percentage of total sales attributable to the minor items may be surprising. If so, sales concentration on major lines will be indicated with perhaps some "house cleaning" of minor items.

Step 3: Break down sales into control units for each principal product, or the ones you intend to analyze.

Step 4: Select the basic data which you intend to use as a measurement of your control units. This may be population, wired homes, auto licenses, manufacturing units of the type using your product, or native white families. Experiment until you find the data most suitable to your products.

Step 5: Develop or adopt a market index. This will be used to measure your sales opportunity in the various control units. The index should be shown in percentages for the geographical market divisions you have selected as your control units. (Such an index will be found in *Sales Management's* "Survey of Buying Power.")

If the foregoing outline has been followed to this point, you will now have (1) a measurement for each of your control units of your sales (last year or whatever period) by products, and (2) the sales potential for each product for each control unit. With these data before you, you will be able to follow the sales progress of each product, area by area and period by period.

This description is probably an oversimplification of the means of control. The seasoned sales manager will be keenly sensitive to the human-relations angle of administering sales with the aid of these data. Extreme care will be exercised to use the facts developed in such a manner that salesmen will be stimulated and encouraged to better performance. The program should be "sold" to the field organization as a practical and helpful means of improving the company's position and the individual salesman's opportunity.

A simple approach that salesmen will readily understand involves the

determination of a level of sales performance for each control unit. Here is how one large company uses this index in determining geographic variations in sales performance:

We start with the assumption that the company's volume is influenced by forces, economic and managerial, which are beyond the control of individual salesmen. We say that it is the responsibility of each salesman to sell a share of that company volume varying with the potential of his territory. It is up to each of them to gain in volume at a rate at least equal to the company rate of gain.

Determining Territorial Performance

(Assumed company volume $10,000,000)

	Territory *A*	Territory *B*	Territory *C*
Per cent of potential in each territory.....	10	5	3
Par for each territory.....	$1,000,000	$500,000	$300,000
Actual volume	750,000	600,000	150,000
Index of sales performance (actual ÷ par)....	75	120	50

By using a market index, you can then determine how you are doing in each of your control units. Here are the steps illustrated in the foregoing table:

1. Determine the "par" for each control unit. If your company volume is $1,000,000, par in the territory representing 10 per cent of your potential is $100,000.
2. Divide actual sales by par, for each area. The answer is an index figure, a percentage—the percentage which each area's sales were of that area's par.

We call this index figure an "index of sales performance."

Now we have the performance index of each of our control units. We know what each of our control units is doing and what it should have done. We can spot our weak areas and give them high-priority attention. We can go into the field and tell a salesman that his sales are 10 per cent below what they should have been and we are talking in terms he can understand.[10]

While one of the results sought through the use of an index of sales performance is a more equal distribution of sales effort, it should not be assumed that lack of sales effort is wholly responsible for market underdevelopment. Individual markets are subject to many influences. In studying the nature of these influences and their importance, some of the marketing research procedures described in the early part of this chapter should be helpful.

A class-of-trade approach in the analysis of reasons for sales weaknesses may prove productive in the case of many consumer-goods lines. In recent years the marketing patterns for many products have undergone wide changes with respect to retail outlets. If your products are sold by a variety

[10] Richard D. Crisp, S. C. Johnson & Son, Inc., American Management Association Marketing Series 63. 75 cents.

of retail outlets, an analysis should be made of the percentages of sales made to each class of trade.

The trend of nongrocery products to distribution through food stores is a good example. The following table indicates the importance of some of these changes over a 1-year period. The purchases were recorded by a consumer panel in a Southern city. The percentages are of total sales within this market.

Product	Grocery store's share, per cent	
	1947	1948
Face cream	1.6	3.9
Hand lotion	4.5	11.7
Shampoo	14.8	20.8
Shaving cream	6.7	9.2
Tooth paste	19.0	24.8
Tooth powder	6.5	16.6

7. *Limit marketing objectives; sell intensively*

In planning the new marketing venture or in the expansion into new markets, the selection of first objectives will be influenced by a number of factors. Some of these involve long-range planning for the business venture. What are its aspirations?

At this stage of planning two points are important: (1) it is not essential that a business be "national" in scope to be either a successful or a big business; and (2) the ideal business operation should be aimed at earning a profit from all sales. A marketing plan that results in sales and promotional activities being spread too thin will encourage problem or loss markets and curtail profits. Few manufacturers ever develop the maximum profitable sales potentials in their most important markets.

Other factors which should be appraised are—

The availability of capital for advertising and sales promotion expense
Time required to develop individual markets to the point where they are self-sustaining
Capacity of markets to absorb product in profitable quantities
Location of best markets
Consideration of the next step in the expansion program

Appraisal of all of these factors probably will point to the advisability of limiting marketing objectives to fewer and better markets.

This principle of concentration of sales in a number of markets that is

relatively small compared with the whole is a rather basic pattern of marketing. The same principle is applicable to distributors, wholesalers, and retail outlets.

If you are marketing a food product, for example, you will find that the Department of Commerce defines 184 wholesale grocery trading areas. Twenty of these, less than 11 per cent, represent more than 50 per cent of the total retail food sales potential of the United States. If this same pattern of analysis is extended to retail food outlets, you will find about 20 per cent of all retailers doing close to 80 per cent of the total food-products volume. Selective distribution in the volume retail outlets therefore offers substantial opportunities for sales economies when compared with the older objective of "100 per cent distribution."

Selective distribution is equally important if distributors or dealers are used. An excessively large number of dealers results in low gross sales per dealer. Too little emphasis is placed on the line, and dealers are difficult to control.

After 3 years of postwar selling, Thor Corporation had 20,000 dealers. Sales analysis revealed that 28 per cent of the company's dealers were accounting for 87 per cent of all of its sales. Turning the figures around, 72 per cent of its dealers were making only 13 per cent of its sales.

This analysis established that too much selling time, money, and effort were being wasted on unproductive outlets. It was decided that during the ensuing 12-month period, the number of dealers would be reduced to 7,000. The purpose was to obtain the right number and right kind of dealers to bring maximum sales at minimum cost.[11]

An index of buying power or sales potential is a requisite in establishing dealer sales areas and in determining the number of dealers necessary to develop the company's sales potential effectively and economically. The application of such a yardstick may result in the elimination of some low-potential areas without loss in profitable sales volume.

In the consumer-goods field it is essential that the manufacturer engage in continuous demand-creating activities in order to attract and hold the support of large-volume retail outlets. This requires the use of advertising.

Newspaper space and radio time may be bought more economically in large metropolitan centers than in small cities. And if distribution is sufficiently widespread to justify the use of national magazines, the circulations of many of these will be proportionally heavier in the areas of more concentrated population. (New York City is an exception.)

[11] See "Thor Adopts Limited Distribution," *Sales Management,* April, 1950.

8. *Advertising*

Advertise consistently to build product familiarity. The manufacturer of a good product uses the power of advertising to accelerate its rate of sale. Advertising does this primarily by building product familiarity and acceptance among those who are its natural purchasers. When employed consistently over long periods it builds company and brand reputation. Another name for this is "consumer franchise." This can have a value many times in excess of a company's physical assets.

In the consumer-goods field, advertising is the most widely used form of demand-creating activity. It not only influences consumers but impresses favorably those large retail outlets whose support is so essential to successful product promotion.

The competitive nature of consumer advertising should be thoroughly realized by the new marketer. Unless the new product offers some unusual or revolutionary advantage, sales activity may not be immediate or in large volume. First advertisements will be aimed at inducing consumers to try the new product, or to witness a demonstration at dealers. In so doing, the new product will be attempting to change buying habits or impressions created by the advertising and promotion of longer established competing brands which are well entrenched.

The marketing plan should take into account the nature and amount of advertising of competing products. This should include such essentials as size of space units in printed mediums, frequency of insertion, use of radio or television, and an estimate of the expenditures of competitors in the various mediums.

If the marketing plan is local or regional in scope it may be feasible and affordable to outadvertise competing national distributors in the more limited sales territory. National brands with many regional competitors seldom find it possible to match several more intensively promoted brands in a number of local markets.

Good advertising strategy will require that a sufficient expenditure be made, especially during the introductory period, to create a definite sales activity. A well-rounded plan will coordinate interior store display, cooperative advertising, and dealer support with advertising schedules. The entire program should be intensively promoted to the field selling staff and by them to wholesale and retail outlets.

One of the important secondary uses of advertising in the packaged-goods field is as a vehicle for special "brand promotions." The purpose of these promotions is to force more goods into consumers' hands, to attract and

sample new users, and to revitalize a brand in the consciousness of retail dealers.

Such promotions extend over a limited period; make use of continuous floor, counter, or shelf displays; and, if successful, raise the level of sales above the level which existed prior to the promotion. Examples of such promotions are so-called "1-cent" sales, two packages sold in combination at a reduced price, and a premium or contest offer. Such promotions always move substantial quantities of product to regular users, but this possible disadvantage is overbalanced by the greater number of new users who are induced to try the product.

In recent years, retail sales have tended to concentrate in large volume outlets in variety, drug, and food stores. At the same time distribution patterns have continued their tendency to overlap. Many standard drug, cosmetic, and household convenience items are now sold by grocery supermarkets. Large drug stores handle books, dolls, costume jewelry, and nylon hosiery.

These large outlets offer to shoppers the advantage of "one-stop" service. But they thrive and develop primarily on their abilities to reduce costs of selling. They rely on open, mass display and self-service. Little opportunity is afforded for clerk recommendation or "push" since the consumer makes her own selection.[12]

Well-advertised brands are the lifeblood of these retailers. These outlets should be accorded an important position in the marketing plan. Some products can benefit directly from cooperative advertising placed by such large retail outlets and financed wholly or in part by the manufacturer.

Industrial and textile manufacturers make important use of trade publications to reach selected groups of buyers, to keep them posted on product uses and developments, and to prepare the way for personal selling. Since such advertisements are directed to purchasing agents, engineers, and other executives with specialized interests, they should be as complete and informative as space will permit.

A manufacturer of a new textile product, for example, used two trade publications consistently over a 2-year period. During this time he was able to build up distribution in department stores throughout the country, enjoyed a sizable volume of sales, and was ready at the end of the period for consumer advertising in women's service magazines. The use of low-cost advertising mediums during the distributive period saved him a large premature expenditure in consumer advertising, much of which would have been wasted.

The selection of advertising mediums will be governed to a considerable

[12] See "400 Mass Retailers," E. B. Weiss, *Printers' Ink*. $5.

degree by the nature of the product and the product story or theme that is to sell it. Selection should be made by a competent advertising agency with successful experience in promoting the sale of other related types of merchandise. These general suggestions about mediums should be helpful:

Daily newspapers and radio are "fast acting" mediums
For frequently purchased packaged goods of low or moderate price, a good medium combination is a daily newspaper and radio "spot" advertising
National magazines enable the advertiser with widespread distribution to buy coverage of selected segments of the population at low cost compared with either newspapers or radio. Such selectivity is determined to a considerable extent by the editorial appeal and content of the specific publication. But note—
Advertising in national magazines will have a longer effective life but will be slower acting than the two other principal mediums
It is a mistaken policy to undertake the use of magazines on the theory that widespread distribution will follow, with or without the aid of merchandise brokers. The marketer with expanding sales should await the period in his development when he can make use of the economies of magazine circulation without curtailing entirely the use of other essential mediums
Television, as its facilities become available to more and more of the population, will become an increasingly productive advertising medium at lower costs per thousand than have prevailed during the early years of its development as an advertising medium. Marketers for whom programming costs are now prohibitive may find the use of television "spots" a very productive alternative
Outdoor posters, generally used by national advertisers as a supporting medium, may be bought at low cost per thousand observers, reach all segments of the population, and are especially effective for merchandise purchased frequently or on impulse. They have the important advantage of repeated exposure. Advertising budgets should be sufficiently sizable to permit posting in several cities; otherwise production costs of lithographed posters will be excessive

Point-of-purchase advertising. Any device at the point of sale which is successful in attracting attention to a product and suggesting its utility will stimulate sales with or without advertising. In variety, such devices may range from a cutout packing carton which opens up into an attractive counter display to a more elaborate case or rack for the display of a line of products. In its simplest form it could be a lithographed easel card to which were fastened small packages.

The display should be easy to read, suggest the uses of the product, and contribute to ease of purchase.

Products making use of point-of-purchase display material generally outsell competing products not so displayed. And retail stores using displays of advertised goods outsell other retail stores which do not make effective use of this material.

A special research study in drug stores included in the Nielsen Drug Index indicated that

> Display increases sales 41 per cent: nondisplay decreases sales 24 per cent.
>
> Sales in the stores properly displaying a typical, nationally advertised brand increased 41 per cent. Sales in the nondisplay stores went down 24 per cent on the particular brands featured in the display stores. In other words, the display stores divert business from the nondisplay stores. The net effect of increased display effort is frequently a gain in sales—an average 8½ per cent sales gain in the particular cases studied.[13]

Consideration should be given to the extent to which such material will be used by retailers before commitments for purchase are made. It is difficult to obtain placement of point-of-purchase material in large food stores. On the other hand, drug stores, tobacconists, hardware, radio and electrical appliance, and household appliance stores generally make good use of point-of-purchase material.

The advertising budget. Costs chargeable to a major product or group of products should be carefully budgeted in advance. Special expenditures which cannot be anticipated or timed exactly should be placed in a "reserve fund" and if possible earmarked so that they will not be spent for undesignated activities.

Expenditures may be definitely controlled if they are allocated to the several months during the year and approval given only to those items provided for, month by month.

If the budget covers many different advertising activities, it is wise to make a distinction between "direct" and "indirect" expenditures. The "direct" group should contain all expenditures for advertising specifically aimed at consumers or users of the product. The "indirect" group should include the secondary or incidental activities in the advertising program.

Adoption of a policy against the use of budgeted advertising money for space in miscellaneous programs of men's and women's social, fraternal, or union organizations and other nonproductive devices mistakenly sold as "advertising" will aid materially in conserving company funds for useful purposes. Such expenditures are essentially charitable contributions and have little or no publicity value.

[13] "Nielsen Cases Prove Dollar Value of Displays," *Advertising Age*, April 3, 1950.

A sample budget of a food manufacturer with national distribution will illustrate these points:

Direct Expenditures:	
Magazine space	$ 450,000
Magazine production	54,000
Radio spots (time)	375,000
Radio spots (production)	8,000
Newspaper space	250,000
Newspaper (production)	20,000
Total	$1,157,000
Indirect Expenditures:	
Package inserts	$ 35,000
Recipe booklets	27,000
Dealer shelf strips	6,000
Store demonstrations	11,000
Contest premiums	24,000
Salesmen's samples	2,100
Total	$ 105,100
	1,157,000
Advertising budget	$1,262,100

Selection of an advertising agency. The use of advertising to expand markets and increase sales will necessitate the selection of an advertising agency. It will be the function of the agency to study your sales opportunities, your problems, and your product and within the limitations of your budget to plan, design, and prepare advertising copy for placement with the various advertising mediums.

This is an important step. The selection should be made with the greatest care after the screening and appraisal of three or four of the most likely available organizations.

A close working relationship should be sought, and the selection should be entirely free from any personal influences or relationships. Assuming that all candidates have complete facilities, medium recognition, and financial responsibility, an important consideration should be the individual or team within the agency who will be charged with the responsibility for servicing your account. This individual can be the head of a small agency or the manager of your account in a large organization. Size is of secondary importance.

Examine carefully into the account manager's personal experience in merchandising similar or related products and his general business experience. You will be looking to this individual to see to it that you obtain the proper amount and kind of service from others on the agency staff.

Ideally, an advertising agency should share responsibility with your sales

department for sales progress. Independence of thought and opinion should be encouraged. A capable agency will not object to minute scrutiny of plans or to a request for pretesting advertising copy or special promotional plans.

The principal requirement should be the ability of the agency to produce effective advertising for your product, that is, the physical advertisements, whether they be printed, visual, or oral. Good advertising copy is the priceless ingredient in any successful marketing plan.

In addition to the routine questions which will normally be asked of a prospective advertising agency, the following points also should be explored:

What individual in the agency is to be directly responsible for our account? Will he handle also the accounts of other advertisers? How will this affect the time he can devote to our business?

What contributions has the agency made to the selling strategies of its clients? Cite specific examples and results

Is the agency experienced in pretesting copy themes or individual advertisements? Will the agency test ours?

How much time do the agency's account managers spend in the field with customers and salesmen of its clients?

It is worth keeping in mind that an agency exists on the fees it collects from clients and the commissions paid to it by advertising mediums. If many of the services you require do not involve commissionable space, you will get better service if you arrange for the agency to serve you on a fee basis.

It is quite possible that your needs for service during the developmental stage of your business will be out of proportion to the agency's opportunity for income. If so, it is unfair to ask your agency to serve your account at a loss during the early growth stages in the expectation of larger future expenditures.

Changes in agency relationships are costly. Select your first agency with great care.

9. *Research*

Research continuously to improve product, to expand sales, and to lower selling costs. Successful selling is a dynamic function. Competition and the changing needs and habits of people make it so. Many unseen forces constantly challenge the marketer's ability to hold his position or to make sales progress. The origin of these forces is sometimes external, sometimes internal.

Most insidious of all internal dangers is the gradual formulation within an organization of a static pattern of thinking about a product or its merchandising. Such patterns seem to develop quite logically and always have some basis in experience. They reject ideas that are "not in the tradi-

tion." And through repeated rejection, they tend to stifle experimentation and original thinking which does not fit into the accepted framework.

Facts provide the only dependable protection against these challenging forces. These facts should be developed through a continuous program of research to insulate the product against the inroads of competitors, research of the buying and usage habits of users of the product to expand sales, and sales analysis to reduce selling costs. This job is never finished in a successful and expanding business.

Although frequently difficult to determine, the causes of business failure or a decline in sales are nearly always extremely simple and singular. After studying a large number of cases over a period of several years, one former sales executive (now a marketing consultant) says that 90 per cent of these failures can be ascribed to some one of the following simple causes:

Gradual, but unsuspected, product obsolescence
Insufficient promotion or advertising to maintain sales activity
Changes in needs or usage habits of customers
Loss of market to improved product filling same function
Need for establishment of definite product difference
Failure of product to live up to advertising claims
Advertising directed to a declining age group
Advertising not attuned to buyers' interest
Unrealistic pricing, or discount policy
Lack of incentive to wholesalers and distributors
Need to modernize product and package

The institution market. It is not uncommon for the marketer of consumer goods to by-pass or neglect the institution market. This market is composed of the hotels, commercial eating places, hospitals, institutions, and other places where large groups of people are fed or cared for. It is an expanding market of such magnitude that a considerable number of manufacturers confine their marketing activities to it exclusively.

Hotels and hospitals are volume users of furniture, bedding, linens, and chinaware. They buy kitchen and cleaning equipment as well as food and laundry supplies.

Marketers of consumer packaged goods will find it necessary to provide special large-size packs if they intend to operate in this market. Certain lines of merchandise move to this trade through specialized distributors who do not operate in consumer goods channels.

Reliable data on the volume of sales of representative types of merchandise to different groups in the institution market are difficult to obtain. There are several trade publications catering to the several specialized groups and these are good sources of information.

It is estimated that 60 million meals are served daily in public eating and feeding places. These meals are consumed as follows:

Place consumed	*Per cent*
Commercial restaurants	53
Hospitals	8
Industrial restaurants	11
Hotels	11
Schools, drug stores, clubs, and soda fountains	17

The number of establishments where meals are served is estimated to be 525,000. A partial analysis of these by type of institution affords a graphic picture of the extent of the institution market: [14]

Type of institution	*Number*
Restaurants and cafeterias	310,000
Hotels	15,100
Hospitals	8,500
Residences of involuntary confinement	7,000
School lunchrooms	31,600
Salvation Army and Red Cross	5,000
Summer camps	3,500
Miscellaneous eating establishments	2,100
Ice cream parlors	10,000
Drug stores	31,500
Clubs and lodges	31,800
Boarding houses	8,900
Industrial restaurants and cafeterias	28,000

The trade publications covering the various fields offer an opportunity for advertising coverage and market development at a favorable cost in comparison with advertising in consumer mediums.

Marketing private brands. Manufacturers whose brands are well established with users or consumers at times have an opportunity to increase manufacting volume substantially by packing private brands for large chain or syndicate store operators. Customarily these private brands are merchandised through the same retail stores in competition with the manufacturer's brands and at lower prices.

Macy's and affiliated department stores, for example, carry an extensive line of standard drug and cosmetic products under the Macy-controlled label. Large food chains offer such products as cold cereals, flour, shortening, and gelatin desserts under their own labels in direct competition with advertising manufacturers.

Opportunity to pack private-label goods generally raises the question: "Shall we pack these goods and compete with ourselves?" The proposal may involve packing a lower priced line or a different size package.

The decision will involve many considerations, but none of these should

[14] Department of Commerce, based on OPA data.

be emotional. The danger of "internal competition," in most instances, can be disregarded. If your company does not decide to supply these goods, then some other company will. Competition will not be eliminated by a negative decision.

If the sales opportunity is substantial, the added volume may serve to reduce manufacturing costs on your established lines. Your sales policy should be sufficiently elastic to take maximum advantage of such opportunities in this era of mass distribution.

On the other hand, the manufacturer whose sales have consisted exclusively of private-label merchandise may find it profitable to explore the opportunity for promotion of his own brand or line of products.[15] By gradual conversion of his private-brand manufacturing volume to controlled sales, his business will be less susceptible to price competition from low-cost producers. His ability to expand will be more directly related to his merchandising ability and financial resources.

[15] See "The Marketing Strategy of Botany," *Printers' Ink*, April 21, 1950.

Section 8

HOW TO ORGANIZE FOR GOOD CUSTOMER RELATIONS

BY

A. H. CHUTE

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HOW TO ORGANIZE FOR GOOD CUSTOMER RELATIONS

This chapter is concerned with organizing your firm's policies, procedures, and personnel so as to produce and protect good customer relations.

Customers afforded the earliest field for development of public relations, and they remain one of the most important areas for cultivation. Despite the abuses and neglect of the postwar period, customers form one of the most important assets of any business venture. Their opinions concerning your business enterprise will largely determine whether and to what extent they will begin or continue to buy the products and services of your firm.

Introduction

Recognition of customer relations. Increasingly business concerns face a demand that they use their collective power and positions of trust to operate in such a manner as will serve to the best advantage the long-range interests of the public at large. Paul Garrett (General Motors) has said that "public relations is a philosophy of management which, deliberately and with enlightened selfishness, places the broad interest of the public first in every decision affecting the operation of the business." [1]

But is it not enough merely to *be* good; you have to *appear* to be good, as well. Good public relations is good performance—publicly appreciated. Bruce Barton stated in 1935, "No major industry has the moral right to allow itself to be unexplained, misunderstood, or publicly distrusted; for by its unpopularity it poisons the pond in which we all must fish." [2] You must build a character and personality for your company behind its products or services. You dare not "achieve a caricature by default"!

What competition have you in customer relations? More than half the top businesses of the country have some form of specialized public-relations function, but only about 15 per cent have any kind of well-rounded program. Pressure has been placed upon you and leadership provided; but there is still plenty of room for your public-relations program, if soundly based, to become effective.

[1] *Public Relations Journal,* May, 1948, p. 3.
[2] *Fortune,* May, 1949, p. 200.

How inclusive is a customer relations program? Especially if you produce goods for direct consumption, your customers may include all the other publics—your employees, stockholders, community and governmental officials and employees, persons with the press and radio, and even those supplying you with materials, supplies, and public utility services. The important public relations techniques for use with employees and with stockholders are discussed in other sections.

If you are a manufacturer, your customers may include—

Other manufacturers, wholesalers, dealers, distributors, retailers
Those to whom these "customers" sell in turn
Ultimate consumers supplied by retailers or by your house-to-house or direct-mail methods

We shall deal with two kinds of customer relations:

1. Binding dealers, distributors, and other sales middlemen to the house
2. Developing and preserving the valuable goodwill of ultimate customers for an immediate supplier, as a retailer or public utility

What customer relations is not. Some businessmen still hold to the outmoded idea that a public relations program of whatever character is a temporary device, suddenly adopted, for pulling a company out of difficulties. When a hostile public has been developed through aggressiveness, indifference, or carelessness, it seems easy, on a fire-alarm basis, to call in a "miracle man" in the form of a public relations consultant, hoping to have him "make powerful medicine" and cure all, without disturbing the policies and practices of the company. This no longer works. You have a better educated public today.

And customer relations is more than merely competent selling. Your firm needs to distinguish between the important techniques for *giving* your customers what they want in terms of products and services and the techniques of *getting* from customers and your other publics what your enterprise wants in the form of public acceptance and approval of your policies and programs.[3]

Others hold the impression that public relations consists primarily, if not solely, in obtaining plenty of favorable press publicity. This may have its place, but it is only a small part of a well-planned public relations program.

1. The place of customer relations in your company organization

Public relations in its various aspects should be a top-management function handled at the policy-making level, since everything a company does may affect its relations and reputation. The customer relations phase has

[3] Baldwin and Mermey, *Footnotes to Public Relations,* February, 1949, No. 33.

often been handled as a minor aspect of the work of the sales manager or the advertising manager. The work of both managers can influence customer relations greatly.

A large concern should have a public relations executive reporting directly to top management. In a smaller concern, a major executive should be authorized to assume, as an important phase of his responsibilities, the development of a public relations program and the coordination of all activities in so far as they may come to public attention and evaluation.

The actual handling of the public relations activities, including customer relations as a primary portion, is done in one of three ways:

1. As an inside function handled fully by a competent executive of the firm
2. Headed by a company executive, with the actual public relations development in the hands of outside public relations men
3. Entirely in the hands of a public relations counselor outside the firm

The chief advantages and disadvantages of these arrangements follow:

Public Relations Organization—Inside Executives vs. Professional Counselors

Inside Executives

Intimate knowledge of affairs. If the inside men are major executives, they possess the necessary information to make competent decisions since they are acquainted with actual policies, procedures, and operating personnel. They are familiar with products, processes, and selling and service problems.

An easier start. A simple, easy start toward care for customer relations can be made if an executive will take responsibility for informing himself and coordinating the matter for his chief who is "too busy" or thinks professional counsel too expensive.

Limitations on insiders. The company executives can oppose their chief or associates only to a limited extent, as their livelihoods may be at stake. There is danger of becoming "yes men." It is difficult to reeducate one's superior to new and unfamiliar ideas.

Familiarity to the public. The name of an identified official of your well-known company may carry considerable weight in a direct appeal to the public.

Professional Counselors

Freedom from internal politics. The public relations counselor from an outside firm is free from the internal pressures under which employees must operate.

Highly specialized knowledge. He maintains a high professional competence in his field, commanding the respectful attention of his client's executives.

Neutral viewpoint. He can better evaluate situations and proposals from his disinterested and unbiased position and can speak his mind more freely. He can help get a company started in the right direction.

Broader contacts. He brings a broader base of experience and often has access to information not available to associates of any one firm.

Professional independence. Jealous of his reputation, he will refuse to accept dictation from company executives where expediency may be primary.

Limitation on the outsider. Since professionals usually work behind the scenes, their names, if used, have little value in case of a direct appeal to the general public.

2. *The job of a customer relations executive or counselor*

The company executive responsible for customer relations development and control, or the counselor brought in from a professional firm, will need to—

Know his employer or client and his concepts of business, including his peculiar ideas and ambitions, his psychology of business, his attitudes toward his dealer organization, his customers, and his community, his feeling toward governmental regulation, his relationship with his sales and advertising employees and other associates

Learn thoroughly the motivating forces in the organization and the actual policies directing its activities

Become familiar with the production as well as advertising and selling problems of the organization, including earlier history

Test out the state of morale of the organization

Sample the feelings toward the company among representative dealers and ultimate consumers, interpreting public attitudes and behavior to the management of his company

Set up a mechanism for conducting surveys among customers or otherwise obtaining a continuing flow of information about customer reactions in the light of a competent knowledge of trends of general public psychology

Carefully choose appeals, devise methods, and select mediums for interpreting the ideas and actions of his employer or client to the customer public in the light of that public's interests

Help to indoctrinate the advertising and sales forces, correspondence units, credit and adjustment offices, delivery units, and any other employee groups having any contacts with customers, to a complete and practical knowledge of the ways in which their respective tasks fit into the customer relations policies and programs of the firm

Keep his associate executives reminded constantly but diplomatically of the customer-relations aspects in all proposed policy decisions and choices in procedures

3. *Qualifications of a customer relations executive or counselor*

The customer relations executive or counselor that you select should have these characteristics, so far as possible:

He must possess imagination and initiative, not relying too much on others' ideas but doing a custom-tailored job for his firm or client

He will like and understand people and himself be likable and readily understood, even though he will remain in the background of most of the activities he supervises

He will be recognized as having alertness, good judgment, energy, sincerity, self-confidence, poise, good humor, and tact

In all relationships he will, above all, be able to understand, define, respect, and respond to the other man's viewpoint, whether consulting with other executives or planning customer relations appeals

His knowledge of survey methods will be competent, especially in the field of opinion research

He will be a keen student of customer psychology and buying motivation, with a good sense of values

A quiet ability for unobtrusive leadership, good sportsmanship, and fair play will enable him to obtain readily the cooperation of others

A competent background of knowledge and understanding in the fields of sociology, politics, applied economics, personnel management, and consumer economics will be invaluable

He will possess high facility in the use of language, whether in speaking before a group, dictating a letter, writing an article for a trade journal, preparing a publicity release, analyzing a catalogue or advertisement, "toning down" but "pepping up" a series of collection letters, determining the nature of a customer's grievance over the telephone, helping set up a salesmen's or dealers' contest, or inspecting copy for proposed dealer aids

He should be expert in judging timeliness, suitability, clarity, good taste

4. The elements in a customer relations program

When setting up or reappraising a customer relations program, certain steps should be taken:

Adopting a public relations policy. The decision to review your company's policies toward obtaining and maintaining better public acceptance should start within the company and *at the top.* All executives must be "sold" on the idea and become sincerely public-relations-minded. To be effective, the director of public relations for the company must sit in with top management.

Enrolling the employees. Proper steps need to be taken to inform the company's employees concerning any changes to be made and any activities to be undertaken for bettering customer satisfaction with the company's products, services, and policies. They must be led to a sincere belief that their livelihood is substantially dependent upon customers' support, and that the company's clients must be treated with respect and consideration.

Provision for fact finding. Internal studies and external surveys are required to ascertain the answers to such questions as—

Why will customers wish to buy your products?

Why have customers stopped trading with you?

How can you minimize or avoid frictions with customers?
What positive steps can be taken to increase customers' satisfactions with your company's products, services, and policies?
What underlying causes of complaints and adjustments can be removed?
What past marketing errors can be remedied?
What further aids can be provided for dealers and their customers?

Objectives. Preliminary objectives need to be set up in connection with the steps proposed above. Based on data from such studies and surveys, definite and clear-cut objectives are needed to guide the developmental and remedial programs upon which you decide to embark.

Attention to other publics. Although numerous concerns have limited their public relations activities to the field of customer relations, often as a minor adjunct of the advertising department, sound customer relations programs will be reinforced by proper attention to programs for employee relations, vendor relations, community relations, government relations, trade relations, and press relations. Customers earn their livings in all these areas and largely form their opinions concerning business enterprises in those activities.

> He who has a thousand friends has not a friend to spare;
> But he who has one enemy shall meet him everywhere.

An open-door policy. Executives in all organizational units having customer contacts will need to make themselves readily approachable for dealers and other customers having questions to raise, problems to solve, ideas to discuss, or complaints to register. This availability should extend to other publics, also, particularly the press and radio, as the latter build up an interest in the doings of your company.

Provision for checkup and follow-through. It will be highly essential that competent officials sincerely and realistically interest themselves in learning the results of the studies and surveys undertaken. They will provide for checking to assure that proper remedial and developmental courses of action are planned and executed, based on the findings of the studies and surveys.

5. *Getting the facts for customer relations*

The business world must build bridges for understanding and cooperation with the citizen-organization world, against ignorance and misunderstanding of business, which might become permanent suspicion and hostility.[4]

If management men are not willing to speak out, to be quoted—and sometimes risk the chance of being misquoted—and if they are not willing to assume responsibility for telling the management story, they can hardly expect to be accepted as leaders, and the public will seek its leadership elsewhere.[5]

[4] *Footnotes to Public Relations*, No. 33, February, 1949.
[5] *Management Topics*, Methods Engineering Council, September, 1949.

You can assume that customers like your products and services, your selling methods, your policies respecting credit, returns and adjustments, and the like; but *do you know*? Have you asked them or had anyone question them competently for you?

You must acquire facts for anchoring and supporting both ends of that "bridge of understanding":

Facts about the company you work for—these to be presented through the most suitable techniques to your customers

Facts about the customers' wants and preferences, likes and dislikes, favorable and adverse opinions about your concern, its policies, attitudes, and procedures—these to form a basis for revision of your policies and procedures if necessary or desirable

Internal facts. Facts about your own concern can be obtained most completely and with least bias through—

Studying your firm's internal publications—policy declarations, systems and methods manuals, employee handbooks, instruction sheets and charts, and house organs

Studying its external publications—catalogues, dealers' and service men's manuals

Interviewing executives and representative workers having to do with policy formulation, organization and systems, production, advertising and selling, credits and collections, complaints and adjustments

External facts. "Public relations," said Henry Weaver of General Motors, "means finding out what the people like and doing more of it, and finding out what they don't like and doing less of it."

Facts about the people's attitudes and probable courses of action can be obtained through—

Frank interviews with dealers, distributors, and retailers who handle your products

Interviews made by apparently disinterested outsiders employed by you to obtain the opinions of civic leaders, educators, bankers, industrialists, and members of the ministry, bar, press, and radio

Competent surveys among customer groups, conducted anonymously either by your own public relations staff or by professional research or polling agencies retained for the purpose, perhaps on a continuing basis, because of their greater experience in preparing questionnaires, training field crews, conducting surveys, and compiling and interpreting the results

6. *Avoiding or minimizing frictions with the public*

Applying the modern theory of "preventive medicine," one of the best and simplest methods of gaining customers' goodwill is, obviously, to take positive steps to avoid or minimize the development of ill will. Some houses are using these methods to assure better customer satisfaction:

Testing and inspections. Manufacturers and retailers alike provide for adequate and honest testing and inspection of all merchandise manufactured in the plant or purchased for resale in the store. They check frequently or continuously the quality of maintenance and repair services for many lines and such customer services as alterations of clothing, making curtains, or laying of floor coverings by retail establishments. Certain large stores as well as manufacturers maintain their own testing laboratories or contract for such services.

Complaints and adjustments. Prompt and intelligent handling of complaints and requested adjustments is highly essential, as it will often head off a rapidly increasing bitterness in the mind of a customer who believes that he is being given the "run-around treatment." Meeting the particular situation is only the first step in this phase of customer relations. You will wish to provide for careful and systematic examination of the underlying causes for complaints, classifying and organizing the facts, and making recommendations to engineering, production, sales, or service departments as your findings may indicate.

An important phase in this activity is that of respecting the customers' time and convenience. For example, some rubber-products firms formerly required that customers take an automobile tire back to the place of purchase in order to obtain an adjustment for unsatisfactory service, rather than, as later, permitting any dealer or distributor to adjust the matter. Many retail stores apparently still try to make the handling of complaints and adjustments as difficult and unpleasant as possible for customers. Patrons are not impressed by having company rules or policies quoted to them. They demand satisfactory goods and services, and their goodwill accrues for firms that handle complaints and adjustments with a smooth and friendly flexibility.

Customer service departments. Numerous manufacturers and some wholesalers and retailers center all activities concerning customers' interests in a customer service department. This gives prompt sympathetic attention to customers' complaints and requests for adjustments, inquiries about operating difficulties, and suggested betterments. But it is also constantly on the alert for positive new channels of customer service.

Reasons why customers left you. Alert manufacturers and retailers alike have undertaken to learn why customers have ceased trading with them. Have you investigated your customers' reactions toward your company on these points?

- Indifference, arrogance, or haughtiness of sales force
- Overselling, aggressiveness, or high-pressure insistence by them
- Lack of information among the sales force concerning—
  - The nature, construction, and possibilities of your products
  - Proper use and care of the product, including simple methods for avoiding or minimizing trouble in its use
  - Competitive advantages and limitations of your product, both in use and for resale
  - Data that will justify your prices in relation to values
- Exaggeration or misrepresentation concerning the product, perhaps due to careless advertising or to salesmen's inadequate information concerning it
- Irresponsible promises made concerning the time and conditions of packing, delivery, or credit; unexplained delays
- Uncertainty among the sales force as to what the concern's policy and course of action will be in a given circumstance
- Attempted substitution of goods, whether by salesmen or in packing
- Concealment of errors or failure to accept responsibility for them
- Reluctance or refusal to exchange goods in cases where the customer believes the request justified
- Playing favorites among customers or groups
- Handling too brusquely or with apparent indifference—
  - Customers' inquiries, complaints, or claims
  - Correspondence on credits and collections

And, on the customers' side—

- Misconceptions concerning your product, prices, services, policies, and organization, which need to be—
  - Investigated and defined
  - Studied and analyzed, to gain the customers' viewpoint
  - Answered fully and simply in proposed explanatory or educational material in your advertising, sales training, and letters or bulletins to the selling force

When investigating such questionable conditions, the inquiring company management will often need to go outside usual channels of records and reports for its data. For example, some firms intercept periodically from the incoming mails all letters of complaint and inquiry, make notations concerning them, return them to usual channels, unknown to routine workers, and

later check up in detail on their disposition. Under fictitious but convincing names, company officials or their outside investigators originate letters and telephone calls of inquiry and complaint to determine directly just how such matters are actually handled.[6] Outside aid by competent polling or research organizations will usually be required to ascertain and interpret customer attitudes toward your company and its products and services.

Sometimes it is desirable to take the following steps:

Inform employee groups concerned that—
- Unsatisfactory conditions are known to exist
- Top management is definitely interested in betterment of conditions
- Responsibility for continuing shortcomings will be traced

Present to employee groups concerned some specific, concrete lists of points to be checked in their work and steps to be taken toward accomplishing betterments

Arrange for responsible persons to check systematically on the nature and degree of progress made

Assure that individuals contributing noticeably to betterment will be told of the company's appreciation of their thought and efforts; positive incentives may be provided

Admit frankly in correspondence with customers or in salesmen's talks with them that conditions are unsatisfactory and *tell them what steps are being taken to correct the faults;* perhaps ask the customers for suggestions; thank them for suggestions received

When performance has been restored to normal, publicize it

In an interesting attempt to learn why customers had been alienated, a department store in Saint Paul made up a list of customers who had ceased trading with the store during several years of changes in ownership, management, policies, and procedures. A young woman, cooperating as a graduate student in a local university, was given an intensive brief training concerning the store, was furnished the use of an automobile and the list, and given access to executive offices and files. She spent months in contacting customers in their homes, clarifying their complaints, tracing the offending transactions through the store's records, and arranging for action to satisfy the customer, in each instance. A large percentage of lost customers was regained for the company. Careful identification and classification of the causes of complaints permitted necessary correctives in the store.

7. *Attracting and holding customers*

Many techniques can be used for gaining and holding the goodwill of customers. Preliminary to employing any of these methods, satisfactory answers should be obtained for all these questions:

[6] *American Business,* May, 1948, pp. 12, 54.

Exactly who are your customers? (This will probably require studies of the firm's sales records and correspondence and, often, more or less formal surveys in market areas)

Just why will customers wish to buy your products? (So that you can use full understanding and "play your winners" in approaches to them)

To what extent can you emphasize your well-established reputation and customers' earlier satisfactory experiences with your house, based on quality, fair prices, proved values, full line of products, and your guaranties of satisfaction?

What is there about your selling force and your sales and credit policies that customers will tend to approve or prefer?

Are your service policies and facilities a strong factor of attraction?

In what ways does your firm demonstrate leadership in its production and marketing fields?

Just how are your products and services directed toward satisfying customers' *known* interests?

Do you make a strong and well-planned effort in all your advertising, selling, and correspondence to "put yourself into the customer's place," to understand his motivation, and to appeal skillfully to it?

Do you in simple and straightforward fashion talk the customers' language, avoiding all terms that might be perfectly clear to your production or office forces but too technical or confusing for the customers?

8. Good relations with all types of customers

Whether you have in mind other manufacturers as customers for your products, dealers or distributors, retailers, or ultimate consumers, there are certain things to watch that are universal to good customer relations. Be sure that you—

Study the women's interests. Women make many purchasing decisions and influence choices in many other lines. They prefer—

Products that are clearly designed to reflect their comfort and convenience, such as kitchen sinks and tables of the right height, appliances (such as vacuum cleaners and food mixers) that are lightweight but sturdy, furniture that is light to move about and easy to clean, wrinkle-resistant fabrics, timesaving and less arduous processes for cooking, sewing, washing, and cleaning

Products that combine usefulness and good value with attractiveness and good taste

Products that respect sanitation, hygiene, and the welfare of their families

Some manufacturers are respecting women's interests in these ways:

By employing competent home economists and women trained in art and design on their own staffs or in a consulting capacity, in connection with—

Practicality, convenience, and attractiveness in design of products

Preparing instructional booklets and charts on the use and care of the products, to accompany the packaged product or to be made available on request from the customer

Preparation of advertising and sales appeals for use in printed mediums and on the radio; also merchandising ideas for sales-training manuals for salespeople, educational materials for use in the schools, and company periodicals directed toward the home

Development of such activities as cooking and sewing schools in retail stores or sponsored for customers in various communities by local newspapers or retail merchants' associations

Preparation of talks and illustrative materials that can be used by merchants or their representatives before women's clubs, parent-teacher associations, convention "workshops," and the like

Preparation of prearranged articles for women's magazines

By submitting samples of new, improved, or redesigned products to consumer panels of women, in advance of release to the market, for their reactions and suggestions

By employing their own or outside research organizations to conduct carefully preplanned studies, contests, inquiries, and canvasses among women to ascertain their wants, likes and dislikes, and prejudices, and to obtain their suggestions concerning product preparation, performance, and distribution. These must be handled tactfully as well as scientifically, to gain women's respect, since women are typically suspicious of propaganda efforts

By contacting women who are leaders in their communities, to help remove prejudices or misconceptions among women concerning your type of product, its quality and performance, the integrity and reasonableness of your advertising and selling, justification of your price structure and costs of distribution, the acceptability or excellence of your employee relations, and your company's stand on issues of the day (since women love to champion and defend causes)

By obtaining women as members of consumer advisory councils for larger retail stores, submitting to them as groups various problems concerning store operation and public relations. Sometimes a different group of women—customers and community leaders—is invited in for each of a series of store receptions or teas, at which similar matters are presented to each group for discussion and advice

By inviting customer groups, as well as wives of employees and their women friends, to company open houses or plant or store tours, with well informed and friendly guides, a carefully simplified explanatory talk by a suitable executive, refreshments, and a suitable souvenir booklet or other memory items

By founding research scholarships for women students in suitable colleges and universities

Study the youth market. During the war years, "teen-agers" gained new importance as job holders and income producers, as purchasers for the home, and as an identified group for product designing, marketing recognition, and even their own publications. They have, definitely and distinctively, their own tastes and modes of expressing them. In studying the youth market—

Have your inquiries concerning the young people's tastes and wants determined directly from those young people; no adults are qualified to speak for them

Use interviewers of their own age—not adults, because—

Youth are suspicious of the motives and tastes of adult interviewers who cannot meet them on their level and "talk their lingo"

Youth are liable to color their replies to adult interviewers so as to "tell them what they want to hear"

Some youth delight in misleading adults as to their ideas, tastes, and standards

Think in terms of planning separate shopping facilities that will attract and please them, advertising directed toward their own field of group interests, their own fashion shows, sponsored clubs, and other special events

Set up independent consumer panels among the youth group for determining their reactions to proposed new products, and their style acceptance

Explore the possibility and advisability of having high-school advisory boards for retail-store guidance, like those at the adult and college levels of taste

Include teen-age representatives for radio forums, discussion panels at business clinics, and in committees planning for civic commemorative and promotional events

Analyze the older folks' market. People well along into advanced years are steadily becoming of more significance marketwise, and they have their own tastes and preferences. Some of the larger department stores are recognizing this group through such means as special fashion shows and store parties for great-grandparents or for people over eighty.

Organize for prompt satisfactory service. This idea is perpetually new for too many organizations, since it is disregarded or handled perfunctorily in too many instances. Plan, organize, check, and recheck to assure that—

Sales orders and repair orders are carefully written out in full detail, with attention to terms, delivery dates, and conditions

Sales guaranties, as to terms and limitations, are made clear to customers

Price estimates for special or repair work are carefully made and properly recorded for quick future reference

Customers wanting older parts or repair jobs are not brushed off as nuisances but given prompt attention and full courtesy

Special or repair work is carefully inspected before its release to customers

Careful records are maintained for all special and repair work, as a springboard to later contacts with customers and to enable further remedial work if later required

Employees are carefully trained to take down full details of telephoned or personal complaints and to tell the complaining customer what sort of aid can be expected, and when

Customers can obtain price or other information over the telephone without irritating long delays

Commitments on deliveries, pickups, special processing, and the like will be faithfully kept or the customer notified of the change in plans a reasonable time in advance of scheduled need

Promises to "call you back" on telephoned inquiries are promptly and faithfully redeemed

Substitute executives are specified and available to take telephone calls for executives out of town, ill, on vacation, out to lunch, or "in conference"

Inquiries by mail for samples, prices, catalogues, bulletins, or other information are answered promptly (not weeks later) and fully (not one question, with other inquiries blithely ignored). Besides customers, this may include your own salesmen's requests for special information, bids and estimates, statements of policy, data on inventories, deliveries, and credit (better check)

A competent executive is designated as an "alibi hound" to trace down to their causes all broken promises, unsatisfied complaints and inquiries, and irritating and frustrating cases of "giving the customer the old runaround" and to make carefully thought-out recommendations for remedying these breaches of good customer relations

Study packaging, wrapping, and delivery. Customers are as much interested in *how* they receive merchandise and services supplied them as in *what* they get. A competitor may often furnish the same goods and services that you do, but he may do it more acceptably. Customers will decide—and steer their trade where best pleased. So check to—

Make sure that packages provided for your products—

Are pleasing in appearance

Are easily stored on dealers' shelves, with economy in display or storage space required

Fully protect the merchandise according to its nature

Are easy to open and carry clear and legible instructions to facilitate the opening

Are such as to contribute to the salability of the goods

Determine whether the packages might be designed to have a reuse value to customers, when emptied of the original contents (Have you used the services of an expert package designer?)

Consider whether it will not be desirable to place on the package an offer to replace unsatisfactory merchandise. The customer will note the offer favorably, even though she may not take the trouble to replace an off-quality package that comes into her hands

Assure that shipping cases and methods of packing, checking, and billing are such as to bring your goods into dealers' or other customers' hands in prime, or at least acceptable, condition

Instruct your salesmen to inquire and check up frequently on arrival condition of shipments reaching customers and to recommend remedies for faults found

Have stockkeepers and deliverymen carefully trained in handling merchandise within your plant and in trucks and other delivery and moving equipment

Arrange to have your deliverymen convincingly schooled in the idea that they represent your institution to customers to whom they deliver goods. A trucker can build goodwill by inquiring concerning the order in which a building contractor wants a truck of material unloaded and stored, with the order of next use in mind. Similarly, for order of placing goods into storage in a warehouse or for routing through a store's receiving and marking rooms

Encourage your deliverymen (and salesmen) to note customers' special facilities, or the lack of them, so that your company might handle a specified customer's shipments in a particularly considerate manner. For example, you might please and accommodate a customer by delivering your goods on pallets for a plant equipped with pallet trucks in its warehousing

Stimulate your deliverymen to be considerate of the customers' interests so that they will do no damage with their trucks, will be careful not to track dirt into customers' homes, and will show reasonable courtesy to other customers in their cars on the highway

Train your delivery force to be alert as they enter places of business and customers' homes to notice needs for the company's goods and services which can be introduced tactfully in a manner such as to build goodwill for the interested firm and its men. Some small retailers make it a practice to handle personally the first delivery to the home of a new customer, making such observations as well as impressing the customer with the personal interest taken in cultivating her trade

Study customer appreciation. Companies of all kinds send out cards or letters at Christmas or New Year's expressing appreciation of the customers' business and good relations during the year. These are obviously forms sent out wholesale. Retail stores often send out letters, apparently signed by the vice-president, stating that the store has greatly missed the customer because of her failure to use her charge account in recent weeks. No matter how skillfully the fill-ins of names and addresses are done, customers recognize these for the form letters that they are. But really personal letters from a known company executive can carry considerable weight in building customer goodwill. Have you tried these?

A letter expressing appreciation of a customer's long-time record of making prompt payments, with few returns or claims for adjustments. (The letter should have no other purpose whatever, such as enclosing a new price list or catalogue or mentioning an exhibit at an approaching trade show; it should be *pure appreciation*)

A letter of recollection and appreciation on the fifth, tenth, fifteenth, etc., anniversary of the opening of a customer's account. (Obviously it will require some digging through ledgers and correspondence to establish these facts.) So much the better if the letter can include some personalized recollection, "Do you remember, Bill, when . . .?"

A personal letter of congratulation to a customer who is opening a new or enlarged plant or store, a well-known schoolteacher on an advanced anniversary of her service with the local schools, or a public official, civic leader, or member of the clergy reaching a similar anniversary in years of service to his community

9. *Customer relations for manufacturers*

Dealer relations. Dealers have been found to favor—

Inquiries from manufacturers concerning the types of dealers' helps they desire and the forms of selling and advertising support they consider most valuable to them, rather than dealer campaigns dropped upon them ready-made and inflexible

Manufacturers' salesmen who—

- Are trained to do quick, competent, confident selling, saving the dealers' time and avoiding uncertainty or confusion
- Are interested in each customer's opportunities, problems, and plans
- Are competent to estimate the dealers' stock needs accurately, avoiding either starved stocks or overloaded inventories
- Are able to suggest ideas for improved operations
- Are fully informed concerning new uses for your products and your new services available
- Are convinced of the superiority or quality of your line and fully able to prove it and arouse the enthusiasm of the dealers

Are competent to do an immediate job of "trouble shooting"
Are authorized and able to make adjustments in prices and credit details
Correspondence from their suppliers which is friendly and personalized
Support from the manufacturer in the form of—
Carefully planned advertising and dealer aids that reflect the dealers' and customers' viewpoints:
Counter and window display pieces and equipment
Mat services, radio scripts, and blowups of national or sectional advertisements for display in windows or within the dealer's selling space
Materials for use in handling his own customers, such as movie reels, sound slide films, other visual aids and demonstration apparatus, sample kits and swatches, structural cross sections of product, color-matching equipment, maps and road guides
Manuals, guides, and selling kits to help his own or his customers' salesmen to become better informed about the products and more capable of selling them
Booklets for ultimate customers, coaching them in the selection, use, and care of their own products and sometimes of related products
Training courses provided for dealers or their salesmen, mechanics, and service men; training demonstrations
Prompt and careful handling of investigations and plant surveys, estimates and proposals, inquiries, claims, and complaints
More careful packing of shipments, since damage in transit has become too high
Better balance of sizes and price ranges in assortments offered
Avoidance of frequent and unexplained substitutions in shipments
Competent, well-trained installation men, follow-up inspectors, maintenance men, and repair men
Better advance knowledge of proposed price and catalogue changes and of style and model obsolescence, with warnings to move the threatened older stuff
Fairness in discounts and commissions, and avoidance of competition from the manufacturer
Fair treatment of the "little fellow" against the bigger one
Often, protected lines and territories
The assurance of continuing association with a house that has solidly established, and will continue to maintain, a reputation for reliable quality, excellent performance, and unquestioned integrity in all its dealings

Other manufacturers as customers. For getting and holding the goodwill and business of other manufacturers who use your products in their own

processing, you can *make their interests obviously your own.* You can do this through—

Your advertising. Your technicians can carefully write data concerning typical problems that such customer processors may encounter in their operations. These reports should describe fully—

- Various situations as case studies
- The causes underlying each objectionable development
- Methods for appraising and testing the situation
- Techniques for rectifying the difficulty
- Precautions to be taken for avoiding or minimizing the trouble in the future

Such information can be presented to your customers through—

- Your advertisements in technical and trade magazines
- Special articles written for such magazines after proper arrangements, with proper credit given to your company and its technician or executive
- Booklets or folders to be sent through the mails to your customers, either unsolicited with an explanatory and friendly covering letter, or in response to their requests based on offers in your periodical advertising
- Literature to be left with customers by your salesmen on their calls, after careful explanation of the nature and purpose of the material

Some manufacturers have built up the processors' goodwill as well as their own trade by describing the processors' products in the manufacturers' own advertising of the materials utilized

Visits from your company executives. A call at your customer's place of business can be used to—

- Express appreciation for the business from his house, his prompt payments, and his progressiveness
- Inform him about new products or services available, particularly as they relate to his own processes and problems
- Answer his inquiries or record them for prompt answer by the technicians at your plant
- Become more familiar with his plant facilities, processes, problems, plans, and possibilities, so as to assure more intelligent and sympathetic treatment of his correspondence

Product research. You can keep customers closely informed of your progress in developing new products they can make, using your products as materials. As examples—

- A leading manufacturer of plastics and allied materials maintains a program of developing new products that molders can make profitably from its line
- Another manufacturer works on ideas in electrical appliances, carrying the development of a design job up to the point of making a

model, before making a charge for its services. The idea is then promoted to the engineering and sales personnel of electrical appliance manufacturers, producing a model at cost, if desired [7]

Study of improved production methods. Various manufacturers assign their own technicians or retain outside consultants to study and improve production methods and results, for the benefit of their customers using those methods. Others help their own vendors or suppliers improve products and methods so as to benefit from better quality, reduced costs, and a better price structure and thus contribute to their own customers' goodwill

Product evaluation. You can assist your customers in determining the quality and sales possibilities of the products they are making from your line of materials. For example—

A leading chemical company uses a technical evaluation committee at its home office to study its customers' products from the standpoints of basic design, production techniques, comparison with other materials, and resistance to potential service hazards. Samples are also sent to a consumer panel for further appraisal from the user's viewpoint

Marketing possibilities. Similarly, you can make available to these producer-customers the technical advice of your advertising and selling staffs for determining market potentials for their products and for choosing advertising media and planning sales strategy

Future industrial customers. Manufacturers in various engineering lines, such as structural steel and ceramic products, have produced highly useful handbooks and manuals bearing the company's name which are placed into the hands of technical college students. Some of the leading laboratory houses in the manufacture of pharmaceutical products each year entertain thousands of medical and pharmacy students for several days of carefully preplanned visits to their plants, with special lectures and demonstrations and suitable entertainment.

10. Customer relations for retailers

Manufacturers need to create reputations for their *lines of products*; but retailers must build prestige and customer loyalty for their *stores*. It is in retail establishments that ultimate customers are the most numerous and come into most intimate touch with the company. The retailer's very existence depends upon that customer goodwill, since customers can obtain most lines of products from other retailers in the trading area.

Naturally retailers were among the earliest developers of customer relations. But many retailers still overlook even the simpler goodwill factors. To

[7] *Business Week*, Sept. 24, 1949, pp. 41–42.

a greater degree than among trained purchasers for industrial plants, new generations of customers for retailers are coming annually into the markets. Anything that you do in the field of customer relations will be new and effective for many of them.

So you will need to plan for and maintain--

Attractive buying surroundings. When you provide a lovely store with fine shopping facilities, you flatter your customers that you recognize and defer to their good taste and love of the beautiful. You want them to be comfortable while shopping there, too. So take care along these lines:

Assure that the color combinations in your store—walls and ceiling, fixtures, and floor coverings—reflect the best in harmony and good taste. Expert advice in use of color can be obtained in most communities, from architects, painting and decorating contractors, or from art or home economics teachers in high schools or colleges

See that store arrangements are changed frequently. Women, who constitute most of your customers, like to rearrange things in their own homes, to revive interest. Purchase of interchangeable showcases, counters and tables, step-up racks and islands, cabinets, back bars, and other store equipment, from the standpoint of dimensions, will help you in avoiding monotony of arrangement

Provide doors that are easy to open and enter, broad store aisles, outside sidewalks that are kept free from obstructions and unsightly trash, safe staircases, and broad approaches to elevators and escalators

See that your store lighting is clear and adequate but free from distressing glare (consult your lighting company for tests and recommendations)

Have your store heating and air conditioning kept free from extremes of heat and coolness

Give the utmost care to cleanliness and sanitation, and to prevention of odors and objectionable noises

Avoid sweeping or other distracting cleaning during store hours

Assure that employees wear only clean, neat clothing; it is well to assure uniformity by providing rules on the subject

See that pet animals are kept out of the store, especially in food sections, and that a careful extermination program is maintained for insects and other pests

A superior selling force. We are back now into a buyers' market; customers must again be *sold.* Mere vending-machine techniques no longer serve. Customers must be persuaded that they *wish* to trade in *your* store. Assuming that you have procured suitable merchandise in acceptable quality, quantity, and assortments, and that it is properly handled and attractively displayed, then your salesmen can "make or break" all your other activities.

Test your selling force in the light of an earlier discussion in this section, "Reasons why customers left you." [8]

On the other hand, customers in a retail store typically *like* salespeople who—

Show a genuine friendly interest in learning and helping to solve the customers' problems, yet are professional in attitude

Are well informed and scrupulously honest concerning the merchandise they sell, as to its construction and sources, advantages and limitations for particular purposes, service quality, care, value in relation to price, and guaranties

Know what merchandise is advertised in the current newspapers and what is displayed in the street display windows, its prices and characteristics, where it is to be found in stock, and how to place it quickly before the customer on her indication of interest in it

Can serve their customers' interests by well-directed but unobtrusive suggestion of related merchandise, better buys, departmental specials, new goods, or goods now available which had earlier been in short supply

Can tactfully play up the store's services such as gift wrapping, counseling services, personal shopping guidance, designing and fabrication to order, and special ordering

Are fully informed about the store's policies and system and are able to make promises about deliveries, credit, layaways, return privileges, and the like

Are courteous, patient, and considerate in all matters

But to obtain, train, and retain salespeople of that description will require continuing, positive action and supervision on your part. Such traits must start at the top of the organization. Any institution is the lengthened shadow of its founder or reflects the personality of its chief.

Comforts and conveniences in retail stores. You can check on other retail stores that have provided for their customers conveniences such as the following:

A radio-equipped truck stocked with basic merchandise cruising around in one of the large store's main delivery areas is ready to make delivery within minutes after a customer phones in an order

A shoe store records all sales of children's shoes. A few months after the latest purchase, a card is mailed inviting the customer to come in to have the shoes checked

Tray luncheons are served to customers undergoing treatments in the beauty shop

A rack of umbrellas is available for free loan to customers caught in a shower

[8] P. 285.

Chairs are provided in drug departments, and a glass of ice water, for customers waiting for the delivery of their prescriptions

Small stores are beginning to furnish toilet-room facilities for mothers and their small children

Chairs are placed outside the entrances for customers arriving before the store's doors are opened

Direction sheets or booklets are handed to customers showing the location in the store for all departments and numerous important types of merchandise

In smaller retail stores, clearly visible department signs, often neon lighted, are placed over wall cases or in other strategic locations

Special inside displays of merchandise featured in outside display windows are shown prominently, so as to save customers the trouble of inquiring and searching for it

Numerous stores are placing cards carrying merchandise information next to goods on display or are attaching informative tags or labels to the goods, so as to aid customers' decisions, minimize misunderstandings, and speed selling service

Price lists are posted by the telephone in some smaller stores, for answering inquiries. Clerks are trained to obtain the customer's name and address early in the conversation so that she will not hang up abruptly after stating her order and be disappointed at receiving no delivery

Personal shoppers and interpreters acting in an advisory capacity are provided to conduct customers on requested shopping tours through the store or to handle orders sent in by mail or telephone

Budget counselors help lower income customers to study planned purchases and adjust them to income and earlier financial obligations

Special counselors are available for career girls, for brides, for grooms and their ushers, for expectant mothers, for home decorating, for sewing, knitting, and make-over work, and for hostesses' problems

A gift counselor who will record dates of anniversaries for businessmen or other customers and, subject to carefully recorded preferences and instructions, will provide suitable gifts from the store's stocks or special orders to cover those occasions

Special pre-Christmas gift and fashion shows for men customers only, on selected evenings

Use of the store's auditorium for women's club meetings, for high school plays, for special fashion shows in which the group's members may assist as models, for Saturday morning movie showings and theatricals for customers' young children, for evening meetings of civic groups

Tours of the store "behind the scenes" for women's groups or classes of commercial students in the schools

Providing, in a drugstore or drug department, a stock of crutches, baby scales, wheel chairs, and oxygen tents for loan to customers or doctors

Maintenance of convenient files such as a list of dressmakers in a department store, a register of trained nurses in a small-town drugstore, or a roster of plumbers in a hardware store selling kitchen and bathroom fixtures

Change-making machines near public telephones and a supply of small change in the possession of doormen to assist patrons in paying for taxicabs

A supply of paper tissues beside a self-service meat counter in a supermarket, with which customers can wipe their hands

Keeping order-taking telephone operators on duty late evenings, early mornings, or sometimes on Sundays so that customers may phone in their orders of advertised merchandise at their own convenience. A Detroit men's apparel store installed a microphone and coin slot outside its show window so that a customer could deposit his quarter to activate the recording mechanism inside and dictate an order for numbered merchandise in the window to be delivered next day, with the deposit credited in payment

Modernization or rearrangements of service facilities so that customers will not need to stand in long lines awaiting service in your restaurants, at the post office, gift-wrapping booth, or at cashier, layaway, and adjustment desks

Such customary services as gift-wrapping departments, post-office branches, checkrooms, supervised nurseries for children, rest and writing rooms, check cashing, ticket-sales booths, a rack of city directories or telephone books from other cities, services of a notary public, appointment corners or books

Care and accuracy in services. Customers have come to expect extensive services in retail stores and they want them well handled. Even if errors have been reduced to a fraction of 1 per cent in your store, any fault is 100 per cent to the customer who suffers from it. So check on—

Faults of courtesy. All types of employees who contact the public can often be inconsiderate, abrupt, inattentive, uninformed, unobliging, impatient, impolite, chewing gum or smoking in presence of customers who are obviously displeased, or publicly manicuring or renewing make-up. Well-enforced rules should care thoroughly for all such matters.

Putting the customer at ease. This is especially essential when the customer is facing an interview for establishing a credit account with your store, making a claim for adjustment, or interviewing a buyer or executive when trying to trace down a source for some wanted merchandise or service agency.

Keeping promises. Special effort often must be made to assure that employees understand thoroughly the limits within which they can promise

additional shipments of wanted merchandise, deliveries at certain specified times, return privileges, credit concessions, and the like. When a special promise is made, it must be kept religiously. For example, a store's chief executive remained at his office overtime to assure that an awaited wedding dress was completed as promised, and he delivered the gown in his personal car to the anxious young bride.

Mechanical faults in system. All care must be taken to prevent or minimize the charging of merchandise bought on credit to wrong accounts, delay in posting payments or returns, misspelling of customers' names, or misuse of titles, as "Mr." for "Miss." Local obituary columns should be watched closely and the store's mailing lists corrected at once to assure that advertising pieces, collection letters, or solicitations to use inactive accounts are not addressed to customers recently deceased. (Cases have been known in which such letters have been mailed for persons 5 years dead.) Simple mistakes in delivery may be easily explained. But those alibis do not remove the disappointment and resentment of a customer at having her plans ruined. A customer does not soon forget or forgive her embarrassment when an article bought to be carefully gift-wrapped and delivered to a friend reaches that friend in rough unattractive packing with the sales slip, its price very evident, tucked carelessly into the array.

Goodwill-building services outside the store. You can join other leading stores in employing these activities for goodwill building:

Using the "welcome wagon" or similar greeting services to bring your store to the favorable attention of newcomers to the area

Selecting and training competent persons in your organization to make public-speaking appearances to represent your store. Your fashionists, home decorators, advertising staff, and personnel officers can appear before women's clubs, school and college classes, parent-teacher groups, men's luncheon clubs, church and service clubs, college fraternities and sororities, and local radio forums

Making store executives available as judges for school debates and contests, for discussion panels at business clinics, and for some of the appearances listed above

Sponsoring hobby clubs and athletic teams of local schools, helping maintain clubs and summer camps for underprivileged children, contributing prizes for athletic, dramatic, or handicraft contests

Contributing display space in store windows or inside the store and mention in the store's advertisements for featuring exhibits of boy or girl scout handicraft, educational or historical exhibits, community charities, and community planning and development events

Cooperating in making available to local children the enjoyment of special children's dramatic events, symphony concerts, and juvenile art exhibits

Sponsoring research and development activities. For example, a large mail-order house has been cooperating with agricultural authorities among Southern farmers to help bring about better crop diversification and stockbreeding, offering young animals for farm boys to raise, paying for the services of lecturers from agricultural colleges, providing prizes for those getting the best results, and setting up numerous college scholarships for needy farm boys

Sponsoring and underwriting the erection and maintenance of local historical landmarks or memorials; assisting with development foundations

Making the time and efforts of your executives available for earnest, active participation and leadership in activities and organizations for community betterment

Summation

If and when you undertake a program of customer relations, identifying and supporting it as such, *remember* that

Public relations is an attitude rather than a technique; it is a policy rather than a department It is the external evidence of having conducted the internal affairs of a business in a way of which you can be proud.[9]

Any realistic and effective program must—

Start from the top and receive the full, honest support of your executives. (It's a "shirt-sleeves job")

Frankly and correctly reflect the policies of your company

Be thoroughly "sold" to all levels of employees

Pivot continually around the *ascertained* interests of customers

Be set up with definite, specific objectives

Be subject to continuous and careful follow-up, evaluation, and adjustment as necessary

Customer relations cannot be separated from your company's other policies:

Employee relations (discussed in Section 9) will determine whether your company's employees possess the interest, morale, and enthusiasm to carry out an adopted customer relations program, convincingly

Stockholder relations (discussed in Section 10) can obtain intelligent understanding of, and support for, an effective customer relations program

Vendor-creditor relations will assure that your suppliers will cooperate effectively in your merchandising plans. They and your governmental, community, and press relations will all contribute their share to the building of an excellent reputation for your company, spreading amazingly, for good or for bad, "along the business grapevine"

[9] Otto Kleppner, *Advertising Procedure*, 4th ed., Prentice-Hall, Inc., New York, 1950.

Section 9

HOW TO ORGANIZE FOR GOOD EMPLOYEE RELATIONS

BY

LEE H. HILL

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HOW TO ORGANIZE FOR GOOD EMPLOYEE RELATIONS

Introduction

Labor relations are often considered the sum and substance of employee relations.

Happily, that is not true. Labor relations cover the relatively limited area of contact between management and the labor unions representing some or all of its employees. Employee relations cover *all* the myriad contacts between the company and its employees.

Although the relationship between management and individual employees is often forgotten when public attention is focused on management-vs.-union conflict, management cannot afford to overlook the broader, more fundamental relationship.

Unfortunately, some managements themselves have been misled by the assumption that their chief concern is with *union* relations, overlooking the far more significant and basic factor of *employee* relations.

Management-employee contacts. When an employee is hired, there is no labor-relations aspect to his selection as an employee and his assignment to a specific occupation or department. The employer selects from among those available the worker best qualified for the specific job. Subsequently, the employee may be subjected to an orientation program, during which he learns of the history of the company and something about its products or services. He is advised of company employee policies, is given some preliminary instructions concerning safety on the job, and is told something about the benefits to which he becomes entitled as an employee of the company. Then he is introduced to his foreman. He is assigned to a particular job. A foreman or instructor may show him how his machine operates or how the job is to be performed, or may tell him from whom he is to take orders, when and where he is to have lunch, where and how he may get needed tools, what to do in case he feels sick or gets hurt, when and how he will be paid, and all the other details of the starting routine. After the new employee goes to work, probably the most important single factor in his mind is the attitude of his foreman and the care that his foreman takes in helping him to bridge that difficult adjustment period until the new employee becomes "one of the gang."

During this period the union steward may approach him with reference to union membership, but the employee's main concern is whether or not he is making the grade, whether the foreman approves of his work and actions, and whether the other employees accept him as one of them.

When he receives his pay check at the end of the pay period, that pay check comes not from the union, but from the paymaster of the company. It is true the union may have negotiated the wage rates and therefore may bear some responsibility for the amount of the check, but the connection is an indirect one and the employee very properly regards his check as coming from the company and the amount of the check as being determined by the company. If the employee has some question in his mind, the natural person to whom he turns is his immediate supervisor. It is only when the employee does not get a satisfactory solution to his problem and feels it necessary to call in a union steward that *labor relations* enter the picture.

In addition to these points of contact, there are such important factors as safety on the job, availability of machine safeguards and personal protective devices, adequacy of the machines that he works on, the flow of material, the making of time studies and the setting of incentive rates, the provision of lockers and sanitary facilities, organized recreation, group insurance, employee benefit associations, and communications to and from the company. All these are but some of the points of contact between employee and management which go to make up the complete entity of employer-employee training, counseling, welfare activities, requests for transfers, individual wage increases, promotions, the suggestion system, and use and issuance of personal protective equipment and tools. Only a very small proportion of these are ordinarily included in the term "labor relations."

1. Evidence of poor employee relations

Poor employee relations manifest themselves in a variety of ways.

Absenteeism. A rising rate of absenteeism is one reliable index of growing employee discontent. Sometimes the employee stays home because of a slight indisposition that he would normally take in his stride. Sometimes he may find other pretexts, for the average worker hates to admit, even to himself, that his job has become so distasteful that he prefers to stay home and listen to "soap operas" rather than go to work.

In themselves, absenteeism figures may be considered a fair rule-of-thumb index of employee morale. They assume even greater significance, however, if each absence is investigated to determine the real underlying cause, and if the various causes are then tabulated, analyzed and interpreted, and brought to the attention of top management. Absentee figures have an important story to tell, if management will but take the pains to evaluate their signifi-

cance. Both from the viewpoint of interrupted production and the viewpoint of employee relations, absenteeism deserves more study than it normally receives.

Requests for transfers. Similarly, a request for a transfer may be a sign of discontent with work, supervisor, environment, or fellow employees. Normal human inertia tends to make people prefer to remain on the same job and a part of the same informal group. Changing jobs requires effort and adjustment to a new environment, new people, and usually somewhat different work. When an employee requests a transfer, it is well to look into the situation to determine the root of any possible discontent that might be sufficient to make him overcome this normal inertia.

High turnover. A high rate of turnover is an even more urgent danger signal for alert management, and particularly so when it affects the long-service employee. He prefers the environment he knows, with all its imperfections, to the turmoil and readjustment involved in finding and fitting into another job with a different company. And he is likely to think twice before he sacrifices the seniority "rights" associated with most jobs. He has a stake in his present job.

Therefore, when he is so upset and dissatisfied with his present job that he decides to change, there is likely to be a serious underlying cause.

Disciplinary difficulties. Poor employee relations are likely to lead to deterioration of plant discipline. If an employee believes that management has no interest in him or, what is even worse, that management has no use for him, he is not likely to respond to the normal disciplinary requirements of any civilized group. Disciplinary action is necessarily based on regard for others and on respect for authority. If employee relations have reached such a state that employees disregard management's authority, discipline goes out the window. Loss of control within an organization may result from loss of respect for that authority which is necessary to the smooth, orderly operation of an industrial plant.

Cleavages. Militant unionism or other direct action by employees may be caused by the nature and political inclination of the union's leadership. On the other hand, continued and increasing demands on the part of unions, an excessive number of grievances, evidence of restricted production, short work stoppages, and many other manifestations of cleavage between management and employees may be the outcome of poor employee relations within the organization.

Work stoppages. The final and well-nigh inevitable climax of poor employee relations, if not corrected, is a complete interruption of the business by strike, slowdowns, or "work holiday." While it is well known that "unauthorized" strikes, "spontaneous" walkouts, and the like are not always what

they are claimed to be, many work stoppages are the end result of poor employee relations. In many cases a strike is an explosion resulting when long-smoldering dissatisfactions are suddenly touched off by what may appear to be a trivial incident. Unfortunately, some managements are unaware of the dangerous status of their employee relations until the explosion of a strike brings it dramatically to their attention. And even then, management is likely to lay misplaced emphasis on *labor* relations rather than undertake the less glamorous but more fundamental job of building sound employee relations.

Summary. Where good employee relations do not exist, it is easy to blame many things for the condition. Some point to the employees and say that they are lazy, unreasonable, or uncooperative. Some point to the union and say that it fights management and prevents management from doing the right thing by its employees. Some point to the union leaders and say that they are trying to undermine management or invade the sphere of management. Some point to union-biased legislation and say that management's hands are tied. Some point to the national administration and say that it appeases organized labor and is opposed to progress in enterprise. Others point to the critical times in which we live and say that in these days we can't do what we want to, anyway.

There may be some element of truth in all these explanations. But the fact remains that, after making due allowance for all these factors beyond the control of management, the most decisive factor in creating a sound employer-employee relationship is a management that is alert, sound, enlightened, and appreciative of the critical importance of sound employee relations.

2. *Employee wants*

Many surveys have been made in an effort to determine what employees want and which of their wants are the most important to them. It is not surprising to find no unanimity about the results of these surveys and opinions. Americans are a heterogeneous people, composed of segments of different backgrounds and cultures. There can normally be no unanimity on such questions as opportunity vs. security, shorter hours vs. more pay, etc.

Moreover, the relative importance of various employee wants changes with time and economic conditions. The things that seemed most important to workers in 1933 seemed of much less importance in 1947. In 1933 widespread unemployment served to underscore the need for job opportunity. At that time much was heard about the right to work, and make-work projects and share-the-work plans were in vogue. In 1946, as war production tapered off and industry was involved in reconverting to civilian production and

Employee Wants

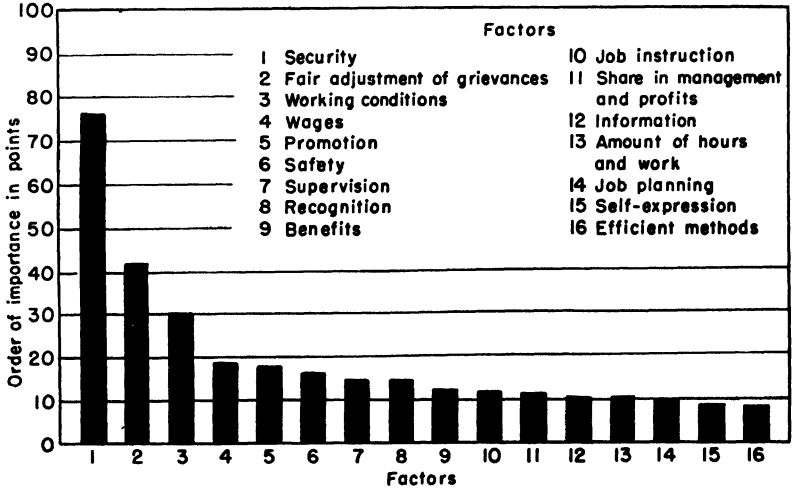
(Order of importance of factors affecting the employee relationship, as summarized from available surveys *)

Factors	*Order of importance*	*Reciprocal*
1. Security	1.33	0.751
2. Fair adjustment of grievances	2.40	0.417
3. Working conditions	3.33	0.300
4. Wages	5.33	0.188
5. Promotion	5 55	0.180
6. Safety	6 00	0.167
7. Supervision	6 80	0.147
8. Recognition	6.88	0 145
9. Benefits	8 00	0.125
10. Job instruction	8.50	0.118
11. Share in management and profits	9.00	0.111
12. Information	9.63	0 104
13. Amount of hours and work	9.70	0.103
14. Job planning	10 67	0 094
15. Self-expression	11 80	0 085
16 Efficient methods	12.00	0.083

* 1. Available surveys as presented in the material on hand are dissimilar to the extent that the same factors do not always appear in each survey.

2. The number of people who answered each survey is not known; therefore it is impossible to obtain weighted values per factor used.

3 The ranking shown on the chart is tentative because all surveys did not include the same factors. For example, the No. 1 factor was obtained from three surveys, while supervision, which ranks seventh, was based on 15 survey results.



Relative importance of employee wants. (From Hill, Lee H., "Pattern for Good Labor Relations," McGraw-Hill Book Company, Inc, 1947.)

services, the emphasis changed to maintenance of peak wartime take-home pay. Instead of plans for spreading the work, employees became much more interested in such matters as getting back to a 40-hour week, with hourly wage-rate increases adequate to maintain high wartime earnings.

Employee wants also depend in large measure upon the actions of the management of the enterprise in which they are employed (see table on page 309).

General rating of employee wants. The foregoing chart summarizes the findings of numerous investigations with respect to this subject. No factor can properly be considered independently of others, the sole purpose of the illustration being to get some indication of employees' views on the relative importance of the various factors pertaining to their work.

While security is listed as the most important of employee wants, it should be noted that many of the surveys were taken during the depression, when security denoted the difference between having a job and being thrown on relief. But in addition to job continuity, security also means personal security—*i.e.*, that the employee can trust his employer, that he can count on being accepted as "one of the gang" in his work group, and that he will not be discriminated against. It is in large measure the search for security that accounts for employees joining with others to form unions, since the very act of doing things in concert lends an aura of security and approval to employees' acts.

The employee's feeling of security may be enhanced by good management in many ways. In the first place, management's complete assumption of its responsibility for adequate planning can result in greatly increased regularization of employment, minimizing the peaks and valleys that characterize many company employment charts. Secondly, a considerable part of the employee's lack of security may be due to the fact that he knows little about the company or about his status in it. Adequate information can help in this respect, together with an indication from the supervisor that he knows the type of work the employee is doing and the problems he is meeting and that his progress is being noted. And, finally, it is up to management to sell the employee the conviction that he will be fairly treated. In this connection it is deeds, rather than words, that count.

The employee's second most important need is the knowledge that complaints will be fairly and promptly heard and appropriate action taken. If the employee has a valid complaint, it is up to management to do something about it—and do it promptly. If the employee's complaint is based on misunderstanding or imagination, he deserves an explanation.

Of the three most important employee needs, working conditions are

listed as third. Working conditions, in the sense used here, refer not only to the physical working environment, but also to the relationship between the employee and his supervisor, and other psychological factors. Many employers have gone to great lengths to provide excellent physical working conditions for their employees and have been surprised that better relationships have not automatically resulted. Employee good will cannot be bought by lush expenditures. It has to be earned by proving to employees that they are being treated like the human beings that they are.

It is interesting to note that, in this summary of many investigations, wages are a poor fourth in the listing of important employee needs, rather than the first, as many employers assume. Rates of pay and working conditions are high on practically every list of union demands. Entire industries have ceased to function and national crises have arisen over the question of an hourly wage increase. But the individual employee is usually far more concerned with the question whether his rate of pay is fair as compared with others in his department (and, to a lesser extent, in comparison with others in his plant and community) than with the absolute amount of money he takes home on payday. His relative pay keenly affects his pride and dignity, and these are of most concern to him. Accordingly, wise managements are concerned with job evaluation, merit-rating systems, and other techniques for attaining and maintaining a just and fair rate schedule, and positioning employees appropriately within the rate ranges. It is quite probable, however, that wages might come very close to the top of the list in times of rapidly rising prices.

Next to the proper wage for the job, employees are interested in receiving pay increases when deserved. A pay increase means more than increased earnings; it is a symbol of progress and of recognition of the employee's work. Accordingly, a pay increase based on merit is far more significant to the employee than one based on length of service.

The fact that in so many cases wages constitute the chief bone of contention between management and unions in collective bargaining may be interpreted to mean either that the union seizes on wages as a popular subject on which to make demands or that wages have become a symbol for other employee needs which have not been met and about which the union can take but limited effective action.

Of the remaining employee wants listed on the chart, none of which are nearly as important as the first three, it may be noted that the chief employee consideration as to promotions is that they should be made fairly, with due recognition for merit and ability as well as for length of service. Employees properly consider it to be management's responsibility to provide a safe place

to work, with appropriate machinery safeguards and personal protective devices. Failure on the part of management to provide these is regarded as evidence of management's disregard of employee welfare.

While supervision is listed seventh on the chart, it is obvious that every phase of the relationship between management and employees is affected by the kind of immediate supervision provided for employees.

In rating "recognition as an individual," it is doubtful whether many employees understood what was meant. Employees deeply feel the need for recognition (by being accepted as a member of the work group, being consulted by the boss, etc.) but are very unlikely to talk about it in those terms.

Employee benefits (including pensions, medical services, vacations, and insurance plans) rank ninth on this listing of employee wants.

Job instruction, tenth in order of importance, represents the employee's desire to be told what is expected of him and how he may best perform it. Many employee-training programs are helpful in this respect, but in the great majority of cases, job instruction is left to the employee's immediate foreman or instructor.

Employees are human. Regardless of temporary variations in direction, regardless of passing catchwords and slogans, one thing seems unalterable and fixed in the catechism of employee wants: *Every employee wants to be treated like a human being.*

That is a simple statement to make, but its implications are profound. Every slight to his personal importance, every wound to his pride, every insult to his dignity, will find some way to express itself. The slight may be unintentional, the wound purely accidental, the insult mere carelessness; but the effect on the employee will be felt and will seek to make itself heard.

Being a human being, the employee wants his pride and dignity respected. For that reason alone, a public reprimand can wreak havoc.

Pride in work. Every self-respecting man takes pride in his work. While it may be true that the creative pride of the artisan has been reduced because mass production has resulted in skill dilution, it is too often overlooked that the man whose job it is to tighten nut No. 3,467 as the cars go by on the conveyer takes real pride in his work. He needs to feel the significance of his contribution.

Pride in one's work is not only a basic expression of individual dignity; it is one of the most useful characteristics for management to cultivate and develop.

A man's just pride in his work is a good thing for a man to have. It is a good thing for management to encourage. Given pride in his work, the employee will give it his best. Take away his pride, and the work loses significance.

Much has been said about the workers' loss of pride because work simplification and mass production have led to less need for skill and judgment. While it is true that there are now relatively few workers who take a single operation all the way through to make a complete product, nevertheless it is not to be overlooked that each worker's self-respect requires that he attribute significance to his particular part of the operation.

Acceptance by fellow employees. Every employee wants to be treated like a human being. He wants and needs the acceptance and approval of his fellow employees. And to get it he will cut his income, if necessary, or help out a fellow employee, or badger his foreman. If the group, with or without union intervention, has agreed to restrict production to an agreed level, most employees will participate in controlling output, even though it may result in loss in take-home pay, in order to retain the approval of fellow employees. Other employees have sought to gain the admiration of fellow employees by egging on the foreman, by pretending to misunderstand instructions, or by getting the foreman to "blow his top." These are cases in which a regard for approbation by fellow employees is more important to the individual employee's pride than his chances of promotion or his acceptance by representatives of management.

Evidence of management interest. It is the need for self-respect that makes management interest in employee suggestions so effective. Sometimes the mere fact that the supervisor has taken the trouble to get the facts makes the employee realize that management is interested in him. For example, one employee submitted a safety suggestion involving the application of a lift that he had seen in operation in a railroad shop. A thorough investigation was made, including a visit to the railroad shop to see the lift in operation, and the matter was fully discussed with the suggester. Despite the fact that the suggestion was not adopted, the employee expressed his appreciation for the thorough consideration that had been given his suggestion. He knew and management knew that the decision was sound, and both learned something in the process. The obvious consideration of the suggestion and the explanation for its nonacceptance did more to build a sound relationship than if the employee had received a $50 suggestion award, for the employee knew that his suggestion had been treated with all the respect it deserved.

Fair play. Despite the normal desire for progress and advancement, not every employee wants to be president of the company. Many employees do not want promotion and the responsibilities that go with it. But it makes a great difference to every employee, regardless of his ambition, whether promotion in the company is based on merit or on favoritism. Promotion by whim or favoritism not only hurts the employee who should have been promoted, but arouses resentment in most other employees.

A consideration of the fundamental importance of the employee's desire to be recognized as a human being inevitably leads to the conclusion that the most important relationship in which the employee is involved is that between him and his immediate supervisor. As Morris S. Viteles stated, "The relationship between first-line supervisors and the individual workman is of more importance in determining the attitude, morale, general happiness, and efficiency of the employee than any other single factor." [1]

It follows, then, that if management is sincere in pursuing the goal of ideal employee relations, it will give primary importance to the problem of selection and training of the first level of supervision. Training, of course, includes not only formal training but the examples set and instructions issued by higher levels of management.

The union's role. If it is true that the employee's most serious need is to be treated like a human being, it may very well be asked why union demands are silent on this score.

The answer seems to be twofold. In the first place, no one has yet been able to write a contract specifying the content of "treatment like a human being." Secondly, that treatment must come from management. The union cannot supplant management in assuring the employee that he will be treated like a human being. That is the human by-product of the employee's immediate supervision, backed up by top-management interest and appropriate company policies and organization. Management selects and trains the foremen; management determines the policies and organization for putting them into effect; management determines the working conditions. Management and management alone can determine how much effort it will devote to the problem of showing the employee that it recognizes him as a human being.

3. *Employee morale*

The employer who is truly and vitally concerned about employee relations finds the root of that concern not only in the knowledge that it is good business to have good employee relations, but also in his personal interest in and attitude toward his employees.

While high morale and good employee relations are not identical, it is clear that the establishment of good employee relations is the major factor in high employee morale. Whether morale be measured in the employee's attitude toward the company or in the degree of his satisfaction with his work environment, good employee relations inevitably lead to high morale.

"Morale" is a much abused word. Not only is it the pretext for all kinds of nonsense, from questionable motion pictures to the fanfare of "pin-up"

[1] Morris S. Viteles, *The Science of Work*, W. W. Norton & Company, New York, 1934.

publicity, but it has resulted in all kinds of mistaken ventures on the theory that high morale can be created by the fluff of high-pressure propaganda exemplified by music on the job, patriotic parties, inspirational programs, rallies, letters, bulletins, and drives, shopping services, beauty parlors in the plant, door prizes, and beauty contests. Some or all of these may have their place in specific situations. But they cannot safely be substituted for the basic factors that determine morale in the employer-employee relationship.

Employee "morale" may be defined as the attitude of the employee toward his work environment, and more specifically toward the employer as represented by the foreman and higher supervision.

In a sense, the state of the employee's morale may be dependent upon the degree to which the employee's deep-rooted wants are affected by his work situation. That is, morale is likely to be high if the employee is convinced that—

His job is secure so long as he continues to do satisfactory work
His supervisor recognizes him as an individual human being and treats him as such
He is being treated fairly by the employer—and has an adequate opportunity to be heard if he isn't being treated fairly
His company is interested in his welfare and progress
His work is important and significant
He knows his company and its products, and when changes are made he is notified in advance and is told why
The company recognizes when he does outstanding work (and, conversely, the company is alert to condemn shoddy work by those who try to "get away with it")
There is a fair opportunity for advancement
The company is willing to listen to his suggestions and consider them on their merits
His company is well thought of in the community

4. Organizing for good employee relations

How, then, does a management that is really concerned about good employee relations go about achieving them?

There is an unfortunate belief that all that is required to establish good employee relations is to "do a selling job." Some people believe that the employees can be sold on the company as one would promote a new brand of tooth paste. Good employee relations can be achieved, but not that simply. Good employee relations are like any other commodity: they cannot be "sold" for long unless the product to be sold is good. In the case of employee relations, that "product" is a vital interest in employee welfare, buttressed by sound, fair, definite employee policies, administered by a com-

petent, carefully selected, and thoroughly trained management group. Neither good intentions nor good policies alone can result in good employee relations. But both of these can bring about good employee relations if administered by sound management.

In the first place, the interest in good employee relations must start at the top. It has been well said that an organization is but the lengthened shadow of the chief executive. If the chief operating executive (whether he has the title of chairman of the board, president, executive vice-president, or general manager) is vitally interested in good employee relations, he will infuse that interest throughout the organization. If he has no real concern in sound employee relations, anyone else in the organization, whether he is in charge of production or head of the employee-relations department, will have an uphill battle, with the odds against him.

Within limitations, every business management carries its own employee-relations destiny in its own hands.

Good employee relations do not come into existence simply by wishing for them. The first step to implement such a desire is to *organize* for good employee relations.

Management knows that production requires a manufacturing organization, and marketing requires a sales organization. Similarly, in order to achieve sound employee relations, management must be prepared to maintain in its organization an employee-relations organization or its equivalent (sometimes referred to as the industrial-relations, or the human-relations, or the personnel organization).

But the employee-relations function differs from every other management function. It touches every employee in the entire organization from president to sweeper. The employee-relations department is an arm of management, and at the same time a confidant of the worker who has a gripe against management. It originates and interprets company policies in order to achieve uniformity, and at the same time is alert to human reactions that may make it desirable to make exceptions in specific cases. It has no line authority, yet advises all members of management in their relations with their subordinates. It is the source of specialized and technical information, and yet it must keep its feet on the ground, and appreciate the importance of the very practical work environment and human reaction of every employee in the organization.

Because it is in intimate contact with every element of the organization, the operations of the employee-relations department are doomed to failure unless its functions are clearly understood by top management and have its backing. It is not enough for top management to set up an elaborate employee-relations department and say, "That takes care of our employee

relations. Now we can forget that phase of the business and devote our attention to production, sales, and finance." By setting up an employee-relations department, top management simply provides additional help in getting its employee relations on a sound basis; but employee relations remain a major function of every supervisor, from the assistant foreman to the president. By their very nature, employee relations are not a separate segment or function that can be delegated to a specialist for handling. Employee-relations department specialists can assist, evaluate, investigate, interpret, recommend, advise, and carry out a few specialized functions, but they cannot replace the supervisor in his role as management representative in the employer-employee relationship.

Fundamentally, employee relations are the living relationship between every employee and his immediate supervisor. The cultivation of that relationship cannot be delegated to anyone else. The employee-relations department cannot segregate and take over the complete task of building sound employee relations.

Staff. It is this characteristic of inseparability between the supervisor as an operating link of the organization and as the core of the management-employee relationship that is responsible for the employee-relations department's being designated a *staff* department. As a staff department, it replaces the operating or line department only as to certain specialized functions. It does not replace the line supervisor as the major representative of company authority and source of company decisions with respect to individual employees. It is available for advising the supervisor with respect to personnel or labor-relations matters when he is in doubt. It collects necessary personnel and labor-relations information to help the supervisor in his relations with his subordinates (and sometimes in his relations with his associates and superiors). It interprets and defines company policies in their application to specific situations. It forecasts and anticipates future problems and prepares appropriate company policies to cope with such problems when they arise. It reports to top management concerning the effectiveness of existing policies and practices. It is the *staff* on which the line supervisor and top management lean in employee-relations matters.

The full importance of the employee-relations department's role in the company organization can best be understood if consideration is given to its major functions.

Major organizational functions. These major functions of the employee-relations department may be grouped under three main classifications:

1. To evaluate employee policies in operation, and report to top management on the operation of existing policies, suggesting desirable changes and forecasting trends

2. To formulate, codify, and interpret company policies
3. To carry out specialized functions, such as recruitment and selection of new employees; technical assistance in safety matters; training; administration of group health and group life insurance and other welfare plans; initiation and supervision of job-evaluation plans; advice on merit ratings; provision of special employee services (such as canteens and cafeterias); assistance in labor negotiations; maintenance of channels of communication, etc.

While the last two major functions are fairly well understood, the significance of the employee-relations department as controller of the employee-relations account is not generally understood. Even those managements that appreciate the vital importance of the human element seldom look to the employee-relations department to keep them advised of the current over-all status of their employee relations.

Employee policies. Especially in the older, larger companies, "company policy" is a phrase to conjure with. There is the supervisor whose stock reason for not complying with any and every employee request is, "It's against company policy." On the other hand, there is the staid, routine mind which rejects every suggestion of change with the standard road block: "It's against company policy." To these people, company policy is a convenient subterfuge.

In the very same company, conscientious supervisors may be having a hard time trying to determine what *is* the company policy applicable, let us say, in the case of a requested transfer on the part of an employee who is doing satisfactory work in his present department. In all too many cases, the applicable company policy may be buried in the memory of the oldest living supervisor, or contained in some circular letter, long lost in somebody's files.

Written policies. Since employee relations are the everyday business of every supervisor, each with a different degree of training and understanding, company employee policies must be reduced to writing and made available to every supervisor, in order that employee policies may be known by every supervisor, and in order that application of employee policies may be uniform. Besides these obvious reasons for reducing employee policies to writing, there is another reason that is not so apparent. In any specific employee-problem situation, a decision may be made which is suitable for that specific situation but entirely unsuitable for other situations of the same class. Yet that decision may be followed as a precedent in these other situations, because no one with sufficient authority has taken the time to think it through. When, however, an employee policy is reduced to writing, someone at the policy-making level must think it through, and the resultant policy is likely

to be far sounder than one arrived at as an expedient to meet a specific situation and thereafter blindly followed.

It is sometimes objected that reducing employee policies to writing ties the hands of the line supervision and limits their discretion. It is true that dependence on written policy limits supervisory discretion. That is one of the purposes of written policies. Unlimited supervisory discretion necessarily results in departmental and even individual discrimination. If the elimination of such discrimination requires limitation of supervisory discretion, then it must be limited. But even a written policy leaves a great deal of discretion in the hands of the supervisor. There is no way in which top management can get its policies known to and carried out by first-line supervision unless such policies are reduced to writing. In fact, as has been well said, "A policy is not a policy unless it is in writing."

In order that written policies may be easily available to first-line supervision, it is obvious that in an organization of any magnitude it would be wise to develop a policy manual, preferably loose-leaf, for easy amendment, and indexed for easy reference.

The policy manual, while desirable, should not be relied upon as the sole instrument for disseminating information concerning employee policies. Discussion meetings, oral explanations, and policy-training classes are all helpful. But the best training that any supervisor can get with respect to employee policies is to have *his* superior practice those policies, especially in relation to the supervisor himself.

"That's the company policy." It is a fine thing for management to develop and apply enlightened employee policies. It is an even finer thing to know when to make exceptions in the application of policies.

It is the easiest thing in the world to apply every policy inflexibly. But mankind is too various, human situations and their effects are too different, to ensure fairness by following rules or policies, no matter how wisely prepared. Even judges find it necessary to temper justice with mercy. In the field of employee relations, policy application must be tempered with a liberal dose of judgment. In fact, while supervisors should be guided by company policies, the reason for any action should be explained on its own merits, and the trite explanation, "Sorry—that's company policy," should be forbidden. Passing the buck to company policy is just as bad as passing the buck to higher supervision. Not only should "company policy" be avoided as an excuse or pretext for any action or decision, but foremen should be alert to cases warranting exceptions being made in the application of company policies, and management should provide an easy way for approving exceptions in meritorious cases.

Policy development. Before a policy can be written, it must be developed.

An employee policy cannot be prepared by a policy formulator in an ivory tower. It must be the result of intimate knowledge of the company's operations and practices, and their effects on employees in all departments. If a policy is formulated to meet a situation in one department, it must not be adopted until its application to other departments and classes of employees has been evaluated.

If a complaint results in a decision to furnish rotary-furnace operators in the gear department with special face shields, what should be done about the furnace operators in the carburizing department? And what should be done about the cupola tenders in the foundry and the electrolytic-furnace operators in the metallurgical laboratory?

If exempt salaried employees in the home office are to be paid for authorized overtime, consideration must be given to the application of the same policy to the regional offices, where the degree of supervision is likely to be much less. If overtime is to be paid for, will the policy be equally applicable to the employee who is called upon to be on the road for weeks at a time, when he alone can determine how much time per day his mission requires? The extension of the policy to salaried personnel on the shop payroll must also be considered.

Some considerations of a similar nature are involved in every policy decision. No one man can make a sound decision unless (1) he knows a great deal about the organization and operations involved, and (2) he has the benefit of recommendations from those who are intimately familiar with the many applications which that policy will receive in practice.

The development of employee policies takes time and patience. It is more important that they be right than that they be developed to meet a specified schedule. Time is of the essence—plenty of time.

5. Specialized employee-relations functions

In addition to its policy-forming and human-auditing functions, the employee-relations department is usually charged with the performance of certain specialized functions to assist the line organization and to help provide, maintain, and train the man power through which the line organization operates.

Because certain specialized employee functions are delegated to the employee-relations department, it is easy to reach the fallacious conclusion that the employee-relations department handles all employee-relations problems. Whether employee relations are good, bad, or indifferent depends primarily upon the interaction of line supervisors and the workers under their supervision. The employee-relations department can help, advise, observe, recommend, and perform some specialized employee functions; but it cannot

and should not try to replace line supervisors as *the* representatives of management in the eyes of the employees. In performing its specialized employee functions, the employee-relations department acts in a staff capacity, an arm of operating management.

Industrial experience has shown that there are specific formal techniques of personnel administration which can be delegated to specialists in an employee-relations department, and particularly in companies which are large enough to warrant a fully staffed employee-relations department. Even in companies which are so small that a separate employee-relations department cannot be justified, it is necessary to delegate these functions to some group or individual, even if only on a part-time basis. The important thing is to recognize the need for the use of these various techniques and to make sure that responsibility for their performance is specifically designated and generally understood.

Employment. The central employment office is usually the first element of an employee-relations department to be created. At first the employment manager's job may be limited to recruitment, selection, and placement of new employees. But before long the employment manager finds that employees whom he has hired come back to him for advice and look to him as a source of information about the company and about their place in it. He finds his activities expanding considerably beyond the mere matter of hiring new employees. He begins to receive complaints, requests for transfers, questions about safety, etc. Every employment office finds itself called upon to do far more than merely recruit, select, and place new employees.

While an employment office may thus acquire additional personnel functions by default—because no other agency is available to discharge these functions—it cannot discharge them properly unless it is specifically organized to do so. And if it is organized to discharge a wide variety of personnel functions, it becomes a personnel department rather than an employment department. No personnel function should be permitted to remain unassigned. If a personnel function needs to be performed, it should be specifically assigned to a given person or department, and the entire organization should be informed that such person or department is responsible for handling all problems involving that function.

It is now generally understood that an employee-relations department performs specific personnel and labor-relations functions. As a minimum, the employment section of the employee-relations department should be responsible for recruitment, interviewing, selection, and placement of new employees, and termination of employment of employees leaving the organization. Usually the employment section also has the responsibility for maintaining personnel records and identifications, administering leave-of-absence and

absenteeism policies, conducting special investigations, and clearing transfers. In some cases the employment section also participates in recommending promotions and administering centralized discipline.

The primary functions of an employment office in an industrial plant are to procure, select, investigate, classify, and place as many workers as are needed in the shops and offices of the plant.

In a "tight labor market," when labor is scarce for the many jobs available, the main problem of the employment office is to get enough people to satisfy the growing demands of the company. At such times, employment interviews may be shortened, and every effort made to expedite hiring available applicants and putting them on the job. On the other hand, when there are more applicants than jobs, the employment office may be justified in spending more time with each applicant in order to make sure that the company hires the best of those available. However, whether the labor market is tight or plentiful, any management which is vitally interested in its employees will take pains to set up desirable standards which must be met by applicants for employment. The kind of men who will make up the organization is determined at the employment office. As labor leaders are fond of saying, "After all, if you complain about the acts of our members, remember that you hired them."

Many problems may arise in connection with the primary function of the employment office—the recruitment, selection, and placement of a working force. Adequate sources of desirable applicants for employment need to be developed. One of the most important factors in the development of an adequate source of desirable applicants is good employee relations and community public relations on the part of the company.

A company's reputation in the community may very well determine the caliber and composition of its working force. The opinion of its employees is a most important factor in determining its standing in the community.

In that connection, it is most interesting to note the experience of one long-established factory engaged in war production during the Second World War. Being hard pressed for additional employees at a time of serious labor shortage, this company carried on an intensive advertising campaign by means of local newspapers, radio announcements, billboards, motion-picture appeals in the local theaters, churches, etc. At the same time, the company urged its own employees to invite their friends to come to work for their company.

During a 3-month period, while recruitment was at its peak, records were kept of the sources that brought new employees to the company. The results were startling. Of all the employees hired by this company, 61 per cent applied for employment either because they had friends or relatives there,

or because they were former employees themselves. The remaining 39 per cent applied for a variety of reasons, such as referred by the U.S. Employment Service (10 per cent); by nearby residents (2 per cent); referred by local school (2 per cent); radio advertising (2 per cent); billboard advertising (1 per cent); referred by local draft board (1.5 per cent); and newspaper advertising (3 per cent). It is also interesting to note that only 6 per cent of all the employees who came could ascribe no reason for having picked this particular company as the one in which they wanted to work.

Obviously, the employees must have been sold on the company, or they would not have urged their friends to come to work there. It is quite clear that satisfied employees are an asset to the employer in many ways that are not obvious at first blush.

Employees do not, however, automatically act as recruiting agents for their companies, even if they are proud of them. But they can be encouraged to do so by bulletin-board notices or appeals in employee publications. In the specific case discussed, a portion of the employees were circularized weekly by individual letters addressed by the employment manager to their homes.

A company that considers itself a permanent element in its community should develop as many points of contact with the community as possible. The employment section can play an important role in this contact with the community. The employment manager (or an assistant) should be available for active participation in business groups, parent-teacher groups, school programs, vocational-guidance clinics, nationality organizations, veterans' organizations, and social-service organizations. He should be prepared to explain his company's place in the community, the opportunity it offers for permanent, useful employment, and the kinds of skills that are most likely to be in demand 1, 2, and 3 years ahead. He should cooperate with local vocational schools, encouraging their full utilization by present and prospective company employees, and bringing the benefit of his practical knowledge to the assistance of local school boards and directors.

The employment manager can do much to make his company a respected member of the community.

The development of adequate sources of applicants for employment, essential as it is, is only the beginning of an employment program. Even when sources of applicants have been carefully developed, the efficiency of a company's working force may depend largely on proper techniques of selection and placement. It is being increasingly recognized that attitudes toward reasonable authority and cooperativeness may be as important as technical ability in the development of a proper body of employees. Successful selection and placement, in turn, depend upon adequate knowledge of the jobs

for which the employees are being selected. The absence of job analyses and job descriptions frequently contributes to employee maladjustment and may result in high turnover.

Placement. Getting the right man on the right job is no easy task. Many employees come to industrial plants offering specific skills or services. Unless employees are utilized at their highest skill, they will be dissatisfied and will show their dissatisfaction in any of a number of ways. The best safeguard for getting the right employee on the right job is to have an adequate, trained staff in the employment office, utilizing a standardized and tested interview procedure, to the end that all the available information regarding the applicant will lead to placing the employee on a suitable job.

Placing the employee on a suitable job does not necessarily mean hiring the best available employee and putting him on an available job. An employee with a great deal of initiative, assigned to a monotonously repetitive job, not only would be unhappy on the job but would not perform the job as satisfactorily as would another employee with less initiative. An important consideration in placement is to place the employee so that he will be utilized at his highest skill, to assure best performance, satisfactory adjustment, and maximum development of human resources.

Applicants for jobs do not ordinarily resent being asked a large number of questions. However, interviews can be so conducted as to arouse antagonism and give the company an unfavorable reputation. A series of essential questions can be developed into a standardized interview procedure which will give the employer all the information he needs in determining the experience or training of the applicant, his adjustment to his work and fellow workers, and his motivation for desiring a job in that plant, without seeming to pry into the applicant's private life. Information about the applicant's background gives the employer some protection against unscrupulous job seekers who have little or nothing to offer the productive effort or who are getting jobs for reasons not in accord with the company program.

Another adjunct to the placement procedure is personality and aptitude testing, a technique that has received fulsome praise as well as severe condemnation.

If tests are administered by people who have adequate training in the interpretation of the test results, and if they are used to supplement other types of information rather than as the basic information on which to make final decisions of job placement, they can be very valuable.

If a testing program is to be undertaken with respect to employees already on the payroll, great care needs to be taken because employees may be led to believe that the testing program may be used as a device to avoid promoting those who deserve it, or otherwise as a pretext for discrimination. It is

preferable to start a testing program on a voluntary basis, as an additional service to those employees who want to find out where they are likely to make most rapid progress. It may also be used in the case of "problem children," to help them orient themselves.

Employment section as a screen. In its relationship to the line departments, the employment office, being a staff department, should not definitely hire an applicant for a specific job. It interviews all applicants and screens out those considered undesirable. Then it recommends suitable applicants for specific openings, subject to acceptance or rejection by the head of the department concerned. It is the line department that actually hires the applicant.

After an applicant is hired, it is desirable that he be put through an induction, or orientation, process, which can conveniently be a function of the employment section. This induction procedure may take 15 minutes or a whole day, depending on the size of the company and the stage of development of its employee relations.

Those companies which devote appreciable time and effort to the induction procedure find that it pays dividends in helping the employee to feel more at home, more welcome on the job. It shortens the period of instability and insecurity that usually accompanies immersion in a new environment. It gives the employee the necessary preliminary information that makes him feel at ease. It helps the employee get off to a good start, and it may permanently affect his attitude toward the company.

Since placement is still far from being a scientific process, even when all available devices are utilized, it is good practice for the employment section to maintain contact with the new employee for a brief period of time, by means of postemployment interviews on the job with the new employee and with his immediate foreman. Such interviews may take place a week or 10 days after the employee starts on his job, and again 5 or 6 weeks later, or in any event before the employee has completed his probationary period.

These interviews are designed to determine whether the employee is adjusting properly to his new environment, whether any special questions or problems have arisen, and whether his work and attitude are satisfactory. These adjustment interviews help the employee to feel the company has maintained its interest in him, and may also disclose whether the employee should remain on his current job or should be transferred. It requires care and tact to conduct these interviews in such a way that the immediate foreman's prestige is fully protected and increased, rather than minimized.

Arranging such an adjustment interview with the new employee and his foreman just before the employee completes his probationary period constitutes an excellent method of determining whether the employee is the kind

who is likely to be a permanent asset to the company, or whether his employment should be terminated. All too often, the probationary period, designed to be a period of testing, is allowed to lapse by default, and no action is taken until too late. An employee who is retained beyond the probation period is justified in believing that he has made good, and that he will be retained so long as he continues to render the same kind of service and so long as business conditions permit his continued employment.

Records. Records are the history upon which present action is based in an effort to determine the future. In order that they may be of real assistance, records should be scrupulously fair, adequate, and centralized in one place.

Usually, the place where employee records are centralized is the employment office, which contains not only the records of present employees, but also all records of applicants and of former employees.

Employee records are of many kinds and of various degrees of complexity. The larger the company, the more it is likely to rely upon records. Accordingly, a larger company would be likely to have more detailed records, to compensate in some measure for the widening gap between upper management and rank-and-file employees.

As a minimum, every employee record should have the information necessary to identify the employee fully, and to identify his occupation, classification, and department. It is highly desirable that his rate of pay and history of changes in rate of pay and occupations be included, as well as a record of his correspondence with the company, promotions or demotions, transfers, health records, accidents, absenteeism, length of service, discipline record, and suggestions.

Transfers. Transfers between jobs or departments are an important aspect of employee relations. An employee who is a detriment to one department may be a positive asset in another. Transfers are a mechanism for better matching employee wants and skills with job demands. Transfers may be used to alleviate situations due to incompatible personalities. Transfers are required to give selected individuals varied work experience. Incorrectly used, transfers may be a source of great employee discontent.

Since it usually contains the central employee files, the employment section properly serves as a clearinghouse for all transfers. It is the exchange to which notices of surplus man power or vacancies are sent. It is the one place, aside from his foreman, where a disgruntled employee may go to announce that he wants a change, or is ready to quit.

Every request for a transfer deserves a careful investigation to determine the real reasons. If the request comes from a supervisor, the employment office should ascertain whether the supervisor is merely trying to foist an undesirable employee on another supervisor, or whether there is a personality

or other problem involved, or whether there is a sound reason for making the transfer requested. If the request comes from the employee, there is very likely to be an unsatisfactory situation at the bottom of it, since ordinary human inertia would make the employee desire to remain on a job he knows and remain a member of his informal group. It is the duty of the employment office to ascertain the facts and to make recommendations that will remove the cause of any dissatisfaction that exists. Here again the services of a liaison representative of the line organization or an employment advisory committee can be extremely helpful.

Each time a man is moved from one machine to another or from one department to another, a whole chain of new reactions is set up. Does the employee understand why he is being moved, or is he left to suspect that he may not have been doing his job right, or that he made some important mistake, or that his foreman "has it in for him"? How does the transfer affect the employee's prestige and self-esteem? Is he being taken away from a job in which he takes real pride to another which he knows little about? What may be to the superintendent merely efficient allocation of the working force is to the employee an intensely human problem.

Transfers made at the request of the employee have just as much capacity for error as those made at the instance of management.

Despite the cost of transfers, management has an obligation to make transfers whenever a transfer will enable an employee to be used at his highest skill or maximum ability. Even a well-organized placement service in the employment office will not make the correct placement in every case; or a more suitable opening may develop after the employee has been hired on an available job; or the employee may develop new skills or learn additional techniques or acquire other interests after he has been hired. Continuous efforts to place employees at their highest skills is good management and makes for good employee relations.

Exit interviews. The employment section is the gate through which an employee enters the organization and through which he leaves it.

Every employee who is about to leave an enterprise offers management at least three significant opportunities: (1) he may be able to point out something wrong in the organization or its policies, for when he is on the point of leaving he is likely to speak very frankly; (2) he may be saved as an employee, preventing loss of his experience and skill, and avoiding the time and expense of recruiting and training a new employee to take his place; and (3) the manner of his leaving may improve or damage the company's standing in the community.

All these factors justify the increasing utilization of the exit interview for all employees leaving the company, whether the termination be voluntary or

by way of discharge. Some companies also provide for an exit interview in every case of layoff, at which time employees are told about their rights to unemployment compensation, and what are the prospects of their being called back to work, and when.

Where the employee is leaving the company of his own volition, the exit interviewer at the employment office attempts to determine the real causes, and if the employee is worth saving (and the presumption is that he is), the exit interviewer does what he can to retain the employee. In this task, the exit interviewer must maintain a delicate balance. On the one hand, he should not show any special favors to a quitting employee, as that would encourage threats to quit over any minor complaint. On the other hand, if the employee has a legitimate grievance that is within the company's control and employee policy to straighten out, the exit interviewer should take steps to do so.

In any event, if the employee finally decides to quit, it is a function of the exit interviewer to "sell" the employee on the reasons for the company's action, if possible, so the employee will remain an asset to the company even after he terminates his employment relationship.

The valuable information gathered from exit interviews should be transmitted to some centralized point, which evaluates all employee reactions. At the same time, any unhealthy situations discovered as a result of exit interviews should be promptly corrected, again preferably with the aid of the line-organization liaison representative or employment advisory committee. It is frequently desirable to have members of line supervision sit in on exit interviews.

Job evaluation. The correct determination of wage rates is obviously of great importance to the employee and an essential in a sound employee-relations program. To the employee, the rate of pay is important not only because it determines his standard of living, but also because it determines the employee's relative standing in the department in which he works. If the employee finds another worker doing the same work but getting more money, he will immediately suspect favoritism, with all the demoralizing effect of such suspicion. Similarly, if employees receive the same pay for work of varying degrees of skill and effort, there will be no incentive for greater effort and self-improvement.

The setting of wage rates "by gosh and by guess" is responsible for many of the inequitable and unjustifiable wage rates that may be found in industry today. Such wages have been responsible for a great deal of friction and for some of the charges of favoritism brought against management.

Some wage structures "just growed," like Topsy, with no logical relation-

ship between wages paid for various jobs. Some wages have been set by superficial comparison with other jobs.

Job evaluation, based on accurate job descriptions and an analysis of the factors required to perform the job satisfactorily, and a weighing of the factors, is an art compounded of intimate knowledge of the job and its requirements, an understanding of the factors into which all jobs can be broken down (such as education, physical exertion, responsibility, mental effort, and experience), and judgment.

Once the jobs have been properly analyzed and evaluated, it is a relatively simple matter to convert job ratings into wage rates.

Obviously the line supervisor cannot be expected to be an expert on rate setting. Nor can the line supervisor alone achieve uniformity in rates throughout the organization. This is a job for the specialist, and such special service may well be rendered by a job-analysis section of the employee-relations department.

The job-analysis section may have the functions of working with the line organization to obtain accurate job descriptions for each occupation, preparing job evaluations, advising on merit ratings, incentive systems, etc. In brief, it renders a technical service relating to wage rates and promotions.

In performing its wage-evaluation functions, the job-analysis section also has an auditing function. Frequently it is used as a central control in wage matters, so that every increase in wages or salaries, and every initial wage or salary for new employees, becomes subject to screening by the job-analysis section. In times of plentiful man power, and under pressure to cut costs, some supervisors may attempt to pay less than the minimum rate for certain occupations, while in times of man-power shortage, and pressure for higher production, rates higher than the maximum may be resorted to. There may also be differences of opinion when it comes to setting rates for new occupations.

Here again the services of a liaison representative with the line organization or committee may be very helpful in getting good results.

Likewise, the job-analysis section can be very helpful in explaining wage rates to employees who believe their jobs should receive a higher rating. It can also play an important part in the handling of wage grievances and complaints.

Management should be on guard lest its reliance on scientific wage evaluation make it blind or insensitive to employee wage complaints. While sound job analysis should reduce legitimate employee complaints on this score, no technique is so perfect as to avoid all errors. Job content may change, or may have been wrongly evaluated. Moreover, whether or not

the employee's complaint be factually justified, if he believes his wage is wrong or unfair, he deserves sympathetic consideration and a full explanation. It may be that the employee's wage complaint has its root in some other maladjustment that can easily be corrected.

Being intimately familiar with wage rates and the basis underlying these rates, the job-analysis section should be called upon in all wage negotiations, either to participate actively or to furnish the necessary information.

The job-analysis section should be responsible for making accurate wage surveys in the area and industry, to serve as a guide to management and as a corrective for false information that comes by the grapevine. No company is ever entirely free of the rumor that someone else nearby is paying 10 (or 20, or 30) per cent more for the same job. The job-analysis section should be able to state authoritatively whether the rumor is true, or what the facts of the case really are. Sometimes such wage surveys are conducted by a local trade association.

The job-analysis section should also be in position to advise management concerning the operation and relative merits of various incentive systems, and their applicability to the company's specific situation.

While job analysis is a valuable tool to assure equitable wage rates in the shop, a modified job-analysis technique is equally essential for the salaried occupations. There is just as much need for equitable salary administration as there is for equitable hourly wage administration.

Merit rating. Just as job evaluation is a technique for the evaluation of jobs, so merit rating is a device for fair and impartial evaluation of men as workers.

Every time a foreman makes a decision with respect to job assignment, transfer, discipline, promotion, wage increase, or demotion, he must evaluate the man he is dealing with and judge his capacity as compared with that of other men in the department. Merit rating was developed in an effort to substitute calm analysis in place of prejudice on the one hand and favoritism on the other, and to get away from the injustice of snap decisions.

Merit ratings are periodic evaluations of employees in relation to their performance on the job. Their primary function is to determine the relative ranking of employees in the order of their effectiveness on the job, to assist the foreman in making decisions relative to promotion, demotion, work assignments, and transfer. Another important function of merit rating is its influence upon the employee's supervisor, since it forces him to evaluate the employee's work with a considerable degree of objectivity. A third important function of merit rating is that it provides the supervisor an opportunity to discuss the employee's record with the employee, thus giving the employee some idea of where he stands and why, and how he can improve his record.

Merit-rating programs are of various kinds. The most common variety of merit-rating program is based upon supervisory evaluation of separate characteristics, such as quantity and quality of work performed, initiative, dependability, cooperativeness, etc., of each employee. The total rating is supposed to determine the employee's effectiveness on the job, at the same time highlighting his shortcomings.

A simpler method of merit rating is for the supervisor merely to list the employees in his department in the order of their relative over-all effectiveness, from best to poorest. This method may also be utilized with reference to various specific employee characteristics, combining such specific rankings to obtain a general rating of each employee. It eliminates the need to give an absolute (and artificial) rating to each employee characteristic, since it merely requires the supervisor to consider each employee in relation to other employees.

A more theoretical approach to merit rating is the "forced-distribution" system, in which the supervisor is required to separate his employees (on paper) into five groups, the best employees being put in group A, the second best in group B, and so on. Furthermore, he is required to locate a given percentage of the employees into each group, as for example, 10 per cent in group A, 20 per cent in group B, 40 per cent in group C, etc. Each supervisor is required to allocate the same proportion of his employees in each of the various groups, thereby eliminating to some extent the tendency of some supervisors to rate all their employees on the high side, and of others to rate their employees low.

Whichever method of merit rating is selected, supervisors must be trained in its correct usage, in its limitations, and in the best ways to make the most of a merit-rating system. It cannot simply be installed and then forgotten. It needs the continuing observation, follow-up, and control of a staff specialist or group, although its actual administration must be a line responsibility. It is logical to assign the staff function with respect to merit-rating plans to the job-analysis section of the employee-relations department.

The staff assistants of the job-analysis section should be limited to recommending an appropriate merit-rating program, gaining its acceptance by the line organization, being prepared to advise in its administration, and checking to see that it is operated properly.

A merit-rating program, properly administered, can be extremely valuable in focusing supervisory attention on employee performance and development. Sometimes the effect of personalities is further minimized by having each employee rated by two or three supervisors. It is easy, however, to reach the point of diminishing returns.

Merit rating is far from foolproof. There is always a tendency to misuse

it by "working backward from the answer"—*i.e.*, filling out a merit-rating form in such a way as to come out with the rating the foreman has previously concluded is right. For this reason, no merit-rating plan can be successful unless supervision is thoroughly sold on its advantages and is determined to make it work.

Properly introduced and used, merit rating can be a definite asset. Improperly introduced or administered, it may do more harm than good.

Promotions. In most companies (except the very new ones), management is composed very largely of men who have been promoted from lower levels. Accordingly, promotion policies very largely determine the composition of management itself.

From the viewpoint of the employees, promotion is both the road to bigger and better things and a reward for loyalty, application to the job, skill, and experience.

Promotion not only builds the management group, but constitutes a force for good or bad employee relations. Even those employees who do not want the responsibility of promotion for themselves are very much affected by the criteria used in making promotions. All employees understand the justice of promotion on the basis of merit, while promotion on the basis of favoritism or pull is universally condemned.

Accordingly, management tends to be more and more careful about promotion policies. But just what constitutes merit? Does a superior mechanic necessarily make a good supervisor? So varied and diversified are the duties and qualifications of a good foreman that, were he to excel in them all, he would deserve the level of salary usually reserved for the president of the company. But it is clear that the human-relations aspect of the foreman's job is second to none in importance, for his success is measured by his ability to weld his subordinates into a loyal, cooperative team.

Accordingly, selection of men for promotion is not a simple procedure of pinning a badge on Joe and saying, "O.K., Joe, now you're the foreman of Department *X*." It is a matter that requires the most careful consideration of (1) the characteristics required of a good foreman, and (2) the capacities and qualifications of the available candidates.

It is expecting the impossible to expect each foreman and superintendent to be able to make such a selection unaided. Merit rating helps, but more than that is needed. The characteristics required of a good foreman may very well be defined by the job-analysis section, with the closest cooperation of the line organization. The selection of candidates for promotion might very well be done by a central committee of high-level supervisors, with a representative of the job-analysis section sitting with such a committee as a consultant.

The very existence of such a committee might well serve to offset charges of favoritism in promotion and gain fuller employee acceptance of the company's promotion policies.

Training. It is quite possible that the eminently successful Training within Industry program which accomplished such wonders during the Second World War may have done a disservice to industry in the long run because of its emphasis on a rigid, high-speed technique of instruction in a relatively limited field.

Actually, employee training may be as far-ranging and versatile as industry itself. It ranges from the induction program and on-the-job training to apprentice training, university-level classes, broad-gauge training in economics and company policies, and executive development.

The first thing that usually comes to mind in mentioning employee training is the on-the-job training given by a foreman or instructor to a new employee or a newly advanced employee. That is still an important element of employee training, and no amount of staff assistance from the training section of the employee-relations department can replace the valuable, man-to-man relationship created by a foreman teaching one of his subordinates the proper way to do a job, or the safe way to lift, or the best way to get along with the gang.

But there are many useful ways in which the training section can supplement the foreman's training and provide additional training in other fields.

For example, the training section can offer classes in shop mathematics, micrometer reading, basic electricity, shop sketching, etc., all of which are directly helpful to the employees on their jobs and help them to prepare themselves for progress and advancement. Such courses should preferably be offered to the employees without charge, on their own time. If the demand is great, special booklets may be prepared for use in such classes, using the company's own products, familiar to the employees, as examples to illustrate the various courses. The more closely these courses are related to the employees' work, the more effective they are likely to be.

Courses of this kind can be organized most effectively by means of a training committee consisting of representatives of upper levels of shop supervision. The training committee may request the training section to offer certain desired courses, or may pass on suggestions made by the training section.

The advantages derived from this type of employee training are greater than those that meet the eye. Not only does such training result in greater skill and ability on the part of the employees, but it gives employees a sense of accomplishment and progress that cannot be obtained from their daily work. Employees who feel that their progress on the job is inadequate may

feel that after all they are not wasting their time, since they are preparing themselves for better jobs. And they are, for the interest resulting from scholastic progress may make promotable material out of employees who would otherwise stay where they are.

The training section does not necessarily need to include on its staff the instructors or discussion leaders for these various subjects. It is far better, and arouses greater participation and interest, if the classes are conducted by employees or members of supervision, and often unsuspected teaching talent may be thus uncovered. Resort may also be had to part-time teaching by local vocational-school, technical-school, or other adult-group teachers. Where classes in these subjects are available in the community, many companies encourage their employees to take these courses by paying part of the tuition.

There is another type of employee training that is receiving greater attention from management. This relates to semicultural training, which may not help the employee directly on his job, but teaches him more about his company, its products, and its place in industry. This may consist of classes, open to all employees, describing the company's products, achievements, contributions to industry and consumers, famous machines or other products, inventions, etc. Courses may also be given on the company's organization and policies, describing the work of the various departments and how they mesh together to produce the company's products or services. It makes the work of most employees, both shop and office, far more significant when they understand the contributions made by the various departments, many of which are but vague names to most employees.

If at all possible, these classes should be led by the heads or other responsible executives of the departments concerned, with a discussion period following the presentation. This type of class offers a channel of communication between employees and management that is seldom appreciated.

Some companies have done a splendid job of using classes on company organization to illustrate problems of basic economics, providing the best possible basic education concerning the nature of our economy and how it is affected by taxes, wages, profits, prices, etc. Such classes probably constitute the best possible form of adult education, especially if active employee participation can be obtained. In many cases, local municipal-school facilities may be available for such courses.

A still different field of employee training relates to subject matter which may be unrelated to the employees' work or company, but which improves employee morale by directing their interest and increasing leisure time into constructive channels. For example, the training section may offer classes in foreign languages, current events, labor relations, etc. How much the

company may want to do in this direction may well depend upon the local availability of similar instruction at extension courses and vocational schools.

The training section should directly supervise any apprentices the company may be training. The value of apprenticeship courses should not be minimized by the high-speed training that characterized the critical period of the Second World War. It takes time and development to make a journeyman —a skilled craftsman. Apprenticeship programs have a definite place in industry, and their usefulness has not been reduced by the advent of mass-production techniques. The need for skilled craftsmen will probably always exist, despite the pronouncements of those who believe that mechanization will invalidate human skills.

If the apprenticeship program involves any appreciable number of apprentices, they should preferably be supervised by full-time apprentice supervisors reporting to the line organization. These apprentice supervisors should, however, consult periodically and frequently with the training-section staff to discuss progress, receive suggestions, and keep the training section fully advised of the development of each apprentice. The training section should be responsible for the classwork for the apprentices, either directly or through local vocational schools, and it should be responsible for routing apprentices through the various job assignments necessary to complete a full schedule of craft training.

In the larger companies, the training section is also responsible for advanced scholastic work, such as that for graduate engineers, and in some cases companies have undertaken to provide a complete educational program leading to postgraduate degrees.

One of the most fundamental training needs in any company is the training of foremen and other supervisors. As employee relations become ever more important, the training of foremen in the human-relations aspect of their work needs more and more emphasis. No sound training program for foremen is possible unless management has (1) determined what are a foreman's functions; (2) determined who are foremen and who are not; and (3) clearly identified those who are foremen.

Foremen need to know how to be effective supervisors above all else. The best way to learn is the conference method, with a limited group and plenty of opportunity for discussion. Courses in leadership, in grievance handling, in employee policies are essential. Also necessary are courses in forms and procedures, how the payroll is figured, production control, etc.

But foremen's courses cannot be effective unless thoroughly endorsed and backed up by higher line supervision. Nor is it much use to teach a foreman good human-relations techniques if he himself does not receive that kind of treatment from his own superior. So the best way to begin foreman

training is to start at the top with the plant managers and superintendents, and not until they have been through the entire course and approved or modified should it be given to the foremen, preferably using line supervisors as conference leaders. The role of the training section in this field is to help develop the course and to provide the facilities for organizing conference groups. The greatest possible participation from the line organization in all aspects of foreman training should be cultivated.

The training section is the natural department to maintain the closest possible liaison with local vocational schools, university extension courses, colleges, etc. It should always be prepared to advise employees about available local educational facilities and courses, help employees register for such courses, and advise with them on progress from time to time. The training section should make it a point to advise employees' superiors that their employees have registered for special studies, either within the company or at outside schools.

It becomes apparent, then, that the role of the training section is that of a catalytic agent in the employee-training process, rather than that of a school or university. It requires but a limited staff, but can perform unlimited miracles in employee advancement, morale, and communication, and it can do much to strengthen the very fiber of the supervisory group. It multiplies the human assets of the organization.

Health and safety. Promotion of safety on the job is good business and good employee relations. Safety is an integral part of each employee's job and each foreman's responsibility. But the foreman can get a great deal of help from the safety section.

A good safety program depends on safety engineering, the development of safeguards on all equipment used, whether it is a loading platform or a punch press. It is the employer's legal and moral obligation to provide a safe place to work and to have all machinery appropriately guarded. Safety engineering enables the employer to do so. While safety engineering can be done by the line organization, there is less likelihood of compromise with production demands if safety engineering is carried on as a staff function of the safety section.

Closely allied to safety engineering is the provision of personal protective devices—safety goggles, safety shoes, respirators, masks, leg guards, asbestos gloves, etc. Some of these, such as safety goggles and safety shoes, may be worn by all employees. Others, such as respirators, gloves, and masks, may be necessary only for employees doing special jobs such as painting, tending open furnaces, etc.

The utilization and selection of machinery safeguards and personal protective devices require highly specialized knowledge, including intimate

knowledge of the requirements of state laws and codes, familiarity with plant operations, safety devices available, safety practices elsewhere, available safety literature, and contact with safety and health organizations.

The line foreman or superintendent can hardly be expected to have such information at his finger tips. But he should always be able to call on the safety section to provide him with the answers to any health or safety problems that may arise.

In addition to recommending suitable personal protective devices, the safety section is frequently delegated the job of maintaining all personal protective devices in good repair and of distributing and fitting them to individual employees.

The safety section frequently has the responsibility of supervising a health program. This involves solving problems of plant ventilation and heating, noxious gases, toxic materials, allergies, excessive heat or dust, etc. To be fully effective in this field, the safety section should be called to sit in whenever new materials, equipment, or plant layout are under consideration. Many of the problems can be solved far more easily if the safety experts are called in on the initial planning, rather than by trying to effectuate changes in an existing layout.

The safety section cannot operate effectively unless it has complete information available on all safety matters. This requires (1) continual periodic inspection of safety conditions by trained safety inspectors, and (2) detailed reports, followed by analyses, of all accidents. With this information, the safety section can submit periodic reports to top managements and superintendents, and can determine what phase of safety work is in most urgent need of attention. Accident analysis is a sound basis for safety-program development.

The effectiveness of safety work depends in great measure upon the employees themselves—upon their interest and concern about safety matters and upon their having adequate knowledge. A perpetual educational campaign is an integral part of every safety program. The safety section should carry on such a campaign with the assistance of the staffs of the advertising and public-relations departments, directing its educational program at supervisors as well as rank-and-file employees. Safety classes for foremen, safety classes for employee safety committeemen, posters, letters to employees at their homes, safety items in employee publications—all have their place and are helpful. The foremen are the key to a successful safety program. No amount of "education" about the need for safety glasses will be effective if the foreman himself neglects to wear them in the shop. Top management has an obligation to impress on the foreman that he is no less responsible for safety than he is for protection.

From the employee standpoint, a company that is callous about employee safety is obviously selfishly interested in nothing but profits, regardless of its official pronouncements, while a company actively engaged in promoting safety thereby proves its interest in employee welfare.

The close coordination required between the safety section and shop supervision can be promoted by the organization of a safety council of top-level shop supervisors, meeting once a week to discuss safety progress and special safety problems.

Full utilization of the safety section may well include having the safety section pass on new product design from the viewpoint of customer safety. This may not only improve the product but provide the sales department with an excellent selling advantage.

Medical facilities. The extent of medical facilities necessary in any plant may obviously depend on (1) the size of the plant, (2) the types of operations involved, and (3) availability of nearby medical assistance.

Whenever possible, a doctor should be available to examine applicants for employment before they are hired.

A doctor should also be available to provide physical examinations for employees working on dangerous occupations; those who work with poisonous or toxic materials; crane operators and others who must climb to high elevations; those who work under conditions of extreme heat; etc. Such periodic examinations are desirable from the viewpoint of both employees and management, and may result in a transfer from a harmful occupation before the condition becomes serious.

Some companies provide periodic physical examinations for all employees, and there is much to recommend such a program.

Liberality should be used in making medical and first-aid facilities available to employees, for it is far better to spend some time unnecessarily than to run the risk of infection or injury. Many companies encourage their employees to come to the plant hospital for minor nonindustrial illnesses or first-aid assistance, on the theory that it makes them better workers while they are on the job. Liberality in medical and first-aid matters pays off in good employee relations.

Responsibility for supervising the medical staff and medical policies may be assigned to the safety section.

Discipline. The word "discipline" has a rather horrendous sound, evoking visions of courts, jails, and arbitrary defense of arbitrary authority. It is even possible that callous enforcement of discipline in some companies has given some semblance of fact to such a concept. At any rate, such a concept is far removed from enlightened, genuine industrial discipline.

Industrial discipline is the maintenance of orderly operation. Shop rules

are merely one guide for the maintenance of discipline. Penalties are but one way—one of the least effective ways—of maintaining industrial discipline The provision of a fixed penalty for a given violation of shop rules is probably the worst possible approach to the problem of industrial discipline.

The very existence of industrial organizations depends upon the *voluntary* cooperation of the people who make up the organization. Voluntary cooperation is not brought about by rigid rules and penalties.

On the other hand, employees are entitled to an orderly place in which to work. The operation of any organization depends upon each individual doing his particular job, in order that raw material may be received, processed, assembled, and shipped. Obstacles anywhere along the line may affect many employees, since the work of each depends upon that of others. Interdependence is as real as it is in the case of a group of mountain climbers fastened to each other by a rope.

Those who look upon discipline as a question of meting out punishment to fit the crime have an entirely erroneous conception. Industrial discipline is the maintenance of orderly voluntary cooperation.

The enlightened view of discipline means that whenever there is a failure in orderly, voluntary cooperation, management must determine the real causes and take whatever action may be appropriate to prevent recurrence of such failures. The real causes are seldom apparent. It may require careful consultation, inquiry, investigation, and judgment to determine the causes and to provide appropriate measures to prevent repetition.

For this reason, some companies have developed a central board to consider all disciplinary cases which, in the opinion of the foreman, require more than a simple warning. The board, which may be located in the employment section where all employee records are available, may utilize the services of investigators in order to obtain complete information on any case coming before it. The board considers each case on its own merits, determines the causes of discipline failures, and takes appropriate measures. These may include transfer, demotion, correction of company policy, suggestions for correction of an employee's domestic situation, reprimand or transfer of a supervisor, or layoff or termination of employment of an employee. All employee discipline records are available to the board for guidance, but the board never blindly follows precedents.

Employee services. Industrial history is studded with shining examples of employers who took great interest in their employees, provided extensive services for them—and came to grief. In some of these cases, managements have felt that their employees were ungrateful, or didn't know what was good for them, or were being led astray by outside agitators.

The fault may have been attributable to management. The manner of rendering services is fully as important as the content.

Employees do not want to be made to feel that they are objects of managerial charity. Many of the paternalistic schemes of bygone days made them feel that they were recipients of charity. They didn't like it. Paternalistic employee services got a bad name.

These unfortunate experiences should not deter employers from providing all the employee services that are reasonably possible. But they should be furnished by an appropriate organization, in a manner to make employees feel that they are really helping themselves, rather than being objects of employer charity.

The employee-service section can be of inestimable value in promoting employee morale and in cultivating the desire to cooperate.

Employee counseling, whether used only when employees want someone to help them out of their troubles or as a major continued activity, can do much to assist employees to help themselves. The undirected employee interview, in which the employee is led to recite the whole situation that troubles him, and encouraged to think through his own solution, has much to recommend it. In other cases, the counselor may be able to explain the misunderstanding on which the employee's unhappiness is based, or direct him to someone, in or out of the company, who can help him. Not all types of employee problems are amenable to the same treatment.

If the employee-service section has skilled counselors available, the entire organization should be advised to refer troubled employees to the section, since amateur but well-meaning counselors can sometimes do more harm than good. It is fundamental that counselors, to be effective, must respect employee confidences.

While the company should not put itself in the position of giving legal advice to its employees, it can frequently assist them with quasi-legal advice in cases of evictions, income-tax problems, garnishments, leases, etc. Sometimes the mere advice to take his case to a lawyer may be helpful. The employee-service section should be prepared to render such quasi-legal assistance.

A major and growing field of activity for the employee-service section is that of employee recreation. Much of our maladjustment is due to the fact that we are becoming a nation of onlookers rather than a nation of participants. Good healthy participation in such employee activities as sports, amateur dramatics, musical activities, debating clubs, airplane clubs, women's groups, folk dancing, etc., can draw employees into active, sociable participation that can do wonders for individual happiness and creation of plant friendships.

Healthful recreation becomes ever more important as the work week grows shorter and leisure time increases.

In order to encourage maximum participation, such activities should be so planned as to leave the major work of organizing, planning, and operating them to the employees themselves. The amount of unsuspected talent discoverable through such activities is amazing, and the human development it brings about is well worth the tactful supervision it requires from the employee-service section. The section should be prepared to see that all activities fall within the broad outlines of company employee policies, recommend appropriate financial support, where necessary, for the various activities, and be in position to make contact with all outside recreation personnel and facilities.

While employee housing is usually left to the employees themselves, except in company towns, the employee-service section should be prepared to find housing facilities when the situation is tight, and should assist employees facing eviction or other unusual housing problems. The section should also maintain close contact with local housing officials and organizations.

Employee cafeterias, restaurants, and commissaries, which can be a fruitful source of employee problems, are also frequently a responsibility of the employee-service section. So are transportation problems, including group riding. During the Second World War, rationing was also usually handled by the employee-service section. Other miscellaneous employee services may include contact with retired employees, correspondence with employees on military leave of absence (and welcoming such employees when they return for a visit), supervision and training of matrons, and a wide variety of personal services designed to relieve employees of unnecessary worries and keep them on the job.

Many plants have a welfare fund to relieve needy cases among employees. This is appropriately administered by the employee-service section. If there is an employee credit union, it may be a function of the employee-service section to maintain close contact with its operation. Similarly, the employee-service section may supervise or advise on the operation of a suggestion-award system.

Not the least important of the employee-service functions is the administration of such employee-benefit functions as group life insurance and retirement pensions, which are too often handled as mere accounting problems in the accounting or controller's department.

Another important function that may be assigned to the employee-service section is the supervision of employee publications and the servicing of bulletin boards. Employee publications are an extremely important channel of

communication. Properly used, employee publications may not only sell the company's story and employee policies to the employees, but may also be used as a medium to express employee reaction to management. The greatest possible employee participation is desirable.

In publishing employee bulletins, plant papers, and booklets, the employee-service section should work very closely with the advertising and public-relations departments, and utilize all the technical, writing, and artistic facilities of those departments.

Thus, the employee-service section seems to be a catch-all of many unrelated activities. But they all lead to one purposeful goal—give the employee room for individual development, relieve him of unnecessary worries, and make him feel an integral part of "the company."

Employee communications. If it is assumed (1) that the chief operating executive is vitally interested in good employee relations, (2) that sound employee policies have been developed and reduced to writing, and (3) that all levels of supervision have been informed of these policies and have been trained in applying them, there still remains the basic problem of getting management policies thoroughly understood by employees.

Management must tell its story to its employees. It must do a thorough, careful selling job, evaluating its "prospects" (employees) as carefully as an advertising executive seeks to evaluate the field to which he hopes to appeal. The language must be simple, the approach sincere, and the intentions inherent in actions, rather than limited to words. Employees resent insincerity as much as they resent being talked down to. And they are quick to detect inconsistencies between act and deed.

In order for management to sell its story to its employees, it must establish channels of communication. "Channels of communication" is a cold, technical-sounding phrase. One way to make it meaningful is to think of it as a private line between the president's office and Rudy, the sweeper in Department Z. How can the president show Rudy that he is interested in him? Even more important, how can the president find out what Rudy thinks of him and of the company?

President to Rudy. The president can demonstrate his interest in Rudy by seeing that Rudy is provided with an employee manual, a booklet in which company employee policies are reduced to informal, clearly understandable language.

Some companies, having developed their employee policies with exactitude and appropriate legal reservations, publish these policies word for word in their employee manuals. The wording essential to employee understanding is usually quite different from the wording of a board of directors' resolution or a legal document. Much is to be gained by making the employee

manual an informal, human document, written from the employee's rather than the company's viewpoint. The policy may be—

The corporation shall grant every employee who has completed 1 full year of continuous employment a vacation period of 1 week with pay for 40 hours at his base hourly rate. Vacations shall be scheduled in such manner as not to interfere with operations or require the hiring of additional personnel.

The employee manual may cover the subject thus:

If you have been with us for a full year, you are entitled to a full week's vacation with pay during the vacation season. When you are eligible for a vacation, tell your foreman when you'd like to take it, and he will do his best to meet your wishes, provided it doesn't conflict with vacation schedules of other employees or with production requirements.

One way in which the president can talk to Rudy is by bulletin-board notices. Some companies reserve bulletin-board notices for stiff, formal announcements that make Rudy feel that he ought to hire a lawyer to tell him just what they mean. Such notices serve to emphasize that the factory involves the formal, nonhuman regimentation of masses of men in an artificial environment. On the other hand, the notice can be clear but friendly, with a personal touch that makes Rudy feel that there must be a real guy rather than a legal automaton in the president's office.

Note, for example, the difference in tone between the following two bulletin-board notices:

BULLETIN-BOARD NOTICE

September 6 being Labor Day, the shops and offices of the corporation will be closed.

* * *

HOLIDAY NOTICE

My very best wishes to all my fellow workers for a happy holiday week end. Since all shops and offices will be closed Saturday, Sunday, and Monday, September 4, 5, and 6, a big week end is ahead of us.

If your week-end plans include driving on the road, let's remember that Labor Day week end brings all too many fatal accidents. Let's drive so that we can all be back in one piece next week.

Those who are back on the job on Tuesday, September 7, will be paid at their base rate as though they had put in their regular 8 hours on Monday. Those who are requested to work (on special rush work or emergency maintenance) on Monday, September 6, will be paid at double their straight-time earnings for work done on that day.

(signed) G. H. FRASER
PRESIDENT

Bulletin-board notices need not be limited to notices of holidays, layoffs, and changed schedules. Rudy would be very much interested in reading on the bulletin board (before he sees it in the paper) that the company has just

received a big order, or marketed a new product, or declared a dividend. Many of the things that require executive attention also deserve a place on the bulletin board at the appropriate time—and that time is *before* the public at large learns about it. One of the best ways to establish confidence in management is for employees to get the facts from management before they hear about them from their friends and neighbors.

Another frequently utilized medium of communication with employees is the poster. Some companies believe they improve employee morale greatly by exhibiting series of colorful posters on bulletin boards throughout the plant. Such a "morale campaign" has the advantage of simplicity and ease of operation, since, once the selection is made, it is only necessary to change posters every week or two.

The poster does have a definite place among the mediums of communication, especially in the fields of safety, health, and plant housekeeping. But it is quite probable that the advantages of posters as a means of communication have been oversold. In some few cases, poster compaigns have done more harm than good because managements have relied upon such a campaign, believing that the poster campaign would perform the miracles claimed for it, when they would have done better to take more specific corrective measures. While suitable posters have a place in a rounded program of communication with employees, they should not be relied upon as an exclusive medium.

If "the company" is to be more than a vague, impersonal entity, more than the "soulless corporation" he reads about occasionally, Rudy should be brought face to face with some of the facts about his company. Too often managements feel that Rudy wouldn't understand anything about that, and that, moreover, Rudy just doesn't care.

Rudy wants to know about his company. And he has some awfully mistaken ideas about how much profit the company makes, and how much of the sales dollar goes to him. The more alert managements tell Rudy about it by means of special annual reports for employees—employee yearbooks that tell him about employee activities and company sales, employee benefits and company profits, how much went to the stockholders and how much went into reserves to make his company stronger, and how annual employee earnings have risen steadily from year to year. It makes Rudy proud to be able to talk about his company's activities and sales and prospects. He will talk about it to his wife and children at dinner, and all of them will acquire more interest in their company.

Some managements make their regular annual stockholders' reports available to their employees. That is better than nothing, but it is far better to prepare a special annual report to employees. It goes without saying that the

financial information in the employee report must be as simple as it is possible to make it. At the same time, its preparation must avoid "writing down" to the employee. It takes time and no little imagination to prepare an annual employee report. In addition to showing the share of total outgo that goes for materials purchased, salaries and wages, and dividends and reserves, the annual employee report offers management an opportunity to show employees how much its taxes amount to per employee, how the number of stockholders compares with the number of employees, how much investment is required to make one job in the company, etc. The employee yearbook is also an excellent medium for reviewing the operation of various employee-benefit plans, the suggestion system, recognition given the company during the past year, and the role of the company in the community.

Annual statements come only once a year. The president talks to Rudy oftener than that. The president may talk to Rudy monthly, or semimonthly, or weekly, by means of an employee publication—a publication that tells him about fellow employees returning from military service, about employee recreation, about employee safety and promotions, about employee suggestions and what was done about them, about the products the company makes, about distinctions or awards the company has won, and about the contributions the company has made to the community or the nation. It lends dignity and interest to Rudy's job to know about these things. And he likes to know about them in advance, so that he can tell his friends about them rather than have them tell him.

Occasionally the president writes a special letter to Rudy (and Rudy's fellow employees) telling him of something especially interesting and timely. If these letters are reserved for the annual Community Chest and Red Cross drives, the president is missing a bet. He might well write Rudy a letter of commendation when a critical order was shipped on time, or to tell him how proud he was that the plant looked so trim when a group of foreign engineers (or the governor) visited the plant last week. Letters from the president should not be reserved for charity appeals or golden-anniversary congratulations. They should be used whenever occasion warrants, bringing the employees closer to the company. Some companies send these letters to employees at their homes, where the wife and children can also read them and take an increasing interest and pride in their association with the company.

In some companies a loud-speaker system enables the president to talk to Rudy in person. This has been used very successfully by many industries to transmit the dynamic personality of the chief executive, and his enthusiasm and optimism, to the men and women at their desks and machines. But the microphone seldom flatters, and not all executives are born broad-

casters. The medium of communication should be attuned to the personality of the executive.

Neither the loud-speaker system nor any other system of communication should be limited to messages of exhortation or rosy reports of achievements. Channels of communication should be used primarily to enable the company's top management and its rank-and-file employees to *understand each other better*—not merely to overwhelm with propaganda. Channels of communication are most effective when used to discuss common problems, forecast future progress, answer inquiries, and disclose information about the company. No channel of communication is effective unless it has prestige in the mind of the employee.

One frequently overlooked channel of communication is the local newspaper. Some managements discover the local newspaper only when a strike is imminent or has been begun, and then fill its pages with anguished screams of wounded righteousness. By then it is too late to do a constructive job. The local paper is a daily or weekly message. It can be used to tell the president's story not once but repeatedly. It can tell a message in different ways again and again and again.

It can tell its story in words. It can tell it better in pictures. It can tell the story by way of an educational advertisement or a lively, human-interest news story. Sometimes a published letter to the editor is a good medium. Contact with the local newspapers must be carried on by someone in management who knows his jobs, who lays out a long-range program, and follows it through with imagination and tact. And it must be done *continuously.*

In addition to advertisements and news stories in the local press, alert managements seek to establish good relations with the local newspapers and, most important, let the local press know that someone from management is available at all times to give the company's reaction to any development involving the company. Such relations cannot be developed instantaneously when needed. They must be cultivated continuously. Fortunately, many managements are becoming increasingly aware of the importance of the printed word, and do not shy away from the press or meet every press inquiry with "No comment." Community public relations are becoming increasingly recognized as an important factor in employee relations.

Some companies have even recognized the value of incorporating employee-relations material in their national newspaper and radio advertising, having discovered that good employee relations are an excellent source of public goodwill.

While the channels of communicataion from the president to Rudy are varied and more than one is available, it cannot be emphasized too strongly that the president's message must be sincere and must be consistent with

Rudy's experience in the shop. If the president tells Rudy how much he's interested in his welfare, but his foreman fails to deliver to Rudy a message from his wife that the sick baby has suddenly taken a turn for the worse, Rudy will take every message from the president with a grain of salt. And the president's message about the company's fair-wage policy will be worse than wasted if Rudy finds he's getting less money than some other employee for the same work.

Channels of communication between the president and Rudy must be established, kept open, and used consistently and wisely. But if the president should come to the conclusion that these channels of communication can be a synthetic substitute for a genuine interest in employee relations, he will one day suddenly and painfully realize his error.

Rudy to president. The channels of communication from the president to Rudy are much easier to maintain than those in the reverse direction. But the mere fact that communications in the reverse direction are difficult does not minimize the importance of maintaining these channels open and in operating condition. The lack of knowledge of employee reactions in top-management circles is as vast as it is unfortunate. It is rather surprising that the average industrial organization works as well as it does when it is considered that in so many cases the president has not the slightest idea how Rudy feels about the company, the company's policies, or the way the company treats him.

Of the various ways in which Rudy can communicate with management, the most dramatic is the strike. A strike usually means that Rudy very definitely dislikes something and is taking extreme measures to show his dislike. (Of course, it is possible that Rudy made no decision at all in this case, for in some cases it isn't Rudy but his union representatives who decide that a strike is necessary to show that Rudy disapproves of something.) But the strike is a wholly inadequate channel of communication, because (1) it does not tell the management exactly what is wrong (the reasons advanced by the strike leaders are seldom the real causes); and (2) by the time the dissatisfaction has attained the proportions of strike action, it is usually rather late to undertake constructive action. Unfortunately, some managements put off employee-relations functions as relatively less important than other management functions, until a strike suddenly makes employee relations their No. 1 problem.

One means of communication that some managements have provided in an effort to determine employee morale or employee reaction is an opinion survey. This is usually a rather extensive program that may involve sending a lengthy questionnaire to each employee, with subsequent analysis of the returns, requiring very careful interpretation. This procedure may or may

not get appreciable returns from the employees, and there is always a question whether the employees who do return a completed questionnaire are representative of the majority or whether it is only the cranks or those with an ax to grind who take the trouble to fill in and return the questionnaires.

Some employee-attitude surveys are made by personal interview of a selected portion of the employees. This is also an extremely elaborate procedure. Both these types of surveys may be objectionable in that they may arouse employee resentment if employees do not understand their purpose.

Some companies have, however, had good results from employee-attitude surveys.

Contacts. Because of these and other objections to formal employee-attitude surveys, some managements have been moved to consider more carefully the actual contacts they have with their employees in an effort to evaluate employee reaction through normal management channels. The number of contacts that management has with its employees, even aside from the direct contacts with line supervision, are seldom fully appreciated, even by management representatives themselves.

The line organization may be perfectly satisfactory for the transmission of instructions and information downward. It is an appropriate medium for the exercise of authority from the top down. It is not necessarily a good channel for transmitting employee reaction upward.

The reasons for this are fairly obvious. In the first place, the immediate supervisor is so close to the trees he may not be able to see the forest. He may be in such intimate contact with the employees whom he supervises every day that it may be difficult for him to select the significant employee reactions from the regular run-of-the-mine reactions which he gets from his employees almost every minute of the day. Obviously he cannot report every reaction that he obtains from his employees, or he would be doing nothing else.

In the second place, the immediate supervisor is rather hesitant about transmitting upward employee reactions that may be critical of the line organization. Some of these reactions may be critical of the immediate supervisor himself. Some of them may be critical of the upper levels of the line organization. Some of them may be critical of company policies. In any case, the immediate supervisor may fear that when he reports these reactions to his superior, the immediate supervisor himself may be criticized for his mishandling of the situation, or his clumsiness in transmitting instructions of upper supervision, or in application of company policy.

Just as his relationship with his immediate supervisor is the most important factor in the employee's work environment, so the relationship with *his* superior is the most important factor in the work environment of the imme-

diate supervisor. The immediate supervisor's report to his superior is likely to be largely determined by (1) what he believes his superior would like to hear and (2) by the possibility that his superior may criticize him.

The immediate supervisor may also fear that employee reactions which to him appear innocent may be considered by his superior to be a reflection on his own ability as a supervisor.

Furthermore, the immediate foreman has usually had a considerable amount of experience in being the bearer of bad news, and he doesn't like that role. Some elements of management may take out their dissatisfaction at the receipt of bad news by finding fault with the person who brings the bad news to them. It is obvious that this reaction is the surest way of plugging up that particular channel of communication.

Still another reason why the supervisor is not a good channel for the transmission of employee attitudes is that the supervisor himself is frequently subject to the same griefs as is the employee. If he cannot make his own griefs felt by his superiors, he feels that there is not much point in passing on the gripes and reactions of his subordinates. The ferment of foreman organization in recent years indicates that foremen themselves may not be too happy about their situation. In such cases, foremen may become insulators rather than conductors in the line of communication.

Grievance machinery. One important channel of communication is the formal grievance procedure.

While it is generally recognized that an adequate grievance procedure is the foundation of any sound collective bargaining relationship, a formal grievance procedure is at best an imperfect instrument of communication between employees and management.

A careful analysis, however, of all grievances received is a necessary function for any management interested in the reactions of its employees. Where grievances are technically defined as being limited to questions of interpretation or violation of the collective bargaining agreement, the technical definition of the grievance should not blind management to the human value inherent in all complaints, whether or not they fit the technical qualification of a grievance. Even where a grievance relates to something entirely beyond the control of management, it may still be significant and may shed light on matters within management's province.

Besides the grievance procedure, other sources of information concerning employee reactions are available to management and should be carefully considered. Union newspapers are a fruitful source of helpful information concerning employee reactions. If nothing else they may indicate areas in which employees may need constructive information to overcome misinformation received by employees from other sources. The columns of the

local newspaper should be watched, particularly the letters to the editor, because they may disclose significant reactions.

Another source of information about employee reactions is found in letters from employees to various members of management. These should always be centralized in one place for handling and analysis, even though they are sent to particular individuals because the employee involved may personally know the individual addressed.

Staff channels. Whereas the line organization is immersed in the major problems of production, the staff organizations, such as the employee-relations department personnel, are free to observe, analyze, and determine the facts and factors that hinder or facilitate the functioning of the line organization. The line organization directs—the staff advises and assists the line.

The various staff elements of the organization must be impressed with the importance of providing unrestricted and directed flow of information from the employees to top management. All the management people involved in such matters as employment, employee counseling, employee training, safety work, welfare, transfers, disciplinary measures, labor relations, job analysis, time study, employee recreation, medical service, and all other staff functions should be trained to report accurately employee sentiment and significant employee remarks to a central place, where these reactions may be analyzed and summarized. The significance of employee-attitude trends should then be determined, and periodic reports made to top management.

The contacts with employees made by the employee-relations staff, for example, are many and various, and range all the way from a preliminary employment interview, before the employee is hired, to an exit interview when the employee leaves, with many an important contact between these extremes.

Many managements have established exit interviews for all employees who quit their employment. Such exit interviews, usually conducted by the employment office, are designed to determine the real causes for the employees' quitting and, if possible, to save valued employees for continued employment. When an employee has reached the point where he is ready to quit his job, he is more likely to be frank and honest in his evaluation of his employment experience than at any other time. If the exit interviewer is intelligent about his interview, he can learn a great deal about the effect of company policies and about the conditions in the department of the quitting employee.

Making a record of such interviews and filing them for future reference alone does very little good. The interviews must be analyzed and summarized so that a glance can show what departments may be trouble spots and what factors are most important in causing employees to leave. These

cases should be analyzed not only from the viewpoint of correcting the condition of which the employee complains, but from the viewpoint of the influence of that condition and its correction upon the entire employee body. Intelligently utilized exit interviews can be a very important channel of communication between employees and management.

It should not be overlooked that the exit interview furnishes an excellent continuous survey of employee attitudes. Assuming that the turnover for the average plant in the United States is about 6 per cent per month, it is obvious that in the course of a year as much as 72 per cent of the total employee body will have passed through the plant and have left. Therefore, without running a special employee-questionnaire survey, the exit-interview technique alone would provide management with a continuous source of information from a significant proportion of employees.

Discipline records can be a very significant index of employee reaction. Discipline records can serve as a check on

Employee policies
Employee screening
Employee placement
Supervision
The results of various employee policies in action

Collecting accurate and adequate records of all disciplinary matters in one central place for analysis and periodic report to top management can be very helpful.

One point of employee contact which is not often appreciated is that made by safety inspectors, safety engineers, personal-protective-device distributors (such as safety-goggle stations), nurses, matrons, etc. These people have daily, repeated contacts with employees and necessarily discuss with them causes of accidents, means of accident prevention, health, safety, and sanitary conditions in the shop, and allied matters. These are quite personal matters, and frequently lead to extremely frank, unrehearsed, significant statements of opinion. If these management representatives are taught to make reports on employee reactions, and such reports are centralized in one place for analysis, management can have a very useful channel of communication from employees.

Another management source of information concerning employee reaction (but one which must be treated carefully in order to safeguard employee confidence) are the numerous employee service contacts. Counselors, recreation leaders, and welfare people are frequently in a position to get important employee reactions to a very varied assortment of company policies. The same goes for grievance investigators, employee-training instructors, and

other personnel people. But it is important to make the point that none of this information is of very much value and none of it reaches top management unless a deliberate procedure is established for communicating all these reactions to a central point for summary and analysis, with periodic reports to top management. The continuous function of coordinating these reports might be assigned to the research section of the employee-relations department.

Labor relations as a phase of employee relations. Labor relations, *i.e.*, relationship with unions, are perhaps the most dramatic aspect of employee relations. They are also the area in which management is most apprehensive of the possibility of being divested of its authority and functions. They are the area most affected by legislation and government regulations. Accordingly, they are the area in which management is most sensitive and in which it is likely to take decisive action.

But the true relationship between management and employees depends only in part on management's relations with the union. Management's many contacts with the employees themselves are far more important in the determination of employee attitudes. If, in his everyday experience, the employee becomes convinced that management is sincerely interested in his welfare, that management is willing to listen to his suggestions and complaints, that management will give him a square deal, that management treats him like a human being—then it becomes a relatively difficult matter for the union to upset the basically sound relationship between employees and management. In fact, in such a situation, the union is not so likely to undertake an antimanagement attitude, for it will conclude that it can do more for the employees by working with management on a constructive plane.

On the other hand, if the employees have been treated arbitrarily, if they have been led to believe that management will not listen to their complaints or suggestions, if they are convinced that management regards every employee as a clock number rather than as an individual human being, then the employees are likely to express their frustration by extravagant demands through the union. The union is then more likely to adopt a quarrelsome, uncooperative attitude and to conduct antimanagement campaigns.

Important as they are, union relations are but one aspect of the employer-employee relation. And what is more significant for management, the kind of labor relations that any organization enjoys are likely to be in considerable measure the result of the kind of employer-employee relations that management has fostered.

The labor-relations section is that part of the employee-relations department through which all contacts with labor unions are channeled. It conducts all the correspondence with the unions, participates in grievance

handling at approximately the third step, represents the company in arbitration cases, participates in negotiations, and conducts all necessary correspondence with government labor agencies.

It is highly desirable that all correspondence with the unions be centralized in one place in the company, and the labor-relations section is that "place." Since the section studies and analyzes grievances at all levels, it can best determine the significance of various union demands and requests.

If, as is quite common, grievances are handled verbally by the foreman in the first step, the foreman should feel free to consult the labor-relations section if he is in doubt as to contract interpretation or company policy. In the second step, the grievance is usually presented in writing to the superintendent. He, too, should be free to consult the labor-relations section if in doubt, and copies of all grievances and rulings on them should be sent to the labor-relations section for study and analysis.

If the superintendent's handling is not satisfactory to the aggrieved employee, the grievance may be appealed to the works manager or a board of top-ranking supervisors. The head of the labor-relations section should sit with the works manager or be a member of the board, to present the human-relations aspect in any consideration of the grievance, and to interpret applicable company policies and observe them in operation.

It is obvious that, in handling grievances and arbitration cases, the labor-relations section must work in the closest possible harmony with the line organization. That harmony will be subjected to much stress and strain, but it will prevail if the line organization wants to cooperate and the staff organization realizes the importance of maintaining the prestige of the line organization.

The labor-relations section's participation and analysis of grievances in the various steps, together with information from other sources, should enable it to transmit to top management periodic reports on the status of employee morale and on the operation of employee policies. Such reports may constitute a human audit of the company, and top management will soon come to realize their importance.

One of the most important functions of the labor-relations section is the part it plays in contract negotiations. Counsel should be available for consultation and drafting, but the lead in collective-bargaining negotiations should be taken by the labor-relations section, which should prepare the background material, recommend changes in the existing contract on the basis of past experience, study the union demands, prepare counterproposals, and participate in (or conduct) the actual contract negotiations. Collective-bargaining negotiations are a warmly human selling job rather than an exercise in legal logic.

In conducting or participating in negotiations, the labor-relations section should be in complete harmony with the line organization every step of the way. It is the line organization that will have to live with the agreement and administer it. Line supervisors must completely understand what is involved, and should be given as much information as possible during the negotiations so that they may understand and accept the result.

Living under a collective-bargaining agreement. Negotiating a collective-bargaining agreement is only the more dramatic phase of collective bargaining. Far more important, from both management and employee standpoints, is the day-to-day operation under the argreement.

A collective-bargaining agreement is intended to stabilize the relations between the parties for the life of the agreement. Anything that interferes with peaceful operation under the agreement strikes at the foundation of collective bargaining.

Any dispute about the interpretation of a collective-bargaining agreement can and should be settled by arbitration if direct negotiations fail. Many collective-bargaining agreements provide that there shall be no strike, slowdown, boycott, or lockout during the life of the agreement, and that unsettled disputes about interpretation or violation of the agreement shall be taken to arbitration. Such provisions are the essence of collective-bargaining agreements. They should be jealously maintained, and violations should be punishable by law.

But not all agreements provide for arbitration of disputes concerning interpretation or alleged violation of the agreement, although such provisions are becoming fairly customary. Where such provisions are not included in the agreement, the parties are not likely to agree to arbitration at the time that a dispute arises, because at that time tempers are likely to be ruffled, and the strained relationship is not conducive to an agreement concerning the matter to be arbitrated, the selection of the arbitrator, the rules for arbitration, etc. Consequently, there is no way to determine the correct interpretation of the contract, or whether either party has violated it, except a lengthy court proceeding, or a strike, or lockout.

Relations with unions are likely to be better if all contacts are made through the labor-relations section, whose primary concern is good *employee* relations. Such centralization also ensures that all written communications with the union are centralized through a single department, which should also be responsible for keeping the official record of union relations.

Employee-relations research. Just as product development depends on research, so is the application of good industrial-relations techniques helped by adequate research—research into the effectiveness of various employee-

relations techniques and policies, and into the applicability of new techniques to the particular conditions of the plant.

Industrial-relations research is no ivory-tower project. It is a very practical, down-to-earth undertaking.

Industrial-relations research may be of great assistance in the development of new employee policies by keeping management abreast of developments in the rapidly changing field and determining whether techniques that have been found to be successful elsewhere are applicable in a specific plant, and what modifications may be necessary in order to make such techniques successful.

The research section may conduct investigations into profit-sharing plans, various employee-security plans, retirement plans, employment-stabilization programs, etc., and be ready to make recommendations at the appropriate time. Or it may study the operation of an incentive plan in a given department, to determine whether it is applied fairly or whether there is evidence of limitation on production.

The research section should be able to advise management what the cost of a proposed personnel program (such as compulsory wearing of safety goggles, for example) may be, and what results may be anticipated from it.

The research section may make an exhaustive study of seniority systems—an extremely complicated and far-reaching matter—and reach conclusions that will guide the labor-relations section in the next collective-bargaining negotiations.

The research section may study the budget of the entire employee-relations department to determine whether the company is receiving dividends on its expenditures, and what sections are not making the most of their opportunity.

One of the most important functions of the research section is to forecast the possible adverse employee reactions that may be expected as a result of introducing new practices or policies, in order that advance steps may be taken to head off such adverse reactions or convert them into favorable channels.

Industrial-relations research may also be considered a means for keeping the entire employee-relations department alert and on its toes. It helps to prevent continuance of those things which are carried on simply as a result of inertia. Sometimes it is just as important to stop certain operations as it is to start others.

Another important field which may be assigned to the research section is that relating to company organization. There are relatively few companies with a separate staff department devoted to the never-ending task of studying the company's organization for the purpose of improving it.

The organization of a company cannot be divorced from its personnel. As

personnel, conditions, products, and policies change, so must the organization of the company be modified in order that it may maintain and improve its efficiency and effectiveness. There is no one perfect type of company organization. The research section may have as one of its chief functions the study and observation of the company organization and the recommendation of changes in it.

One of management's chief obligations to its employees lies in the area of continuity of employment. The day is gone when management could afford to hire new employees upon receipt of a big order and lay them off when the order had been completed. The cost of turnover and unemployment compensation alone is a factor to be reckoned with. But far more significant are the intangible factors—employee morale, community prestige, public opinion—all of which are vitally affected by the insecurity and callousness of hire-and-fire employment practices on the one hand and by the stability and improved relations resulting from year-round employment on the other.

While few companies are so situated that they can guarantee year-round employment, a great many companies can do more than they have done to remove employment fluctuations. Employment stabilization affects all departments and many company policies. It requires careful preliminary research to determine how best to begin, and what are the various techniques and their relative merits. The research section of the employee-relations department is an appropriate department to do this preliminary research and to make recommendations for approval by top management.

Organization. Reference has been made to an employment section to recruit, interview, select, test, place, induct, and follow up new employees, transfer them from job to job, and terminate their employment when they leave; a job-analysis section to see that they are equitably paid; a training section to train them and open up new vistas of development; a health and safety section to assure their safety and good health on the job; an employee-service section to help them get properly adjusted and help their morale and sociability; a labor-relations section to deal with their representatives; and a research section to help keep the entire operation on its toes.

It is obvious that such departmentalization may not be necessary, and in small companies it may not be possible. However, in every case, the corresponding employee-relations function should be recognized, and the responsibility for it should be assigned to someone. In those cases in which the organization is too small to justify specialists in these various fields, full use should be made of labor-relations and industrial-relations consultants, local and national trade associations, and local industrial-relations associations.

Head man. All the activities of the employee-relations department are centralized in the head of the department, who should report directly to the

chief operating head of the company. It is becoming more and more customary, especially in the larger companies, to find the head of the employee-relations department bearing the rank of vice-president, and reporting directly to the president.

If the head of the employee-relations department is made subsidiary to the head of the production, manufacturing, sales, or any other department, his effectiveness is greatly limited, and it becomes difficult if not impossible for him to render a company-wide service, or even to do an adequate job in any department.

The head of the employee-relations department must have certain essential characteristics. He should combine tact with conviction. He should be able to sell his program to the line organization and yet be prepared to resort to pressure when that is necessary. He should have a deep, abiding faith in the importance of the human factor. He should be able to accomplish his purpose through other people. He should be endowed with a passion for anonymity. He should be prepared not only to give credit where credit is due, but frequently to give credit to others when it is in fact due to himself.

While maintaining a due regard for the authority and prestige of the line organization, he should make himself respected by the line organization for his ability and knowledge of the field, his ability to predict the results of a given course of action, and his interest in the welfare of all employees of the company while bearing in mind the long-range interest of the company. He must know and understand the nature of company organization.

He must be able to sell himself and his program not only to the line organization but also to the operating head of the company. He should continually impress the operating head, and the board of directors if necessary, with the importance of the human factor. He should be able to report at all times on the status of employee relations and to prove the dollars-and-cents value to the company of improving its employee relations.

He should know how to fill the role of employee-relations spokesman in the community.

The head of the employee-relations department should be prepared for a never-ending task of correcting errors. He should expect to help many without receiving a word of thanks. He should be grateful if he is given the means and organization with which to continue doing his job.

6. A world to gain

The achievement of good employee relations means the attainment of that intangible known as employee "morale," but it means more. *Good employee relations are the best guaranty any company can have of continued success in any field of endeavor.*

Employees who are proud of their company constitute the best possible advertisement any company can have, not only in the plant community, but wherever its employees go, and wherever they may have friends. The salesman who is "sold" on his company is a far more enthusiastic salesman than one who merely sells a good product. A customer or prospective customer who visits a supplier's plant can tell almost at once whether a good relationship exists between employees and management. If high morale exists, the company can be assured of having available to it the pick of prospective employees, assuring it of an ever better organization.

Good employee morale *pays off* in dollars and cents. Where good morale exists, employees put their hearts into their work, as well as their hands and brains. They enjoy their work, and they do it better and more efficiently. Higher efficiency means greater output and lower costs. In fact, it is probable that in no other single field can management show so great a return for so little investment. Appropriate encouragement can release untapped latent reservoirs of employee contributions to the success of the business. Satisfied employees are eager to suggest improvements. Satisfied employees take a personal interest in the welfare of the company. Satisfied employees require far less supervision. Satisfied employees cause less wear and tear on the machinery and equipment. Satisfied employees cause less avoidable waste. Satisfied employees are probably the most valuable single asset that any company can have.

Employees who appreciate their company do not leave it for other opportunities. Nor are they as likely to demand transfers to other jobs or departments, except for the purpose of utilizing their highest skills. The resulting stability in the working force is an important factor in achieving ever higher efficiency. Employee turnover is costly in many ways that are difficult to evaluate.

Aside from its dollars-and-cents value, aside from its humanitarian value in bringing satisfaction in place of spiritual repression to millions of people, the achievement of good employee relations has an intensely personal value to the men and women who make up management. For the only possible complement of good employee relations is good management relations. Where good employee relations exist, management has the opportunity to lead rather than drive. Management is looked up to, rather than vilified. Management's role is voluntarily accepted by the employees, rather than being forced on them by concepts of authority and legal rights. Only where good employee relations exist can management fully devote its time and effort to managing the business, rather than be perpetually engaged in overcoming human friction. Good employee relations are indeed the lubricant that makes an organization function smoothly.

In no other field can management reap so rich a harvest as in the field of improved employee relations. In no other field can so much be accomplished, both for the individual company and for our society. New, rich areas have been explored but remain to be fully developed and utilized.

The tremendous improvements which have been made in processes and equipment have their future counterpart in improvement in relationship that can and will be made between management and employees. Management's success in the future will be gauged largely by the progress it makes in improving that relationship.

Section 10

HOW TO ENSURE BETTER RELATIONS WITH STOCKHOLDERS

BY

DANIEL J. HENNESSY

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HOW TO ENSURE BETTER RELATIONS WITH STOCKHOLDERS

The purpose of this section is to outline ways and means of keeping stockholders informed and interested in the work and progress of your company.

Although in recent years increasing reliance has been placed on annual reports as a means of communicating with shareholders, there are numerous other ways to attain the same objective. The most effective stockholder relations program is a balanced, year-round program which combines all, or most, of these devices.

Introduction

An understanding of the need for good stockholder relations is the first step in setting up a program. In addition to your legal accountability to these investors, as provided by SEC regulations, stock exchange rules, and other requirements, here are some of the reasons for your constantly striving to keep your shareholders informed:

The management is responsible to the board of directors, which is elected by the stockholders at the annual meeting of the corporation. Therefore keeping the electorate informed is as important in the business world as it is in the world of politics

Many steps which the management deems advisable in the course of business require stockholders' approval. Depending on the laws of the particular state, or other pertinent regulations, these might include: adoption of a pension plan; disposing of the assets as a whole; the mortgaging of property; an increase or decrease in the authorized stock

When and if you decide to issue new shares, your stockholders should constitute your No. 1 prospects. They will be, if they appreciate the company's dividend record and potentialities, and if they are in accord with the policies of the management

If the stock is widely held, the shareholders may be important as a consuming public, depending, of course, on the nature of the product. Many companies make full use of their shareholders as "good-will ambassadors" in their respective communities

The investing public, made up as it is of people from every walk of life, is a strategic segment of society. Given the true facts about the enter-

prise system, and inspired to spread them wherever possible, stockholders have the power to "tip the scales" against subversive ideologies and doctrines

1. What kind of facts to communicate to shareholders

In the average corporation, there is no lack of interesting information to pass along to stockholders. Here are some of the items which leading companies include in their annual reports, letters to stockholders, newsletters, company magazines, and other stockholder-relations mediums:

Company policy. The management should make clear what it believes and practices in regard to stockholders, employees, customers, suppliers, and the general public. This would include such aspects as—

Research
Service to the public
Employee relations and fair compensation
The best possible product at the lowest possible price
Truth in advertising
Conservative and realistic accounting
Fair return to the investors
Sound public relations
Leadership in the industry

The enterprise economy and how it works. Here are some of the questions which a company can, and should, answer for its stockholders and, through them, for the community at large:

What is profit? Who gets it, how much, and why?
Why is investment necessary?
What proportion of the sales dollar accrues to shareholders? How much, in wages, to employees? How much, in salaries and other compensation, to top executives? What becomes of the balance?
Why are reserves for various purposes advisable?
Who owns American business—the few or the many?
How does competition make for progress?
How do corporations contribute to the American standard of living?
How do they help preserve human values and the freedom and dignity of the individual?

The sales dollar and where it goes. "What becomes of the money?" is a universal cry, and the wise management sees that both shareholders and employees are told the complete story. Through charts, graphs, pictograms, and other devices—as well as through the accounting medium of the annual statement—the company publishes the facts regarding such things as cost

of materials, payrolls, taxes, selling and administrative expense, depreciation, dividends, reserves, etc.

In this connection, it is wise to remember that different people react differently to words, phrases, and figures. For example, some will grasp the profit significance better if it is expressed in percentages, rather than in lump sums. Others prefer to have such data shown in terms of the average employee per week, or in the form of a comparison with like figures of the previous year.

The word "profits" in itself arouses varying responses. Some companies leave it out altogether, substituting "income," "net income," "payments to tool owners," and so forth. Others retain the word, but explain its meaning in various ways, such as "incentive to risk savings," "the margin out of which contingencies must be met," "the rent for the use of savings," etc.

The story of prices. When the price trend is upward, alert management counters possible resentment by disclosing the reasons and thereby shifting the blame. When the price trend is downward, it hastens to show how its sound management policies and practices have enabled it to give customers more for less. Rising costs are explained by comparing taxes, wages, material cost, construction and replacement costs, etc., with those of prior periods. At the same time, if possible, readers are shown how today's dollar's worth of the company's product or service represents *better value* than before.

Investment and ownership. Evidence abounds that neither stockholders nor employees fully understand how much investment is needed to make jobs and to keep the wheels of industry turning. Neither do they realize, generally speaking, that most corporations whose shares are publicly held have more stockholders than they do employees. Dramatizing the first point is one of the best ways to justify the enterprise system, as by showing how much net capital per wage earner employed is "chipped in" by others, to make jobs possible. Dramatizing the second will help to counter the fallacy that the many toil in servitude for the benefit and aggrandizement of the few.

Public-relations aspects. The company should let the stockholders and employees know what it contributes to the economy in terms of—

Jobs and job security
More pay for fewer hours of work
Lower costs and wider markets
Indirect employment of others
Higher living standards for all
Enhanced opportunities for the future
Benefits to the plant community

Day-to-day news about the company. Much of the information which is interesting to stockholders can be told twice—first in the form of news, as

soon as feasible after it happens, and in summary form in the annual report. Here are some of the items which constitute "news" to the shareholder, the employee, and the general public:

- Executive changes and new personnel
- Research developments
- New plants and equipment
- Advertising campaigns
- Important new outlets and resources
- Legislation and court decisions affecting the company
- Industry programs and objectives
- Pertinent anniversaries, such as—
  - Birth of the founder
  - The first incorporation
  - Discoveries, inventions, and patents
  - First entrance into each new field
  - Original contract with the union
  - Acquisitions and mergers
- Honors and recognition achieved by the company or its executives
- Employee-relations topics, including—
  - Twenty-five Year Club or other recognition of older employees
  - Suggestion and safety awards
  - Retirement plans and pensions
  - Other employee benefits
  - Collective bargaining notes
  - Employee activities, including those of social and recreational nature
- Significant statistical summaries
- New products and new markets
- Changes of any kind which make "news"
- Notice of annual and regional meetings
- Minutes of such meetings after they are held

2. *Obstacles which must be overcome*

When planning the stockholder relations program and putting it into effect, care must be taken to overcome the obstacles which impede understanding and discourage readership. Because *you,* the issuer, find your annual report, monthly newsletters to stockholders, and other material both interesting and convincing is no reason why the addressees should feel likewise. In fact, it is a good idea to *discount* the latter's willingness to read and absorb the contents, just as the professional magazine editor provides for a large tolerance of indifference on the part of his prospective reader. Here are some of the things which stand in your way when communicating with the average stockholder:

He may be skeptical, even cynical, about the accuracy of statements made by the management—particularly financial statements

He may not comprehend the language of business, and especially the accounting terminology which experts deem precise

He may have exaggerated notions regarding the profits which the company *should be making,* and hence disbelieve or be confounded by the true report

He may not keep informed about business generally, or about the industry in which the company operates, and hence may lack a basis for appreciating company progress

He may be deriving false notions from such partial "evidence" as plant expansion, executives' salaries, the size of the company, retail prices of its products, seasonal markdowns, the extent of its advertising, etc.

In order to grasp the full impact of these attitudes and misconceptions, read "The Public's Acceptance of the Facts and Figures of Business Accounting," based on a survey made for Controllership Foundation, Inc., by Opinion Research Corporation. This study divulged the existence of the following conditions:

Almost half the persons queried (45 per cent) said most companies actually make more than they report

More than half the persons queried (56 per cent) criticized company profit reports because they had "too many figures and big words." This was the answer of *51 per cent of those who held stock*

When asked to name "the per cent net profit that business generally makes today," the average (median) figure named was 25 per cent. Curiously enough, the survey showed, the public's estimate of profits made by companies is the same whether people are thinking of sales as the base or capital invested!

As to keeping abreast of information about business, only 17 per cent of the stockholders queried read the newspaper financial pages thoroughly

As far as "false notions" are concerned, of those people who named some company or industry as making too much profit, 39 per cent gave high prices as the reason, while another 23 per cent based their impression on hearsay and reading

To summarize:

The public, including many stockholders, has an erroneous impression of the amount of profit made by business firms

A considerable section of the public does not understand the terms in which business reports are couched, even though they are sanctioned by long use

In spite of certified audits and all the safeguards imposed by Federal and

state laws, and by the regulations of the securities exchanges, a substantial percentage of the public distrusts the financial statements of business

3. Getting the business story across

In view of these obstructions to ready understanding, as between stockholders and management, the shareholder-relations program must be shaped and conducted with them in mind. For example:

The financial "facts of life" about the company, including its sales and earnings, expenditures, and condition, must be highlighted

These essential facts must be expressed, explained, and interpreted so that they will be understood and accepted as true

There must be some background or basis of comparison against which company progress can be measured—such as records of past sales, earnings, and dividends; total sales and average earnings of the industry; and other pertinent data

Some more frequent means than just the annual report, for communicating with stockholders, should be provided. Newspaper accounts are not enough as a supplement, although they do constitute the second most important source of information about companies, according to another survey by the Foundation

Communication should not be confined to figures and statistics, both for interest's sake and to combat "false notions" of the sort referred to above

In addition to the annual report, the stockholder relations program should include such tried-and-true devices as—

- Annual meetings
- Regional meetings
- Interim reports
- Special letters to stockholders
- Welcome letters to new stockholders
- Company publications
- Newsletters and bulletins
- Dividend enclosures
- Special offers to stockholders
- Publicity
- Advertising to stockholders

4. The annual report: two schools of thought

During recent years, many advertising and public relations experts, anxious to overcome the obvious misunderstanding and frequent distrust of the facts and figures of business accounting, seized upon the annual report as a vehicle (1) for explaining the company's position, condition, and prospects, and (2) for defending and explaining the free-enterprise system. According to one advocate,[1] the "modernized" report can do the following:

[1] Lillian Doris, *Modern Corporate Reports*, Prentice-Hall, Inc., New York, 1948.

Make friends for the corporation among all the groups with whom the company has any contact—stockholders, prospective investors, employees, customers, creditors, suppliers, distributors, dealers, bankers, rating agencies, investment advisers, newspaper editors, financial writers

Create a confidence in the corporation that will discourage hasty liquidation of its securities, whatever the provocation

Add prestige to the corporation

Mark the management as progressive

Interest stockholders in promoting the company's products and services

Create fresh investor interest in the company

Give the corporation an opportunity to tell what it has accomplished, what it is prepared to do, and what it stands for

In short, do practically everything, within the limits of one volume, that constitutes *a complete stockholder-relations campaign!*

The result of this thinking has produced a yearly flow of attractive, expensive, beautifully illustrated, handsomely charted brochures and booklets, covering in narrative style every possible aspect of the companies' operations, not excluding economics lessons, "state of the nation" reports, flow-charts of income and disbursements, vital statistics on stockholders and employees, chapters on research, plus a host of devices for "livening up" the annual report. In the effort to become "dynamic" and "engrossing," however, the real meat of the annual report—the actual reason for its being issued at all—the financial statement and the profit-and-loss statement are buried or eliminated altogether.

Because its studies and opinion polls revealed gross ignorance of company affairs on the part of people in general, and on that of stockholders in particular, Controllership Foundation, through the Elmo Roper organization, conducted a study of annual reports and how they are regarded by the large and small investors to whom they are sent. Entitled "What People Want to Know about Your Company," this far-reaching study showed the need for *a different kind of annual report,* one which will give stockholders and other readers *the information they desire.*

As the Roper report determined, stockholders seek, in the main, four specific items of information:

1. Earnings
2. Dividends
3. General financial position
4. The company's outlook for the future.

Because this information was either not contained in the annual reports which reached them, or because it was so overbalanced by other material, 40 per cent of the run-of-the-mine shareholders queried in the Foundation

survey professed that these reports had no utility, and 60 per cent termed them only "moderately useful."

It seems obvious from such evidence that the annual report is not a suitable vehicle for editorial statements, general news, personnel items and write-ups, dynamic artwork, or intricate charts and tables. While companies need more, rather than less, publicity and public relations, the Foundation's survey proves that it does not pay to use the annual report primarily as a public-relations document.

5. What the five "publics" want to know

Do not be misled by the erroneous assumption that a single "public" or type of audience exists for the annual report or that the latter is a safe bridge to link together the many and diverse groups which are concerned, or should be concerned, with its contents. There is no common denominator of readership to which one all-purpose report can be directed. Instead, there are five, perhaps six, separate and distinct readership groups, as follows:

1. The run-of-the-mine shareholders, who possess no accounting knowledge or experience, and whose appetite is limited to essential facts, outlined quickly and in simple language
2. The more sophisticated large investors, who understand accounting terminology and who are avid for more details
3. The stockholders (particularly women) who rely on friends, relatives, and professional advisers for information on investments
4. The financial community, including bankers, trust officers, investment counselors, security analysts, etc.—experts who are professionally interested in the progress and condition of the company
5. Employees, whether shareholders or not, and their local and national unions. The unions might be considered a sixth "public"

Here are the major things to keep in mind regarding these groups:

The run-of-the-mine stockholder is indifferent and apathetic to most facts about the company, or companies, in which his money is invested—even to the point of not knowing (and apparently not caring) whether the company in which he is most interested earned more money last year than it did before; whether it had any outstanding bonds, and even whether the stock is selling for more or less than when it was purchased. The average stockholder, as the Foundation survey showed, is content to know about the earnings of the corporation, and he would like to have someone give him an appraisal of the company's financial strength and soundness. The average stockholder is anxious to get dividends, and is interested to know whether "his company" will remain strong

enough to safeguard his capital and keep paying the same—or a bigger —return on his money. But he regards these as simple questions which can be answered in a paragraph, and says he will be satisfied if the company gives him these answers.

The large investor, on the other hand, is apt to concentrate on the income statement and other strictly financial data. Here is a typical reaction from such an individual. "The first thing I turn to when I open a report," he avowed, "is the income statement. I follow it down from gross to net and get the relations between each figure. Then I turn to the balance sheet to determine the current financial strength of the company. I compare total assets and total current liabilities, and then examine the nature and amount of each of the items included there. I am particularly interested in the nature and size of investments, the amount of cash, the liquidity of the current assets, the vulnerability of the inventory figures, and so on. Then, if I know anything about the industry and its financial requirements, I can judge pretty well how financially sound the company is. I will know how subject it is to a business recession by the nature of the business and the relative size of its inventory and cash position in comparison with its short-term liabilities." Large investors, the Foundation survey confirmed, actually would like annual reports to give more details. Here are some which such investors asked for when interviewed in the survey:

Description of management personnel, *i.e.,* who runs the company
Reconciliation of the surplus and reserve accounts
Consolidated income statements and balance sheets going back 10 years
The company's plans for getting more business during the coming year
Appraisal of the competitive situation in the company's field of activity
The nature and size of any hidden reserves
Back history of the company's earnings and dividends
The amount of money spent in research
How much of profits are due to increased inventory evaluation
Complete exposure of expense items
Details on contingent liabilities
Programs and policies for the future
Salary deals with executives
Sales-cost breakdowns

Bankers and financial analysts, along with investment counselors, brokers and other members of the financial community, are still more sophisticated in their consumption of corporation financial data. Here are some of the principal things this "public" would like to know about your company:

More information on total labor costs, wage rates, wage raises granted, negotiations with unions
Comparative income-statement and balance-sheet figures for 2 to 10 years back
Better and more informative figures on reserves, depreciation reserves and inventories, and the methods used in calculating these items
Total income broken down by source from which derived and use to which put
Quarterly or monthly figures supplementing annual reports
More information which will facilitate an approval of management
Additional breakdowns of operating expense and of changes in total income prior to net earnings
Expansion planned and completed, and costs thereof
Reconciliation of figures reported in the annual report with those used in income-tax returns

Employees, as a rule, are interested most in facts which bear on job security. They especially want to hear about such things as expansion plans, new products and services, and prospects for next year—and they regard such facts as clues to job security rather than to company earnings or financial condition. If your plans include a special annual report to your employees, there are the items to be featured.

Unions and union executives differ according to whether they are national or local in character. The local union officials have the same viewpoint as the rank-and-file employees, but national unions usually have trained labor economists and research directors who are as economically and financially sophisticated as the security analysts, brokers, and bank executives. Their interest is in data which will serve their special viewpoint in collective bargaining, such as—

Wage breakdowns to show how much was paid to executives, supervisors, and employees who are not eligible for union membership
Similar breakdowns according to bargaining units
Complete cost breakdowns and inventory figures
Data on depreciation and reserves
Dividends paid to stockholders

6. *How to inform all five "publics"*

As this brief summary makes plain, the five major "publics" can be boiled down to two: (1) the financially unsophisticated, which would include the run-of-the-mine shareholders, plus the employees and local union officials; and (2) the financially erudite large investors, bankers, analysts, etc., plus the large investors and the national union experts. The way to bridge the two groups, and serve them both well, is to prepare *two* annual reporting documents, as follows:

1. Send a simple, one-page statement to *all* stockholders and employees, preferably in the form of a letter from the president of the company, which would confine itself to the following points:
   Earnings
   Dividends
   General financial position
   The outlook for the company
   This letter, in order to meet stock exchange requirements, should be accompanied by a condensed income-and-surplus statement and a balance sheet
2. Prepare for distribution a full-scale annual report of a purely statistical nature. Include all the facts, figures, ratios, and other information which the large investors and financial experts require and which they now have to "dig up" laboriously from a multitude of sources. Make this second book—a true fact book or reference work—available on request, and include a note to that effect in simple form

The following wording, tested by the Foundation, is offered as a guide in preparing the president's letter:

We made X dollars per share last year, as compared with Y dollars the year before. We paid you Z dollars in dividends as against R dollars last year. The present prospects are that we will not do quite so well next year, but we think your dividend is probably safe if nothing unforeseen occurs.

As companies in this field go, we are in a fairly strong financial position. We have no large outstanding debt, but we do not have the reserves to weather a good-sized recession without going into debt to do so. Our financial position has been improving the last two years, however, and two more years of good business should put us in A-1 financial condition.

We shall be glad to try and answer any specific questions about any phase of the business if you will write us. We publish a complete report for banks, insurance companies, and some of our larger investors. We shall be glad to send you one if you will fill out the enclosed postcard. But we do not wish to burden you with this document unless you want it.

Follow these findings when preparing future annual reports for your company, and you will have less to worry about in regard to stockholder relations!

7. *Interim reports to stockholders and other contacts*

Never be content to communicate with shareholders only through the medium of the annual report. Make the most of other opportunities to tell them of company progress and what the management is doing. Interim financial statements serve this purpose well and are also helpful to new stockholders who were not "of record" at the time the previous annual report was mailed. Here are some other types of communication which may suit your purpose:

Newsletters and other publications, including research bulletins, employee publications, company house organs, etc.
Reprints of speeches by company officials
Significant booklets and pamphlets
Dividend inserts of various types, including descriptive folders about company products, calendars, blotters, etc.
Institutional advertising and publicity, the latter worded specifically for acceptance by financial editors of daily newspapers and the editors of general business magazines and newspapers
Personalized letters to stockholders on matters of special importance, especially issues which may come up for handling at the next stockholders' meeting
Letters from the company president to all new shareholders, welcoming them to the group and enclosing a brochure about the firm and its policies
Personal contact with stockholders, obtainable through regional meetings, plant visits, "open house" affairs, etc.

8. Making the most of the annual meeting

In order to have a successful annual meeting (from the stockholder-relations point of view) you must plan and promote it well in advance and make every possible attempt to obtain a large attendance. Perfunctory notification is not enough: tell stockholders *why* they should come; *what* they will derive from attending; *who* they will see at the meeting, and *how* to get there with a minimum of effort. Some companies even provide special trains and busses to take stockholders from nearby cities to their annual meetings. Here are some other things to keep in mind:

Prepare, distribute in advance, and adhere to a written agenda
Allow time out for—or, better still, serve—refreshments or a light lunch
Start the meeting on time
Keep the ball rolling: never allow interest to lag
Vary the presentation and the pace, by using films, demonstrations, and other such devices
Streamline all possible reports, minutes of past meetings, etc. If you can, preprint such papers, and give each stockholder a copy to take home. Dispense with all reading, by resolution, so far as the legal counsel will allow
Have a chairman who knows how to preside—one who has the "human touch" and can stimulate audience participation at the right times
Avoid steamroller tactics, or any appearance of wanting the proceedings to be "cut and dried"
Elicit questions, answering as many as you can. If some are unanswerable without research, promise to mail the reply to the questioner. If you

know the answer cannot be found, the best response is, "I don't know. It would help us a great deal to know the answer to your question." Incidentally, never talk down to the audience. Reversing the celebrated quip, if you give intelligent answers, you will receive intelligent questions

Record the proceedings, and send copies of the transcription to all who attended—and to the other stockholders as well—after editing to delete repetitious and irrelevant details

Whether it be in connection with the annual meeting, with the preparation of the annual report, or with any other segment of the stockholder-relations program, remember that the more thought you put into this effort, the better will be the return. Feeding facts to shareholders is a habit which grows with the years, and the more you do it around the calendar, the better it will be for all concerned—the management included.

9. *Check list on stockholder relations*

I. What do stockholders really *know* about our company? Are we keeping them up to date on the following points:
   1. What *kind* of company is it?
      a. What it makes (if a manufacturing concern)
      b. What it sells (if a distributing concern)
      c. What it does (if it is a service company)
      d. Where its major installations are located
      e. Number of employees
      f. Number of executives
      g. Number of regular customers
      h. Number of stockholders
      i. Relative place in the industry
         By volume
         By capacity
         By capitalization
         By number of employees
         By number of stockholders
         By number of years in business
   2. Who runs the company?
      a. Officers and other top executives
         Who they are
         Where they came from
         How long with the concern
         Their stockholdings, if any
      b. The board of directors
         Who serves on the board?
         Background and present business connections of individual board members

c. Recent changes in managerial personnel
d. The "who-why-what-where-when" of executive changes

3. Earnings and dividends
   a. Growth in earnings and dividends over 25 years
   b. Dividend history over similar period
   c. Stock dividends, rights, etc.
   d. Company policy regarding write-ups, depreciation, intangibles, etc.
   e. Comparison with other companies in the industry
4. Financial administration
   a. Sources of fixed capital
   b. Key ratios
      Current assets to current liabilities
      Capitalization—common to preferred; funded debt to surplus
      Sales to inventory
      Net income to total assets
      Net income to net worth
   c. Financial statements
      Inventory condition and policies
5. Production facts
   a. Improvements in productivity rate over significant period of years
   b. New installations and equipment
   c. New methods employed
   d. Trends in operating costs
   e. Steps being taken to improve efficiency, reduce waste and unnecessary overhead
   f. New products
6. Employee relations
   a. Union status and new contract developments
   b. Employee benefits
   c. Pension plans
   d. Promotion policy
   e. Health and safety
   f. Suggestion system and awards
   g. Comparison with other companies in the industry
7. Advertising and sales
   a. Why advertising is important
   b. Campaign reviews and forecasts
   c. Advertising goals and objectives
   d. Appropriations for advertising and promotion
   e. Mediums employed—newspapers, general magazines, trade papers, radio, television, etc.
   f. Market data

g. How salesmen are selected and trained
h. Relations with customers
i. Sales plans and policies

8. The research program
   a. History and achievements of the research department
   b. Research personnel and organization
   c. Appropriations and budgets
   d. Ratio of research expenditures to sales
   e. Research activities, if any, being carried on outside the department
   f. The company's participation in joint research
   g. Ratio of basic to applied research
   h. Short-term and long-term objectives
9. What does the company contribute to others?
   a. *To the industry:*
      Trade-association activities
      Displays and exhibits at conventions of allied organizations
      Cooperative advertising or research
      "Support" advertising in association-owned magazines, programs, etc.
   b. *To the local community:*
      Participation in local fund drives
      Lending property, equipment, and personnel for deserving activities
      Donations for charitable use
      Cooperation with churches, local organizations, service clubs, etc.
      Activity in local chamber of commerce or board of trade
      Compliance with local regulations, ordinances, and restrictions
      Other steps which demonstrate company's sense of civic responsibility
10. The business outlook
    a. Sales and earnings forecast
    b. Pertinent findings by government economists, banks, and others
    c. Probable effect of predicted developments on company's sales, prices, earnings, production, etc.
    d. General business outlook
    e. Estimating and meeting competition—
       From other industries
       From other companies in the industry

II. How do we convey such information to our stockholders?
    1. By the printed word?
       a. Letters from the president
       b. Descriptive folders and dividend enclosures

c. Stockholder magazines
d. Newsletters
e. Announcements and minutes of stockholders' meetings
f. Institutional advertising and publicity

2. Through meetings?
   a. Annual meeting of stockholders
   b. Regional conferences of stockholders
3. By personal contacts outside of meetings?
   a. Visits to stockholders' homes and places of business
   b. Encouraging stockholders to visit the company's headquarters and plants

Section 11

HOW TO FIND THE BEST LOCATION FOR YOUR BUSINESS

BY

DAVID SCRIBNER

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HOW TO FIND THE BEST LOCATION FOR YOUR BUSINESS

1. Pattern of the metropolitan district

Location. Location is everything or nothing. It is the aspect of a site. In a positive sense it is labor, management, raw products, and finished goods; in a negative sense it is just a spot on the map.

There is probably more sentimental rationalization concerning the location for a business than there is reasoning. The factors which make a location ideal for one business may or may not apply to another.

In the retail trade, there has grown up a sort of patois used to describe location. One hears of "100 per cent locations" where large chain stores are located or prosperous department stores attract crowds and other stores bask in the reflected prosperity of the big advertising budgets of the center of attraction. For a good retail location, your business may be of the type that depends upon a large volume of small purchases and requires a 100 per cent location or one bordering on it. Other stores attract people to them by the special goods or services they have to offer.

Another example may be seen in the case of Lane Bryant's store in Brooklyn, which is on a side street—a decidedly secondary location as compared with that of the large department stores one block away on busy Fulton Street. A pedestrian traffic count shows about ten persons on the side street for every 100 on Fulton Street. Now, if Fulton Street is a 100 per cent location (and there are a dozen good stores to prove it), then this would appear to be only a 10 per cent location. But further examination shows that 90 per cent of those who turn into the side street go to Lane Bryant's store. This is a specialty store which essentially caters to oversize women and which has demonstrated in many cities that it does very well in a secondary location.

Corners. The advantages of a corner location are stressed by many retailers. This location is compared with a site in the middle of the block and the advantage of the corner is called "corner influence." This added value reflects in the land, and although the building may be designed to take advantage of it, the increment is to the land. Added value for a corner location may be 10 per cent or 50 per cent. There are many formulas and curves to chart the added value of corners compared with inside lots, depending

upon the corner. The added value for corner location is dependent upon the additional patronage which may be obtained by exploiting two streams of traffic rather than one, and it applies to the 20 or 25 feet on the corner. The 20 or 25 feet adjoining the corner is called the "key" and the key influence is usually only 20 per cent of the corner influence. The weighing of the factors involved in this measurement is solely that of the trained real-estate appraiser who knows how to interpret earnings, capitalization, and comparable sales. In general, it is well for the man inexperienced in real estate to calculate the corner-lot value as follows: (1) Determine the value of a typical inside lot of the same size on each of the two streets; (2) apply the unit values to the lot in question.

Example. A 40- by 100-foot lot on Main Street is worth $40,000, and on the side street it is worth $10,000.

40 by 100 ft. on Main St.	$40,000
100 ft. on side street at $250 per ft. would equal $25,000, but corner influence extends only 20 ft. or ½ area of the lot	12,500
Key influence for the balance of the lot at 20 per cent of corner influence	2,500
Total	$55,000

There are corners in all big cities which crowds pass like cattle in a chute and which offer little or no advantage, except for advertising, over inside locations, but again, for the retailer who depends upon a volume of trade, the corner location is important and often worth the added cost. Corner influence should be considered only in good retail locations. In secondary locations it has a declining influence in ratio to the general lack of retail desirability of the location.

Other retail factors. There are many arguments as to the east side of the street vs. the west and the north side vs. the south. The influence of these factors varies with the type of establishment and from one part of the country to another. In general, there is no rule for this, and each city must be examined by itself.

There are cases where a heavy flow of traffic discourages customers from crossing the street and makes for a concentrated retail section on one side of the street while the opposite side may become a secondary location. More often, however, locations in proximity to the large advertisers such as department stores are desirable for volume stores of the 5-and-10-cent type and specialty stores. In this case, being directly across the street from the large advertiser is often more desirable than being around the corner or farther down the block on the same side. Directly opposite R. H. Macy's great store on 34th Street in New York is a better location for a specialty shop than on the same side in either of the adjoining blocks. Location on a block is often

important if the blocks are very long. Another factor of importance is a curve in the street, where the problem of visibility is of concern. An example is "Little Fifth Avenue" in White Plains, N.Y., where Arnold Constable has a store on the outside of the curve and enjoys visibility from both directions, while the inside of the curve is vacant land. If the climatic factors are such as to be reckoned with, then the sun and wind determine the natural trends of location.

It is a good rule to look at the rents being paid by other retailers as a guide. If, for example, a shoe store has a 20-year lease at a high rental, and other stores of national chain type have high rentals, the chances are that they enjoy a high retail volume and the business risk for a similar type business is reduced. At the same time, the venture of starting a service-type business or one which does not depend upon volume is risky, as this type of business seldom would pay the premium for 100 per cent location.

Another guide is sidewalk pedestrian counts, which have a great bearing on volume retail trade, but have little influence upon the quality or so-called "carriage trade" type of enterprise. An analysis of traffic counts and pedestrian counts as to the predominance of men or women has a more important bearing than mere numbers.

Even the best of retail streets are affected by such "dead spots" as churches, libraries, monuments, and parks. The influence of St. Patrick's Cathedral is not so noticeable on New York's Fifth Avenue as is the influence of St. Thomas Church, a few blocks to the north, where the volume of trade on the opposite side of the avenue is higher than that enjoyed by the shops on either side of the church. In the first instance, Rockefeller Center more than offsets the influence of the Cathedral, while in the second instance, there is no such compensating factor.

Experience has shown that there are certain physical features about retail space that are desirable and other features that are undesirable. Basements are important, as they provide the ideal space for excess inventory, packaging, and shipping, and often may be used to supplement the regular display space during busy seasons. Good basement display space for which adequate stairs are provided is generally considered superior to second-floor space for retail purposes.

Mezzanine space is desirable for office work and sales space, but for the latter it should be at least 9 feet high and have the same clearance height, in order to provide adequate lighting. This added height tends to create awkward space in shallow stores, but it is desirable in stores of sufficient depth to offer attractive display space. It is difficult to display small objects in a store 19 feet high, but the same space may be ideal for furniture, antiques, rugs, cars, or other large objects.

Another important aspect of stores is that they should be neat, not gaudy. Clear signs—single-color or clear white neon lighting—against the façade are far superior to hanging signs or multicolor flashing signs.

Transition areas. When a section of a city is known as a "transition area," it should be regarded by the prospective tenant or purchaser with a very jaundiced eye. The term usually refers to a section which has been jumped over in the development of the city pattern or an area of the city which has been left behind in the city growth. It is characterized by marginal industry and retail and wholesale trade which does not depend upon either sidewalk or vehicle traffic for customers. The used-car, used-furniture, office-fixture, hotel-supply and similar forms of enterprise that inhabit such a section are necessary for each city, but are not characteristic of good downtown established locations. These are frequently very profitable business firms, and if the merchandising is aggressive, customers may be attracted in spite of the location, but generally the firms must go out after the customers.

It is the direction that the transition is taking that is important. Many downtown core areas now tenanted with first-class retail establishments are actually dying because of the competition caused by outlying sections which can attract the vehicle-borne trade while the central section, which cannot provide adequate parking, cannot serve its customers. In this case, the downtown area is in transition from a profitable retail section and the outlying area is in transition toward becoming a good retail section. The Chamber of Commerce of the United States, in its report "Making Better Use of Today's Streets," says:

> Decentralization is regarded as bad when it reaches the stage where established downtown businesses and property begin to suffer losses which if continued cause rentals to drop, stores to close or move, and buildings to be neglected.

Secondary locations. There are a great many business enterprises which need not be located in a high-volume business section and for which the cost of occupancy in such locations would be prohibitive. Home outfitters who have large inventories, food stores including supermarkets, chain stores of the Sears, Roebuck type, and many of the service businesses are found in secondary locations. Food stores are the cornerstone of such locations. About 28 per cent of all retail dollars go into food, and a corresponding volume is reflected in wholesale.

It has been the experience of the fast-growing Safeway Stores chain in a city in which it is established that when they open one of their large supermarkets they are able to close three or four of their older retail outlets. While the other stores were central and depended upon pedestrian customers, the newer stores are in secondary locations and depend upon vehicle-borne customers. The effect of the trend to supermarkets, larger per-customer

purchases, and more rapid turnover of inventory is the more intensive use of secondary locations.

Parking area requires large plottage, which is just as important as the actual retail space. The Urban Land Institute examined a great many shopping centers in peripheral locations and found that the ratio of 2 to 3 square feet of parking space per square foot of retail space prevailed. The newest shopping centers of this type are now being designed with 4 or more square feet of parking space per square foot of retail space. Factors which have a bearing upon the ratio are many, and it is dangerous to rely upon a rule of thumb. For years there was a standard rule that 200 square feet of space per car was sufficient, but this no longer may be taken for granted. The postwar car doors are larger, requiring greater aisle space; and longer overhang in the front and rear require greater turning radius. The figure is probably closer to 250 square feet per car than 200. While supermarkets put customers through their turnstiles rapidly, restaurants, barbers, hairdressers, dentists, and dress shops are very much slower, with a consequent greater number of car hours per square foot of parking space.

This retail trend has been called "decentralization." It is not limited to shopping centers where an over-all plan exists for the use of common facilities by many tenants, but is also found among independently owned retail outlets.

Combination retail and manufacturing—or retail, wholesale, and manufacturing—businesses are often found in secondary locations. Likewise banking facilities are usually adequate. When they are not, something is wrong.

It is here that the prospective owner or tenant should carefully regard the real-estate situation. He should look at the vacant plots and determine whether a building can be created to his specifications at less cost to him than the cost of renting an existing structure. Another factor is the proximity of steadily employed wage earners as a backlog for any business enterprise which may be undertaken. When this factor is favorable, it may be found that the location is a good one for his own labor as well as the customers; when this factor is unfavorable, the contrary is likely to be the case.

It has been taken for granted for many years that 10 shops in a cluster could be supported by 500 families, and above the 10 basic shops of a neighborhood group, one shop for each 100 families. Such rules are not reliable, but should be considered as a very rough approximation. Likewise, the method of allowing for 65 to 75 linear feet of store front per 100 persons. The reason for the lack of accuracy of these methods is that they apply to an urban area and not to any specific subsection thereof. Studies of the Urban Land Institute ("Community Builders Handbook") show that "the number of tributary families times their normal yearly expenditures for

various items will provide a guide to the approximate sales volume which may be expected." The Institute goes on to state:

This kind of study is adapted to individual projects and can be further refined and extended with the availability of additional local data. David Bohannon has used a detailed form of this method in evaluating a shopping-center location which he is developing and which illustrates the kind of survey warranted in the larger center. The economic aspects of the survey were prepared by McConnell's Economic Surveys and cover the following items:

- Determination of the economic trading area tributary to the shopping center
- Present population, families, and purchasing power for—
  - The entire county
  - The trading area
  - Ratio of trading area to county
- Population, families, and purchasing power for the trading area estimated for the current year
- Annual purchasing power after deducting other expenditures of
  - Federal taxes
  - Automobile transportation costs
  - Mortgages and rentals
  - Local taxes
  - Insurance, savings, etc.
  - Retail sales in other centers within the economic area

  Deducting these six items from the gross purchasing power leaves the commodity dollars spent elsewhere
- Analysis of competitive retail shopping areas
- Analysis of the proposed shopping center regarding type of stores and the priority of their establishment in the center

An item of interest is the stress which has been laid on provision for parking. The center as now designed provides for all the automobiles in the tributary area to park on the average of three times a week, assuming a 5-hour shopping day. This is considered a nearly ideal provision.

2. *Price that a business can afford*

The cost of occupancy is the primary limiting factor, and the determination of just what a business should pay for its rent or ownership is always a matter of debate. It depends in great part on the character of the business —whether it is retail, wholesale, industrial, or of the service and professional type.

Retail—commercial. In the case of retail establishments, the following table of experience shows what the average rental of space has been found

to be (*i.e.*, this may be taken as what these businesses can afford to pay for rent) in terms of percentage of gross sales:

Type of business *	*Range, per cent*
Amusement parks	4
Antiques	5 to 10
Art and gift shops	6 to 12
Auto accessories	1 to 10
Auto agencies' used cars	2 to 4
Auto-parking lot	50
Auto parts	1
Bakeries	2 to 9
Barber shops	15
Beauty shops	10 to 20
Books, second-hand	12 to 15
Books and stationery	5 to 12
Bowling alleys and poolrooms	10 to 12
Business schools	12 to 12.5
Bus terminals	5 to 7
Cameras and supplies (*see* Photographers)	
Candy and nuts	8 to 15
Children's and infants' wear	4 to 10
China and glassware	6 to 8
Cigars, cigarettes, and tobacco	2 to 10
Cigars, cigarettes, and tobacco with luncheonette and fountain	8
Cleaning and dyeing	8 to 10
Clothing	5 to 8
Cocktail lounges (*see* Taverns)	8 to 10
Cosmetics	10 to 12
Cutlery stores	7.5
Delicatessen and dairy products	5 to 7
Dental supplies	5
Department stores:	
$500,000 to $1,000,000	3
Over $1,000,000	1.5 to 3
Department stores, men's	3 to 5
Department stores, women's	5 to 8
Drugs	3 to 10
Drugs, prescription	8 to 15
Electrical goods	5 to 7
Engineering and architectural supplies	12 to 5
Five-and-ten or 25-cents-to-$2 stores	4 to 8
Fish and seafood markets	6
Floor coverings (*see* Rugs, domestic and floor coverings)	
Florists	6 to 12
Fruit and vegetable stores	3 to 15
Fruit juices	10
Furniture	2 to 8
Furs	6 to 12
Garages (storage, wash, gas, oil)	40 to 45

* This table is based upon one prepared by the National Institute of Real Estate Brokers, associated with the National Association of Real Estate Boards, and is modified by other data and the author's experience.

Type of business	*Range, per cent*
Gas stations	1⅓ cents a gal.
Grocery stores, chain	1 to 4
Grocery stores, ordinary	2 to 8
Hardware	5 to 8
Health foods	8
Hosiery, lingerie, and gloves (*see* Women's wearing apparel)	
Hotels	20 to 40
Household appliances and radios	6
Ice-cream stores	6
Interior decorating and home furnishings	4.5
Jewelry, costume	5 to 15
Leather goods	6 to 10
Linens	6 to 15
Liquor stores	5 to 10
Markets (super)	1 to 3
Meat markets	2 to 6
Men's clothing	4 to 8
Men's furnishings	6 to 15
Men's hats	8 to 12.5
Men's shoes	5 to 10
Men's tailors	6 to 10
Motion pictures	12 5 to 25
Musical instruments	6 to 10
Music department in department stores	10
Office appliances	5
Opticians, optometrists, and optical stores	8 to 20
Paint and wallpaper supplies	4 to 10
Parking lots	40 to 60
Pens, cards, and specialties	5 to 10
Pets	7
Photographers	8 to 12 5
Pianos and musical instruments	6 to 10
Poolrooms (*see also* Bowling alleys and poolrooms)	10
Radios (*see also* Household appliances and radios, Pianos and musical instruments)	5 to 9
Radios and electrical appliances	6 to 8
Radios and records	6
Records (*see* Radios and records)	
Restaurants	4 to 10
Cafeterias	4 to 8
Luncheonettes, lunchrooms, and soda fountains	6 to 10
Tearooms	5 to 10
Rugs, domestic and floor coverings	8
Rugs, Oriental	4 to 8
Seeds	7
Shoe repairing	10 to 15
Shoes (*see also* Men's shoes, Women's shoes)	5 to 10
Shoes, orthopedic	8
Silverware	8 to 10
Specialty stores (nonadvertising)	7 to 10
Sporting goods	6 to 10
Stationery (*see also* Books and stationery)	8 to 10
Surgical supplies	6

Type of business	*Range, per cent*
Tailors (*see* Men's tailors)	
Taverns (*see also* Cocktail lounges)	6 to 10
Theaters (*see* Motion pictures)	
Tobacco (*see* Cigars, cigarettes, and tobacco)	
Toys	10
Trunks and leather goods	6 to 10
Watch repairs	20
Women's wearing apparel:	
Cotton wear	7 to 10
Dresses, suits, coats	1 to 9
Popular price	5 to 7
Higher price	6 to 8
With millinery, hosiery	6 to 8
Foundation garments	8
Furnishings	6 to 10
Hosiery	6 to 10
Millinery	10 to 15
Popular price	8 to 20
Higher price	10 to 15
Shoes	6 to 10
Popular price	5 to 8
Higher price	6 to 10

Wholesale. Most wholesale establishments handling food have found that to be competitive they must take merchandise in lots, break them up into components, store them, assemble them into orders, and load them on outgoing vehicles for a total cost of under 5 per cent to the retailer. In many instances, this has been reduced to 3.5 per cent. Of this total, that portion which is the cost of occupancy is usually less than one-quarter and often closer to one-tenth.

The greatest advance in planning for the most efficient use of space has taken place in the wholesale and warehousing fields. Not long ago, when labor was getting 50 or 60 cents an hour, any old building would do; but today with labor getting at least twice and usually three times that figure and still capable of manually moving only 6 tons per day, efficient space, mechanical lifts, and other aids mean good use of real estate. Here, location becomes increasingly important, and analysis of ton-miles of haul to serve customers is indicated as well as thoroughgoing study of transportation.

The wholesale business is the distribution business, and its use of real estate is limited to the means of distribution (or transportation). For this purpose *all* means of transportation are important. Good sites with rail and highway locations zoned for industrial use are hard to find in many cities, and rail, highway, and water transportation is even more difficult to obtain.

In New York City so much of the good waterfront property has been diverted to highway use, housing, or public use that its great mercantile

position is endangered. This is true because of the fact that in New York the rail freight is practically all floated on car lighters so that rail and water are largely synonymous.

Establishing truck by-pass routes so that truck, truck-trailer, trailer, and semitrailer vehicles are excluded from central business districts has been the rule in many cities. In order to enable its streets to carry more business traffic, Dallas recently prohibited parking on four principal downtown streets between 4:30 and 6:00 P.M. Results have been so satisfactory that the ban will be applied to additional streets. On one artery, curb parking is not permitted in the morning on the inbound side, and in the afternoon on the outbound.[1]

Location of a wholesale establishment must be such as to serve the majority of its customers in an economical manner with the greatest efficiency. Recently, Manhattan Grocery Co., the largest grocery cooperative in New York, called in a firm of realtors to find the best location for a new warehouse. The site that was finally selected is very close to the theoretical center of population of the city as a whole. It is on an excellent rail line and is connected with the main arterial truck routes serving the entire metropolitan area. This cooperative is owned by the four hundred or more independent grocers, who, in order to compete with the chain stores, must be very efficient. Thus one progressive wholesaler met the location problem and solved it.

But to deliver the goods to the retailer, the wholesaler must be able to unload.

In most cities the problem has to be met at the curb, and that's where the trouble begins. The natural practice in downtown sections is to start unloading merchandise slightly in advance of the morning peak traffic load. By rush-hour time, the curbs are nicely lined with trucks. One answer which has obvious drawbacks is to require loading or unloading at night or in early morning in advance of the rush hour.

Control of truck loading and unloading is an important feature of a traffic "speed-up" program in Philadelphia, where all streets in the downtown district are one-way except three. Except on two one-way streets, loading or unloading may be done at any time on the right-hand side, but on the left side, it's another story. On the left, no stopping at all of passenger cars is permitted at any time and a truck may not load or unload unless a special permit is obtained.

Permits are granted only for off-peak hours when the load is of such a nature that it is impractical to carry the load across the street. The minute the load is dropped, the truck must be moved to the right-hand side of the street, even to get delivery receipts signed.

On Chestnut Street, which is inbound, no loading or unloading is permitted on either side during the morning rush hour, and on outbound Walnut Street no stops are allowed during the afternoon rush hour.

In some cities it is possible to meet trucking needs in a relatively easy manner. For

[1] Chamber of Commerce of the United States, in its report "Banning Parking at Rush Hours."

example, in Hickory, N. C., one of the principal business streets is paralleled by a moderately wide street which is actually a sort of glorified alley. By city ordinance the business houses along the main street are required to have all loading and unloading done in the rear. Formerly, most of the loading operations were performed at the front entrances, blockading the flow of traffic and usurping space for curb parking of customers.

Curb loading zones are coming into more common use. Typical of these are those recently installed in Mansfield, Ohio. Congestion caused by a mixture of trucks and passenger cars, looking for places to park or unload, was particularly annoying on one side street where curb park is permitted. Curb loading zones, providing for unloading a half dozen trucks at a time, were established on each side of the street. Some 70 trucks a day are unloaded with little bother to traffic [2]

Unless and until the wholesaler is able to locate where he can receive the goods, sort, store, assemble, ship, and deliver, he is not performing the function for which he is paid and he will fail. Location, for the wholesaler, is a factor of the highest importance. This involves an understanding of a city as a whole and the wholesale trade, perhaps more than any other, is dependent upon the entire metropolitan area. Arthur M. Weimer and Homer Hoyt in their classic *Principles of Urban Real Estate* approach the problem of such a study in a practical manner:

One method for collecting the necessary information is by the use of "dynamic" or "time-interval" maps. A photograph or a map of a city at a given moment of time fails to show the dynamic character of the city's growth. Several photographs taken at different time intervals or several maps for different periods reveal the processes of change. Thus, if the location of a certain type of area has changed from one period to another, it is possible to determine the direction and speed with which such movements have occurred by using devices of this type.

Generally speaking, a period covering at least the past 25 years should be studied. If possible, such analyses should be carried back to the turn of the century, and should include a description of the city as it existed then. Another detailed description should be worked out for a period around 1918 or 1920 These periods are suggested because they represent well-marked stages of city development and the specific dates are usually well fixed in people's minds: 1900 by association with the turn of the century, and 1918 or 1920 with conditions as they existed at the end of the First World War. These situations should then be compared with current conditions.

If it is possible to undertake careful and intensive research, specific information can be secured from such sources as the Sanborn Insurance Maps, which show locations of individual structures in many cities for periods as far back as the 1880's. Also, valuable assistance can be secured from the United States quadrangular survey maps, which provide similar information. Older maps of cities can frequently be found that provide valuable data. City histories and old newspaper files often include accounts of the development of particular areas

Regardless of the plan of attack adopted, at least two maps should be prepared, one of which will indicate the areas occupied by (1) factories and heavy industries, and (2) those occupied by distinct racial, national, or low-income groups in 1900, 1920, and at the present time. The second map should indicate the boundaries of the chief central and outlying shopping or commercial areas, as well as the boundaries of the most fashionable residential areas for each of these periods

[2] Chamber of Commerce of the United States, in its report "Truck Unloading Poses Problems."

These maps can then be combined into three maps, one of which will show conditions as they existed in 1900, another in 1920, and the third at the present time. From these three maps a reasonably accurate picture can be secured of the major movements affecting the high-grade neighborhoods, the low-rent areas, special racial or national groups, industrial sections, and commercial districts.

Such general maps should then be compared with maps showing the development of the internal transportation system of the city. Maps showing the transportation system at various periods of time can usually be secured from the city offices or from the offices of those who are in charge of the transportation system. Similarly, comparisons should be made with existing zoning maps which indicate the restrictions applying to various areas of the city.

When the movements indicated by the maps have been studied and analyzed, the dynamic forces of city expansion and the probable future structure of the city should become apparent. It is generally possible to assume that existing uses will expand outward in the same sector and that the trend of past development will be continued into the future, unless important and powerful forces are in existence or are likely to develop which will tend to cause a reversal of such trends.

Industrial. Industrial space does not fluctuate to the extent that is characteristic of other real estate. An example of this is shown by the statistics of occupancy of loft buildings in New York City which, in the 20-year period 1929 to 1949, averaged about 90 per cent occupancy with a low of one year at 80 per cent. This may be compared with office-building occupancy, which during the same period averaged about 85 per cent and showed 5 years of occupancy below 80 per cent.

Manufacturers seeking industrial space will always find outmoded space available in any city, for the excellent reason that unless the space is efficient for general use, the chances are that it will not be good enough for a new business except at very low cost of occupancy.

There is no rule of thumb for the cost of occupancy of industrial space. A concern with excellent credit, good standing, and proven experience may be able to occupy quarters on a basis of as low as 6½ per cent of the book value, plus real-estate taxes, maintenance, and repairs. This is the leaseback technique, and in industrial real estate this method is available only to the strongest concerns.

When a city or group of adjacent cities are dependent upon a concentration of one specific type of manufacturing endeavor, it is similar to having one large manufacturer which dominates the area. Both cases are an element of danger, for a single-industry community may be dominated, for good or evil, by a few labor leaders or a handful of the most prominent businessmen or both. Then too, the demand for the products manufactured is the controlling item in the economic life of the area. This demand may be altered by a technological improvement or a new product which is made elsewhere.

Long-range trends in industry have a great deal to do with this, and the vast quantities of vacant industrial space in such cities as New Bedford and Fall River, Mass., after the cotton industry moved south, are testimony to

the inability of a city to absorb its vacant space when it is placed upon the market in large quantities. Such cities often offer the greatest opportunity to a young industry as the whole community will go out of its way to make conditions favorable. Such conditions are known to the various state industrial boards and industrial departments of railroads.

From the standpoint of future effects on real estate values it is important to determine whether the industries located in a city will remain, advance in importance, decline, or move to another location. Among the factors that tie an industry to a city are large plants, heavy fixed capital investments in new and modern machinery, the availability of a large body of skilled labor, favorable freight rates, convenient access to raw materials, proximity to markets, favorable attitudes of local community leaders, and low taxes. In addition, it is important to determine whether any new industries are likely to move into a city. The above factors will also have a bearing on such probable developments.[3]

In the past manufacturing was characteristic of the section of our cities surrounding the central business district. This section, in turn, was surrounded by the industrial workers' dwellings. In our older cities these industrial sections, subdivided between the downtown core area and the slums, still exist. It is here that the multiple-story lofts are found. Many of the heavier industries have moved out of these buildings, leaving them for the lighter manufacturing processes. The result of this is that there is developed a transition in which the lighter and more numerous small industries have displaced the heavier industries and the latter have moved on to a peripheral location.

Industrial plants cannot spend a great deal for land, and they need a greater area than is generally realized. Rail lines are usually important, but also the trailer-truck must be accommodated. The cars of employees, executives, salesmen, and visitors all must be accommodated in today's factory grounds, as well as the loading platforms and a place for trailers awaiting unloading, loading, or pickup. Add to this a one-story or, at most, two-story plant, and the land-use ratio (ratio of total land area to manufacturing space) becomes more like that of a shopping center than like one of the old factories.

Service-type business and professional. These are the users of office space, and although a laboratory or servicing shop may be required, it usually is found as an adjunct to the office if the space is small or in another part of the city if the space required is substantial. Cost of occupancy in office buildings is usually rent, light, and amortization of furnishings, partitions, and decorating over the period of the lease. Heat, cleaning, and service are usually provided by the landlord.

[3] Arthur M. Weimer and Homer Hoyt, *Principles of Urban Real Estate,* under "Competitive Advantage of the Location." Rev. ed., Ronald Press Company, New York, 1948.

Second-floor space for offices in the smaller cities is desirable use of real estate. Such space in shopping centers in the periphery of larger cities is also desirable, but in either case care should be exercised to make sure that the approach to the space is attractive. Too often the stairs are steep, dark, and narrow when they should be easy to climb, with landings, well lighted, and at least 5 feet wide.

Because the cost of occupancy must be a minor part of the total costs of professional practice for doctors, architects, engineers, and accountants, very efficient use of the space occupied tends to keep this portion of the cost to a minimum. For reasons best known to themselves, this does not appear to be the case with lawyers. Doctors, for example, usually have regular office hours, and, therefore, while one doctor is out, an associate may use his office, examining rooms, waiting room, and other facilities. Often these doctors will rent the same space and thus use it for 60 or 70 hours a week instead of 40. Architects, engineers, and accountants use facilities in common to a lesser extent, but they too achieve a flexibility by making use of the space of associates. These factors tend to make the rent of professional space rather high on a square-foot basis, but low per individual, lawyer excepted.

The service-type business includes a great number of businesses. The advertising firm, real-estate office, or insurance business is characteristic of others of the same type. They are primarily sales offices out of which salesmen operate and in which policy meetings are held and detailed work prepared. Any building in a central location adjacent to transportation lines may house such a business, but the more efficient the space the better it is. Rent, or cost of occupancy, is usually a higher proportion of total cost than is the case with users of professional space. A rule of thumb indicates that such users of office space pay from 3 to 8 per cent of total costs for cost of occupancy.

In choosing a location for office space, certain considerations other than cost are important. In the first place, a clean, neat building in a good setting will always be reasonably well filled at high rents, as compared with the same building in a declining section. The physical characteristics of a building are important. In order to be adaptable for the many uses to which office space may be put, flexibility as to electric outlets, plumbing extensions, and other facilities is required. A stock-exchange house, for example, may require 20,000 square feet of space, of which 19,000 square feet may be in two large open spaces and 1,000 square feet may be divided into ten or more offices. Law offices, on the other hand, require many small offices.

Office-building occupancy is a good index of business activity. Here, more than in any other type of business space, the law of supply and demand

works freely and the competitive demand for office space controls the cost of occupancy.

3. *Public controls*

State and local ordinances. The law of supply and demand in free competition regulates the use of all business, including real estate, but in addition, real property is subject to public controls. These controls are sometimes obvious, such as zoning regulations. In some cases they are not so apparent, as is the case of state labor laws which may permit one business to use a building but would make it very costly for another.

Zoning and restrictions are closely allied.

Zoning is a comprehensive mapping out of city land use, and restrictions, in relation to the residential areas, are its refinements

Restrictions stabilize environment—and also stabilize conditions Values are thus maintained Zoning is designed to attain the same objective—the stabilization of land value throughout the city as a whole, which is of great public benefit.

But in order to be effective, a zoning ordinance must be just to property interests—not an uncompromising carrying out of abstract principles, but an intelligent adjustment to the many considerations and forces which enter into its making. In short, a zoning ordinance must be workable, it must be practical, it must be rational, and it must be flexible [4]

Most cities have zoning acts, which derive their authority from the police powers of the community. Zoning is a device to enforce the planning concept of the city, town, or county. There is an increasing tendency to coordinate local area plans into a master or regional system. The plan is more important to a buyer or a business about to undertake a long-term lease than is the zoning ordinance, for if and when the long-term plan is implemented the character of the location may change and the zoning accordingly.

To assert or assume that zoning has failed is to admit one's lack of knowledge of its objectives and achievements. Since the inception of modern zoning in New York City some thirty years ago, all but one (Houston, Tex.) of the 36 cities with a population of 250,000 or more have adopted zoning ordinances, and only four of the 87 cities over 100,000 remain unzoned. Among the communities ranging from a few hundred to 100,000 population, more than one thousand have also availed themselves of this new form of municipal control.

Certainly such rapid and widespread acceptance of this new principle of "property insurance" in itself proves something, and to anyone possessing an acquaintance with urban problems, it means that zoning has filled a real and long-felt need in protecting and directing the orderly development of our urban areas. Significant, too, is the fact that few, if any, carefully prepared zoning ordinances have ever been abolished.

It is important to realize that the many ordinances now in operation were applied to communities already largely built up, sizable portions of which, through the years of uncontrolled development, had suffered various degrees of blight. In fact, certain large sections had become so thoroughly deteriorated it was obvious that the only hope

[4] *Urban Land*, January, 1948.

for rehabilitation would be through some form of urban redevelopment, which principle, fortunately, has been receiving attention in recent years. In many older, more homogeneous areas, which might have been protected and improved under early zoning, political pressure by speculative interests and those who thought municipal growth had no bounds was too great, and consequently the zoning was made much too liberal to be of real value.

Among the more conspicuous examples of laxity in the early ordinances was, and still is, the vast and unwarranted overzoning for business along main thoroughfares—again the product of false hopes and insistent demands of uninformed or avaricious property owners. The fallacy of this early error is becoming more glaring with the passing of time, and a number of cities, notably Milwaukee and Los Angeles, have already made substantial reductions in commercial zoning along thoroughfares where long experience and conclusive facts indicated clearly that the property could never be absorbed for that purpose. Cities are slowly realizing that such thoroughfares are destined to become "ribbon slums" if not needed for business, as no well-informed loan company will risk financing residential buildings in such areas. How unfortunate it is that the main thoroughfares which are used and seen daily by a vast portion of the local population, as well as by visitors, are in the main a depressing hodgepodge of dilapidated structures! Quite naturally the above conditions do create in the minds of many the erroneous impression that zoning has failed, whereas in fact, it has never been given a fair chance to succeed.

The principle of zoning has not failed; rather the failure has been the unwillingness of a few to recognize that the attainment of wholesome community development requires conformity with an over-all plan to achieve "the greatest good for the greatest number." What is actually needed is the strengthening of, and stricter adherence to, zoning regulations. The value of zoning is in the stability it affords, and if it is to produce satisfactory results, frequent piecemeal and promiscuous changes must cease. It is also time to realize that "free enterprise" carries with it the responsibility of providing better living conditions for all, as well as opportunity for individual gain [5]

Zoning usually is limited to regulation of the use to which real estate may be put, of the height and area of buildings, and occasionally of population density. As a rule, a business which exists in a district zoned for other use is there because it was in being prior to the zoning act and it may remain as a "nonconforming" use, but once it ceases to operate, zoning restrictions usually take over.

Building codes. Building codes are supposed to be based upon the concept of the community police power to ensure public safety. Specifications as to the quality of construction and the strength of materials are primary considerations, as are plumbing and electrical codes. The importance of these regulations to a new business lies in the naïve assumption on the part of too many people that any building may be altered to be adapted to the use for which it is intended. Too often the building code which permits a building to exist in a substandard condition will require that it be almost completely rebuilt if any attempt is made to alter it. Also many types of alteration are not possible under local codes.

[5] *Urban Land* in its report, "Has Zoning Been a Failure in Guiding the Orderly Growth of Our Cities?" November, 1947.

Building codes are an important phase of public regulation in the real-estate field, since they provide protection of a type which the individual citizen cannot secure in any other way. However, they are subject to various criticisms. The most difficult problem is that of enforcement, since regulations are evaded in many cities. In addition, they frequently establish requirements which add unnecessarily to the cost of construction. Many of the control measures are unduly complicated and deal with details rather than fundamentals. Frequently they establish requirements which give monopolistic advantages to certain manufacturers, who alone can provide specific types of materials. Sometimes they "make work" for certain building trades Often they tend to prevent progress since new materials, while not conforming exactly to requirements, are often entirely capable of meeting any demands made on them. Many similar criticisms could be directed against plumbing codes [6]

There has been a recent large-scale attempt to standardize and simplify building codes and to correct archaic restrictions, but in many parts of this country there are building codes which prohibit the use of new materials and techniques of construction.

Health, labor, police, fire, and other regulations. There are all kinds of regulations, depending upon the complexity of the city. In some cities, there are no regulations as to the number of persons who may be employed in a given space; in others, this is delineated. Many state laws control the number of employees per toilet fixture. Safety measures require sprinkler systems in buildings of certain types used for certain purposes. Still other regulations require special fire or police permits for certain types of manufacturing.

These regulations are particularly important in industrial operations. Some types of industrial buildings are built for the special use of their owners, and the buildings are not adaptable for general use. This is particularly true of the heavy-industry plants, which are usually of special design. This includes steel mills, building-material factories, glass works, breweries, public utilities, chemical plants, and ice plants. When these appear on the market it is only because they have become surplus property. The adaptation of such plants to other use is most unusual.

Other properties which are more adaptable to general use or industrial plants which were built for multiple industrial use are subject to an endless list of regulations, different in each city, ranging from elevator-load requirements to fire-door controls and from types of sprinklers to materials for stair treads.

The regulations for places of public assembly are particularly stiff. Department stores have to meet different rules than do ordinary street-floor stores.

In New York City the regulations governing the use of occupancy of property is contained in four volumes, while in some cities only the state labor and health laws need be observed.

[6] Weiner and Hoyt, *op. cit.*, under "Building Codes."

For a business seeking a location, a good local architect who understands the application of local laws and "ground rules" is essential.

4. Special considerations

Location in relation to customers. This is of primary importance to retailers and diminishes in importance to the extent that the business in question can go out to its customers.

Here is where the decision must be made as to whether the business should be located in a downtown core area or in a satellite location. In other words, will it rely upon the large volume of daily pedestrian traffic or upon the suburban vehicle-borne customers? Two considerations which have been previously discussed, the pattern of the metropolitan district and the character of the business, should be reviewed.

Chain stores, because of their excellent credit, large central purchasing, low overhead per sale, and diversification, are different from independent retail outlets, but they are an excellent illustration of location in relation to customers. Chain stores are as different from each other as are the independents and the location needs are likewise different. Most chain stores want to be in the vicinity of the local 100 per cent locations, except food stores. Stanley L. McMichael, the veteran real-estate analyst, states in his book *Percentage Leases*:

> Chain stores were the first to develop the technique of scientifically gauging the value of locations suitable for their business. They did this by a study of neighborhood conditions, habits of buyers, and the clocking of the pedestrian traffic, principally women. They gave a rating of 100 per cent to the location that showed the highest and best type of buying traffic. Most 100 per cent locations are occupied by concerns selling merchandise at retail to women buyers. There are some exceptions. Some 100 per cent locations serve both men and women. Sometimes a high-powered chain selling exclusively to men will rent a store in a 100 per cent district and do very well selling to both men and women by carrying a few exclusive lines of interest to the latter.[4]
>
> The 100 per cent district is actually the one in which property checks with the highest type of pedestrian traffic, considering the kind of traffic desired. The location must always be judged in relation to the type of merchandise to be sold in the store being studied. What is the location best suited for? Is it a women's, men's, or a mixed block? Is it a night location? What goods can best be sold here? What kind of clientele is essential to the success of a prospective venture? What may be a "hot spot" for a popular-priced dress shop may be an "off location" for a men's clothing store. What may be a prime location for an exclusive specialty store may prove a dud for a variety store. Basically there is a proper location for every type of business.
>
> The ideal location requirements of chain stores vary widely, and no standardized set of requirements can be quoted. Each chain has its own ideas of layout of counters, offices, and other store facilities. A shoe store, receiving shipments almost daily, can merchandise them in a store 15 feet wide and 60 feet deep, while a variety store will have a 40- to 60-foot frontage with a depth of from 100 to 150 feet. For variety stores, a unit desired in a suburban center is of a different size from one that may be suitable for a downtown location. Variety stores prefer not to own locations outright. Rather they prefer to lease them. Consequently they take only the amount of space needed

and follow a more or less set design in the layout of departments selling various types of goods. No surplus space is required. They prefer a two-story-and-basement building. Large office buildings are out. Usually they ask that the landlord put the property in shape for their occupancy, although some variety chains will make their own improvements if the rental permits them to amortize the cost over the term of the lease and the location is particularly desirable.

The January, 1950, issue of *Chain Store Age* points out a few other factors usually considered by chains in an article by Lucius S. Flint, the magazine field editor. Below are extracted some of the high lights from that excellent article:

Chains are learning that, in most cases, adjacent housing alone cannot be expected to support a major shopping center, but that a center must be well situated in relation to mass transportation. Very large parking areas are now considered absolute "musts" by chains in most lines.

Some store closings are occurring in older districts. The point at which an older store is closed is usually related very directly to lease cost. As older business property becomes less desirable, rental rates usually go down. Policy of most chains is to renew old leases if the rates have been lowered sufficiently to permit a somewhat profitable, though scaled down, operation. Very few chains consider it desirable to reduce floor space in order to continue in an older location.

Careful study is being given to the desirability of remodeling and enlarging individual stores in older areas. The point of decision here often has to do with how much business will likely be pulled away from the area within 10 to 20 years by new districts that have been established or might be established. If competitive advantage could be gained by remodeling and costs could foreseeably be amortized over the number of years of the area's safe business future, then serious thought is given the possibilities for upgrading. Many executives place a great deal of stock in the belief that most customers do not change shopping habits overnight. . . .

While decentralization is occurring rapidly, many executives believe that established locations in central business districts of large cities are still valuable. . .

While a majority of chains now prefer to have their capital in merchandise rather than in real estate, the general attitude is that if a really important location can be obtained only by purchase, the purchase should be made and a build-sell-lease deal can be arranged later. . . .

Standards of selection still vary with the needs of specific types of businesses. Current thinking is along the following lines:

Grocery. Outlying locations definitely preferred, usually in or near a good business district or shopping center. Large parking area indispensable. Superstores a definite trend. Both neighborhood and transient business needed. Importance of arterials to bring traffic from a distance rated more highly every day as larger and larger stores are built. Practically all new units being built to order rather than placed in remodeled buildings.

Drug. Both downtown and outlying locations still successful. Downtown stores must be situated to benefit from heavy pedestrian traffic. Superstore trend here, as in grocery field, means more and more locations are being sought in shopping centers and in good outlying business districts. . . .

Variety. National chains continue to open very large stores in 100 per cent downtown locations of important cities. Additionally, they are opening many stores in shopping centers and outlying business areas. . . .

Cigars. Heavy pedestrian traffic still considered indispensable in this line of business. Office building and hotel locations very good. . . .

Restaurant. For the downtown restaurant, traffic is again considered indispensable. Locations near office buildings and theaters usually very good. . . .

Apparel. Both downtown and neighborhood locations are still considered good Supporting business is necessary. The 100 per cent location is not always considered essential. Ample window space is needed. Room for deep lobbies that can be flanked by windows is considered important by some chains. . . .

Shoe. Traffic is essential but not necessarily downtown traffic. Most of the largest volume shoe units are still in central business districts. . . .

Department stores. Trend toward decentralization of operations continues. Shopping-center locations seem to be preferred, with the department store serving as the hub of the center. While downtown stores are still doing large volume, most operators have come to believe that as cities grow in area they must provide branch stores located conveniently for large segments of the population that are geographically remote from the central business districts. . . .

Furniture. Reasoning of most executives in this line coincides with that of department-store executives.

Specialty chains. Specialty chains in many lines are following the shopping-center trend. . . .

Mail-order-house stores. Like department stores, these chains are opening more and more large units in outlying areas of major cities and smaller stores in smaller cities Most national mail-order chains have not tied in with shopping-center developments as closely as have local department-store chains. They are able to draw traffic from great distances and do not require the supporting business that is necessary in most other lines. . . .

Candy. Pedestrian traffic remains essential because candy is a luxury item often bought on impulse Downtown locations are generally the largest volume locations. . . .

Auto supplies. Many auto-supply chains are now showing much interest in shopping centers, although they do little pioneering. Since only a 60 to 80 per cent location is required in this line, it is unnecessary for the auto-supply chain to go in early in order to get a choice location. . . .

Jewelry. Although they are going into the larger shopping centers, particularly in areas having above-average purchasing power and into some smaller cities, a great many jewelry chains still prefer downtown locations. The 100 per cent location is considered highly desirable if not too costly.

Hardware. Some of these chains are going into both large and small shopping centers as well as into well-developed neighborhood business districts. The presence of at least one good grocery unit in the area is considered almost essential. A good variety of other supporting business is needed. Most operators agree a hardware store cannot pioneer a new district successfully. . . .

There are two aspects to the suburban or satellite business location. The one about which most is heard is that which has to do with the convenience to the customer, and it is not to be underestimated. The other factor is often overlooked in the enthusiasm of opening a business, and that is the occupational hazard of being a pioneer. J. C. Nichols, the late developer of the famous Country Club district of Kansas City, Mo., has learned over a period of many years that even some of the most attractive shopping centers could not carry themselves on today's cost of construction. It is quite different for a well-established downtown business to open a suburban branch than for a new or unknown business to open up in a satellite location. There is obviously less risk for a drugstore than a specialty shop, but to the extent that there is a risk, there is the profit if successful.

An aspect of business that is too often forgotten in good times when there

is enough business for all is that extremely high profits breed ruinous competition. This is true in many cities where there is already an excess of peripheral retail outlets. There are more spectacular examples of this in Los Angeles than elsewhere, but still new ones are created and opened with the floodlights and fanfare of a new show. *Chain Store Age* in its January, 1950, issue calls attention to another such situation:

> Off-center shopping centers? Are some cities reaching saturation point in shopping centers? In southwestern Cleveland two huge unit-building centers are 1½ miles apart. Result: the newer unit, with more stores and twice as much in-front parking space, is pulling shoppers from the older center. Another shopping setup in southeastern Cleveland is little more than 2 miles from an existing big center, with each depending heavily upon auto traffic

Experienced real-estate firms, who keep the same customers and clients over a period of years, always advise the inexperienced or new ventures to start in a proven location.

Location in relation to materials or clients. Service businesses or professional services, which have contacts with all the walks of life of a large area, should seek a location near the theoretical center of population of the area served and then adjust it for zoning and other regulations and to fit into the transportation pattern.

Industrial firms must study their product to determine whether or not it is better that they be near their customers than that they be near their source of materials. The recent change in the base-point system of steel pricing will probably result in a steel mill being built in New England where there is a very substantial market and large deposits of limestone and where the heavy materials of coal and ore may be shipped by water. Bakers have found it cheaper to serve a large area from a central bakery where materials can be handled in large quantities than to have numerous small manufacturing establishments. Fabricators of heavy metal products generally find it better to be near the source of material and to ship the finished product to distant customers. This is especially true of plumbing fixtures, pipes, and structural steel. On the other hand, more complicated fabrications or those which may be made in a lesser number of units usually find that it is cheaper to locate close to customers and ship in the heavy raw materials.

Location as it affects employees. This consideration is of primary importance when continuity of service and low labor turnover are desirable, and it increases in importance as these factors become sufficiently important to outweigh inconvenience to customers, clients, or materials.

Many a large corporation has found it necessary to locate its research laboratory in pleasant surroundings where its employees can find the amenities of life to their liking. So it is that more and more business firms who

specialize in research, analysis, design, or consultant service find that they can achieve the essential quality of performance only by retaining their employees long enough to train and take full advantage of their best ability and for that reason they have located in suburban areas or college towns. The list of those firms which are finding this factor important is a long one and is being enlarged. Many investment-counsel firms, architects, engineers, and those who can have a separate technical and electrical staff find it desirable to have a small office in a central location and large quarters for the rest of their staff elsewhere; the saving in rental overhead is important.

Publishing houses have sought such locations ever since Doubleday located his establishment in Garden City, Long Island, early in this century. Certified public accountants and insurance companies may well follow.

The importance of transportation facilities. It has been truly said that transportation is location. Nothing is more important to a business than transportation. All forms of transportation are of importance: land, air, and water; both public and private. Air transportation is as important to the home office of a national sales office as pedestrian transportation is to F. W. Woolworth. The former must locate in a city with good air service and the latter must be on well-paved Main Street. Grain shippers must be located on good rail or water transportation facilities and preferably both. Many industrialists to their sorrow have located on an otherwise good site for the manufacturing of a product which required either rail or highway transportation, only to find a few years later that they were forced to change their product and that such change required the use of the missing means of transportation as well as the other.

Employees who have to drive to work in their own cars must earn enough to pay for this expensive form of transportation. Dependable and cheap public transportation is essential for all general business locations. Time consumed in travel is nonproductive, and it is the time factor rather than the distance factor which is of importance.

The transportation aspect of a location is the primary reason for its rate of growth. In those cities where the growth is more rapid than the average, there is better transportation than the average. The 1940 Census showed a slowing up of the growth of the country as a whole and a greater decline in the rate of growth of our larger cities. More recent data, however, indicates that the trend has been reversed. The Bureau of Census, in its report "The Growth of Metropolitan Districts in the United States," shows that the large metropolitan districts grew faster than the central city in each year since 1900. But at the same time, the central cities also increased in each year for which there is a report. Thus we see that "decentralizing" is taking

place as between neighborhoods or industries, but not as between cities and their metropolitan areas.

This fact is caused largely by the modern rapid public transportation systems of the American central cities and the extension of this transportation system to the metropolitan area as a whole. This system must be regarded as a vital, dynamic force having a direct bearing upon the use of real estate and its effect on every form of business.

Adequacy of space. The size and shape of the space required by a business is a matter of opinion and has to do with the manner in which a business is managed. It has to do with such things as inventory, off-premises work, ratio of office to shop areas, and other factors of a management type. There is adequate consulting management and engineering talent available to help in determining requirements, layout, and design. Graphs, forecasts, and market data help predict the future course of a business and determine probable future needs, but many a plant, warehouse, retail establishment, or other business real estate becomes economically and functionally obsolete because of lack of parking space, inadequate turning space for trucks, or an unsafe approach to the highway from the property. A good rule of thumb for manufacturers is to figure 250 square feet of off-street parking per car and to calculate one car for every four employees and one car for every visiting salesman or customer.

Retail stores outside downtown core areas would do well to provide a ratio of 4 or more square feet of parking space for every square foot of retail sales space. In many cases, it is well to double this ratio as has been discussed earlier.

The same is true of building space. A manufacturer who made good-quality wooden radio cabinets turned to making modern furniture and immediately found that he needed one-third more shop space and double the storage space for the same number of employees and about the same dollar volume. A home-service store in a rural area had built up an excellent business selling and servicing stoves, washing machines, lawn mowers, and other house appliances; then along came television and he needed more space for display and repairs. Fortunately, he had consulted a good real-estate consultant prior to building his store and had excess height so that he could build a mezzanine.

In old buildings, one has to adjust to the limitations of the structure. There are features that are space savers and therefore make for efficiency. One feature of this kind is adequate loading space. Whether the business be a store, a manufacturer, or a distributor, a space where incoming goods can be placed for sorting and checking and then stored and where outgoing shipments may be assembled will save truck time, reduce costs, and make for

efficient use of space. Floors that are of slightly different levels are to be avoided, if possible; if not, determine whether a roller conveyor can be installed to move goods.

Adequate space means usable space; avoid unusable space which you have to heat and maintain. Structural soundness is an important factor. Always remember that an architect or engineer can give you an impartial opinion as to the floor-load capacity and the characteristics of the building. Additional bracing of floors can be costly and can so clutter up the space below as to reduce its usefulness.

Economic stability of location. This may be determined by a real-estate market analysis. The characteristics of the real-estate market are such that it is an unorganized market based upon informal day-to-day transactions. The degree to which it may be accurately analyzed is in indirect proportion to the complexity of the city in which it is located. Information is usually available as to the supply of space and the demand for it and the extent that population pressure causes changes in the economic situation, thus creating new opportunities, but it takes an expert to properly analyze this information. It takes special training to list all the sales and leases in an area and to determine the unit value of a property, the past trends, and the probable future direction.

Past experience in an area as to mortgage foreclosures is not to be disregarded. Another indication of stability or lack thereof is the number of vacancies as compared with the metropolitan district as a whole or as compared with another similar section. It is a full-time job to analyze this kind of information and requires the type of expert who keeps his records up to date and who is able to make an objective study. Your local real-estate board will tell you which of its members are members of the American Institute of Real Estate Appraisers. If there are no members of the Institute in your community, the real-estate board will probably recommend the best person to answer your particular problem.

Study the community pattern. The community pattern is the result of the habits of its people. These habits cannot be changed, but the wise merchant or manufacturer takes advantage of them and makes use of them. The central business district may appear to be a stationary fixed object held in place by the weight of large buildings, but actually it is either growing or dying and seldom static. It grows with the development of the area served by it and diminishes with the economic reduction of that area. As the city or metropolitan area grows to the extent that it can attract business from outside, so the downtown business district grows. Physical limitation may restrict the growth of the business district and foster the establishment of outlying or periphery business districts, but if the outlying business district

depends upon its local area for support, it may or may not participate in the general economic growth or decline of the city as a whole. The ability to respond to the growth of a community is a necessary characteristic of a good business district. One factor to be considered in this respect is the ability of the district to be reached by auto and the parking capacity. Another factor is the proximity of the business district to the place of employment of the bulk of the people. These and other factors make a city pattern.

A careful study of the city pattern will locate the downtown core area, and if it is drawn on a map it is well to locate the new stores or those that have undergone modernization. Then locate parking facilities, main routes to it, and transportation facilities. Surrounding this area is usually a twilight zone of secondary business and light manufacturing. Now locate the main freight highway into the city and the rail lines; these locate the heavy industrial belt. The next location to determine is the best established residential section and the newest large-scale residential development. The slums and other districts now fall into the picture of themselves. Once you have done this, you have a picture of the city pattern.

Trends—long-term and short-term. Trends are caused by internal adjustments in the city growth or by basic economic changes which have a bearing upon the life of a large segment of the population. The advent or cessation of a major industry in a small city is a matter of very considerable importance. The impact upon a suburban community caused by the bankruptcy of a railroad and the removal of its service is very great. Likewise, the economic forces generated by the extension of an arterial highway or parkway to serve a peripheral community have a great effect upon the area affected. These are fundamental forces and their influence upon real estate is expressed as trends. These forces are slow to generate and of long-term type. A railroad does not fail overnight nor does a responsible large industry move quickly. The condition that brought about the change is one which may be anticipated if a thorough study of the subject is made. The long-term trends are really the cumulative action of many shorter term trends. By short-term trends is meant the sudden more violent movements that take place as a result of more localized action. An area may be donated by a wealthy citizen for a park and the effect upon a neighborhood is immediately felt; new houses are built, bringing more families; new stores result; and there is a need for new schools, better fire protection, churches, sewers, water—all this results in a relatively sudden increase in land value. This is a short-term trend. The long-term trend commences when these changes have taken place and the character of the area has been established and the slow but inevitable decrease in value sets in.

These forces are many and often contradictory. Likewise, the short-term

trends are altered and the generating forces divert them from their course. But the cumulative effect upon the long-term trends may be determined by the skilled student of real-estate values.

5. *Own or lease?*

Having determined the location, the price that a business can afford, and the adequacy of a property, it is well to determine whether it would be better to own or lease. In general, the advantage gained by one method is a disadvantage to the other. The advantages of each may be stated thus:

Advantages of ownership:

Cost of occupancy lower per year
Interest on mortgage, maintenance, depreciation, deductible from income tax
Permanence of address assured
Possible income profit from tenants
Alteration, demolition, or change of occupancy at own will
Property may be security for loan
Possible capital profit from sale

Advantages of leasing:

Fixed and known costs of occupancy
Rent deductible from income tax
Limitation on period of commitment and extent of liability
Lease salable as part of business
No capital tied up in land, bricks, and mortar
Less basic capital required

Both methods of occupancy require a great deal of paper work, legal forms, title searches, and other technical work which should be handled by a lawyer. Both methods also involve advance planning, but in the case of a lease the planning is of shorter duration. This is the main reason why most tenants prefer to lease. They feel that although it may cost more, there is a certain degree of flexibility which cannot be otherwise obtained. These decisions, whether to own or lease, have to do with the nature of the business and the degree of risk of the business itself.

This problem, to lease or to buy, should be discussed with the real-estate consultant, the lawyer, and the income-tax adviser. All are important, and it always pays to use the experienced services of all three. In the case of the lawyer and the income-tax adviser, the fee is always paid by the business seeking space and so the services of an independent real-estate consultant should be used and a fee paid. The broker in the transaction is paid by the lessor or the seller, and his advice may be colored by the commission involved. Experienced and timely third-party advice is always worth its cost. It is usually the best bargain that a young business can buy.

Section 12

HOW TO RUN AN ACCOUNTING SYSTEM

BY

MAURICE E. PELOUBET

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HOW TO RUN AN ACCOUNTING SYSTEM

1. What accounting can do for management

How to run an accounting system and how to get the best results for the least expense and effort can be dealt with from two points of view: that of the executive, who is interested primarily in objectives and results, and that of the accountant, who is interested in the means and methods of attaining the objectives and getting the results required or needed by management.

No man can be a capable manager or executive and at the same time personally exercise any effective detail control of his accounting affairs. If this ever could have been done, in some simpler and faraway time, it is not possible now.

In a small business the executive must rely on his bookkeeper, his certified public accountant, and possibly some other advisors, such as specialists in machine accounting, appraisers, or industrial engineers, when the occasion demands.

In larger enterprises many of these functions are performed by members of his own organization, acting under his controller.

The sections which follow this will explain what we might call the "how" of an accounting system. They cover how to run a cost system, how to avoid business fraud, how to use budgets for the control of the business, and how to design systems for internal control. This section is devoted to the "why" of an accounting system: why we use the elaborate and intricate forms and methods of modern accounting, with all of its burden of detail, its mechanical complexities, and its large number of employees engaged in producing masses of detailed statements. All accounting work must justify itself by results. The statements must either be useful to the management, or required by some outside body or agency, or required by some general business customs or regulations. Statements which have no internal use and which are not required for any external purpose should be discontinued as soon as discovered.

While management cannot devise or operate an accounting system, management is the only source from which we can discover what is expected of an accounting system and what its useful functions are. Accounting officials

may suggest to management that there are certain accounting facilities which they are not using, but it is management's decision as to whether or not these shall be availed of. To show what the properly organized accounting system can do—or, to put it in other words, what can be demanded from a properly organized accounting system—an oversimplified chart is presented of functions under a controller and a financial vice-president. In many organizations, the controller and the financial vice-president will be the same person. If there are a number of subsidiary companies and branches, there may be a man who fills the functions of controller in each branch or subsidiary. In any event the functions under the controller will be the same. In some organizations it will be advantageous to have functions such as the tax department and internal auditing under the controller of each branch or subsidiary. In other types of organizations, it will be better for these functions to be centralized. This depends largely on whether the problems in the different branches or subsidiaries are the same or different. If, for example, state taxes are a very important feature, it might be advisable to have a tax division in each branch wherever it is located. If the company has several branches in the same state, obviously it would be better to have the tax work concentrated. These are questions for the individual organization, but the distribution of functions and what may be expected from the different accounting offices and officials are the same in any case. Many variations in the distribution of functions might be required, but the functions themselves and the reports which management can expect are about the same.

A list of the reports and statements which management might expect from a modern accounting system follows. The list is neither inclusive nor exhaustive. Many reports with different titles than those in the list certainly will be required by the management of different corporations, although it is probable that few reports not covered in general in the list will be needed. The time classification of the reports is not at all rigid. Some of the "daily" reports may be required no more frequently than weekly, while some of the "weekly" reports may be necessary daily. With modern mechanical equipment it would probably be possible to prepare almost any of the "weekly" statements on a daily basis, although this would be too expensive and complicated to be warranted except under special conditions. Some of the statements listed under the financial accountant might be prepared by the cost department, for instance, the statements on expenses. Some of the statements might be required only occasionally, and if this is so, provision should be made for discontinuance as soon as they are not required. What we are considering here is the use of the accounting system by management other than the accounting officers and staff. The collection and disbursement of cash,

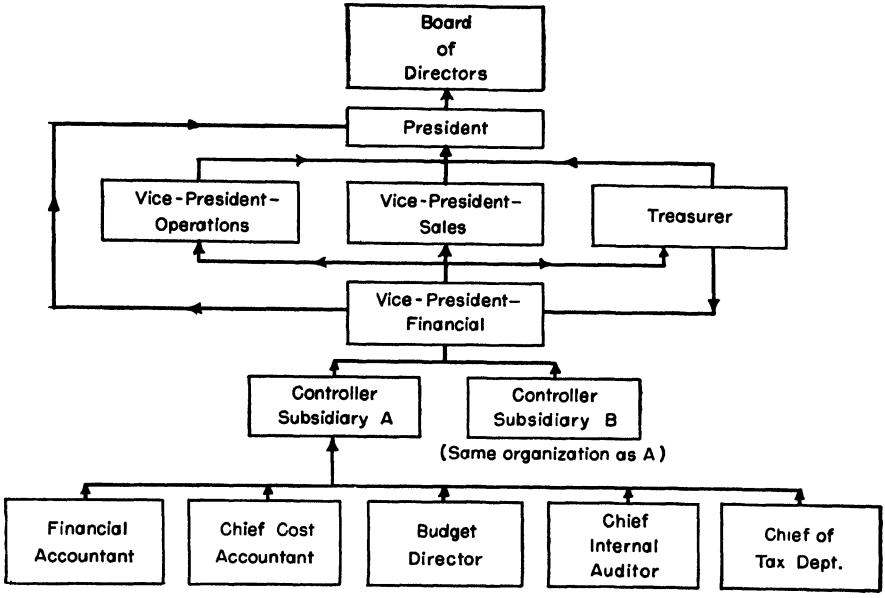


Chart showing functions under a controller and financial vice-president.

the preparation of sales and purchase orders, the mass of details involved in setting standard costs, and the collection of the voluminous details required to establish a budget are considered here only from the point of view of their final results. The sections following and a large literature cover these questions in detail. Our concern is with what the accounts can do for management.

It is unlikely that any one organization will require all the reports listed and it is equally unlikely that an enterprise of any size will not require some reports which are additional or which differ in some way from those described. The check list is suggestive only, but it is hoped that everything of importance is covered.

Reports Usually Found Necessary in a Manufacturing Corporation

(Prepared by or under the Direction of the Financial Accountant)

Daily Reports

Cash position
Sales (orders taken)
Unfilled orders
Purchase commitments

Weekly reports

Payroll summary

Payroll analysis, as between—
- Direct labor
- Indirect labor
- Construction labor
- Overtime worked

Number of employees
Average wage
Bonus or incentive wage
Shipments to customers (dollars or quantities or both) —perhaps analyzed as under "Sales"
Materials received
Collections on customers' accounts classified by age of accounts
Lists of overdue accounts receivable
Summary of accounts payable

Monthly reports

Balance sheet—comparative with beginning of year
Income account (month and year to date), comparative with same month of previous year
Sales, orders received analyzed by—
- Geographical distribution
- Products
- Size of orders
- Stock or special
- Salesmen or sales offices

Materials and supplies received and taken into account:
- Raw materials
- Parts
- Manufacturing supplies
- Other supplies
- Machinery and equipment
- Construction supplies

Expenses:
- Fixed
- Semivariable
- Variable
- Commercial
- Administrative

Cash receipts and disbursements agreed with income account
Inventory statements, estimated if perpetual inventories are impracticable
Construction program:
- Expenditures for year
- Expenditures or unfinished projects, in total
- Appropriations unexpended

Graphic presentation of reports for directors

Annual reports

Detailed comprehensive report to management on operations (this may sometimes be prepared by the independent CPA) including:
- Comparative balance sheet
- Comparative income account:
  - Explanatory schedule for each balance-sheet and income-account item
- Explanation of unusual or significant items
- Cumulative surplus account
- Statement of cash receipts and disbursements

Balance sheet and income account for stockholders or other security holders

Balance sheet and income account for credit grantors

Reports required by governmental bodies. (These are merely examples. There are many others and every corporate accounting officer should make certain what reports his company is responsible for)
- Securities and Exchange Commission
- Interstate Commerce Commission (if a manufacturing corporation has railway or utility subsidiaries)
- Federal Power Commission
- State Public Utility Commissions

Special statements

For security issues

For purposes of merger or acquisition or sale of subsidiaries

For management profit participation

For pension plans

For self-insurance of any type

Statements of current or appraised value of buildings, machinery, and equipment

Statements of current value of inventories, investments, or other assets not to be converted into cash in the ordinary course of business

(*Prepared by or under the Direction of the Chief Cost Accountant*)

Cost reports

Estimates on new work or products:
- Full overhead basis
- Differential basis

Standard or historical costs of products

Standard or historical costs of processes, cost centers or operations

Comparative statements of fixed, semivariable, and variable costs

Statements showing the nature of, and reasons for, variances of actual costs from standards

If job costs are used, progress reports on unfinished jobs

Statements showing comparative and cumulative processing losses

Comparative statements of any of the foregoing for different plants or subsidiaries
Production reports—daily, weekly, or monthly

(Prepared by or under the Direction of Budget Director)

Budgets

Preliminary budget
Agreed master budget
Monthly comparison of results and budget
Detailed monthly comparison of results and budget for departments, plants, or subsidiaries

Breakeven-point statements

Entire enterprise
Entire plant
Departments

Forecasts of—

Cash requirements
Effect of changes in sales volume
Effect of changes in wage rates
Effect of change in material prices
Effect of changing products, dropping some or taking on others
Effects of regulatory legislation other than tax legislation

(Prepared by or under the Direction of the Chief Internal Auditor)

Audit reports on plants and departments
Special investigations
Reports on system of internal check and control
Personnel reports

(Prepared by the Tax Department)

Tax returns

Federal income tax
State corporation taxes
Excise taxes, if these apply
Various reports on payments made to others, withholdings, and the like
Estimates of effect of proposed or current legislation
Estimates of effect of new decisions or regulations affecting the enterprise

One set of accounts to produce all statements. An accounting system should show the relations of the corporation or business to its individual creditors and debtors; it should give the management what it needs for operating and control purposes; it should make possible the preparation of statements for proprietors, security holders, and credit grantors; and it should provide for the preparation of statements to government departments, agencies, and other administrative bodies. All this should be done from one

basic set of accounts. The accounting system should be designed in the beginning to produce the statements which are its final purpose and object.

There are many general principles and methods of devising and establishing an accounting system, all of which are fully covered in good technical works. Except, however, for the most simple and the smallest enterprises, there are no ready-made, complete systems. No properly devised system can be established until the accountant responsible for it understands fully the nature and the purposes of the business, the type of men who are the executives, and the type of men who will be operating this system. He must understand what is really in the mind of management and what its policies are before he can set up accounts which will produce statements which will express those policies or which will assist in carrying them out. He must be the careful and intelligent reporter and interpreter, always looking to the best interests of his client or employer, never deceiving him into thinking he has a temporary advantage, never letting him think that an easy way is necessarily the best way, but never restraining him from taking chances except by pointing out the nature of the chance that is being taken and the result if things go wrong.

Accountant's responsibility for management decisions. The accountant is not responsible for management's wrong decisions. He is, however, fully responsible for management's ignorant or uninformed decisions where the ignorance and lack of information is caused by statements which he has prepared improperly or inaccurately. No human mind can grasp the complexities of the operation of a large or even a moderate-sized enterprise without the use of accounting statements of some sort. If these statements are correct, if they give the proper impression, if they bring out the salient facts, then no management decision based on them is the fault or the responsibility of the accountant. But if the facts are incorrect, if the impression given is false, if the information is inadequate, then the responsibility is clearly and squarely on the accountant. Generally speaking, management must believe what its accounts tell it. It has neither competence nor time to examine into the accuracy of the statements which are presented to it. Management, security holders, creditors, customers, the government—all are entitled, if a proper modern accounting system is in effect, to rely on the statements produced by it.

If such statements can be readily prepared and are substantially accurate when they are prepared, then the system is functioning. If this is not the case, the system is not functioning. Management is entitled to have an accounting system which functions adequately, does as much as is required, but no more, and does this at a minimum cost.

Operating information. The list covers, primarily, the information which the management uses to operate the business from day to day. The management of a firm (say a manufacturing enterprise) generally must know its position in unfilled orders, purchase commitments, commitments under a program of capital expansion, and cash requirements for a considerable period in the future. Management must know, with more or less precision, what its various products cost it to produce, and frequently it must know the components of the costs of the different products which it makes or of the product which it might make. Generally, the estimating function of cost accounting is more important than its historical function.

Forecasts and projections. These things all have to do with the future. We are told that accountants should not prophesy, that it is their business to record and analyze and compare. However, the ultimate value of all internal accounting information is as a basis for future action. All management action which accounts and records can guide or affect is necessarily future action and all accounts designed for any management purpose must be looking to the future. As Patrick Henry said, "I know no way of judging the future but by the past," and it is the accountant's duty to provide the solid background of properly classified and analyzed past experience as a basis for future management action.

Requirements in integrated enterprises. If all this information is necessary in one fairly large manufacturing organization, it is even more essential when one man or a small group of men are responsible for directing the operations of a group of manufacturing companies or of an integrated group as, for example, the United States Steel Corporation or one of the integrated nonferrous metal companies. Management decisions in a single factory are difficult enough with adequate records and are, generally, impossible on the basis of personal observation and memory. Without comprehensive accounts, it is almost impossible to solve the problem of analyzing the conditions in a number of different plants and comparing these conditions as a basis for deciding when and where, for instance, to expand and contract, where to manufacture a new product, what manager is most capable, or what manager should be replaced. If such decisions are attempted without this accounting information, the result is almost certain to be chaos and failure.

2. *Interaction of accountant and management*

Policy decisions and the accountant. No competent executive would attempt to operate a business of any magnitude without accounts which were, or which appeared to be, adequate and comprehensive. While it is the duty and responsibility of management to make decisions, it is the responsibility and duty of the accountant to see that the information on which the deci-

sions are made is accurate and that it conveys the correct impression. While the accountant should not make decisions on matters of policy, it is nonetheless true that he cannot help influencing such decisions.

His statements must make an impression of some sort by their arrangement and emphasis as well as by the facts themselves. Management will act according to the impressions it receives from the statements.

A simple example of this is in cost accounting. If a company operates under a standard cost system, and if the costs are determined by operations, and if furthermore a new product is to be manufactured which will require no operations except those necessary for products already being made, the cost accountant can produce a cost for the new product by using costs for materials and operations similar to those now in effect. It will, to all appearances, be a proper cost for the new product and under some circumstances it might be. However, the cost accountant should not proceed with the compilation of such a cost until he knows more about what the management has in mind or about the purpose for which his cost is to be used. If it is intended to substitute the new product for an old one it is probably correct to include in the costs, as he would have done if he used previous operation costs, all the overhead allocated on the usual basis. There would be no more production to absorb the overhead and the fixed charges would remain as they were. If, however, it were contemplated that the new product would represent an addition to the volume already manufactured, then the cost which he compiled might be quite misleading. The new cost either should show a new distribution of fixed charges or should show that the new product would not necessitate any increase in fixed charges and might be profitable on a differential or "out of pocket" basis.

Management must tell the accountant. Until he had some idea of the purposes and intentions of management, the accountant would not be able to give a proper statement of the cost of the new product no matter how carefully and accurately his figures were worked out. Management has a right to demand from its accountants and its accounting system correct answers to its questions on a correct basis. Mere technical and arithmetical accuracy is not enough. Management cannot, generally, look behind the figures presented to it. It must accept what its accounting department states as facts. Management itself may be at fault in not taking the accounting department sufficiently into its confidence, or in not giving the accounting department information which it may think is irrelevant or unnecessary but which, in fact, the accounting department needs. The real responsibility, however, lies primarily with the accountant. It is his statement that is being acted upon, and it is his duty to be certain that his statements are prepared on the basis and for the purpose which management has in mind. This in no

way means that they should be warped to the desires of management; they should, however, be very carefully prepared according to the needs of management.

The accountant must understand the business. All this should make management realize that the accountant must now have a much broader and more comprehensive idea of the business than he ever had at any other time. This does not mean that he must know the business in the sense of being able to operate or direct it. He must, however, understand fully the processes, the purchasing policy, the sales policy, the general progress of mechanical or other invention in the industry, and its relation to other similar industries and the government. He cannot arrive at any sound decisions on such matters as rates of depreciation, methods of depreciation, inventory methods, or costing methods without fully understanding these things. Assuming that he must understand these things, and that he must prepare his statements with this in view, what in particular is the management of a modern, well-organized corporation entitled to receive from its accounting department in the way of statements of internal operation and control at the present time?

3. *Statements required*

First and foremost, correct and adequately detailed statements of past operations must be prepared. In the early days of accounting it was often thought that these were enough and that management could, from a clear statement of the past, make its own decisions and reconstruct its own figures for the future. That day has gone if, in fact, it ever existed. Few men can be sufficiently versed in the technical and mechanical details of an industry and also be good enough accountants and analysts to arrive at sound conclusions from statements which merely show past transactions.

Management must have costs. In addition to clear and adequately detailed statements of past transactions, management is entitled to costs on the basis most appropriate for the enterprise—standard, process, job, or whatever method really reflects the operations and the policy of the company. The operation of a cost system and the selection of methods depend naturally on the purchasing policy of the company, the method of pricing, and the type of its customers, as well as on its more immediate cost factors. As an example, in an industry where prices are fixed for a considerable period, the so-called administered price industries, a different inventory and cost method is required than in industries where the price of the product varies almost directly with the price of the principal raw materials. In the latter type of industry, the last-in–first-out inventory method is indicated. In the former type, the first-in–first-out, or average method, may be better adapted to the

needs of the enterprise. Certainly it does not call imperatively for the last-in–first-out method where prices are not particularly sensitive to immediate changes in material prices and where commitments are made for many months or a season ahead.

Estimates and projections. Once a reasonably satisfactory cost system is established, management is entitled to an estimating system based, of course, on the results of the cost system. Another, and closely allied, statement to which management is entitled is a budget, annual or for shorter periods. In a sense, every standard cost or estimate based on a standard cost is a small budget, as it tells management what can be expected under given conditions in the future. The budgetary feature of the accountant's work is assuming more and more importance.

With the increasing requirements of government and with the increasing number of elements in our economic structure which make for rigidities of various sorts, the necessity for careful estimates of probable changes is even more pronounced than it was in earlier periods. A budget is in no way a forecast in the sense of the word which is used when accountants are told they should not make forecasts. A budget is merely a projection of what may be expected, given certain basic facts and assumptions. The accountant does not make the assumptions; he merely works out the results based on them.

Many accounting statements are called "forecasts"—for instance, forecasts of cash requirements—but all these statements are merely projections into the future based on the assumption that known facts and conditions will either continue or change in a given manner. The preparation of such statements requires great skill and judgment. Misunderstood or in the wrong hands, they are dangerous. Generally, they should not be permitted to go beyond the hands of management. Properly used, they are one of the most valuable tools which management has at its disposal. If certain given conditions and assumptions are presented to the accountant and he prepares from them a statement of projected operations which shows an undesirable result, management, if it is convinced that the accountant's statement is correct on the bases given, will probably change its plans and possibly its policies.

Internal check and control. Another feature which management is entitled to look for in any adequately designed accounting system is a proper, effective, and not too cumbersome system of internal check and control. Much has been written about this, and there are ample authorities to be consulted. The general principles are clear and well understood, but their application to an individual situation may be difficult and complicated. It is the duty of the principal accounting officer of any corporation to see that proper

internal check and control is instituted and carried out. It is the duty of the public accountant to satisfy himself that this is the fact.

Accounting is a record of responsibility for money, property, and things. Internal control is a means of ensuring that this responsibility is actually discharged.

The means and methods of internal control are discussed in later sections and in a fairly large literature on the subject. It might, however, be useful to management to list what internal control might be expected to cover and establish:

Cash

Disbursements are for—
- Wages
- Materials and supplies
- Expenses
- Dividends
- Repayment of loans

Receipts are on account of—
- Goods sold to customers
- Material and scrap sales
- Sales of investments or property
- Interest and dividends
- Loans or sales of securities

Accounts receivable

All trade accounts are for goods shipped or services rendered

No shipments are made which are not billed

No unauthorized credits or allowances are made

All accounts are collectible except those noted as bad or doubtful

All other accounts or notes receivable are for an authorized transaction for company account

Accounts payable

All trade accounts payable are for materials received or services rendered

All purchases or expenditures are for company account and properly authorized

All accounts or notes payable for loans or advances are properly authorized and are for company account

Inventories and materials and supplies

All purchases are for company account and properly authorized

Physical receipt of all material is checked

Issues of materials to production departments are authorized and recorded

Process inventories are taken or estimated at least monthly

Scrap, waste, and spoilage is recorded, compared with past experience and analyzed as to cause and reasonableness

Proper physical inventories are taken and discrepancies between book and physical inventories are analyzed and reconciled

(In addition to the foregoing, properly developed statements of variances between standard costs and actual results are a valuable means of control)

Buildings, machinery, and equipment

All additions are properly authorized

All sales, retirements, or dismantlements of plant or equipment are authorized and recorded

Depreciation is calculated correctly on established bases

Taxes

All taxes, city, state, and Federal, are scheduled on return and payment dates and officer or employee responsible for preparing return is noted

Periodical statement of status of any disputed tax is made

Securities

A complete, up-to-date list is kept

Securities are with a trust company or other authorized depository or are kept in safe-deposit vault with proper control of access by officers

All securities said to be company property are so in fact

Title to securities is in the name of the company or in the name of a company representative properly indorsed

Securities, if not with a depository, are examined and counted periodically by company officials or independent certified public accountant or both

Income which should be received on securities has, in fact, been received

Current value statements. There are statements of another type which, while not in universal use, are prepared by the accounting departments of many forward-looking corporations. These are statements of the present or market values of property as compared to book values. Many corporations which prepare such statements do not use them for any public purpose. They are, however, of great value to the management not only for their most obvious purpose, that of making certain that the property is adequately covered by insurance, but also for satisfying themselves that they are receiving from their customers, in their sales prices, enough to replace their plant at the prices at which it will probably need to be replaced when that takes place.

There are other advantages in having statements of values of assets on hand, particularly in states like New York where surplus is calculated on the basis of actual or current values rather than on book values. These records are not difficult to keep and maintain. If the company has a good engineering department, index numbers can be developed and applied which will bring the plant values to current values. If the inventory is carried on some method which produces other than current values, it is ordinarily a simple matter to apply current prices to the material in the inventories. Such figures would not necessarily constitute accounting figures for a financial adjust-

ment of the books, but they are close enough to give management an idea of what it is dealing with and to give some idea of what a liquidation or replacement basis might be. Many corporations have a periodical or continuous appraisal made by an appraisal company, and this appraisal generally covers current or insurable values as well as cost values. In many corporations it would be dangerous to try to do business without some statements of this sort. A current-value statement has considerable usefulness, but like many other statements which are not directly taken from the financial books, it must be used with care, and as it is less subject to control it is more subject to abuse.

Statements to proprietors, security holders, credit grantors, and other third parties. There is another purpose in an accounting system which has been in existence almost as long as accounting, that is, the requirement to prepare statements for proprietors or for third parties who have some interest in the business as creditors, guarantors, and in some cases customers, and who have a right to statements of the position and results of the entire enterprise. These are usually statements of past transactions and at the present time are generally prepared on a basis of cost. Many businessmen and accountants think these statements should be modified to reflect current costs rather than past costs when the inventory method uses or produces a material cost other than one approximating current replacement cost (say first-in–first-out, or some similar method). These statements also show depreciation widely different from that which would be arrived at by depreciating on replacement values. The accounting profession and business in general have not yet come to any conclusion on these questions, but the seriousness of the problem is widely recognized. Some think the question should not be covered at all in published statements; others think that it should be covered in the income account and disregarded in the balance sheet; while others think the whole question should be covered by supplementary statements. In any event, the facts are of sufficient importance to be in the hands of management, and it is management's decision as to whether and how these shall be given to the public or to credit grantors. It is the accountant's duty, however, if he is making a statement which does not reflect current values, to make it perfectly clear that this is the case, that the properties are not stated at any current or realizable value, that this could be arrived at only by appraisal, and that the inventories are stated on a particular basis which is lower than cost, or lower than current market, or whatever description is appropriate. The accountant's duty in these statements is to present fairly the condition of the company on the basis indicated and to present the facts so that they will give a correct impression as well as being mathematically and technically correct.

Statements to Federal and state government agencies and departments. A function which a modern accounting system must exercise is the preparation of reports for different government departments and agencies, Federal and state, having jurisdiction over the enterprise. No business is too small or too large to escape this. Every business must report to at least one government department, the Bureau of Internal Revenue. Practically all businesses must report to one or more government departments in addition to this. A manufacturing company listed on a registered securities exchange might easily have to report to the Securities and Exchange Commission, the Federal Trade Commission, the Bureau of Internal Revenue, its state taxation authorities, and if it had a loan, the Reconstruction Finance Corporation. If it were engaged in work on government contracts it would have to report either under the Vinson Act or to a price-adjustment board. If it were a public utility it would have to report to one or more state and Federal agencies. Its accounts would be subject to audit and review by representatives of all or any of these organizations. There are many other government departments and agencies to which a corporation might be required to report.

Frequently these reports are to be certified by the corporation's independent auditors. The responsibility here, both that of the controller of the corporation and that of the independent auditor, is somewhat different from that of the auditor or controller when reporting to stockholders or credit grantors. In reports to these administrative bodies there is generally little flexibility in the form or content of the report. This is prescribed, and it is the duty of the accountant to fill out the report as nearly according to regulations or instructions as possible. He does not have any responsibility for the form, and he has no responsibility for the impression it may make on the government department, as the government department has exercised its authority in prescribing the form. Some government accounting forms give definitely false impressions under particular circumstances. The case of several railroads which are required to present their accounts in a certain manner by the Interstate Commerce Commission, where such accounts clearly and definitely misrepresent the income of these railroads, is a good example. However, if it can be established that the facts are correct and the form has been followed, everything which the accountant can or should do has been done, except possibly to append a disclaimer to his report and to protest the inapplicability of the form.

4. Use of mechanical equipment

Another general requirement of any accounting system, or perhaps something which any management is entitled to expect from its accounting advisors and officials, is the fullest and most economical use of the mechan-

ical equipment best adapted to the company's business. There are few operations of an accounting system which cannot be improved and facilitated by mechanical means. The trouble generally is not to find a mechanical means of solving the problem but to choose among the means offered.

The controller or office manager organizing a new office generally suffers from what might be called an embarrassment of riches in this respect. Every mechanical accounting device has its own place and its own advantages. There is probably none which does not fit admirably into some situation. The salesmen for these machines and devices are intelligent men, often well trained in accounting and system work, and it is their business to exhibit the good points of their particular products. It is the duty of whoever is responsible for installing and improving the accounting system to weigh these various claims and to see how the devices can best be adapted to the business at hand. Some types of calculating and tabulating machinery are valuable where large volumes of work are to be taken care of but are impractical or uneconomical where the volume is small. Others are highly efficient with a small volume of work and fall down when the volume is increased. Some organizations require highly specialized machines for particular work, while others need a general machine which can be turned to a dozen different uses. There is a fairly abundant literature in this field, and the claims of the companies manufacturing the machines are generally well founded from a positive point of view. In other words, it is safe to assume that if something is not claimed for a machine, the machine will not have that characteristic or will not perform that particular operation.

It is, of course, well to standardize. Generally speaking, it is better to use the same machine for the same purpose in every branch or department. Maintenance and repair will be simplified and will be less costly, and operators will be interchangeable if it is necessary to concentrate on one department which temporarily has an extraordinary work load. Here again the real answer is a good knowledge and careful analysis of the business and the operations.

One cautionary note might be sounded. A machine which performs an operation efficiently but which leaves a record which cannot easily be audited is not so good as one which does a similar operation but which leaves a record which can readily be audited. Every auditor has had experience with mechanical systems which worked fairly well as far as the operation (say getting out bills, recording accounts receivable, or writing payroll checks) was concerned but which left statements and summaries which could be proved only by doing a large part of the work over again. This is seldom necessary and mechanical means can almost always be devised which will provide for proper detail checks and for adequate total and cross checks

of mechanical work. It sometimes requires a little extra effort in planning the system, but it is well worth the effort in the time saved by the company's internal auditors and by the company's independent accountants. One of the purposes of records is to produce something that can be audited, and this purpose should never be lost sight of.

5. *Background of accounting*

Nature of the accounting process. When we are deciding on what to expect from an accounting system, the fundamental nature of the accounting process must be considered. Accounting is basically a descriptive art. It is a method of presentation, a language, a method of description—what Santayana has so aptly termed "a universe of discourse."

We are describing one aspect of industrial, financial, trading, or governmental enterprises when we use accounting. The aspect which we describe is the financial, the numerical side of the operations. In all but the smallest enterprises this method of description is essential to operation.

Purpose of accounting. As in all other organizational devices, the principal purpose of accounting is to permit one man to control and understand operations which would be incomprehensible to any single human mind without the aid of such a method of description. It has been said with some reason that one of the causes of the disintegration of the Roman Empire was the difficulty, if not the impossibility, of maintaining contact and organization in all the different far-flung sections of the Empire when records had to be expressed in Roman numerals and when all calculations except those which could be made mentally had to be made on the bead frame or abacus. It is difficult to imagine the confusion which would result from attempting to operate the United States Steel Corporation or the American Telephone and Telegraph Company if such means of numerical expression and calculation had to be used. On the other hand, the mere provision of the means of proper accounting does not indicate that enterprises will be carried out on a basis of sound and satisfactory organization. The Mayas of ancient Guatemala and Yucatan had a highly advanced and efficient numerical system. This, however, was used almost entirely, so far as any records indicate, for astronomical and calendar purposes. There is no record of its use for commercial or organizational purposes.

Slow development before twentieth century. Every student of the history of calculating machines knows Blaise Pascal built, around 1640, a number of calculating and adding machines, basically similar in principal to most wheel-driven machines of the present day. The changes which have been made since Pascal's day are not matters of principle but are merely increased speed of operation and modifications such as the negative total device, print-

ing devices, and the like. Practical calculating machines were not on the market until the eighties or nineties of the nineteenth century. Since then, as we all know, the development of machines of this type and of other calculating and adding machines has been phenomenal.

What is the reason for this slow development? Is it because some new principles were discovered? None were necessary. If there had been a sufficient demand, if there had been a great enough necessity for a calculating machine, Pascal's machine could, in all probability, have been developed in less than a hundred years after its invention. It required no new discovery, such as steam or electricity, to make his machine practical. It required merely a working out in detail of what was already known and understood. The development, say, of the chronometer in the eighteenth century, which made exact long-distance navigation possible, was no more difficult than would have been the development of a speedy and practical adding and calculating machine from the beginning made by Pascal. The real reason no such development took place was that commerce did not imperatively demand such a machine. Commercial enterprises were comparatively small, comparatively simple. Even great organizations, such as the British East India Company, the Dutch East India Company, or the Hudson's Bay Company, were trading companies and did not require elaborately organized cost accounts or budgets. Their traders did the best they could with the natives, made large profits, in many cases appropriated substantial parts of these profits for themselves, but still turned enough over to the parent company to make a good showing.

Manufacturing processes were not complicated. Textiles were probably the most highly mechanized industry. We all remember Adam Smith's famous illustration of the making of pins as an example of what he called the "division of labor" or what we would now call mass production. Of course, the pin manufacture now seems to us very simple, very easily controlled. Another condition which delayed the introduction of accounting systems which were efficient in detail was the fact that clerical labor was abundant and quite poorly paid. All these things tended to work together to make it unnecessary to develop anything like our present accounting systems.

Utilitarian character of accounting. While accounting is undeniably an art, it is an art which does not and should not exist in and of itself. The mathematical elegance of the basic concept of double entry has fascinated many minds, including that of Goethe, who once said that double entry was one of the "fairest inventions of the human mind." Nevertheless it is still true that a detailed description of unimportant facts by means of double entry is of little value except possibly as an example for teaching.

In literature or painting we may have a description of something quite unimportant in itself which, by the mere description and by the implications which the author or artist brings into it, is of the utmost human importance. Accounting, however, cannot accomplish this. Accounting is a strictly and purely utilitarian art. Its only value is in its results. The only way in which it develops is in response to the needs of business, government, and individuals. It is the basic means by which single human minds, or a group of human minds, transcend some of their fundamental physical limitations when they come to deal with matters beyond what we might call the verbal or pictorial scope of any mind.

It is the conditions and necessities which call forth the developments in accounting. Developments in accounting have taken place step by step with developments in industry, commerce, and government. The first large and well-organized business operations in modern or medieval Europe were those directed by the Church. We find therefore, some of the earliest examples of accounting, and double-entry accounting at that, in the accounts of the monasteries. We find that the first well-organized public debt, the securities of which were sold to the public, was instituted by the Vatican.[1] Next we find that accounting was applied to the results of commerce in the great trading republics of Italy, Florence, Genoa, and Venice, for example. Accounting was applied in a smaller way to manufacturing and on quite an extensive scale to banking. This is because these were the activities which were of importance in the Middle Ages and in the days of the Renaissance. Such cost accounting as then existed was rudimentary in the extreme, because small enterprises generally had no need for more cost accounts than the proprietor could carry under his hat.

Accounting develops with industry. As Great Britain was the first country to feel the full impact of the Industrial Revolution, so it was the country where accountancy developed first and developed to the greatest extent. Professional accountancy was recognized in Scotland in the middle of the nineteenth century, about thirty years later in England, and about twenty years later in this country. It is now, of course, a well-recognized profession here, with several important specialties. It has developed so much that no accountant can pretend to be a master of all features of his profession. No man can at once be an expert in accounting for corporate financing, in income-tax accounting, in cost accounting, in public-utility accounting, in accounting for consolidations and holding companies, in budgeting, and in the giving of expert testimony and the representation of clients before admin-

[1] von Ranke, Leopold, *History of the Popes*, Vol. 1, Book IV, p. 319, George Bell & Sons, Ltd, London, 1913.

istrative bodies (generally called forensic accounting), to name only some of the specialized accounting fields.

All these activities have developed, not as a result of the initiative or inventiveness of accountants, but as a result of conditions in business and government and in the lives of individuals which required accounts and which required such services. The profession has, so far, never failed business and government when new conditions arose. Whether present conditions—changing value of currency, and unsettled political and economic conditions—are presenting problems the profession will not be able to solve is still an open question.

What is expected of accountants. Having established, then, that accounting is an art, that it is an art which is nothing in and of itself, and that it is a servant of business and government, let us examine what those who employ these servants called accountants expect from them.

Some accountants may not relish being called servants. A little thought, however, should make everyone see that there is nothing derogatory in that title. Probably no one ever has lived to and for himself alone, and certainly no one at the present time can do so. He must constantly serve others. Shakespeare says in *Cymbeline* that "every good servant does not all commands; no bond but to do just ones." According to the Apostle Matthew, as all of us know, Christ said: "He that is greatest among you shall be your servant." We are all familiar with the phrase "civil servant" as applied to a member of the civil service of Great Britain. The title of servant to management, to the public, to government, is a proud rather than a demeaning one. The accountant records what has happened. He classifies the information in such a way that management can make its decisions, so that the proprietors of a business can understand what is going on, and so that those who wish to extend credit to the business will know whether they are justified in doing so. He classifies the information so that the government will know whether the client or the corporation by which he is employed is carrying out its duties and obligations toward the government. He also will tell the management, or any other legitimately interested party, the result of any course of action under any given set of circumstances. He will make this projection not as his employers wish it would work out, but as he sees the facts.

There is nothing incompatible in the idea of professional or personal dignity and the rendering of the service which the client or employer requires. The accountant, in his constructive capacity as a recorder of facts or in his critical or analytical capacity as an auditor, should not at the same time have executive responsibility for that which he records or criticizes. Although the service of the controller or any accountant performing

similar functions for a corporation is primarily to prepare an impartial record and to make an impartial critical review of the facts which he records, it is nevertheless impossible and undesirable for a man of such position to have no voice whatever in executive policies or decisions. So far as his own department is concerned, the controller has, or should have, full executive responsibility. When decisions of general policy are discussed, for example, questions having to do with production, technical changes, expansion of business, advertising, promotion, or the like, the controller often takes part in the discussion but should naturally confine himself to the financial aspects of such questions. His statements and opinions on the financial, tax, cost, and accounting features of the questions under discussion should be made available to management. The controller should not, of course, have executive responsibility for technical, operating, or sales decisions.

Many accountants have become capable executives, and it is frequently greatly to the advantage of an enterprise to choose an accountant for such a position, but the fact remains that once he becomes an executive he ceases to be an accountant or auditor.

Division of work between public and private accountant. In all the foregoing, little distinction has been made between the accountant in public practice and the accountant in private or corporate employment. Most of the operations and functions described would be carried out, in a large and well-organized corporation, by the controller and his staff. At the other extreme, in a small organization, say, where only one bookkeeper was employed, most of the work beyond the mere original recording would probably be done by the professional public accountant. Between these two extremes we might have almost any division of work and circumstances. This would have to be considered when deciding on the propriety and necessity of work to be done by the professional accountant. Questions of independence and responsibility would arise, but this is not the place to discuss them. The bulletins of the Auditing Procedure Committee of the American Institute of Accountants, the rules of the Securities and Exchange Commission, and numerous individual writers have covered this field.

Accounting as a tool of management. In this section, accounting in all its forms has been described and illustrated from the point of view of the man who makes use of it, not from the point of view of the man who produces the accounting results. The position of the man who uses the results of an accounting system is not unlike that of the man or woman who may be a skillful driver but who has practically no idea of what goes on inside the engine or under the hood of his automobile. In these days of highly complex and highly efficient and reliable cars, few of us really understand the operations of our automobiles. But we all know what we expect from

a car and we know what it will do. True, we are all somewhat helpless when it breaks down, but there is almost always a friendly and capable expert available to help us out of our troubles. If everyone who drove a car understood his vehicle, we would have a nation of good automobile mechanics, but no one would have much time for anything else. So it is with modern accounting. Modern accounting is a useful and indispensable tool to modern business and industry, but no one but an expert can understand or operate the details of an accounting or cost system.

There are two tests for an accounting system: (1) whether it produces the statements desired as promptly as it should, (2) whether it produces them as economically and efficiently as possible. Management generally has a good idea of whether the system produces the results desired, but no one but an expert can tell whether the system is actually operating efficiently and economically. There are few places in an enterprise where waste and leaks can be more serious and more difficult to detect than in the accounting and record keeping. The fact that every employee works hard and conscientiously may be entirely irrelevant to the question of the proper operation of the system. The fact that the most modern equipment is used may have nothing to do with its effectiveness, and the excellence of the statements may give little indication of the efficiency of the system. The real indications of economy and efficiency are: (1) whether the system is designed to produce the statements with the least effort and the least amount of duplication, (2) whether the mechanical equipment most suited to the operation is used (not whether mechanical equipment of the best and most modern type is used). Another source of invisible leaks is requiring employees to do work which could be done by an employee of a lower grade or a lower salary. Unnecessary work done in the most capable and industrious manner is wasted. Necessary work, even if it is not done perfectly, is of value.

The question of whether a given accounting system is designed to operate efficiently and is operating efficiently is one which can be answered only after much study by a well-qualified expert. This expert may be an accounting official of the enterprise, or he may be a public accountant. He will never be an operating man, a technical man, or a salesman. Furthermore, examining into whether an accounting system is operating with maximum efficiency is not a thing which can be done quickly or easily. While an experienced accountant can, almost as soon as he enters a strange office, get a general feeling of whether the office is well run or badly run, it will take him a long time, first, to prove that it is badly run, and second, to institute the necessary changes and improvements. There are certain general tendencies familiar to all accountants who have any breadth of experience. One of these is that uniformity is something from which everything tends to depart.

Another is that familiarity with work, if it does not breed contempt, at least has a tendency to breed carelessness. Most employees whose work is not periodically checked have a tendency to take what seem to them well-justified short cuts. These generally result in incomplete records, which cannot be used for the purposes for which they were intended. In an integrated enterprise, uniformity, in some features of the accounts, is of the utmost importance. This uniformity is never attained except by continual check and inspection.

The way for management to get the best results out of its accounting system is to have a competent man responsible for the operation of the system, whether this man be the chief accounting officer of the enterprise or whether, as happens in smaller enterprises, he is the public accountant. Management should hold such a man strictly accountable but give him great freedom of action. Management must also give such a man its complete confidence and give him all the information it possibly can about the business. Management should be demanding as to the results it requires, it should be keenly alive to the possibilities of accounting as a useful tool to management, but it should not concern itself about the details or about the means by which the information is collected and summarized. Modern accounting is a complicated and highly technical service to industry, and few men can be really fully effective as accounting executives and still be able to perform any other important business functions. If management and the accounting department each performs its own function and neither tries to encroach on the other, a smoothly running organization will result. If the place and function of each are not well defined and understood, waste, inefficiency, and lost motion are sure to result.

Section 13

HOW TO CONTROL YOUR DISTRIBUTION COSTS

BY

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HOW TO CONTROL YOUR DISTRIBUTION COSTS

This section is concerned with the methods of controlling the costs of distributing or marketing your products as contrasted with the costs of producing them.

The control of distribution costs is receiving increasing emphasis and attention by business. More interest is being evidenced in the management of marketing costs for a number of reasons. Distribution costs may even exceed production costs in some lines. In the sewing-machine industry, for example, distribution costs were 46 per cent of sales, while the production costs were only 37 per cent. Another reason is that a growing amount of evidence indicates that there is an opportunity for reducing marketing costs, which is just as important as that for reducing production costs following the development of certain principles of "scientific management" in the factory.

1. Misdirected marketing effort

No company makes all its sales at equal profit. There is some volume in every business which is much more profitable than would be indicated by the company-wide profit ratio and a sizable proportion of other sales which are much less profitable—or even unprofitable. These are basic facts of business life, which marketing executives encounter every day and of which they are aware in a general way. Yet these commonplace truths hold secrets which so far have been uncovered and acted upon by relatively few companies.

How is it possible that a large part of the sales made by the individual firm may be unprofitable even though the business as a whole shows a profit?

In most businesses a large proportion of the number of customers, products, territories, and so on, brings in only a minor proportion of the sales volume. Such a distribution of volume would not necessarily result in unprofitable sales, except that marketing efforts, and hence marketing costs, all too frequently follow the number of customers, products, and territories rather than the actual or potential sales volume. In other words, if marketing effort were matched with the results for which it was "responsible," it would be found that a large part of the distribution expenditures would be coupled with only a very small part of the total sales and gross profit results.

There are many reasons why this disproportionate spreading of marketing efforts is common throughout our distribution system. Most firms, even the better managed ones, are unaware of the exact extent to which large portions of their marketing expenses are responsible for bringing in only a minor share of the sales volume. The managements of most firms usually measure the success of their marketing efforts solely by their total dollar sales volume. The manufacturers of branded consumers' goods with a national market typically follow a policy of "100 per cent coverage of the market" in order to support their national advertising.

Management, for the most part, lacks knowledge about the disproportionate spreading of marketing effort because of the difficulty of relating sales results to amounts spent. An even more fundamental difficulty is the lack of any reliable standards for determining what amounts should have been spent on marketing in the first place, and what results should have been obtained from these expenditures. For example, most companies have no scientific basis for determining how much should be spent for their advertising in order to get the most profitable volume.

The lack of reliable standards emphasizes a sharp difference between production cost control and distribution cost control. In controlling production costs, management is largely concerned with the effect of volume on costs, but when planning distribution costs, it is concerned, at least for some of these costs, with the effects of costs on volume (for example, the effect of advertising expenditures on sales volume). In our present state of knowledge, management is much less certain about the effect of marketing expenditures on volume than it is about the effect of volume on production costs. Thus, the right amounts and kinds of selling and advertising expenditures are both cause and effect of the most profitable sales volume for any company. It follows that the control of these costs is most difficult as well as most important.

The objective of "controlling" distribution costs is, of course, to reduce them. The average sales executive, however, seems to think of the control or reduction of his distribution costs as consisting only of setting up a budget, usually arrived at without any reliable performance standards, comparing actual expenses with the budget, and chipping away at various elements of expense which exceed the budget. At best, this method of attack may not get at the heart of the matter. At worst, it may do more harm than good. This could happen if the chipping process weakens needed selling pressures or curtails demanded distribution services, so that sales volume suffers and total unit costs are raised instead of lowered.

The businessman is not—or rather he should not be—basically interested in limiting his over-all marketing expenditures to a certain number of dollars,

or in attempting to force each of these expenses within the mold of some arbitrarily-arrived-at ratio of expenses to dollar sales. The actual experiences of a number of businesses which have successfully achieved striking reductions of their marketing costs show that an entirely different line of attack is necessary. Basically, this different approach involves a fresh and objective look at fundamental marketing policies, such as—

How many and what kinds of customers to sell
What channels of distribution to use
What territories to cover
What products to sell, and at what price

To get this fresh look at fundamentals, and thereby accomplish a reduction in their distribution costs, many of these businessmen are using a management tool derived from their internal records. This tool, distribution cost analysis, is used to determine which sales are most profitable and which segments of sales are unprofitable.

Examples of the actual results achieved and methods actually used by some businesses, which are described in the following pages, show how distribution cost analysis can be used as a management tool to reduce distribution costs.[1]

2. *Customers*

Long-standing policies or philosophies, such as, "Customers are the lifeblood of business," or "Get the volume and the profit will take care of itself," or the widespread belief that "100 per cent coverage of the market" is necessary in all cases to "support" the national advertising of consumer convenience goods, help to explain why most businesses continue to sell to a large number of unprofitable customers. A further explanation can be found in the reluctance to adopt any action or policy that disturbs the *status quo,* such as doing something about unprofitable customers. Finally, of course, there is the fact that most businesses do not have sufficient knowledge of their marketing costs to enable them to uncover, with exactitude, their unprofitable customers.

But the experiences of some businesses show conclusively that knowledge of unprofitable customers, and wise action based on this knowledge, can lead to increased selling effectiveness and substantial reductions in distribution costs as a result of greater efficiency, lower prices, and important increases in profits. This even applies, perhaps especially so, to manufacturers of

[1] The actual cases described in the following sections are taken from "How Manufacturers Reduce Their Distribution Costs," Economic Series 72, U.S. Department of Commerce (Superintendent of Documents, Government Printing Office), Washington, D.C., 1948.

consumer-convenience goods with national advertising campaigns. To increase their profits, the businesses in the cases discussed below reallocated their selling and advertising effort to selected customers and prospects to bring these efforts into closer relation with sales and profit potentialities.

Case 1. Customers were classified on the basis of the amount of their annual purchases, and marketing costs were allocated to each size group. Of the total number of accounts, 41 per cent, bringing in only 7 per cent of the sales, were found to be unprofitable. Over a period of years, most of these unprofitable customers were dropped. In a period of 4 years, sales increased 76 per cent, marketing expenses were cut in half from 22.8 to 11.5 per cent of sales, and a net loss of 2.9 per cent of sales was changed into a net profit of 15.0 per cent.

Case 2. During the war, this business changed a policy of 100 per cent coverage to a policy of selective selling The number of stores contacted by salesmen was reduced by almost one-third. In the first year after the change, the company operated with half the number of salesmen, while sales increased over 45 per cent. Since then (1941 to 1945), sales increased 82 per cent, marketing expenses were reduced from 31.8 to 18.2 per cent, and operating profit rose from 4.7 to 14 8 per cent of sales.

Case 3. Although this businessman sold through exclusive distributors and franchised dealers, he found that he had too many outlets. Poor merchandisers and those unprofitable to the company were eliminated; the number of dealers was reduced from 12,000 to 5,000 in round numbers, while 93 wholesalers were also dropped. Sales volume doubled, and the company's marketing expenses were cut in a period of 2 years from over 13 to 7.32 per cent of sales.

Case 4. A distinction was made between fixed and variable marketing costs, and the latter were allocated to customers to find the relatively unprofitable ones. It was realized that not even all the variable expenses would be automatically saved or reduced if unprofitable customers were dropped, so management drew up a definite plan of cost reduction in each case where a group of unprofitable customers was to be eliminated. Sales executives were at first reluctant to drop customers, even though they were unprofitable, because advertised products would not be available in all possible outlets. In spite of dropping customers, however, sales volume increased, while over a period of years the ratio of distribution expenses to sales declined more than 50 per cent.

3. *Channels*

A determination of what is the "best" channel of distribution for any business involves an appraisal of a large number of specific factors. Many of these factors have broad applicability to all businesses; they relate to sales volume, the costs involved in obtaining that volume, and the resultant profit.

It is axiomatic that any business should use those trade channels which will produce that combination of sales volume and cost which will yield the maximum amount of profit. However, the most profitable sales volume is not the greatest attainable sales volume, whereas, on the other hand, the "best" cost is not necessarily the lowest possible cost. Moreover, both the short-run and the long-run points of view must be taken into consideration. Consequently, the determination of the most profitable channels of distribution is not a simple job.

When analyzing the comparative advantages of different channels, many

businessmen give primary consideration to the factors related to sales volume, without giving sufficient consideration to the relative marketing costs involved in obtaining that volume or to the comparative net profits. One likely explanation for the difficulty in making sound decisions regarding problems in connection with channels is the lack of adequate cost information.

When a business is already using several different channels, then a customer cost analysis (with customers grouped by class of trade instead of by size) will show the relative costs and profits by channels. More usually, however, the problem is to compare actual costs and profits of present classes of trade with estimated costs and profits of alternative channels under consideration. In this case, the problem is not so simple, and it may not always be possible to determine what the results will be until an experiment has been tried.

The cost analyses and experiments of the businesses whose experiences are described in this section show that the choice of the most profitable channels is a problem to be solved individually by each business. A channel that is the most profitable for one firm may not be so for another competitive firm. These cases do show, however, that there is considerable opportunity generally to reduce costs and increase profits through analyses of relative costs and profits by channels.

Case 1. This company distributes through three major channels—route sales, direct shipments, and sales through wholesalers. A test study was made of marketing costs for one of these channels—route sales—subdivided by class of trade and by size of customer. The results showed that 87 per cent of the route customers were probably handled at a loss. It is planned to extend this study to cover all channels of distribution and, if the results are the same, the company intends to revamp its entire distribution system.

Case 2. A distribution-cost analysis showed that 95 per cent of all the customers sold direct in one small area were unprofitable. By applying the results of this analysis to the over-all company picture, two-thirds of the direct customers were estimated to be unprofitable. As a result of these studies, the company is in the process of changing its channels of distribution by transferring unprofitable small accounts, served direct, to its dealer organization On the basis of accomplishments so far, the company expects to achieve lower inventory, overhead, and breakeven points, a 15 to 30 per cent net reduction in marketing costs, and a 20 per cent increase in net profits.

Case 3. In direct contrast to the preceding case, a cost analysis showed that industrial users sold direct were more profitable to this company than dealers. However, variations in cost and profit by size of customer were more significant than variations by channel of distribution. Salesmen were instructed to stop calling on small dealers and to spend more time with large industrials. Distribution costs were reduced by 38 per cent in 1 year.

Case 4. A somewhat unique graphic method of cost analysis was used to separate the variable from the fixed element of each category of marketing cost and for getting costs at different levels of sales volume. Variable costs were allocated to four different channels of distribution. As a result of these analyses, one entire channel of distribution was discontinued, as were small customers in another channel, while sales pressure

on the remaining profitable customers was increased. In one year, net profits doubled from $150,000 to $300,000.

Case 5. Three comparable test areas were chosen, in each of which a different channel of distribution was used for a trial period of 1 year. This was thought to be the only sure way to find out what would happen to sales, costs, and profits if new sales channels should be adopted. As a result of these tests, far-reaching changes in marketing methods are being made by this company. Distribution costs are being cut by approximately 50 per cent, and profits are rising correspondingly, while prices have been reduced.

4. Orders

Small orders have long been an obvious cause of high distribution costs and unprofitable sales. Most businesses have a small-order problem, but many of them are prone to accept it as one of the basic conditions of distribution for which there is no real solution. Most businessmen have long suspected that small orders are a source of losses, but very few of them have any accurate facts as to the dividing point between profitable and unprofitable orders or as to the exact extent of the losses caused by unprofitably small orders in their own business.

Of course, no business can do away entirely with small-order losses. But the experiences of the companies which have made attempts to do something about the small-order problem show that many lines of action are possible, and that the problem is susceptible to control. The first step is to make an analysis of distribution costs and profits—or losses—by size of order. The problems of dealing with unprofitable orders are, of course, closely related to cost control and cost-reduction methods as they relate to unprofitable customers. Likewise, the techniques of cost analysis by orders are similar to the process of customer costing, involving merely a different classification of sales.

Case 1. Most of the orders received from 57.5 per cent of the number of customers, comprising 2.7 per cent of total sales, were found to be unprofitable. This unprofitable business was dropped, and sales effort concentrated on the remaining profitable volume. Salesmen were thereby relieved of 50 per cent of calls formerly made. This enabled them to do a better job by increasing their volume of profitable orders, while reducing their traveling expenses.

Case 2. This businessman made a cost analysis to determine the minimum size of order which could be handled at a profit; over 50 per cent of all orders received were found to be unprofitable. As a result of this analysis, the company changed to a plan of selective distribution, so that the proportion of unprofitable orders has been cut from over 50 to less than 10 per cent.

Case 3. This company also made a cost analysis to find the minimum size below which an order could not be filled at a profit. After a careful study of all the possible effects, it was decided not to accept any orders below this minimum. Not one customer was lost due to this policy, and unit distribution costs were reduced by one-third.

Case 4. A pilot study of the cost of handling various-sized orders showed a range in marketing cost from 4.24 to 21.52 per cent of sales. The results were so revealing that

it was decided to make a more extended analysis. This analysis revealed that the total marketing costs for orders of less than $3.75 were 21.52 per cent of sales, whereas the cost of handling the largest orders was only 4.24 per cent. Needless to say, orders in the smallest size-classes were handled at a loss. Most of the unprofitable orders were eliminated, as a result of a change in marketing policy, and the ratio of distribution costs to sales was reduced by one-third.

5. *Territories*

Analysis usually reveals wide variations in the ratios of sales to regional potentials as between the different territories of a company's market. Businesses covering a large market often get strikingly different results from territory to territory, judged against any measure of the potential business available. These irregularities in sales are usually the result of at least a partial disregard of regional sales possibilities in the distribution of salesmen and advertising to territories. Many firms reduced their distribution costs by reapportioning their selling effort, after analyzing these regional differences in the ratios of sales to potential.

Analysis also reveals wide differences in distribution cost and relative profit ratios as between different territories. Distribution cost analysis pointed the way to greater profits by enabling some companies to realign their selling effort and to concentrate their resources against the more responsive segments of their market. Other steps taken to correct the faults disclosed by these cost analyses, such as the reorganization of territories, also resulted in substantial cost reductions as well as in increased selling effectiveness.

Coverage of more than a profitable amount of territory is common. Although a continued high level of production and employment requires an expanded volume of over-all sales, unprofitable market coverage will in the long run benefit no one. Several firms reduced their costs and increased their profits by eliminating unprofitable territories. Furthermore, potential demand in a new market is only one important factor affecting a decision of market expansion. Distribution cost considerations also enter into a decision to establish new sales territories on a profitable basis.

Case 1. An index of actual sales in relation to potential sales for each product in each territory enables this company to find, diagnose, and correct sales "soft spots." As a result, sales have increased 366 per cent and there has been a 45 per cent reduction in the ratio of field sales costs as compared with the average for the period 1939 to 1941.

Case 2. Towns with the lowest "net yield" (gross profit minus direct costs) have been identified by this company, and it has been determined how much travel costs could be saved if they were eliminated. This has enabled the management to form a judgment as to whether or not a town should be visited and how often. On this basis, approximately 28 per cent of the total number of towns covered were found to be unprofitable, and they were either eliminated or the number of calls was reduced. During a 15-year prewar period, the total number of salesmen was cut from 334 to 189, while sales rose from $10,000,000 to $22,000,000.

Case 3. A large number of towns and trading areas were found by this company to be unprofitable, and over a period of years the number of markets covered by salesmen was reduced from 15,000 to 5,800. A need for continuous analysis and weeding out of unprofitable markets was shown by the fact that a large proportion of the markets retained were still unprofitable. As a result of shifting effort to more profitable markets, there has been a 78 per cent increase in average sales per salesman and a 36 per cent reduction in the ratio of field selling and advertising expense.

Case 4. An analysis of marketing costs by territories and by individual sales routes showed wide variations in costs and profits and revealed wastefulness in the organization of territories. Territories and routes were completely reorganized As an example of the results, one salesman increased his average number of calls per week and increased his sales volume, while he saved 2,000 miles of travel per month and reduced his expense by 38 per cent within a period of 3 months.

Case 5. Big-city business was thought to be more profitable than that from small towns. A cost analysis, however, showed that 84 per cent of all unprofitable accounts were in big cities, whereas a large proportion of profitable customers were in smaller towns. The company is now shifting selling and advertising effort from unprofitable accounts in big cities to profitable customers in smaller towns. In three towns the distribution cost ratio has been reduced by one-third, while the ratio of net profits to sales has doubled.

6. *Salesmen*

The average businessman is keenly aware of the necessity for controlling the cost of his sales force. But the typical businessman apparently views the control or reduction of his selling costs as a process of arbitrarily reducing specific elements of expense which appear "out of line" as compared with a budget, or else he asks himself the question, "What can we eliminate—do without—do more cheaply?" This approach, however, has been viewed by some as a "destructive" approach and as a method of attack which does not really get at the heart of the problem of reducing selling costs.

Others have taken what may be regarded as a positive and constructive approach to the problem. These firms concentrate on getting increases in sales volume from the same or even smaller selling expenditures by apportioning selling effort in closer relation to potential volume, thereby reducing unit costs.

Analyses of the relative costs and profits of individual salesmen, comparisons of sales with regional sales potentials, and routing and scheduling of salesmen are some of the management tools used to reduce selling costs through this positive approach. The first two of these management tools, as well as actual experiments in changing the number of salesmen in a specific territory, have been used to settle the ever-present problem of determining the most profitable number of salesmen to be assigned to each territory. Setting up a detailed route and a definite schedule of calls for each salesman proved to be a most effective way for achieving substantial cost reductions by increasing the proportion of actual selling time spent in the presence of customers.

Case 1. Regional sales potentials, territorial cost analyses, and actual experiments in changing the number of salesmen are used by this company as guides in the territorial apportionment of selling effort. Other factors, such as a tendency toward diminishing returns from selling effort, are also taken into consideration. More efficient apportionment of selling effort by territories was one of the factors responsible for a decline of more than 50 per cent in the ratio of variable selling expenses to sales during the 4 years preceding the Second World War.

Case 2. Under their old system, this company's salesmen spent much time and money in unnecessary travel. Under the new, definite routes were laid out for each salesman which provided the best coverage with the fewest miles of travel. Rerouting increased average selling time spent with customers by 19 per cent, saved 1.5 million miles of travel per year for 105 salesmen, and net travel savings totaled more than $65,000 per year.

Case 3. The basis of organization of this company's salesmen's territories was found to be a serious cause of inefficiency and high costs, especially after unprofitable towns and customers were dropped from salesmen's territories. Sales calls were routed and scheduled to reduce costs and to ensure the proper frequency of calls on customers. As a result, within a period of 4 years, sales increased 76 per cent while the number of salesmen was reduced 20 per cent and travel expense was cut 53 per cent.

Case 4. Since travel and waiting were found to take up as much as 80 per cent of the salesmen's time, an extensive routing and scheduling system was set up to increase the proportion of actual selling time spent in the presence of the customers. As a result selling time was increased from a low of 20 per cent to as much as 50 per cent of total salesmen's time. The number of salesmen was reduced from 334 to 189 over a period of 15 years, while sales rose from 10 million dollars to 22 million dollars.

7. *Products*

The urge to increase volume, so as to utilize plant, marketing facilities. and personnel more economically, has caused many firms to add new products to those already handled. How far the combined selling of products may be extended economically depends on several factors. If these new products appeal to similar consumer groups, sell through the same channels, move to the same markets, and require equal amounts and similar kinds of selling efforts, adding them may be profitable.

On the other hand, lack of uniformity in these and other respects often creates many managerial problems. The manufacturer may find the advantage of more complete utilization of facilities and personnel offset by such difficulties as the training of salesmen to sell a multitude of products and the managing of distribution for dissimilar products.

Where products are marketed in combination with others, their individual sales rates depend to a considerable extent upon their "family" relationships. That is, a product's sale may depend not only on its own characteristics in relation to the market, but also on the degree to which its distribution fits in with that of other products. Where perfect conformation takes place, the selling of an additional product may, within limits, bring about substantial economies.

However, the selling of different products involves the use of facilities and personnel in varying degree because of differences in their physical characteristics, handling requirements, sale in varying amounts, and distribution to different classes of customers. As a consequence, the distribution expense for some products is very much greater than for others sold by the same firm, and the different products earn varying rates of net profit.

As in the case of customers and territories, product cost analysis and comparison of actual sales with potentials reveal that many companies have expanded their product lines unprofitably. Shifting efforts from less profitable to more profitable products, or eliminating unprofitable products entirely, resulted in more efficient selling efforts, lower costs and prices, and higher profits.

Case 1. Actual and potential sales volume and other factors were the basis on which 18 unprofitable products out of a line of 39 products were discontinued Besides eliminating the losses for which these unprofitable products were directly responsible, other cost savings and advantages were achieved. Sales increased 366 per cent, while distribution expenses were reduced 55 per cent.

Case 2. A new product was added and promoted vigorously because of its high gross-margin rate over factory costs and because of the theory held by some of this company's sales executives that a new product added to a family of products costs almost nothing to distribute However, analysis showed that the expenses of distributing this company's family of products were not true joint costs, even though many of these costs were incurred in common. Allocation of costs to product lines showed the new line to be relatively less profitable than others, and effort was shifted. As a result, total distribution costs per unit of product declined from 65 to 59 cents, whereas net profits rose from 9 to 17 cents.

Case 3. Annual profit-and-loss statements are prepared for each line in this multiple-line business, product lines are regarded as independently operating subsidiaries making use of certain common distribution facilities These profit-and-loss statements are used by management in connection with product development, apportionment of selling effort, pricing, and other marketing problems A "forecast" profit-and-loss statement for each product line is used to reduce operating data to their corresponding amounts at any level of general business activity. As a result of this system, distribution cost ratios since the Second World War have been reduced by almost 50 per cent.

Case 4. Standard unit order-filling (office and warehousing) costs are allocated to each of approximately 175 commodity classes. These standard unit order-filling costs have helped the company accomplish a more efficient order-filling job, while relative profits by product classes have helped to concentrate selling efforts on the most profitable products.

8. Physical distribution

An additional course of action for reducing marketing costs—and one which might well precede those described above—is to make cost studies of the performance of internal or physical distributive functions, such as storage, inventory control of finished goods, order assembly, billing, receiving, shipping, and delivery. Many firms have found that there are important

opportunities for eliminating inefficiencies in the performance of these distributive functions.

Some companies have benefited from the experiences of progressive wholesalers in improving their physical distributive operations. For instance, the modern, one-story, streamlined warehouse building in the wholesale grocery trade is an outstanding example of how efficiency can be improved and costs reduced. Here orders are made up according to the assembly-line principle and mechanical tabulating equipment is used for preparing invoices, for making sales analyses, and for perpetual inventory control.

The experiences described in this section show that there are many practical possibilities for reducing costs by eliminating inefficiences in the physical distributive functions.

Case 1. A study by this company revealed that it cost more than twice as much to handle the same amount of the same kind of merchandise in one company warehouse as in another. Remedial actions resulted in net annual savings of $70,000.

Case 2. In this company's highest cost warehouse, the cost per case of merchandise handled was more than eight times that of the lowest cost warehouse. A typical case of merchandise was physically handled 14 times before it was delivered to a customer. By using pallets and fork trucks, this was reduced to three handlings, with a warehouse-labor saving of 9 cents per case These and other savings added up to $100,000 in 1 year, and when several new warehouses have been constructed, annual savings in excess of $250,000 are expected.

Case 3 A detailed analysis of delivery operations was made by this company, including the placing of time-study men on delivery trucks. For each truck studied, various cost factors were computed, such as the cost of deliveries for any size and any distance. These cost factors were the basis for far-reaching changes which resulted in reductions in delivery costs, as well as in other cost savings, such as in warehousing. Over a 10-year period there was a 50 4 per cent reduction in unit marketing costs, amounting to savings of over $2,000,000 per year.

9. *Evaluation of cost-reduction experiences*

Several questions are likely to arise just because the experiences of the companies which have been highlighted in the preceding sections are so striking. These questions are discussed below:

Are the above cases extreme examples, or could others expect similar results? It is probable that when time-and-motion studies, cost accounting, and the principles of "scientific management" were first being developed in the factory, skepticism greeted the announced results of increased output and reduced unit costs. Now, however, hardly anyone would question the very great achievements in the way of increased output per man-hour and reduced unit factory costs since the 1880's when Frederick Taylor developed certain principles of scientific production management; yet production men would be the first to admit that unit production costs are still very far from their irreducible minimum. It should not be too surprising, therefore, to find cases

where striking achievements have been made in the reduction of unit distribution costs.[2]

Even in the more efficiently managed companies there is much misdirected marketing effort and, therefore, important opportunities for reducing distribution costs. Furthermore, disproportionate spreading of marketing efforts appears to be common throughout our distribution system. Rather than the above cases being extreme examples, therefore, it is probable that others, if they took similar action, could expect to achieve improvements in their efficiency and reductions in their distribution costs at least as striking as those which were highlighted in the preceding pages.

Is the use of management tools such as distribution cost analysis and market potentials solely responsible for the results achieved? Some firms have greatly reduced their costs and increased their profits by abandoning "indiscriminate distribution," or a policy of "100 per cent coverage" in favor of a policy of "selective distribution." The actual experiences outlined above clearly demonstrate that the use of distribution cost analysis and market potentials as management tools for eliminating misdirected marketing efforts offers to most businesses an important opportunity for reducing distribution costs, increasing net profits, and lowering prices.

Of course, other types of marketing research, in addition to distribution cost analysis and market potentials, need to be brought into play in connection with a policy of selective distribution. For example, in product selection, while distribution cost analysis is most useful in discovering unprofitable products already being sold, additional market analysis is needed to find out in advance what new product fields should be entered, and how the entry into the new market should be made for maximum profit.

Also, there are other very important marketing policies which have a bearing on the control and reduction of distribution costs. For example, the proper selection, training, and compensation of salesmen; the correct organization of the sales department; the use of sales forecasting and budgetary control; the careful formulation of the advertising plan and the selection of advertising mediums—all these play important and familiar roles in distribution cost control which should not be minimized.

In many of the cases, increases in sales and reductions in costs following various changes in distribution policies have been due in large part to rises

[2] It is not to be inferred from the above that what is suggested is an application of so-called "engineering thinking" to the problems of distribution. Rather, the parallel to be drawn is between the very large reductions in unit production costs, which actually have been achieved, and the possibly equally great (if not greater) opportunities for reducing unit distribution costs by the development and use of management principles and techniques peculiarly adapted to the more difficult problems in the field of distribution.

in price levels and to generally favorable business conditions. However, allowance for these "extraneous" influences does not detract from the validity of the cases as a whole as examples of the cost reductions which can be achieved by the use of distribution cost analysis and market potentials.

What caused increased sales volume in spite of the fact that, in some cases, selling and merchandising efforts were reduced to an even greater extent than the reduction in the number of unprofitable customers, towns, and so forth? A policy of selective distribution led to increased profits by one or the other of the following routes:

Where the total expense that was saved exceeded the gross margin that was given up as the result of dropping a segment of unprofitable sales

Where the marketing efforts and total expense were reduced, while sales were maintained, as the result of better apportionment of effort

Where the marketing effort and total expense were maintained, while sales were increased, as the result of better apportionment of merchandising activities

Where, although marketing effort and total expense were reduced, sales were actually increased—also as the result of apportioning effort in the closest possible relation to potential sales results

While some companies reached greater profits by all of these routes, it is the last one, of course, which calls for an explanation. In some companies, the misdirection of marketing effort was of large proportions; that is, a distribution cost analysis showed that a very large part of the distribution efforts and costs were matched up with a small but very unprofitable segment of the company's total sales. When these unprofitable sales were dropped, the diversion of some effort to profitable areas increased sales at the same time that cost per unit fell and net profits rose.

Will the elimination of unprofitable sales cut off small business from sources of supply? Some have objected to the general adoption of a policy of selective selling on the ground that many small businesses would be cut off from a source of supply. Such an objection, however, appears to be groundless.

In the first place, selective selling does not mean that all small-volume sales fall in the unprofitable category, or, conversely, that only small-volume sales may be unprofitable; nor, as will be discussed below, does it follow that all unprofitable sales should be eliminated. In some cases, a very large business may be an unprofitable customer to a particular supplier because of its small orders and requirements from that supplier, whereas a small business may be a profitable customer.

One wholesaler who has been following a policy of selective selling for the

past 15 years through the operations of his voluntary group explained as follows why this policy does not cut off retailers from a source of supply:

It is a fallacy to assume that selective selling would cut off many food outlets from a source of supply if generally adopted. If each retailer concentrated his purchases with a relatively few sources of supply, then, instead of retailers buying from many wholesalers, and instead of wholesalers selling a large number of retailers, each retailer would have a few sources, each wholesaler would have fewer customers, and there would be closer relationships between wholesalers and retailers—and lower operating costs—to the benefit of all concerned.

Finally, some suppliers, such as wholesalers, have found it profitable to organize their entire operations so as to handle efficiently the business of relatively small-volume dealers. Surrounded by other wholesalers who were competing vigorously for the business of the largest retailers in the area, they have concentrated on selling a segment of the market in which they could, and did, operate profitably.

10. Converting loss sales to profitable volume

Although the cases highlighted in preceding pages place apparent emphasis on "dropping" unprofitable products, customers, and territories, it should be stressed that there are many practical possibilities for converting losses into profits other than by the elimination of unprofitable sales. For example, the following list, by no means exhaustive, shows some of the policies that can be adopted for converting relatively unprofitable commodities into sources of profit:

Simplify the line. Reduce the number of sizes, styles, qualities, and price lines. Simplification may result not only in reducing distribution costs, but also in increasing sales, by permitting concentration of advertising, selling, styling, and design on a smaller number of items. One knitting mill, for example, sharply reduced its storage costs and inventory losses by restricting the variety of articles offered for sale and attributed a rapid increase in sales to this policy.

Repackage the product. A change in the package may reduce the direct costs of packing, and the new container may make possible reductions in transportation, storage, and handling costs. A new package may also influence the volume of sales.

Increase—or decrease—the amount of advertising and promotion work. Whether it would be profitable to increase or decrease advertising depends on such factors as the effect of advertising on volume of sales and the effect of the volume of sales on unit production and distribution costs.

Decrease the price. Sometimes, it may actually pay to reduce the price of unprofitable commodities. When consumer demand is so elastic that a small reduction in price leads to a substantial increase in sales, the result may be a greater excess of dollar gross margin over distribution

costs than the net contribution of the commodity at the old price. This may come about as the result of both an increase in the unit of order, with a reduction in costs, and an increase in total sales sufficient to at least counterbalance the loss of gross margin per unit of sale that follows the price reduction.

Increase the price. Where an increase in price may lead to only a small reduction in sales, it may be possible to raise the price in order to recover the loss on unprofitable products. This would be true if the increase in dollar gross margin would exceed the increase in per-unit cost of production and distribution that might result from the lower volume or the smaller unit orders.

Many possibilities also exist for minimizing the losses resulting from orders that are relatively unprofitable because of their small size. Some of these are outlined as follows:

Devise special routing for handling small orders. An electrical manufacturer, for example, uses only about 25 per cent of the usual clerical routine in handling small orders

Reduce services offered on small orders, such as special storage, free acceptance of returns, and repair services

Minimize broken-package sales by reducing the original package unit, by employing package units of several different sizes, or by developing special-assortment packages for filling small orders

Make a special handling charge for all orders below a minimum size

Employ quantity discounts or increase present quantity discounts with the size of the order. Quantity discounts must, of course, be in line with cost differentials

Establish a minimum size order that will be handled

Offer bonus to salesmen for orders above a certain size, or penalize salesmen for orders below a certain size

Turn small orders over to jobbers, brokers, or agents

In short, it was only after the companies whose experiences were described previously were convinced their unprofitable sales could not be turned into a source of profit by any alternative course of action (such as those outlined above) that, as a last resort, they dropped them. Of course, these companies first made sure that their profits would actually be increased before they dropped the unprofitable sales. However, once they decided that this was the most profitable course to follow, they did not shrink from the seemingly drastic action of eliminating the unprofitable sales.

11. Distribution cost analysis techniques

The usefulness of distribution cost analysis is emphasized by the fact that all the companies whose experiences were highlighted in preceding pages were able to accomplish striking cost reductions despite reliance by some of

them on relatively crude and simple methods of analysis. The cost reductions were accomplished because the misdirection of marketing efforts was of such large proportions and, therefore, the opportunities for improvement were so great. It is probable that any company, if it has been operating for many years on a program based on drift plus intuition, likewise has a marketing operation which can be improved substantially by the adoption of policies based on even relatively simple techniques of distribution cost analysis.

An extended discussion of the principles and methods of distribution cost analysis is beyond the scope of this section. However, the basic procedures or steps involved, which will be discussed later, are outlined here:

1. The separable, or direct, expenses are measured and assigned direct to customers or commodities
2. The common, or indirect, expenses are allocated or assigned to functional-cost groups
3. The factors which measure the variable activity of the various functions are identified, and the amounts of these factors, in the aggregate, are determined
4. A measurement is made of the share of the variable activity of each of these functional-cost groups which is utilized by the segment of sales whose cost is being measured
5. The ratio of the share of the activity of the function that is being utilized by a segment of sales (Step 4) to the total quantity of the activity of that function (Step 3) indicates the portion of the cost of that function which is allocated to that segment of sales
6. The excess of dollar gross margin over the sum of the direct expenses and the shares of the various functional-cost groups allocated to a commodity or customer or other segment of sales indicate its relative profitability or unprofitability

Functional classification.[3] Although the proportion of direct marketing costs may frequently be significant, the greater part of a firm's distribution costs are likely to be indirect. To facilitate their allocation, as well as for purposes of expense control, these indirect expenses are classified into functional groups.

The basis of the functional classification which would be used by any given firm is a study of the marketing activities performed by that company. It is important that the functional classification be sufficiently detailed so that the work performed in any one function will be of the same general kind. Such homogeneity facilitates the assignment of an entire functional-cost group by the use of a single factor of allocation, as will be described hereafter.

[3] A functional classification puts together all the expense items that have been incurred for the same activity. A functional classification, therefore, permits the allocation of an entire cost group by means of a single factor.

Assignment of natural expenses to functions. It is usually necessary to apportion many natural-expense items among several functional-cost groups, since they relate to more than one functional activity. They are distributed by means of time study, space measurements, counts, managerial estimates, and other methods. The increased cost and effort of preparing functional-cost classifications may be much more than offset by the advantages of improved cost control, as well as by the advantages of cost analysis.

Illustrative functional classification. Most companies, especially those serving wide markets and producing and selling a number of products, have complex organizations and engage in a wide range of marketing activities. Consequently, it is difficult to set forth a widely representative functional classification of distribution expenses. Each company would have to set up its own classification to reflect its own marketing activities. For illustrative purposes, however, a functional classification of distribution expenses for a rubber manufacturer is shown below:

Functional Classification of Distribution Expenses for a Rubber Manufacturer [4]

Investment in finished goods:
- Taxes on stock
- Insurance on stock

Storage of finished goods (portions of following expenses applying to factory, branch, and district warehouses):
- Rental expense, or
- Maintenance and repairs to buildings
- Taxes on buildings
- Insurance on buildings
- Depreciation on buildings
- Heat, light, and power
- Outside storage space

Inventory control, finished goods:
- Salaries—stock-record clerks
- Salaries—merchandise distribution (allocation of stock to district and branch warehouses and preparation of orders on factory)
- Overhead—space, equipment, supplies, and supervision charges

Order assembly (physical handling):
- Salaries—warehouse labor
- Overhead—space, equipment, supplies, and supervision charges

Packing and shipping:
- Material
- Labor
- Overhead

[4] The functions and the primary-expense accounts are based, in part, on those suggested by the *Uniform Accounting Manual for the Rubber Manufacturing Industry* (commercial expense division), The Rubber Manufacturers' Association, Inc., 1933.

Transportation (on merchandise shipped from factory or branch to customer and from branch to branch, and on returned goods):
- Freight
- Truck
- Express
- Parcel post
- Transportation on consigned merchandise, factory to branch

Sales solicitation (special commodity or customer subdepartments or subfunctions will be set up according to the operating organization of the company, each with the following primary-expense accounts):
- Salaries—salesmen
- Commissions—salesmen
- Commissions—agents
- Commissions—brokers
- Traveling expenses—salesmen
- Entertainment—salesmen

Overhead (except for the second account below, these overhead accounts would not, of course, be set up by commodity or customer subdepartments):
- Salaries—sales executives
- Salaries—merchandise-department managers
- Salaries—district-branch managers
- Sales employment and personnel
- Sales training
- Sales research
- Sales engineering service
- Adjustment
- Sales records
- Space and equipment charges

Advertising:
- Advertising space
  - Newspapers
  - Magazines
  - Posters
  - Outdoor signs
  - Electric signs
  - Advertising agency services
  - Art work—outside
  - Radio
  - Displays
  - Motion pictures
  - Electros
- Overhead
  - Salaries—advertising managers and assistants

Advertising expenses
Space and equipment charges
Order entry:
Salaries—clerical (allocated portion)
Overhead—space, equipment, supplies, and supervision charges
Billing:
Salaries—clerical (allocated portion)
Overhead—space, equipment, supplies, and supervision charges
Credit extension:
Salaries—clerical (allocated portion)
Overhead—space, equipment, supplies, and supervision charges
Accounts receivable:
Salaries—clerical (allocated portion)
Overhead—space, equipment, supplies, and supervision charges

Allocation procedures. After the indirect costs have been classified by functions, they are allocated on the basis of utilization by products, customers, and so forth of the variable activities giving rise to these costs. The principle followed is to charge the product or customer (or other segment of sales) with the cost of its share of the variable activity of each functional-cost group; that is, the cost of the portion of the variable marketing and administrative effort for which it is responsible.

Variable functional activity. The identification of the variable activity which is involved in each functional-cost group and the broad relationship between the functional costs and the characteristics of products and customers are often evident merely from study. Some functional activities vary according to certain characteristics of the commodity and are not greatly affected by customer characteristics. Others vary primarily according to certain customer characteristics regardless of what product is being purchased.

For example, the variable activity involved in the storage and investment functions depends almost solely on the bulk, weight, perishability, and inventory value of the product stored, and is affected but little by the customer who buys the product. Similarly, the credit function will vary according to the financial integrity and other credit characteristics of customers with little regard to the nature of the commodity on which credit was extended.

As regards still other functional-cost groups, the broad relationship between these costs and product and customer characteristics is more complicated. For there is every shade of combination of customer responsibility and commodity responsibility for the variable activity, and therefore for the amount of expense, within the different functional-cost groups.

Partial allocation. It is the considered opinion of this author that it is neither feasible nor useful to attempt a full allocation of all distribution costs

in most businesses, although there are many who make such an attempt. That is, those functional activities which vary entirely with customer characteristics should not be allocated to commodities, and, conversely, those related solely to commodity characteristics should not be allocated to customers. However, some functional-cost groups would usually be allocated to both customers and commodities.

Partial allocation and pricing. In addition to the difficulty of tracing a direct connection between the variable activity of some functions and product or customer characteristics, there is another reason for not making a full allocation of distribution costs. For the control uses of these cost data which we are discussing—namely, to discover the unprofitable parts of the business, to determine the appropriate action to be taken in regard to these unprofitable sales, and to set profitable prices—little would be gained by making a full allocation.

A full allocation may involve the assignment of some indirect expenses which represent functions not being used to capacity,[5] on the basis of an arbitrary factor such as sales volume. This may have the effect of making some commodities, customers, etc., with large sales volume and low percentages of gross margin, appear to be relatively unprofitable. Actually, since these functions are not being used to capacity, these indirect expenses would not be affected by substitution, elimination, or an increase of sales in the short run.

For example, storage and investment costs usually would not be allocated to customers, because these activities are not usually related to customer characteristics and because they would not be affected by short-run changes in the number of customers. Likewise, credit costs usually would not be allocated to commodities, since they would not be affected by addition or elimination of products "at the margin."

A desire for a full cost allocation may involve an erroneous conception of the use of distribution cost analysis in connection with pricing policy. It appears to some that if they know the total or "real" unit distribution cost, plus the total unit production cost, they can then arrive at the proper price merely by adding the desired unit net profit. If, however, such a pricing procedure gives insufficient recognition to demand, it may be worse than one which is not based on any knowledge of unit costs at all. If prices determined on this total unit cost-plus basis are too high, in the light of demand and competition, sales volume may be lower than before, so that total costs per unit will be higher than calculated and may not be covered even at the

[5] Such evidence as is available indicates that important distribution facilities or functions may, in normal times, be rather consistently underutilized in the typical business.

higher prices. Or if cost-plus prices are too low, then profits are sacrificed.

Summary of procedure. The chart on this page summarizes the preceding discussion of distribution cost analysis techniques, showing some illustrative functional cost groups and bases of allocation to commodities and to customers.

Functional Cost Groups and Bases of Allocation to Commodities and to Customers

Functional cost groups	Bases of allocation	
	To commodities	To customers
1. Investment in finished goods	Average inventory value	(Not allocated)
2. Storage of finished goods	Floor space occupied	(Not allocated)
3. Inventory control, finished goods	Number of invoice lines	(Not allocated)
4. Order assembly (handling)	Number of standard handling units	Number of invoice lines
5. Packing and shipping	Weight or number of shipping units	Weight or number of shipping units
6. Transportation	Weight or number of shipping units	Weight or number of shipping units
7. Selling	Time studies	Number of sales calls
8. Advertising	Cost of space, etc., of specific product advertising	Cost of space, etc., of specific customer advertising
9. Order entry	Number of invoice lines	Number of orders
10. Billing	Number of invoice lines	Number of invoice lines
11 Credit extension	(Not allocated)	Average amount outstanding
12. Accounts receivable	(Not allocated)	Number of invoices posted

12. *Cost analysis as a basis for sales policy*

Sometimes, as a last resort and after investigating all other alternatives, the decision is made by the executives to eliminate the unprofitable sales which have been revealed by a distribution cost analysis.

A decision to eliminate unprofitable sales is far-reaching, affecting every aspect of the business. A decision to eliminate an unprofitable segment of sales because its "savable" distribution costs exceeds its net revenue, for example, would need to be reviewed in the light of the fact that smaller production runs and a reduced scale of production with the same amount of

fixed costs might increase the unit manufacturing cost. Thus, further cost analyses are necessary if the business executive, after studying all the alternative courses of action, seeks to determine the effects of eliminating those unprofitable segments of sales that cannot be turned into source of profit. These further analyses involve the following steps:

1. Make a forecast of just what will happen to sales volume over a period of time, after the business changes from a policy of indiscriminately covering the entire market to a policy of selective distribution. This, of course, is an analysis to be made by the marketing executives.
2. Estimate the decrease in total expense that would result from eliminating the unprofitable sales. This is not an easy matter, since the distribution costs which were allocated to sales to discover the unprofitable segments would not provide the answer. For some of these costs could not be saved and would continue after the sales were dropped. Therefore, it is necessary to separate the nonsavable (or fixed) costs from the savable costs. The total savable costs less the net revenue that will be given up show, of course, the net savings, or the addition to the net profits of the business that will result from dropping the unprofitable sales. (Of course, if the net revenue that will be given up exceeds the expenses that will be saved, the net profits in the short run will be greater with the relatively unprofitable sales than without them.)
3. Make definite plans to get expenses down when unprofitable sales are to be cut off. The experiences of several businesses have shown that projected savings in distribution costs often are never realized because of failure to make and execute definite plans for expense reduction.

As is true of cost accounting in the factory, although there are certain "general principles" or basic techniques, there is no one "right" method of distribution costing which can be used by all businesses. Rather, these basic techniques of distribution costing must be applied by each company individually; a distribution cost system must be designed on a "custom-made" basis, adapted to the individual circumstances of the business.

Despite the fact that businessmen are left to make their own choice among a rather confusing array of possible procedures, however, it is hoped that they will be encouraged to use the same basic management tools for analyses of their own marketing costs and to take similar action toward reducing their distribution costs, lowering their prices, and increasing their net profits.

Section 14

HOW TO RUN A COST SYSTEM

BY

C. W. SARGENT

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HOW TO RUN A COST SYSTEM

Introduction

A cost system is not an end in itself. It must be built to serve specific management needs and purposes. These needs and purposes differ from company to company. A preliminary task in designing a particular cost system is to determine the requirements in that individual case. These needs depend upon the nature of the business, its methods, problems, and productive processes; also, upon the individual attitudes and preferences of its managers and the extent to which they wish to develop the potentialities of cost-accounting methods. How a cost system should be set up to realize its potentialities, particularly from a control standpoint, is discussed in the following five parts.

1. Objectives of the cost system

Objectives in brief. At the outset of a study of costs in business management, it must be recognized that—

Cost is a factor in most management plans, decisions, and policies
The cost of operations—the current day-to-day expenditures made to produce products and to secure sales—must be subjected to constant scrutiny and control
Product unit costs are required for a number of purposes

In view of these needs, it may be said that the objectives of a cost system, briefly expressed, are to—

Supply cost facts for all managerial plans, decisions, and control efforts
Provide the means of controlling current operating costs
Furnish the data required for compiling product unit costs
Record in the accounts the total cost values associated with—
  Materials and other cost factors acquired
  Materials transformed into finished products through the activities of the factory
  Finished products shipped in the process of earning revenue
  Marketing, and other general activities

The cost system—the interrelated group of procedures by which these objectives are accomplished—consists of two parts:

1. The formal cost procedures—the original records of transactions, journals, ledgers, accounts, and reports—that are commonly referred to as "cost accounting"
2. The additional and supplementary analytical procedures and reports that may be referred to as "cost analysis"

The first two objectives listed above would not have been stated as purposes of a cost system scarcely more than a generation ago. The emphasis then was upon summarizing the historical, or so-called "actual," costs of manufacturing products. A tremendous change has taken place, in the meantime, in the direction of making the cost system a vital staff auxiliary, directly charged with the responsibility for aiding management in the control of the cost of current operations, and for supplying management with cost data pertinent to arriving at decisions relative to future plans, policies, capital commitments, and operating efforts. The cost system is no longer solely an adjunct of financial accounting. It is now an important tool in managerial control.

Product unit costs. The compilation of product unit costs, and the recording of the total costs associated with the physical movements of materials and products into, through, and out of the factory, are still important. Product unit costs serve a number of uses:

They are essential to the valuation of inventory and in costing shipments
They are of limited use, at least in some cases, in setting sales prices
They make it possible, within the limitations of the assumptions made and the methods used, to measure the relative over-all profitability of individual products or product lines, territories, salesmen, or other subdivisions of total enterprise business

Standard unit costs may serve these purposes better than historical, or "actual," unit costs. In this event, historical product unit costs, the determination of which was originally the primary purpose of cost accounting, may no longer be computed. This shift in the type of product unit cost epitomizes the conversion of the cost system from an adjunct of financial accounting into an instrument of managerial control.

Cost data for managerial decisions. Cost is involved as a factor in nearly all business decisions. Management is a continuous process of selection among alternatives relating to such matters as the following:

The kind of business to engage in, and its scope
The selection of a plant location
The type or types of processing, buildings, and equipment to use
The territory to be covered in the marketing effort
The kinds of marketing channels to be used

The expansion or contraction of operations, or plants operated
The manufacture or purchase of a particular part
The decentralization of management control
The change of product design or of material specification
The formulation of new policies, or the modification of old ones
The selection of new machines, methods, or processes
Equipment replacement
Setting economic purchase and production lot sizes
The acceptance or rejection of an additional increment of business at less than the normal price

Several possibilities, or alternatives, frequently are present as to these and many other matters that require executive judgment and solution. The selection of a location for starting a new business, or for expanding an old one, involves comparing relative construction and operating costs in several communities. Creating an efficient organization, establishing good customer and employee relations, doing business abroad, providing a suitable financial structure, securing insurance protection—these and many other matters discussed in other chapters of this handbook involve questions of relative costs, differences of cost associated with attaining a stated objective by alternative means. Cost is often an important element both in choosing among objectives and in selecting among alternative ways of reaching them. The cost system must supply management with cost data that are sufficient qualitatively and quantitatively to enable it to arrive at intelligent conclusions and decisions.

Current cost control. The control of cost means the securing of a high degree of efficiency in the utilization of company resources. In the factory, adequate cost control requires the elimination of avoidable wastes in the utilization of materials, labor, and factory services. The basis of cost control in the factory is essentially physical. The quantities of material, labor, and services used must be in reasonable relationship to output or other measurement of accomplishment. Similar relationships between outlay and achievement must be secured in the marketing activities.

Management relies upon two major devices to secure control of costs—standard cost accounting and budgeting. The term "budget" has two meanings:

1. A coordinated program, expressed in money, set up in advance as a goal to be achieved and as a plan guiding the operations of a period. This is the usual meaning of the word
2. The allowed costs for operating a department, division, or function of the business at various levels of output or volume. Cost statements of this type are called "variable" or "flexible" budgets

The budget as a program is discussed in Sec. 16. The flexible budget is a type of cost standard useful in controlling costs both through standard cost-accounting procedures and through a planned operating program. Budgets and standard cost accounting are not, therefore, entirely independent control instruments. The standards used in standard cost accounting, modified if necessary to adjust them to expected future conditions, are normally the basis for calculating the planned purchasing, production, and marketing programs.

Some varieties of cost. The various objectives of a cost system are not all served by a single kind of cost. Certain broad types are listed below:

Standard material, operation, process, and activity costs. These standard costs—and the underlying quantity, price, time, and expense standards —are useful in making current cost control effective, and in budgeting

Standard product unit costs. This type of cost may be used for inventory valuation, costing shipments, setting sales prices, and computing operating allowances and budgets

Historical total costs. These costs, properly classified by department, objective nature, and degree of variability, are useful in establishing responsibility for actual expenditure, and for comparison with the allowed costs of the actual operations, computed by multiplying the actual output or accomplishment of a period by appropriate unit standard costs

Budgeted costs. These costs are estimates associated with the planned operating program of a period. These estimates may be finally expressed as a projected income statement for, and a balance sheet at the end of, the budget period

Incremental, differential, and alternative costs. These various kinds of cost estimates are useful in supplying data for many management decisions

Cost as a factor in planning, organizing, coordinating, and controlling business activities is discussed further in the following section.

2. *Managerial control and the cost system*

Managerial control. The making of decisions is in a sense both the first and the last step in a continuing, never-ending, dynamic managerial control process. Ideas for the conduct of a business are originated, evaluated, decided upon, and put into effect. The resulting action is then appraised in terms of the objective to be attained, expressed as greater revenue, as lower cost, or otherwise. This appraisal gives rise to a new proposal, an adjusted program. Further plans and decisions are adapted to new needs and changed external circumstances.

The word "control," like many similar words of great significance and wide usage, cannot be defined simply and precisely. Its meaning is flexible. Its connotation in a particular case flows from the context of its use. Webster's New International Dictionary suggests its meaning as "to check, test, verify . . . , regulate . . . , to exercise a restraining or directing influence over; to dominate . . . , curb." Various management meanings of the term are suggested by the following descriptive notations:

The optimum adaptation of the capital commitments and operating efforts of a business to external circumstances

Conducting the capital and operating transactions of a business with a maximum of efficiency and a minimum of waste

Getting the most for your money in the long run

The establishment of a reasonable relationship between effort and accomplishment

Making the right business decisions at the right time—selecting intelligently from alternatives

Distinguishing between chance causes and assignable causes of the variation of business data

"To control means to be able to put any variable to its best possible use through preknowledge of its proper behavior in relation to the performance of a specified task and through full right of disposal over the amount of the variable employed. . . . A variable is any quantity that *changes for the purpose of the particular problem under consideration,* and a constant is any quantity that is accepted as unchanging for the purpose at hand . . ." [1]

". . . comprehends all forms of directing the activities of an enterprise" [2]

A description of the meaning of "control," from a top-management standpoint, follows:

In the broadest sense the word designates the means used to predetermine, and to secure and maintain adherence to, management's established objectives, plans, policies, programs, and standards. The word is also used to refer to the authority to secure such adherence; and to the fact of adherence, or the measured degree of variation of actual performance from management's goals; and the analysis of causes and persons responsible for variances.

The need for control, in the sense just described, is of comparatively recent development. This need grows directly out of the delegation of authority and responsibility characteristic of modern, large-scale enterprise. In small businesses control is effected by direct observation and supervision, and by the personal knowledge of the owner or manager and his contact with each

[1] Harvard Business Case, B.C. 191, p. 7—Novelty Wood Products Company.

[2] *Handbook of Cost Accounting Methods,* D. Van Nostrand Company, Inc., 1949, p. 28.

individual transaction and aspect of operations. This knowledge and contact of top executives is not possible in a large organization, although it is still present, to a degree, in the lower ranks of management. Top administrators —the general, functional, and divisional managers—must nevertheless supervise the activities within their respective jurisdictions despite lack of personal and direct contact with events and personnel. This supervision is accomplished by the delegation of authority and responsibility to lesser executives and by the introduction of other means of managerial control in substitution for the direct knowledge, contact, and action that are no longer possible. The new agencies of control that are now necessarily introduced are the carefully formulated and predetermined objectives, policies, plans, programs, and standards referred to above. These instrumentalities are not mutually exclusive and independent; rather, they are interrelated phases of managerial effort to secure and maintain control under conditions of delegated authority.

Control, as the word is used above, may be applied at all levels of the organization structure and to all phases of operations. As an illustration of its breadth and scope, a book on top-management organization and control [3] discusses the subject under these headings: control of policies, organization, key personnel, wages and salaries, costs, methods and man power, capital expenditures, service-department effort, line of products, research and development, foreign operations, external relations, and over-all control.

Phases of the control process. The exercise of managerial control, the activity of managing in all its various manifestations, may itself be said to form a pattern, to be made up of standard elements. These elements, or phases, involved in the basic process of control are described by Holden, Fish, and Smith as follows: [4] ". . . an *objective* establishing what it is desired to accomplish; *procedure* specifying how, when, and by whom the plan is to be executed; *criteria* as to what constitutes good performance; and *appraisal* as to how well it was done." These points are expressed somewhat more elaborately below.

To secure effective control, at the top or at lower levels, management must have:

Definite *goals* and objectives. These take a great many forms and cover every important aspect of operations. A few matters in connection with which goals are established are listed below:

An over-all profit and financial-position goal, projected in the monthly, quarterly, or annual budget

[3] Paul E. Holden, Lounsbury S. Fish, and Hubert L. Smith, *Top Management Organization and Control,* Stanford University Press, Stanford University, Calif., 1941.
[4] *Op. cit.,* pp. 9, 77, and 78.

The improvement of company position relative to total industry sales
The realignment of productive processes and the flow of material through the plant
The elimination of specified material wastes and operating inefficiencies
The improvement of an existing employee pension plan
The strengthening of weak spots in the organization plan or personnel
The reorganization of the financial structure

A *plan* or method for attaining each goal or objective. This phase of control involves subdividing the task, delegating authority and responsibility for the execution of each part or section, timing the initiation of each effort, and coordinating the multiple activities into a functioning whole moving toward the desired end. A properly designed budget, an effective production control system, an advertising campaign, are illustrations.

A *record* of actual performance or accomplishment. This record may take many forms: interim or final income statements and balance sheets; sales-analysis reports; construction-completion reports; actual-cost records and reports; material-consumption reports; labor-time reports; product-output reports.

Standards in terms of which performance may be rated. These standards may be inherent in the statement of the goal or objective, so that attainment may be expressed as a degree of completion, a ratio of attainment, or a percentage of efficiency. Many types of quantity, price, and cost standards, which may underlie the final goal or objective, although they are not expressly stated in it, may be used in appraising accomplishment.

Comparisons of goals and standards with actual accomplishment. These must be made in terms of individual responsibilities. They must measure the degree of attainment and indicate, if possible, the causes of failure or success. These comparisons should be made regularly and promptly, and need not await the completion of an entire project or period.

Means of securing action to correct the delays, lags, deficiencies, inefficiencies, and maladjustments that are disclosed by interim reports, or to prevent their reappearance if a particular program is repeated.

From the narrower viewpoint of factory cost control, these phases of managerial control may be expressed in the form of questions and answers, as below.

1. *What should be done?* This question is answered in terms of objectives frequently expressed as budgets, production plans, or orders.
2. *How should it be done?* This question is answered in terms of standardized practices and instructions which assure that the best methods are selected in advance and are followed. These practices include

establishing quantitative standards for the use of materials, labor, machine time, and services.

3. *What should it cost?* Response to this question is made in terms of cost standards for material, labor, and other production factors. Cost standards are the product of the multiplication of the quantity standards of Question 2 by applicable price standards.
4. *What did it cost?* Reply to this question must be made in terms of the actual expenditures made to produce a specific quantity of a particular product, to operate a factory department for a period, or to conduct any other segment of operations.
5. *What are the differences (variances, variations) between what it should cost and what it did cost?* The answer to this question may be expressed in quantities, in dollars, or both ways, and should state responsibility for the differences in terms of persons and causes.

Some instrumentalities of managerial control. Managerial control of a business enterprise is exercised through specific methods and procedures. The control instrumentalities, in the formulation and use of which cost information is an important factor, are listed below:

Long-term operating objectives and plans
Long-term capital planning
Policies
Standardization
Cost-volume-profit relationships
Quantity, price, capacity, expense, and cost standards
Pricing procedures
Short-term planning and budgeting

These instrumentalities are not worked out and incorporated into managerial practice in the sequence given above. They are not mutually exclusive. The formulation of long-term objectives, for example, takes place in an environment of existing policies, prices, costs, capital resources, operating conditions, and short-term plans and budgets. The latter are composed in a medium of current standards, operating conditions, policies, prices, cost-volume-profit relationships, and long-term operating and capital objectives. The status of these instruments at a given moment is that they are interrelated and interacting agencies.

Neither are these procedures fixed or rigid. Rather, they are dynamic. They are constantly reviewed, adjusted, improved, and adapted to new external circumstances and internal conditions. The harmonizing of the control instruments, the refinement of their aptness, and the development of their usefulness are constant challenges to management and the cost accountant.

Each of these control instruments is briefly described below.

Long-term operating objectives and plans. Long-term planning requires the anticipation of changes and adjustments in products, markets, distribution methods, production methods and processes, plant location, organization structure and personnel, financial structure and position, and many other matters. Long-term goals, formulated for 3, 5, or more years ahead, may be expressed as schedules of estimated cash receipts and disbursements, debt retirement programs, new financing plans, estimated balance sheets, and estimated income statements. These statements necessarily involve weighing trends in customer preferences, technological changes, direction and amount of price movements, expected material and labor costs, and other factors. These plans and objectives must necessarily be tentative. Accuracy and realism are greatly enhanced by engineering and economic research and analysis which appraise the effect of technological changes, general business conditions, mass market shifts, raw material resources, and labor rates and demands, as they affect the industry and the company.

The purposes of establishing long-term objectives are many. They provide continuity, and are a stabilizing influence in setting up current month-to-month and annual plans and budgets. They provide a coordinating influence by reducing the effect of conflicting purposes and plans, thus utilizing the limited resources of the enterprise more economically. They enable management better to foresee developments, and therefore to direct company affairs more effectively and utilize company resources more profitably.

The cost system must interpret and evaluate the cost facts pertinent to the formulation and coordination of long-term objectives and plans.

Long-term capital planning. Planning the long-term capital needs and sources may be undertaken after, and as a concluding phase of, long-term operating planning. This type of forecasting requires consideration of—

The need for plant investment to—
- Increase plant capacity
- Offset obsolescence and take advantage of technological changes in methods and equipment
- Replace equipment no longer adequate because of physical condition, output capacity, or cost characteristics

Capital required to finance larger inventories, receivables, and investments in subsidiary and affiliated companies

Dividend policy

Readjustment of capital structure

Provision of new capital from—
- Operations
- Stockholders
- Creditors

Long-term capital planning must disclose both the needs for and the sources of new capital. Anticipation in these matters is most important to proper financial management. Planning the future uses of capital, in view of its limited supply, requires weighing the relative importance of various needs. This should result in directing the flow of new and replacement capital into the most profitable and beneficial channels from a long-run viewpoint. The cost accountant must be prepared to make special studies, to utilize the special analytical techniques that are available for selecting among alternative new capital commitments and possible equipment replacements, and otherwise provide cost data and estimates to facilitate long-term capital planning.

Policy formulation. A policy is a general description of an attitude or course of action to be followed in dealing with a specified type of business event, transaction, or circumstance, particularly those of a repetitive nature. It is a general decision, in the nature of a principle or rule, formulated by executives to enable them to delegate authority to others and still retain control of their actions by reason of having established, through the statement of policy, the normal pattern of conduct for dealing with recurrent events. Policies are also established and used by the board of directors and top management to provide consistency of action in their own stewardship and guidance of company affairs. Policies are a type of performance standard.

Policies are made at all levels of management. They should be carefully determined and expressed and should be made available, preferably in writing, to those who must use them in their handling of company affairs. They should be reexamined from time to time. Changed circumstances may require their readjustment. They are not entirely automatic and self-regulating. Their observance must be verified, as in the case of quantity, price, and cost standards. In some areas, this process of verification may be made one of the duties of the internal auditing department.

Some examples of matters in relation to which a company may wish to formalize its attitude through expressed policies are listed below. The general area in which the policy is effective is indicated. Most of the subjects listed are, however, of general concern to the entire organization, and therefore related policies are formulated by top management.

Manufacturing
- Wage-payment plans, methods, and incentives
- Use of quantity, price, and cost standards
- Inspection and quality control
- Stabilization of employment and spreading work
- Wage rates
- Material purchase

Inventory size, turnover, verification, and valuation
Equipment replacement
Maintenance
Employee training
Retirement and pensions
Production lot size
Manufacture or purchase of certain parts
Equipment additions and improvement
Relocation elsewhere in the business of employees released by one department or branch

Marketing
Full product line
Loss leaders
Distribution channels
Territorial expansion
Discontinuance of slow-moving items
Types of customers
Order size
Sales and quantity discounts
Product standardization
Prices
Sales emphasis
Advertising

Finance
Capital structure
Long-term sources of capital
Employee stock ownership
Dividends, stock, and cash
Extension of credit
Collection of accounts
Establishment of special funds
Self-insurance

General
Salaries and bonuses
Research and development
Corporate structure
Organization structure and personnel
Replacement of top-management personnel
Plant construction and expansion
Centralization or decentralization of facilities and management
Executive pensions and retirement
Budgetary methods and procedures

Many policies cannot be formulated without consideration of cost data. It is the responsibility of the cost accountant, directly or through the con-

troller, to furnish data pertinent to arriving at each decision. Pertinent facts frequently cannot be taken unaltered from the formal cost records, but become available only through special study and analysis.

Standardization. Standardization serves the same function in the realm of the physical control of operations that policy formulation performs in the realm of managerial direction and regulation. Standardization, with its interchangeability of parts, its requirements of great accuracy, and its precise designation of production materials and methods, is particularly an American contribution to manufacturing processes. Its aim is to find and define the best productive conditions, materials, and methods, and to prescribe their utilization in a constant, undeviating manner.

In the field of manufacturing, standardization involves these aspects:

Products
Detailed specifications of the types, sizes, and perhaps the uses of standard products made, and the description of the general nature and limitations imposed on the manufacture of special products

Materials
Detailed specifications of the kinds and amounts of material to be used in the manufacture of each standard part or product; the chemical and physical nature of each material, and its technical and trade description

Machines
Detailed descriptions of machines to be used for each operation; the simplification of machine operations, and the reduction in the variety of machines employed to perform identical or similar operations.

Methods
Detailed specification of operating procedures; the manner in which work is to be performed; briefing as to the sequence of action elements, machine feeds, speeds; the use of dies, jigs, tools, and work-positioning and -retaining fixtures

Conditions
Factors relating to light, heat, humidity; accessibility of tools and work; control of movement, fatigue, interruption, and machine condition and repair

Employee qualification
Job analysis, evaluation, specification; employee training, initiative, up-grading, morale

Production control
Methods of controlling processing or operation sequence; the initiation and flow of work through the factory

Instructions
Preparation and use of blueprints and written directions, eliminating

dependence on memory; utilizing the same prescription of procedure each time an operation is performed

Standardization should be applied to clerical and selling activities. In the factory, service as well as productive operations should be covered.

The relationship between standardization and cost is twofold. The effecting of standardization, the items to which it is applied, and the extent to which it is applied require a consideration of cost data, on the one hand. On the other, effective standardization is a potent instrument of cost reduction and control.

Cost-volume relationships. The study of the relationships of cost and volume is a most valuable field for investigation by the cost accountant and for understanding by management.

Various methods for visualizing and expressing these relationships are available. They range from relatively simple tabulations and graphs to complex statistical formulas. In the study of cost-volume relationships, volume is considered the independent, and cost the dependent, variable. For most business purposes the representation of the variation of total cost with volume as a straight line is considered sufficiently accurate within the normal range of volume change. The variation of cost with volume may then be represented by the simple formula for a straight line, the general expression of which is $y = a + bx$, where x represents the number of units of volume (which may be expressed in different units for different purposes); b equals the change in cost per unit of volume; a stands for total fixed cost, which remains unchanged irrespective of volume; and y is total cost. The increment cost per unit is also represented in this formula by b and is assumed to remain constant per unit. This assumption is made in relation to the circumstances existing at a given moment and to the normal operating range.

The analysis of the variability of cost or expense with volume may be applied at all levels, such as—

A single overhead expense item in a particular cost center or department; for example, the cost of operating supplies in No. 1 Machine Department

All the overhead expenses of a cost center or department

All the expenses of each major function of the business such as production, selling, and general administration

The total operating costs of the business

A problem encountered in all these areas of application of expense analysis is the selection of a homogeneous unit for the representation of volume. The larger the area of expense analysis (the function or the total enterprise, in contrast with the cost center or department), the more difficult it is to find a

single homogeneous unit by which volume is accurately represented. If a plant or department produces only one product, volume may be stated in product units. If several products are made, some measure of volume accurate for all products must be found. Measures commonly used are actual or standard productive labor- or machine-hours, standard dollars of labor cost, or percentage of capacity based on one of these. When the overall cost variation for the total business is studied, volume may have to be stated in terms of sales revenue.

An informative result of cost-volume studies is the separation of fixed or constant costs from variable costs; the recognition of the former as capacity cost, associated with the readiness to do business; and the recognition of the latter as the direct cost of business actually done or, if the study relates to the future, of business expected to be done.

The terms "fixed" and "variable" must be recognized as relative. These terms are reasonably accurate in the short run, for a given operating *status quo,* that is, while operating circumstances and policies, other than volume, remain substantially unchanged. Over the long run, so-called fixed costs change because of changes in capital investment, salaries, tax and insurance rates, and other factors.

The importance of studying and understanding cost-volume relationships for all types of costs and expenses, in all areas from the single cost center to the entire enterprise, cannot be overemphasized. The intelligent and alert cost accountant can make a significant contribution to managerial control by informing the executives of his company about these relationships and about the effect upon them of proposed changes in capital investment or operating policies and methods. Knowledge of cost-volume relationships is useful in the following ways:

As a basis for setting normal productive department overhead rates, used for costing the product output

As a basis for establishing service department rates used for allocating the operating costs of these departments to producing departments

As a basis for cost control through the flexible budget. This instrument of managerial control is a tabulation, or graphic representation, of amounts of fixed and variable costs allowed to be spent, in a department or other division of the enterprise, at various operating levels, usually stated at 5 per cent intervals. By comparing the amounts actually spent when operations are at a certain level (say the 70 per cent level) with the amounts allowed to be spent at that level, a measure of spending control and efficiency is secured which relates directly to the responsibilities of specific departmental or divisional executives

Supplementing the use just described, knowledge of cost-volume relationships (as expressed in the flexible budget) and of normal capacity may

be used to separate variations between actual and allowed costs into amounts related to—

The difference in volume between the actual operating level and that which has been established as the normal operating capacity

Other differences more amenable to control by the operating personnel

As a means of recognizing whether a proposed price will at least cover the variable or out-of-pocket costs of the item to which the price attaches, or conversely as a means of calculating a price that will at least cover out-of-pocket costs. It is to be recognized that while variable and out-of-pocket costs are not necessarily identical, even in the short run, a knowledge of the former will greatly facilitate the measurement of the latter in each instance when this is necessary

In estimating the costs expected to be incurred in a future period, and in preparing the financial budget for that period

As a basis for setting normal price—that price which in the long run will recover total cost plus whatever element of profit is included

As a basis for breakeven analysis and profit planning

As a basis for recognizing and measuring the effect of any major change, such as a program of plant expansion, on the relative amounts of fixed and variable costs

The above discussion relates to securing and using facts about cost-volume relationships. A somewhat similar type of cost analysis may be made in reference to any change. What is the cost that is associated with adding a new plant, closing a factory or department; eliminating a sales territory; adding a new salesman; adopting or discontinuing any policy, procedure, or method? Such analyses are necessary in order to disclose the costs related to any proposed action. Without this information an intelligent managerial decision is not possible.

Cost-volume-profit relationships. An extension of the cost analysis just described introduces price and revenue factors, thereby making it possible, in whatever area of a company's business it is applied, to recognize the breakeven (no-profit) point or volume. On the bases of the assumptions made, it is also possible to measure the amount of cost and revenue, and of profit or loss, at other operating points. This type of analysis, or more particularly its visual presentation, is variously described as a breakeven chart, a profit chart, and a profit graph. These devices are very useful in visualizing, understanding, and dramatizing the effects on profits of proposed changes in selling prices, fixed costs, capacity, and sales volume. More particularly they are useful in giving tentative answers in appropriate circumstances to such questions as the following:

What is the effect of a stated change in unit selling price on revenue, on profit at the present level of operations, and on the breakeven point?

What increase in volume is needed to offset a stated reduction in unit selling price, or what is the effect on profits of a proposed increase in selling price which it is supposed will bring about a stated reduction in unit sales volume?

How much can a company afford to spend for increased selling effort to bring about a stated increase in unit sales volume; or, assuming a given additional selling expenditure, by how much must volume be increased to maintain net profit at the same level as before?

Assuming plant capacity is increased by a stated amount, with a resulting increase in total fixed costs but no change of variable costs per unit, what is the effect on the breakeven point and on profit at various assumed levels of operations? What increase of unit sales volume is necessary, at a stated price, to maintain profit at the same level as before? What is the profit effect if only half (or some other proportion) of the added capacity can be regularly used?

If the company normally operates at less than capacity (say 70 per cent of capacity), at what sales price can it afford to sell some or all of the units the unused capacity is capable of producing, assuming that the new price need not be applied to, and will not affect, the present volume of business?

Quantity, price, capacity, expense, and cost standards. The standardization described in an earlier discussion makes it possible to determine, with reasonable accuracy, what each product ought to cost. This predetermination of product cost, based on standardized product and material specifications and manufacturing methods and operations, is accomplished by the calculation of—

Quantity standards

The quantity of each kind of material required to make a single unit or a multiple unit (such as 100) of product is determined on the basis of engineering specifications. This quantity may be called the unit material standard, or allowance. It is a statement of the quantity of material that should be used. If waste, or material scrap, is unavoidable, an allowance for these factors must be included in the standard quantity

The quantity of direct labor time, expressed in minutes or hours, required to perform each operation, or required in each department, must be determined by time study or by the detailed engineering analysis of the elements of each task. If piece rates are used as the method of wage payment, the effect of the time factor is represented in the rate

The number of units of the basis used to allocate overhead to the product. Standard direct labor-hours or machine-hours are commonly used bases for this purpose. Either of these units, in appropriate

circumstances, measures the use made of factory facilities, machines, and services

Price standards

These are the standard unit costs applicable to the quantities of material, labor, and overhead required to manufacture a unit of product

These quantity and price standards describe a unit of product in terms of the amounts of material, labor, and factory service required for its manufacture, and the unit prices applicable to each of these elements. A cost standard is the result of multiplying the standard quantity by the standard price. The standard price applicable to the overhead (factory service) element is usually called the standard overhead rate. It is frequently expressed, as noted above, as an amount per standard direct-labor hour, or per machine-hour. If only one product is made in a department, the overhead rate may be stated as an amount per unit of product.

As a very simple illustration of these factors, assume the following data about product *M*, which is manufactured in Department *A* of a certain factory. The overhead rate for this department is stated on the basis of the standard direct-labor hour, and is calculated as explained in later paragraphs.

Standard Unit Cost of Product *M*

Cost element	Standard quantity	Standard price	Standard unit cost
Material	2 pounds	$1.00	$2.00
Labor	4 hours	0.75	3.00
Overhead	4 hours	1.00	4.00
Total	.....	....	$9.00

Using the engineering data as to material quantity and labor hours, and the forecasted prices applicable to the three cost elements, it is possible to predetermine the standard cost before manufacture takes place. These predetermined quantity and price data represent what *the cost should be* when the item is made. They therefore constitute (1) a device that may be used by the Department *A* foreman and others in planning required amounts of materials and labor for a proposed production program; (2) an objective or goal useful to the foreman during manufacture as a means of determining, as a batch of units of this product move through his department, whether he is using too much material or labor; and (3) a measuring stick for appraising, at the end of a period, the performance of the department and the efficiency of the employees who actually did the work. Standards are, therefore, a powerful instrument for managerial planning and control.

The *expense* and *capacity* standards relate to the overhead element. The expense standards are frequently expressed by means of a flexible budget, briefly described in previous paragraphs. A condensed version of a flexible budget, showing total allowed cost only and not giving detailed allowances for each individual kind of expense, is shown below.

Condensed Flexible Budget for Department *A*

Per cent of normal capacity	*Standard direct-labor hours*	*Budget allowance*
70	7,000	$ 8,500
80	8,000	9,000
90	9,000	9,500
100	10,000	10,000
110	11,000	10,500
120	12,000	11,000

These budget allowances include both variable and fixed expense. Assuming the same degree of variability below 70 per cent as is shown above 70, the fixed expenses of this department now amount to $5,000, and the variable expenses are 50 cents per standard direct-labor hour. The budget allowance at any point may therefore be calculated as $5,000, plus 50 cents times the standard direct-labor hours at that point. Variability is linear and is represented by the equation $y = a + bx$, previously described.

Before the standard overhead cost per standard direct-labor hour can be determined, it is necessary to select the point at which it is expected the department will normally operate. This is the *capacity standard* used (1) to fix the normal or standard rate; (2) as a basing point in terms of which to gauge the actual level of operations of a period; and (3) as a means, with other factors, of analyzing and explaining the difference between the overhead absorbed (taken into the cost of the units of product made in a period) and the actual overhead expenditure of the period. In this illustration, 10,000 standard direct-labor hours represent the normal capacity of this department. The standard rate is therefore $1 ($10,000 divided by 10,000).

The establishment of these standards is a most important step in securing managerial control of costs. Their use for this purpose is explained in later pages. In general, the procedure is this:

The allowed costs of the *actual* output are calculated by multiplying the unit standards by the quantity made

These allowed costs are compared with the actual expenditures (which obviously relate also to the actual quantity made), and differences, called "variances" or "variations," are thereby determined

These variances are analyzed in terms of quantity and price factors, causes, and personnel considered responsible

Pricing procedures. An informative article on the relationships of cost and price is entitled "Cost Analysis a Science, but Pricing May Be Classed as an Art." [5] The title may be understood to convey the idea that many elements of judgment and opinion, and a consideration of factors other than cost, are involved in setting sales prices. This is true whether a company competes freely with others who make an identical or a similar product, or enjoys a complete or substantial monopoly.

Cost-price relationships are unusually complex. The relationship may be tight, remote, or nonexistent; it may be nebulous or certain, obscure or explicit. If cost is an effective regulator of price, whose cost is thus significant—that of the seller in a particular transaction, that of the average or "representative" producer, or that of the "marginal" producer? Also, inasmuch as each producer encounters a variety of types of cost applicable to a single commodity at a given moment, which of these, if any, is significant in indicating or establishing selling price? Some of the types of factory unit costs are—

The actual unit cost associated with the last lot manufactured, as assigned by the cost accounting methods used
The present standard cost of making a unit of the product
The standard cost that would be assigned to a unit of the product, if a different level of operations than that used in the present standard-cost calculations were adopted
The average unit manufacturing cost of the product over a past period
The anticipated unit manufacturing cost of the product in the short-range future, considering the expected level of raw material prices, labor rates, operating efficiency, and volume of output
The so-called normal unit cost
The out-of-pocket unit cost of filling a particular order

To each of these amounts of unit manufacturing cost, appropriate allowances for selling and general expenses and profits must be added, usually through a markup percentage, if cost is to be the basis of setting sales price. Which of the resulting total costs to make and sell should be used in setting price? What will be the effect of the use of a price based on any of these costs on the manufacturer's chance of securing a satisfactory volume of sales? In addition to these considerations, it must be remembered that the importance of various demand and supply factors, of which cost is one, changes from time to time. There are buyers' markets and sellers' markets.

Cost-price relationships also differ among businesses. In stabilized industries, costs that are considered normal in the industry, rather than the individual producer's costs, are more determinative of price. In extractive

[5] E Stewart Freeman, *Controller,* January, 1939.

industries, where the natural resources are definitely limited and increased quantities can be produced only by working more expensive holdings, the marginal cost of the last increment needed to meet current demand is an important if not controlling determinant of price.

In manufacturing industries, the significance of cost in relation to price may differ among the products made by a single company at a given time. This relationship changes over the life history of a single product from the time when the originating company is the sole producer to the time when the product is competitively produced by many. As pointed out by Freeman in the article cited above, when a company is making a varied line of products, the costs—factory, marketing, and general—of a single product can be ascertained only with the aid of a substantial amount of arbitrary proration of certain kinds of cost. Most industrial companies, even relatively small ones, make a varied line. In these circumstances, Mr. Freeman declares, the important thing is that the selling price of a single product cover the marginal costs incurred in its manufacture and sale, and contribute toward paying some of the joint or common costs of all the products made, to the extent that its market value (what the buyer is willing to pay) will permit.

That cost is important in pricing is generally recognized. A recent study [6] by the National Association of Cost Accountants investigated the use of standard manufacturing costs for pricing purposes. Of 72 companies surveyed, 67 replies were received as to the kind of cost used for pricing; 62 companies were found to make use of standard costs in some manner for this purpose. Of the 62 companies, 21 companies manufactured exclusively for stock, 11 exclusively on special order, and 30 both for stock and special order. The 51 companies manufacturing products for stock were found to use standard costs for fixing catalogue prices in this manner:

13 companies used their unadjusted standard costs in fixing these prices. The standard costs of these companies were on a current basis

21 companies adjusted their standard costs by the ratio of actual cost to standard cost. Most of these companies had not revised their material price and labor-rate standards to the current cost basis

5 companies adjusted their standard material costs to current market prices. All these companies made products using basic raw materials such as cotton, copper, and steel

12 companies adjusted their standard costs to reflect expected changes in costs

Of the 41 companies manufacturing to special order, whose products were priced on a bid rather than a catalogue price basis, standards were used in pricing in the following manner:

[6] Research Series 14, Oct. 1, 1948.

39 companies used material- and labor-quantity standards in estimating the material and labor costs of orders

36 companies used material price and labor-rate standards in calculating material and labor cost estimates

37 companies used standard overhead rates in estimating overhead costs

This study indicates that standard costs are important in pricing, both with companies manufacturing for stock and with those which manufacture to special order.

Factory unit product costs also serve financial purposes. They are required in establishing the cost valuation of in-process and finished-goods inventories. Such unit costs, with the associated perpetual inventory records, make it possible to compile monthly profit-and-loss statements without taking a physical inventory.

The cost-price relationship, thus seen to be multiple and diverse, is partially summarized below:

Accounting costs may sometimes be used directly in pricing, or they may be so used after adjustment to expected future conditions. In other cases, cost is not a short-term determinant of price to any extent whatever.

Total product unit cost, including selling and general expenses, may be said to fix the minimum below which price may not go in the long run without impairment of enterprise capital, possible bankruptcy, and consequent reduction of the supply of the commodity available in the market. Normal total unit cost may be said in this sense to indicate normal price.

Out-of-pocket or incremental unit cost may be said to fix minimum price in the short run. Management presumably would not knowingly make a sale involving less income than outlay. As pointed out in the pages on cost-volume relationships, the cost accountant must keep management informed as to such minimums.

If a price is fixed by policy, or by market factors beyond the control of a single supplier, the cost-price relationship is still important in reverse. Price now indicates what costs may be incurred without experiencing a loss. If conversion and nonmanufacturing costs are pretty well stabilized, price less the sum of these costs gives the amount that may be spent as a maximum for material. Price less the manufacturing and nonmanufacturing out-of-pocket costs gives the amount contributed, per product unit, toward fixed costs and profit, if any.

Cost that is too high in relation to a market price that is fixed by factors beyond the control of a particular supplier is a constant reminder of the need for cost reduction and control.

Cost, even when not significant in setting price, is a basis for measuring profitability. Hence costs should be available, separated between fixed

and variable items, by individual product items or lines. Costs also should be segregated by sales territories, trade channels, customers, and orders. In this way the cost-revenue relationships by these aggregates may be made the basis for a more profitable direction of company effort and for establishing wise selling policies.

Pricing is keyed to the future; therefore expected costs are more important than past costs, or even current standard costs unless these will carry over into the future.

When a company is making a number of lines of product, it is important to be able to prove that sales revenue for each line, and preferably for each item, is recovering its own direct costs and contributing something toward meeting the general expenses of the business common to all products.

The cost system must be prepared to meet the varying cost demands involved in pricing.

Short-term planning and budgeting. Budgets are discussed in a later section. Therefore they are mentioned here only to define their place among managerial control instruments and procedures.

Two uses of the word "budget" should be distinguished: A budget may be either (1) a type of standard, as is the flexible or variable budget previously described; or (2) a coordinated forecast and program expressing in money the short-run objectives of the company as related to operating revenues and expenses, planned capital expenditures, cash receipts and disbursements, and planned financial position. The factory-cost portion of the budget, in the sense of a planned program controlling operations for 3 months, 6 months, or a year in advance, is based upon the cost standards described previously, plus any anticipated variance from these standards. The use of cost standards obviously greatly facilitates the computation of the budget. The budget is prepared, however, not from the standpoint of product costing, but rather from the viewpoint of fixing responsibility for expenditure. Hence it should indicate what each executive should spend to carry out the planned sales, production, research, plant improvement, and other programs.

The preparation of the budget alone, irrespective of later use, has very important advantages: (1) it compels thinking ahead, the anticipation of conditions that will be encountered relative to sales, production, materials, labor supply, and other operating factors, thus putting each responsible executive in a better position to adjust to conditions before they are actually encountered; (2) it compels weighing the relative needs of alternative uses of the physical and financial resources of the company, compromising and reconciling competing demands, thus promoting integration and coordina-

tion, so that different sections of the business are not working at cross purposes; and (3) it sets up objectives and goals which are stimulating to effort and rewarding in satisfaction, and perhaps also in bonuses, if attained. In addition to these benefits, the budget also provides a basis for comparing actual with expected operating results in terms of organizational responsibilities. The budget is, therefore, an important instrument of managerial control.

Costs for managerial control. The above discussion of instruments for managerial control has shown a variety of needs for cost information and a variety of types of costs to fill these needs. Major needs and types are summarized below.

Inventory valuation and costing sales. This requirement may be met by using one or all of the following:

Historical, or so-called "actual," product unit costs

Historical product unit costs modified by the substitution of predetermined for actual overhead cost

Standard product unit costs

Pricing. The need for cost data for pricing purposes may be met in a number of ways, using:

Historical product unit costs. This type of cost is often not suitable for pricing (except possibly in an unusually stable industry) for two reasons: (1) it looks to the past, whereas prices are normally projected into the future; and (2) historical costs vary inversely with volume

Historical product costs averaged over a number of years. This type tends to eliminate some of the effects of changes in volume. It will be lower than current actual cost in a period of low production and higher than that cost in reverse circumstances

Historical product costs modified to give effect to expected future conditions relative to material and labor costs, volume, and other factors

Current standard product costs. These resemble modified historical costs, except that the cost effects of avoidable wastes and inefficiencies have been removed

Normal standard product unit costs. These costs are similar to current standards except that they include a broader time basis. This affects principally the allocation of fixed overhead costs

Increment costs. This type of cost disregards the total prorated outlay basis present in the types of cost previously listed. Emphasis is upon the additional costs that will be incurred in increasing the output of a product, or in adding a new product or product line

A single company would not use all these types of product costs simultaneously, although more than one may be used at the same time. As

explained earlier, actual prices may be determined exclusively, in the short run, by market factors. Product costs, both total and incremental, are nevertheless important in measuring relative profitability and in guiding sales effort

Cost control. Each kind of cost referred to above has been a product unit cost. These costs are not useful directly in managerial control, although properly broken down they are useful, particularly the standard cost variety, in planning future expenditures and in calculating cost allowances. Cost control is concerned primarily with expenditures stated in terms of (1) the executive responsible for incurrence; (2) the object or service for which the cost is incurred; (3) the nature of the item in reference to its variability. These purposes require the following kinds of costs and cost statements:

Budgeted costs for a future period, broken down by nature of the item and the responsible executive. The variability factor may be presented through the flexible budget

Actual costs of the period as it progresses and after it is closed, expressed in the same manner as the budget

Detailed comparisons of the budgeted and actual costs, with explanations of differences

Allowed costs for the actual output stated in terms of nature of item and responsibility for incurrence. The allowed direct costs (material and labor) may be computed as the multiplication of unit standard costs times actual output. Allowed overhead costs may be computed from flexible budgets, or otherwise calculated from a knowledge of variability factors applicable to individual expense items

Comparisons of allowed and actual costs in terms of responsibilities and causes for variations

Other needs. A large variety of managerial questions require special cost investigation and research. Some recurring problems, the solution of which demands consideration of cost data, are listed below:

Equipment replacement
Make or buy
Plant location or relocation
Economical lot size
Cost of special runs
Design change
Material substitution
Wage increases
Changes in hours, working conditions, or wage payment plans
Alternative methods of processing
Selection of equipment
Addition or withdrawal of products

Order size
Addition or discontinuance of a sales office or territory
Cost-reduction proposals

The place of the cost accountant. Cost-accounting literature in recent years has discussed extensively the contribution that accounting is able to make directly to the regulation of expenditure and to cost reduction, and indirectly to the improvement of performance and the increase of efficiency in all phases of operations, particular attention having been given to the factory. The expressions "cost control," "control through cost," and "control through accounts" are in common use. It should be clearly understood, however, that neither the cost accountant nor the controller who is his superior (both being members of the staff organization) exercises managerial control, except in his own department. The cost accountant's task is to record, analyze, interpret, and report cost facts and estimates to the various general, divisional, and departmental executives, who are members of the line organization. These men make the decisions and initiate the action, formulate the objectives, plans, policies, and programs by and through which control is effected. The cost accountant, nevertheless, participates in the formulation and use of these managerial control instruments in at least three ways:

1. He supplies cost data, from past cost records and from special cost studies and analyses, pertinent to the formulation of the plans, policies, programs, and standards that management is to use in its control efforts
2. He collects and analyzes cost facts related to current actual operations and performance, and determines the cost of individual products
3. He reports and interprets current cost facts to management, at various levels, and compares these facts with the expectancies indicated by the predetermined plans, programs, and standards

This third type of costing effort is customarily described as cost control. The total managerial control effort with which the cost accountant is affiliated is, however, much broader in scope, as described earlier, although it may be thought of as culminating in this final stage. In all its aspects, managerial control includes these three stages or phases:

1. Planning, or predetermining goals and expectancies
2. Operating, or conducting the day-to-day affairs of the enterprise in its internal and external relationships
3. Comparing actual performance and accomplishment, the results of operations, with the planned goals and expectancies, noting differences and variations, and determining, if possible, the persons and causes responsible for these differences

3. *Planning the system for cost control*

The cost system, like other types of managerial effort, must be planned. The particular purposes to be served, and the methods to be followed, must be worked out in advance to fit the circumstances of each installation. Every phase of each of the parts of the system must be defined in terms of detailed procedures to be followed. All the parts must be coordinated into a workable whole, capable of realizing the ends and objectives that have been set up. Some of the general aspects of the preliminary planning required are briefly described below under the following headings:

Selecting the product-costing method
Standardizing the operating conditions
Departmentalizing the plant
Defining the products to be costed
Fixing the direct-cost standards
Measuring the variability of departmental overhead
Distributing service-department costs
Setting productive-department overhead or process rates
Computing standard unit product costs

Other phases of the cost system—the detailed methods of accounting for material, labor, and overhead and of summarizing the costs of goods finished and sold—must also be planned and designed before they can be put into use. Discussion of these matters is, however, deferred to the discussion on operating the cost system.

Selecting the product-costing method. An early task in planning a cost system is the selection of the kind of product-costing method to be used. Choice is limited essentially to the following methods:

Historical methods
  Order method, also called the job or special-order method
  Process method
Standard-cost method

There are many variations of each of these methods. Many plants employ a combination of methods, using the process system in one division or plant, and a type of standard system in another. Every company has use for the order method, if not for accumulating product costs, then for summarizing the costs of plant construction orders and major overhauling or repair jobs. Only the general characteristics of each of these methods can be described in the limited space available.

Choice among these methods depends upon the objectives which are set up, the nature of the product, and the manufacturing methods used.

The order method. When this method is used for accumulating product costs, a product item is defined in terms of the output made on a single production order. The order may cover a specified quantity of a single part, the manufacture and assembly of a group of parts required for a number of subassemblies, or all the parts and assembling operations required to make a number of finished units. The nature of the individual order is regulated by the production control methods in use, which in turn depend upon a number of other factors.

This method can be used only when the items made on a production order retain their individual identity. They must be distinct articles, in contrast with bulk products such as flour, sugar, and gasoline. The productive conditions under which these articles are made are usually those described as intermittent processing, rather than the continuous processing characteristic of bulk-product manufacture. The method is particularly useful, in the sense that it is the most practicable method, when nonstandardized, nonrepetitive items are made on special order to customers' individual specifications.

The essence of this method is that all production costs are identified or allocated to one or another production order. Material issued from stores is recorded on material requisitions or reports as having been used in the manufacture of a particular order. Labor time tickets show the direct-labor cost of each order. Overhead cost for each department through which the product has passed is assigned to the order by means of an actual, or preferably a predetermined, overhead rate. The number of units of the basis used for applying the overhead cost of each department, multiplied by the overhead rate of the department, gives the overhead cost allocated to the order. Common bases used are direct labor-hours, machine-hours, and direct-labor cost.

An order cost sheet is frequently set up as a means of assembling the costs identified with the order. Many different forms are in use. Usually the sheet is divided into sections for material, labor, and overhead. These types of costs, as incurred in each department, are posted to the cost sheet. This posting is often done on the basis of preliminary summaries so that each individual requisition and time ticket need not be posted. When manufacture is completed, the summarization of each section gives the total element cost, and the addition of the totals of the three sections gives the total factory cost. In this process of summarization and posting, costs incurred in each factory department may be kept separate. The total cost of the order, divided by the number of units produced, gives the factory unit cost which is used for valuing the finished-goods inventory and costing goods shipped. There are many variations in this procedure of summarizing the cost of each order. The essential functions are those that have been described, however they may

be performed in any individual case. Manual methods of summarizing and posting are not economical in large factories, any more than tabulating-machine methods are suitable in a small plant.

The order method is useful, where applicable. It is, however, expensive to operate and should be avoided if possible. It has, moreover, other very definite limitations:

It provides only a weak means of controlling costs. Usually no standards are available as criteria of operating efficiency, and hence it is impossible to judge if, or where, or why, the costs of the order are excessive. Comparisons may be made with similar orders made in the past, or with cost estimates compiled before production was started, but these comparisons do not disclose the differences between the costs incurred and what those costs should be

The costs assigned to the order reflect the cost effects of the accidental circumstances and the chance variations relating to its manufacture

Despite these defects, the order method has been and still is extensively used for product cost accumulation. A comparable procedure is much more extensively, if not almost universally, used to accumulate the costs of plant construction jobs, property changes, and major repair work.

The process method. Under this method the primary basis of product costing is the process, rather than the production order. The process may be thought of as a single operation, or more frequently a group of related or sequential operations performed together. The factory is departmentalized on a process basis. Costs and output are recorded for each department for a fixed period, usually a month. The total cost of a product is composed of the summation of the separate costs of the processes required for its manufacture. The material cost of the product may be included in the processing costs, or it may be summarized separately.

In the simplest production circumstances, where only one product is made in a plant, the division of the total operating expense by the total output, both stated on a monthly basis, gives the product unit cost. But even in these simple circumstances the summation of total expense and total output only would not constitute a satisfactory cost system, although it does illustrate the essential features of process costing. To provide adequate information for management purposes, the plant must be departmentalized so that responsibility for cost incurrence can be established. Costs must be analyzed and recorded for each department to show expenditures for individual materials, types of labor, and kinds of overhead expenses. Some activities of the plant are of a service nature. They supply power, heat, and other utilities to departments making the product. The cost of these services should be separately accumulated, and distributed to the producing departments benefited.

The breakdown of costs departmentally, even when only one product is made, is essential in establishing responsibility for cost incurrence, thereby providing a degree of cost control.

Complications of product costing by the process method arise when more than one product is manufactured. Some of the difficulties arising are briefly described below.

When a product passes through several processes. These problems may then arise:

The problem of selecting a suitable unit for measuring output as the nature of the product changes

The problem of waste, shrinkage, and production losses

The problem of partially finished units in each process at the end of the process period

The problem of transferring costs from process to process and of accumulating the final cost of the product

When more than one product is processed in a department. In this case the products may not be homogeneous as to costs by reason of differences in—

The material element. The material cost of the products, in this event, is not charged to the departmental or process account. The material cost of each product is charged directly to an individual product cost accumulation account

The processing time per unit

If the several products pass through the process in rotation, only one product being worked on at a time, an allocation of the total conversion cost of the period—that is, the processing cost excluding material, may be made in this manner:

A record of the hours spent in processing each product is accumulated for the month

The total conversion cost divided by the total hours gives a rate per hour

The hours applicable to each product, multiplied by the processing rate, produces the total cost assignable to each product

The processing cost of each product is closed to its individual product cost accumulation account

If the several products are processed simultaneously: All may require substantially the same amount of time per unit. In this event, the total processing cost of the period, excluding material, is allocated in the proportion of the units of each to total units processed

If the unit processing time varies among the products, weighted product units may be adopted as a means of prorating the common processing costs. The weight factors are based upon the relative processing time required for a unit of each product

The process method is a very flexible instrument of product costing. It has many variations and applications, particularly in the costing of standardized bulk products and in the mass production of like articles. All companies have use for this procedure in costing factory service and marketing activities, even when other methods are used in costing products. Some conception of the scope of this method may be gained from understanding that at one extreme of its use, particularly when material and processing costs differ among products, the application of this method resembles order costing; in other circumstances, particularly where predetermined processing rates have been adopted, the application of the method resembles standard costing.

Where applicable the process method is less expensive to operate, and more informative from a cost-control standpoint, than the order method. The comparison of actual processing rates in each department, period by period, affords a better picture of cost trends and divergencies, provided the variable and fixed elements of cost are properly segregated, than may be had from a comparison of successive order costs for a single product item. The comparison of predetermined with actual processing rates, and the analysis of differences between them, may also shed some light on department spending, provided allowances are made for differences between the estimated and actual volume of work.

Processing costs, like order costs, are obviously average costs. In the one case the averaging is done over the total number of units processed in a period. In the other case, the averaging is effected over the number of units made on one production order.

The standard-cost method. Some general features of standard costs have already been described. Other aspects are explained in later pages. At this point some problems to be solved in designing a standard-cost system are briefly reviewed.

Major phases of using the standard-cost method are these:

I. Predetermination—in advance of the accounting period:
   1. The advance establishment of detailed quantity and price standards for all elements of material, labor, and overhead, for all products to be made
   2. The calculation of the standard unit cost of each product. Under a complete standard-cost plan, this is the only product unit cost calculation made, inasmuch as actual unit costs are not compiled through the formal cost records. They may be computed, approximately, if necessary, by multiplying the standard unit cost by the ratio of total actual to total standard cost, computed by cost elements in all departments

II. Operation—during the accounting period:
   1. Recording the actual consumption and use of material, labor, and

overhead in each department. Actual quantities, prices, and total costs should be made available

2. Measuring and recording the product output. Detailed records must be kept of the output of each product in each department
3. Determining the allowed quantities and costs, in terms of material, labor, and overhead, of the actual output. This calculation is made for each department by multiplying the actual quantity of each product made (II-2 above) by the unit standards (I-1). The result is a statement of the allowed cost of the actual output
4. Comparing the allowed quantities and costs of the actual output of each department (II-3) with the actual quantities and costs of material, labor, and overhead used (II-1)
5. Analyzing the differences between actual and allowed costs in terms of factors and causes responsible for the differences

In planning a standard-cost system, decisions must be made on the following matters:

The type of standard to be used
The departments or products to be included
The extent to which standard costs are to be introduced into the formal cost accounts
The frequency and manner of analyzing differences between allowed and actual costs

These matters are commented on briefly below.

Types of standards are described as:

Ideal standards, beyond the range of current attainment
Currently attainable good performance standards
Past experience standards
Fixed standards, basing points used as indices by which to measure the trends of performance

The currently attainable standards, requiring good but not impossible performance, are considered most suitable for all standard-cost uses—controlling costs, pricing, costing inventories, and budget planning.

A company planning the use of standard costs must decide the scope of the application of this method. It may be applied only to certain products and departments, or it may be used for all products and factory operations. It may be used as the sole product-costing method; or the order method, the process method, or both may be utilized with it.

The extent to which standard costs enter the formal cost accounts must be decided. At one extreme is the complete exclusion of standard costs from the formal records. Comparisons between actual and allowed costs are then made only in statistical computations and reports. At the other extreme is

the dual record of both actual and standard costs in parallel columns of all inventory and departmental cost accounts. Another possibility is the use of standard costs only in finished inventory and cost of sales accounts. In the author's opinion, all inventory accounts—raw-material, in-process, and finished—should be maintained solely at standard. All differences between actual and standard are then charged or credited to special accounts whose function it is to record these variances. Departmental overhead accounts are charged with actual expenditures, and are credited with the allowed overhead cost of the actual output, either directly or through separate departmental absorbed accounts.

The frequency and manner of comparing actual and allowed quantities and costs depends primarily upon the executive level and the use to be made of the information. The foreman should know at once, daily, the allowed and the actual quantities of direct material and direct labor. He can exercise effective control of these items only on the basis of immediate quantitative information. He may also be informed daily of differences between the allowed and the actual variable overhead expenses of operating his department. Control in this area is not so immediate and exact, but he should be kept informed so that he can recognize trends. Higher executives may need only weekly or monthly reports to keep them informed as to performance. Sales executives may require information about the total difference between the actual and standard costs of products only when a new price list or catalogue is prepared.

This section is directed primarily toward securing the most effective cost control through the medium of accounts. Inasmuch as this objective can be attained most completely only by using standard-cost procedures, much of the succeeding discussion is related to this type of costing method. Order and process methods are mentioned only incidentally. It is to be remembered, however, that both these methods will also be used by companies using the standard-cost method—the order method for costing construction work, and perhaps some special products; the process method for costing service activities, marketing efforts, and perhaps a portion of the product output.

Standardizing the operating conditions. A standard cost plan cannot realize its very definite advantages in controlling costs and planning the budget program unless the physical circumstances of production are adequately systematized. Standardization of factory conditions must precede the fixing and use of quantity and cost standards.

Standardization of the operating conditions requires—

Detailed product specification—the types, sizes, and technical description of each item to be manufactured

Detailed material specification—the types, technical description, and amounts of each material required for each part or product
Careful planning of the plant layout and flow of work
Detailed description of each operation and the operation sequence
Control of operating conditions, such as light, heat, humidity, and other circumstances affecting work performance
Production control, regulating the initiation and flow of work
Selection and training of employees in the performance of their tasks
Written instructions as to what is to be done and how to do it

The above requirements indicate the need for an intimate knowledge of the work to be done in the factory—what, by whom, when, and how. This systemization is closely related to cost control. Without stabilization of the operating conditions, regulation of cost incurrence is bound to be erratic, if not impossible. The objective of standardization is the establishment of stable operating conditions upon which tight standards can be set.

A somewhat related matter is the systemization of the machinery and equipment records. The plant ledgers should include an identification of each item, its location, capital cost, periodic depreciation, and a record of major repair expenditures. These records are the basis for computing departmental depreciation, property taxes, and property insurance costs.

Departmentalizing the plant. Proper departmentalization of the plant is a matter of concern both in setting up the organization structure and in cost accounting. From the former standpoint, a factory department is an area for which a single line executive, usually a foreman, is responsible. The cost system must be fitted to this organization structure, so that cost reports can be made showing the actual costs, the allowed costs, and the cost variances for which each foreman is responsible. Departmental accounts must be provided in the account classification to which actual costs are charged. The account mechanism often requires a control account and a sufficient number of subsidiary accounts to provide an adequate analysis of department expenditures in terms of objects or purposes for which these costs were incurred.

Factory departments are described as productive and service. Manufacture of the product takes place in the former. Service departments provide some utility, or staff or supervisory activity, such as production control, engineering research, and cost accounting. Departmental accounts are provided for both types of departments. Cost accumulated in the service-department accounts is usually distributed periodically to the producing department accounts at actual or standard rates, as a means of effecting the absorption of service costs into product costs. Other cost-accumulation accounts, such as for building service or occupancy costs, must be included

in the account classification. Costs are accumulated in, and distributed from, these accounts in a manner identical with the handling of service-department accounts. For this reason these cost-accumulation accounts are frequently called "service departments," although they actually occupy no part of the plant and have no tangible existence as departments. They are, rather, overriding types of factory expenses.

If different kinds of work are performed in a single producing department as set up for the organizational purpose of delimiting authority and fixing responsibility, it will be necessary for costing purposes to subdivide the department into smaller units called cost centers. This subdivision is required, also, if a single type of work is performed in a department on machines of differing sizes and capacities, and therefore incurring different costs per hour, or if both hand and machine work is performed. One must not carry such subdivision to extremes, nor any further than is necessary to secure overhead or processing rates that are approximately homogeneous per unit of the basis—such as labor-hours or machine-hours—used to absorb this type of cost into the cost of the products manufactured. If a department includes two machines, or two classes of machines, and the operating cost of one is $1 per hour at a stated capacity, and of the other $2 per hour, each of these is a homogeneous rate in the sense that one hour of use may be assumed to have a cost equal to any other hour of use, as expressed by these individual rates. If these rates are averaged, and it is said that a machine-hour of operating effort in this department costs $1.50, this rate is non-homogeneous as well as being entirely fictitious. If product *A* is produced in 1 hour on the $1 machine, and $1.50 is charged for this effort, the cost of product *A* is overstated. If product *B* is produced in 1 hour on the $2 machine, and $1.50 is charged for this effort, the cost of product *B* is understated. The costs of both products are misstated by reason of using an average rate which does not represent the cost of using either machine.

From a product-costing standpoint the final purpose and result of departmentalization, in the sense of both the administrative department and its subdivision into cost centers if this is necessary, is to secure equitable overhead or processing rates which may be used with confidence in computing individual product costs. Such rates are required in all types of product-costing procedures—order, process, and standard.

The word "department" is used herein to indicate any subdivision of the plant for cost-accounting purposes. In some cases, particularly when cost control and responsibility for cost incurrence and cost variances are involved, the administrative department is the intended reference. When departmental overhead rates used for product costing purposes are involved, the area referred to must be understood to be the cost center. The cost-center

rate is then made up of a combination of individual machine and administrative departmental costs.

Defining the products to be costed. Under the order method, the product is defined in terms of the units to be made on the individual order. Each order is a product from a product cost-accumulation standpoint. Products must be defined in more general terms under both the process and the standard costing methods.

The problem under discussion may be partially described by saying that its solution requires a decision as to the scope of averaging to be employed in stating product unit costs. The cost of a single physical unit is rarely, if ever, computed in factory cost accounting. Instead the total cost of a batch of similar units made on one order or in one period is compiled, and the average cost of all units is computed and imputed to each unit. How much further may or should the averaging be extended? Must the units over which the averaging is done be physically identical, or as nearly so as the limits of tolerances and quality require? May size differences, as they exist for example in shoes and clothing, be disregarded? In this event all units of a given style are regarded as identical, or homogeneous, from a product-costing standpoint. May minor differences of style, color, and texture be disregarded? May all items in a product class or line be grouped for unit cost calculations, and for cost-control and budget-planning purposes? Are the limits of product grouping different for each of these cost purposes?

Somewhat similar questions arise about defining product units in preliminary stages of manufacture. These preliminary stages may permit a different grouping of product items than is permissible in the final manufacturing stages.

These questions can be answered only in reference to each cost installation.

Fixing the direct-cost standards. The preliminary work of product design and material specification, standardization of operating conditions, departmentalization, and product grouping for costing purposes having been concluded, and the standard costing method having been selected, the cost-systems man may proceed to the setting up of the detailed quantity and price standards for direct materials and direct labor.

The systems man may not proceed alone at this stage of his efforts. He must depend on the industrial engineer for the quantity factors. He will determine the allowable quantity of each kind of material per unit of each product item. Operating-time allowances will be established by time study of each operation, or by compiling synthetic time standards from known elements of these operations. These quantity standards may sometimes be checked with previous operating records or with experience gained from trial runs. Standard prices for material will be set in cooperation with the pur-

chasing department, looking forward to the expected costs in the coming period. Labor rates will be set, if not already established, in connection with the personnel department. The standard labor time and rate for each operation may of course be expressed as a standard piece rate. Existing methods of wage guaranties and incentives must be considered.

On the basis of these material and labor quantity and price standards, the standard direct-material and standard direct-labor cost of each product may now be computed and recorded on a standard cost card for each product. In many continuous processing industries, direct labor is combined with overhead in a standard processing rate.

Measuring the variability of departmental overhead. Some kinds of factory overhead expenses (depreciation, property taxes, and insurance, for example) are constant or fixed for a given plant capacity and do not change, over the short run, as the number of units of product made in a department increase or decrease. Other kinds of overhead cost vary in proportion to volume, or change in approximately predeterminable amounts as volume reaches a stated per cent of capacity. As a consequence of these facts, the total operating cost of a department increases as output increases, but the cost increase may or may not be in proportion to the volume increase, within the limits of a given capacity.

The variability of each kind of expense in each department must be studied and defined as a step in fixing the overhead expense standards. This study requires—

Ascertaining the best way of measuring volume in the department. The unit selected for this purpose will also be used to allocate overhead cost to each product worked on in the department. Units commonly used, in standard cost practice, are the standard direct-labor dollar, the standard direct-labor hour, and the machine-hour

Measuring the changes, either in individual expense items, or in total department expense, with changes in volume. The former is preferable in that it analyzes the composite of variability that is present in the total. This measurement may be made through study of actual past expenses, and by means of engineering analysis of what expenses should be incurred at various operating levels

The results of this study, the final amounts of each individual expense and of total departmental expense that are considered allowable at stated volume points, may be expressed in various ways:

A flexible budget may be drawn up, showing in tabular form the amounts of expense allowable, in total and for each kind of expense, at each stated volume. Volume intervals varying by 5 per cent over the normal operating range are commonly used

A graphic presentation of these data may aid in visualizing expense variation and in indicating approximate expense allowances within the stated intervals shown in the tabulated flexible budget

Expense variation may be expressed as a formula. The formula for a straight line is generally considered satisfactory as a statement of variability within the normal operating range. The general representation of this formula is: $y = a + bx$, where y = total expense allowance; a = the amount of fixed expense; x = units of volume, measured in units of product if only one product is made, or in some measure of operating effort such as labor or machine hours; and b = the amount of change in the expense per unit of volume. A separate formula is usually necessary for each kind of expense in each department

The purposes of this study of expense variability are to—

Furnish the basis for controlling overhead cost incurrence

Provide cost standards for overhead expense to be used in calculating standard product cost

Facilitate the preparation of the budgeted program for a period

The general procedure by which the flexible budget is used to effect cost control is this:

The budget shows the predetermined expense allowance at various operating points

The actual expenditures of the current period are recorded in the accounts

The actual operating point of the current period is measured in terms of volume units

The allowed expenditure for the actual volume is read from the flexible budget, directly or by interpolation, or is read from the budget graph, or is calculated by application of the expense variation formulas. This allowance should be available for each item of expense and for the department total

The actual expenses of the period are compared with the expense allowances. Variations are stated and analyzed in terms of factors related to volume and efficiency by processes described later

The flexible budget provides the standard for arriving at product cost by procedures described in the section entitled "Setting productive department overhead or process rates."

The flexible budget is used in the preparation of the operating budget in this way. The planned product-production program, having been established, is expressed in terms of the volume of activity required in each department. The allowed cost for this level of activity is already indicated by the flexible budget. This use requires that the flexible budget itself must have been revised to express the expected allowances of the coming period. Such

periodic revision is necessary for the two other uses of the flexible budget, namely, cost control and product costing.

Distributing service-department costs. The planning of the cost system requires, as one phase, the establishment of the bases and methods for distributing service-department costs to producing departments, or otherwise providing the means for their absorption into the cost of products manufactured.

So-called "service" departments may be divided into three types:

1. Contributing departments. These departments aid or assist production, directly or indirectly, in a physical sense. The nature of these departments differs from plant to plant, depending upon the product made and the processing required. Departments of this type commonly found are—
   - Power generation
   - Steam production
   - Electrical distribution
   - Internal transportation
   - Material storage
   - Waste collection and processing
   - Machine maintenance
   - Tools, dies, and pattern manufacture
   - Plating, hardening, and grinding

   Some of these activities, such as plating, hardening, and grinding, may be treated as production departments in some factories.
2. Plant-management departments. Departments of this type provide production facilitation such as the following, each of which is recognized as a separate function and activity:
   - Production planning and control
   - Personnel administration
   - Purchasing
   - Receiving
   - Stock-record maintenance
   - Timekeeping
   - Payroll
   - Product testing and inspection
   - Product design and development
   - Time study and process engineering
   - Plant safety
   - Employee training
   - Plant hospital and first aid
   - General plant supervision
3. Expense accumulation centers. An example of this type is the establishment of accounts to accumulate occupancy expense through sum-

marizing building depreciation, insurance, taxes, and janitor wages and supplies

Service-department costs must be studied and expressed as flexible budgets, thereby being rendered more amenable to control. Such costs may show a greater rigidity, in relation to volume changes, than producing department costs. Some quantitative unit must also be selected for each service department, or related groups of such departments, for the purpose of—

Measuring the volume of service activity
Providing a basis for distributing service-department costs to producing departments

Individual units of activity are desirable, and available in many cases, for the measurement and distribution of contributing-department costs. Some examples are: kilowatt-hours, horsepower-hours, pounds of steam, recorded time, or some other measurable characteristic of contributory service activity.

General measures of activity, such as labor hours, total wages, or numbers of employees, must be used in relation to plant-management departments. Occupancy costs are measurable and distributable on the basis of square feet or cubic feet, either weighted or unweighted.

These measures of service-department activity are used for the purpose of controlling service-department expenditures in the manner explained in the previous section.

They are also used for setting up service-department activity cost rates as a basis for distributing these costs to producing departments. These rates are established as follows:

The normal volume of a service activity is determined and expressed as a stated number of activity units. A distinct unit is usually necessary for each contributing-department activity. A single unit may often be advantageously used for all plant-management activities combined
The service activity rate or rates are calculated by either of the following methods:
  A single over-all rate for each activity (or group of activities, such as plant management) is used. This is calculated by dividing the total allowed expense, as shown by the budget for the normal activity, by the number of units of the activity at that point
  Two rates are used, one for fixed expenses, and the other for variable expenses. Each is calculated by dividing the total of each kind of expense, at the normal operating point, by the number of activity units at that point

These rates are used to distribute service-department overhead costs to the producing departments in either of these ways:

The amount distributed to each producing department each month is determined by multiplying the actual number of service-activity units furnished, or applicable, to that department by the over-all normal service rate. Another method used, but one that is not so reasonable, is to calculate the monthly distribution by multiplying the actual number of units by the actual service-unit cost, as calculated for each month

The amount distributed to each producing department each month is made up of two parts:

The fixed position, calculated by multiplying the normal number of service units furnished each producing department by the normal fixed rate

The variable portion, calculated by multiplying the actual number of service units furnished each producing department by the normal variable rate. A less satisfactory variation is to use the current actual variable rate

The dual rate basis may be considered more satisfactory, but also more difficult of application. The theoretical justification of the dual rate basis is that the fixed service costs are related to the capacity to serve, and hence should be distributed in proportion to that capacity as measured on a normal basis. In contrast, variable service-department costs should vary with the volume of actual demand coming in from the producing departments, and hence the service-department variable-cost distribution should be made on this basis, each service unit of actual demand being priced either at what it should cost normally or what it does cost actually in each period. As between these two rates, the author believes the normal rate should be used, thus keeping in the service-department account, as a cost variance, the cost effect of the difference between these two rates.

It is possible also to treat some contributing-service-department costs, or groups of other costs such as those associated with all plant-management activities, as if they were producing departments. As a result such costs would not be distributed to producing departments, but would be absorbed directly into product cost, as described in the next pages.

Many difficult and detailed questions are involved in the proper control and distribution of service-department costs. Should the cost of one service department be distributed to another, the second then being distributed in part to the first, neither distribution being possible until the other is made, unless some arbirary sequence is established? The best opinion restricts such cross-distribution to the minimum. The above very general discussion assumes that there is no distribution of one service-department cost to another service department. Should dual rates be used? To what extent may the costs of several service departments, which are necessarily kept separate for cost-control purposes, be combined for product-costing purposes? In general,

such combinations should be made in the interest of product-costing simplification, provided the amount of stated product cost is not materially altered. It must be remembered that absolute accuracy of product-cost statement is unattainable in view of the common or joint nature of service-department costs. One must not continue to strive toward a goal impossible of attainment, when it becomes apparent that the result of additional effort is infinitesimal progress.

Setting productive-department overhead or process rates. Setting productive-department overhead or process rates involves four steps:

1. The selection of a measure of the volume of productive-department effort, such as the standard labor hour or standard labor dollar
2. The budgeting of departmental expenses at various levels of volume. These expenses must include both direct and prorated service costs, unless the latter are absorbed directly into product cost
3. Selection of a volume point at which the "normal" or predetermined standard overhead or process rate is to be calculated
4. Calculation of the rate by dividing the allowed expenses at the selected volume by the number of volume units at that point

The first two steps were discussed previously. The third step is often described as fixing the normal capacity of the department.

The establishment of the standard or "normal" costing rate serves two purposes:

1. It is used to calculate the unit standard product cost. The number of hours allowed for the manufacture of a unit of product in a department, multiplied by the standard hourly overhead rate for that department, gives the standard overhead cost of the product. If a process rate (which includes both direct labor and overhead) is used, the total departmental conversion cost is secured by this multiplication
2. It is used to calculate the total standard overhead or process cost of the product made in a department in a period. This figure represents the total overhead or process cost absorbed in the period, and it is used—
   - To relieve the department accounts of the standard cost of the actual output of the period
   - As a basis of comparison with the actual overhead or processing costs of the period

The selection of the volume point at which to calculate the standard overhead rate presents some difficulties. Several concepts of volume or capacity are given below:

Theoretical or potential capacity. When capacity is expressed in hours, this kind of capacity represents the total possible hours that may be

operated in view of over-all limitations imposed, such as the number of shifts. If a department has five machines and operates 40 hours a week for 50 weeks in the year, the total theoretical capacity in machine-hours is 10,000 hours per year

Practical capacity. Interruptions of one kind or another—repairs, machine adjustment, lack of material and operators, improper work scheduling, and other causes—make it impossible for a department to operate at theoretical capacity. If these interruptions are estimated at 20 per cent of theoretical capacity, then practical capacity, continuing the example above, is 8,000 hours per year

Average-use capacity. Experience may indicate that past sales have not utilized the total practical capacity. The actual average use of capacity, in the above example, may have been 7,000 hours. This is sometimes described as the capacity to make and sell

Budgeted or expected-use capacity. This type of capacity looks to the future ability to make and sell, rather than to the past. The stated amount may reflect the immediate expectancies, for one year, or longer-term expectancies (say over a business cycle)

Average-use and budgeted capacities are normally both less than practical capacity. The difference between either of these and practical capacity represents idle capacity, either in the past, or expected in the future. A debatable choice exists, in fixing the volume point for the calculation of overhead or process rates, between practical capacity and expected capacity, measured on the long-term basis. The major point at issue in making this choice is the disposition of the fixed costs of idle capacity. A rate based upon practical capacity excludes this cost from product cost, whereas a budgeted basis, which may also be described as the normal sales expectancy basis, tends to include this cost in the cost of product made over the period used in estimating the expectancy. The logic of standard costs would seem to require the selection of the practical capacity basis. The fixed costs of idle capacity may then be stated explicitly as idle-time cost, or it may be included, unidentified, as a part of the so-called "volume variance."

Obviously the choice made as to the capacity basis of the overhead rates affects the stated amount of unit standard cost, and therefore has a bearing on all uses made of such unit costs in setting sales prices and policies, costing shipments and inventories, stating profit and loss, and measuring relative profitability.

In the final step, it is desirable that two separate rates be calculated, one for fixed costs and the other for variable costs. These two rates may be combined into a single departmental rate for some purposes, and used separately for others. This division is useful in stating the cost of idle time as

noted above, and in excluding the fixed-cost element for other purposes, such as calculating a standard variable-unit product cost. A very reasonable argument is made by a small school of cost accountants that the fixed-cost element should be excluded entirely from inventory valuation and treated as a direct operating cost of the period. This position raises the fundamental issue whether a fixed cost that is incurred irrespective of output can be considered a product cost, and whether the latter should be limited to costs that are incurred directly because of manufacture.

Computing standard unit product costs. Previous pages have described the setting of material quantity and price, labor time and rate, and overhead or processing fixed and variable rates. These data must be assembled on a separate card or sheet for each product item. With the completion of this assembling, one major purpose of cost accounting is achieved, namely the determination of individual unit product costs. Under complete standard cost procedure no other computation of unit product costs is made.

The uses to be made of this information have been indicated in previous paragraphs.

The file of standard unit product costs must be revised periodically—normally, at least annually—as changes in underlying quantity and price standards accumulate.

Summary. Some basic decisions that must be made in planning a cost system, designed to afford a maximum of cost control, have been discussed in the previous pages. The matters covered involve fundamental measures and arrangements to achieve this goal. Obviously, the detailed methods and mechanics of cost-system operation must also be decided upon before the preliminary work is completed. Some of these matters are discussed in the following pages.

The preceding discussion has been concerned with manufacturing costs. The marketing function may also be analyzed, in somewhat similar fashion, in terms of specific activities, their variable and fixed costs, and fluctuations in amount of activity or volume. The standard unit cost for each activity may then be calculated. These activities and their costs may also, in part at least, be identified with products, territories, orders, and customers as a means of cost allocation to these segments of the business.

4. Operating the cost system

Cost-accounting methods and procedures vary widely from industry to industry and among companies in the same industry. Various factors are responsible for these divergencies—the plant layout and organization, the nature of the production flow in terms of intermittent or continuous processing, the kinds and varieties of products made, the type of cost system

selected, and the peculiarities of objective and method of individual cost accountants. Much has been written about diversities in purpose and procedure in different companies and industries. Only certain general features of cost-system operation can be referred to here, and these must be described very briefly by reason of limitation of space.

Certain broad aspects of cost-system operation should be kept in mind:

- The cost accounts must tie in with the financial accounts. The cost and financial accounts must constitute an integrated system
- The cost system must include a detailed reporting and analysis of actual periodic expenditures in terms of—
  - The object for which the cost is incurred
  - The department or cost center responsible for incurrence of the cost
  - The variable or fixed nature of the item
  - The identification of the product with the manufacture of which direct-cost items are associated. Indirect-overhead costs must be allocated to products and hence cannot be identified, as incurred, with a particular product
  - A comparable analysis should be made of marketing and general expenses
- If the order or process methods of product cost accumulation are used, means must be provided for—
  - Accumulating the total cost of each order, or accumulating the total cost of each process and product. The cost elements of material, labor, and overhead originating in the several productive departments must be assembled into total individual order and product costs
  - Transferring the accumulating costs of products from department to department, if necessary under the process method
  - Transferring the total assembled costs of orders and products from various in-process and departmental accounts to the finished-goods inventory, or directly to the cost-of-goods-sold accounts
  - Maintaining finished-stock inventories and costing shipments
- If a complete standard-cost system is used, methods must be provided for—
  - Calculating the total standard costs of products finished and transferring these costs to finished inventory
  - Computing the allowed costs for each department, day, week, or month, and comparing these costs with the actual costs incurred. Supplementing these cost comparisons, daily detailed comparisons of allowed and actual material quantities and labor hours are desirable
  - Following up the cost comparisons to assure corrective action
  - Costing shipments
- An adequate system of cost reports must be provided

Following sections discuss certain major elements and constituent parts of a cost system. These elements and parts are present in all types of cost systems—order, process, and standard—inasmuch as they are primarily concerned with recording actual expenditure or cost incurrence, a necessity under all methods.

Major elements of a cost system. Every cost system must include these major elements:

A classification of accounts
Original records of transactions
Summaries and journals, or substitute methods for performing the journal function
Ledgers, or substitute methods for performing the ledger function

Each of these elements is discussed briefly in the following pages.

The classification of accounts. The classification of accounts, in its total scope, includes all the general and control-ledger accounts with assets, liabilities, net worth, revenue, manufacturing cost, selling expense, general expense, and other items that are required to analyze the external and internal transactions of the business. The classification does not include such subsidiary ledger accounts as those related to receivables; raw-material, in-process, and finished-stock inventories; payables; and stockholders. The classification of accounts is therefore related to financial accounting and budgeting as well as to cost accounting. The latter subject is particularly concerned with the control inventory accounts through which costs flow, the departmental manufacturing cost accounts, the factory reciprocal control accounts, and the analysis of selling and general expenses.

The account classification must usually provide inventory accounts for raw materials, goods in process, and finished stock. These accounts are control accounts supported by raw-material, in-process, and finished-stock ledgers, or comparable detailed records. This minimum of three inventory amounts may be greatly expanded. Semifinished-stock accounts may be needed. The single in-process account may be separated in terms of products or product groups, cost elements, or productive departments. Finished inventory may be broken down by products or storage points.

The department accounts are also frequently controlling accounts supported by detailed subsidiary ledger accounts or analyses.

Three types of detailed accounts are required:

1. Direct department cost accounts. These record the expenditures for which the department executive must take responsibility. In order to understand the nature and degree of that responsibility these accounts should be separated as between variable and fixed items

2. Prorated service-department costs. These accounts record charges arising from the distribution of service-department costs. These distributions should also be separated between variable and fixed elements
3. Department-absorbed or -distributed credit accounts. The former applies to productive departments. Its balance represents the amount of overhead charged into in-process accounts at predetermined or standard rates. The distributed-credit account is found in service departments and its balance represents the amount of cost prorated to other departments

When standard costs are introduced into raw-material, in-process, and finished-inventory accounts, the account classification will also provide certain cost-variance accounts, such as the following:

Material-price variance
Material-usage variance
Labor-time or efficiency variance
Labor-rate variance
Overhead-volume variance
Overhead-controllable variance

These variance accounts may be included among the accounts of each productive department, or they may be set up as general accounts for the factory. In the latter case, the total factory balance in each account should be supported by an analysis showing the amount applicable to each department.

Sometimes the factory accounts are physically segregated from the financial accounts, principally as a matter of convenience when the cost accounting and general accounting offices are separated. Both sets of records are then made self-balancing by the inclusion of reciprocal controlling accounts.

Original evidences of transactions. The transactions of the company with its customers are represented by customers' orders, shipping papers, and invoices. Transactions with creditors are represented by purchase orders, bills, receiving reports, and vouchers. The internal transactions of the business—the issuance of raw material from the storeroom, the incurrence of labor cost, the assignment of overhead to an order or product, and the completion of manufacture—these and the many other kinds of internal cost transactions must be recorded at the time of occurrence, so that the facts may be determined and preserved in written form. These records take many forms. In general terms, they must—

Identify the nature and authorization of the transaction
Indicate the quantity and price factors by which total cost is calculated
Show the control and subsidiary accounts, both debit and credit, affected by the transaction, and identify the production order or product, if this is necessary

The importance of adequate original records of transactions cannot be overemphasized. Any inaccuracies therein are sure to be transferred to summary records. Any deficiency of information therein can be overcome, if at all, only with great difficulty or expense.

A few examples of the many kinds of original evidences of transactions required in the operation of a cost system are: material-used report, attendance card, labor-time ticket or report, order-completion report, production-quantity report, and shipment record.

The journal function. Cost accounting involves many transactions, groups of which have common sources, as in vouchers, material issuances, wages earned, and labor costs incurred. These very numerous transactions, each represented by an original record, cannot be posted to control and subsidiary ledger accounts individually. To do so would require a large expenditure of clerical effort and serve no useful purpose. It is the function of the journal, in some form, to provide one or more intermediate summaries between the original record and ledger posting.

The journal function of summarizing and condensing a large volume of similar transactions is performed in many ways, varying from manually kept journals to tabulating-machine summaries. Large installations must, for reasons of economy, use bookkeeping and tabulating machines in keeping their cost records.

Ledgers. Ledgers are of two types, general or controlling-account ledgers, and subsidiary ledgers. Both take many forms, varying from hand-posted to machine-posted records, and from standard-ruled sheets with debit and credit columns to multiple-column forms used as departmental subsidiary-expense ledgers. Many special arrangements are found convenient for maintaining perpetual inventories and machinery records, and for order-cost accumulation. Ledgers are also maintained on tabulating-machine cards.

The ledger is composed of accounts, each of which summarizes from one or more journal sources the financial effect of transactions related to a single specified aspect of the business. At the general and controlling-account level, the ledger or ledgers are composed of the accounts listed and defined in the account classification. At the subsidiary-account level, the ledgers are composed of accounts with individual kinds of material, orders or work in process, finished goods, the detailed objects of departmental cost, and individual units of factory equipment.

The ledger structure of a cost installation may be described as the integrated arrangement of the general and subsidiary ledgers required in the operation of the system.

Principal cost procedure. A procedure is a planned use of system components—accounts, original records, journals, and ledgers—to record a single

type or related group of transactions. A procedure integrates the utilization of these system elements in order to accomplish a defined objective, such as determining and recording the payroll liability for wages earned. A procedure represents an adjustment of the use of system elements to a concrete situation. The description of a specific procedure must set forth—

The objectives of the procedure
The nature and content of the original record of the transaction, the number of copies to be made, and the destination and use of each copy in posting subsidiary records and in compiling summaries
The method of summarizing the transactions and their entry into journals, the timing of each summary and journal entry, and the mechanical aids to be used
The posting of the control and subsidiary ledger records; by whom, when, from what sources, using what mechanical equipment
The subsequent use, filing, and preservation of the original records of the transactions

Some major types of cost procedures are listed below. This list is not complete, but merely illustrative of procedures commonly required.

Vouchers-payable procedure
Direct-material procedures
  Purchase
  Issuance
  Inventory verification
Direct-labor procedures
  Payroll
  Labor-cost distribution
Overhead procedures
  Accumulation of the overhead costs of—
    Indirect labor
    Operating supplies
    Depreciation
    Property taxes and insurance
    Repairs
  Distribution of service-department overhead
  Absorption of overhead into cost of products made
Summarizing the costs of products finished
Summarizing the costs of products shipped
Analyzing the variances from standard cost
Analyzing marketing costs
Preparing cost reports

Some of these procedures are commented on very briefly.

Vouchers-payable procedure. This procedure is a means of recognizing the liability arising from the purchase of materials, services, and property—the acquisition of any item that will require a cash disbursement in the near future. This procedure, concerned as it is with the recognition and discharge of liabilities, is essentially a financial accounting procedure. It relates to cost accounting also, in that the acquisition of cost factors, such as raw materials and operating supplies, is first summarized through the voucher register. Sometimes also a special procedure is set up to record factory vouchers exclusively.

Material-purchase procedure. This procedure, like others, is established in order to accomplish specific objectives and to routinize the activities required to accomplish these objectives. The major objective of the material-purchase procedure is to have the right quantities of materials on hand at the right time, and to secure them at reasonable prices. The accomplishment of this goal requires—

A knowledge of the need for materials, which is based on—
- Data as to kinds and quantities on hand and available at the moment. This information should be furnished through detailed perpetual-inventory records
- Data on planned production requirements, as shown by the budgeted manufacturing program

A knowledge of sources of supply, current and expected future prices, time required for delivery, storage capacities, and transportation costs

Adequate receiving, checking, and storage facilities and records

Original evidences of transactions and other records commonly used in operating this procedure are listed below:

Detailed material specifications by product items
Perpetual stock records
Statements of budgeted requirements
Purchase-department source and price records
Purchase requisitions
Purchase orders
Purchase invoices
Receiving, inspection, and rejection reports
Purchase debit and credit memoranda, and return-shipment orders
Freight-expense bills
Accounts-payable vouchers
Voucher register and distribution records
Inventory-control accounts

Material issuance and use procedure. This procedure has as its objective the recording of the removal of materials from raw-material stores and their

use in the manufacture of specific products. General requirements are—

Identification of the individual direct-material items transferred from storage to factory; and the quantities, prices, and costs involved. This phase requires authorization of the transfer, and the posting of credit to the proper subsidiary perpetual stock records and associated control accounts

Identification of the departments to which the materials are delivered and the products for the manufacture of which they are used. This phase involves charges to the proper departmental or in-process inventory accounts, and the correct order-cost sheet, if the order method of product cost accumulation is used

Forms and records commonly used include—

Material-issuance requisition
Material-used report
Bill of material
Standard material-quantity allowance
Material-used summaries and journal
Perpetual stock records
Control and department cost accounts

Payroll procedure. The payroll procedure has as its objectives—

The determination of the gross earnings of each employee, the proper deductions to be made from these earnings, and the net amount to be paid for each pay period

The accumulation of the above wage data into quarterly and annual amounts so that correct social-security and withholding-tax reports may be made

Compliance with the Fair Labor Standards Act and with union agreements

The prevention of payroll fraud

The proper recording of payroll liabilities and of their discharge

Forms and records commonly used in this part of the cost system are—

Personnel records
  Requisition for employees
  Employment application
  Hiring record
  Payroll-rate record
  Transfer record
  Rating record
Payroll records
  Attendance and work record
  Payroll-deduction record

Payroll summary
Pay check or envelope
Liability accounts for net pay and payroll deductions
Earnings-summary record
Reports to governmental agencies

Labor-cost distribution procedure. Payroll accounting is concerned with the credit side of wages earned. Labor-cost distribution is concerned with the debit side of wages. The objective of this procedure is to summarize and record (1) the amounts of direct-labor cost identified with each department, product, or production order; and (2) the amounts of indirect-labor costs related to all activities in producing departments not considered to be productive operations, and to all activities in service departments. This procedure gives an answer to the question, usually through a weekly or monthly recapitulation, as to how much labor cost should be charged to each department, process, product, order, operation, or activity that receives separate cost recognition in the classification of accounts and in subsidiary records. The original records of labor cost must make an identification of each item of labor cost in such a manner as to facilitate this summarization. The records commonly used include clock cards and various forms of time tickets, journal entries, and appropriate control and subsidiary accounts.

Overhead cost accumulation procedures. A number of distinct procedures are involved in this phase of the cost system. Lack of space prevents the separate description of each. Kinds of procedures commonly required are listed below:

Operating-supply cost procedure, comparable in objectives and methods to the material cost procedures described above, except that charges for operating supplies used are made to overhead expense accounts
Indirect-labor cost distribution. This is a part of the labor-cost distribution referred to above
Salary payroll distribution. Provides charges to general and departmental supervisory expense accounts
Depreciation-cost distribution. Charges departmental depreciation expense accounts in amounts applicable to the plant facilities used by each producing and service department. Calculation of specific departmental amounts is dependent upon adequate property and plant ledger accounts
Insurance-cost distribution. Comparable to the depreciation-expense distribution, and based also, so far as fire insurance is concerned, upon insurable values detailed in the plant ledger
Property-tax distribution. Comparable to the depreciation distribution, and based also, so far as detailed allocations are concerned, upon plant ledger values

Vouchers-payable procedure. Provides for the distribution of some costs directly to overhead expense accounts

Repair-cost procedure. The objective of this procedure is to charge repair costs to responsible departments, even to individual units of equipment. Methods vary. Some charges may be made through the operating-supply-cost and indirect-payroll distributions. Major repair costs may be accumulated through a repair-order system

Other procedures are often required for such items as patent amortization, workmen's compensation insurance, social security taxes, rent, tools and pattern costs, purchased power, light, and other services.

The result of the use of these procedures is the determination of the periodic overhead cost of operating each producing, contributory, and management-service department.

Overhead service department cost distributions. The nature of these distributions was explained in the discussion of planning the cost system. Distributions of service-department costs are necessary, whether the order, process, or standard-cost method is used. They may be made formally and entered in the accounts by means of one or more journal entries, or they may be made informally, without actual journalization, on a statistical overhead distribution record. The distributions are made in various ways, using, for each service department—

The actual service cost and the actual number of measured units of the basis used to effect distribution. The actual service-department cost is thus closed to the producing departments each month

A single predetermined rate, per unit of the basis, may be applied to the demand for the use of service facilities, as measured by actual units of the basis for the month

Dual rates, one for fixed cost and the other for variable cost, may be predetermined. The fixed cost is distributed on the basis of normal demand, multiplied by the fixed rate. The variable cost is distributed on the basis of the actual current demand, multiplied by the predetermined variable rate

As pointed out earlier, service-department cost distribution may be eliminated, at least to some extent, by absorbing service cost directly into product cost, in the manner applicable to producing-department cost.

Productive department overhead absorption procedures. Procedures of this type have already been discussed in part under the heading "Setting productive department overhead or process rates." These procedures are necessary under all methods of cost accounting, and require—

Selection, as a matter of planning the cost system, of the basis of absorption to be used for each productive department. Direct-labor hours,

actual or standard, direct-labor dollars, actual or standard, machine-hours, and product units, are bases commonly used

The calculation of an overhead rate, an actual, or preferably a predetermined, or standard rate, per unit of the basis

The multiplication of the number of units of the basis pertaining to each product made during a period by the unit rate. Historical-cost procedures differ from standard-cost procedure at this point in this respect:

The order and process methods use the actual number of the units of the basis applicable to each order or product made in the month

Complete standard-cost procedure uses the allowed number of units of the basis associated with the actual quantity of each product made, multiplied by the standard rate per unit

The result of these calculations is to produce figures representing the amounts of overhead cost allocated to each product from each department that has contributed to the manufacture of the product during the month. Properly summarized, these figures give debits, by products or orders, for charging goods-in-process accounts, and credits to the overhead-absorbed accounts of all departments.

Summarizing the costs of products finished. A procedure for summarizing the costs of products finished is necessary in both historical- and standard-cost methods.

Under the order method each order is a distinct product. To summarize the cost of orders finished, it is necessary to—

Ascertain the fact of completion of manufacture

Complete the posting of all material and labor costs and overhead allocations to the order cost sheet which summarizes the cost of each order. Upon the completion of this step, the unit cost of the order can be calculated

Summarize the costs of all orders finished in the period in terms of the goods-in-process control accounts and the finished-inventory accounts involved

Journal this summary

Post the subsidiary in-process and finished-stock inventory accounts

Under the process method it is necessary to compile a product cost sheet, each month, for each product. This step is possible and may be taken only after compiling a process cost sheet, for each productive department, which shows the allocation of the conversion cost of the department to each product worked on during the month. The product cost sheets are summarized and journalized so as to credit the in-process and departmental accounts and charge the finished-inventory accounts, with such posting to subsidiary records as may be required.

The product costs computed under both the order and process methods are the so-called "actual," or historical, costs, except that predetermined overhead or processing rates may have been used.

Under the standard-cost method, the standard costs of the actual quantity of each product made are computed. These totals are journalized and posted as credits to in-process or departmental accounts and charged to the finished-goods inventory-control and subsidiary-stock-ledger accounts.

The result of this cost-accounting procedure is to clear in-process and departmental accounts of costs associated with the quantity of each product finished during the month, and to transfer these costs to the finished-inventory accounts. In some cases, especially when production is for special order rather than for stock, the costs of some or all products finished may be charged immediately to the cost of goods sold.

Summarizing the costs of products shipped. Just as the in-process and departmental accounts must be relieved of the costs of goods the manufacture of which has been completed, so the finished-inventory accounts must be relieved of the costs of goods shipped. A procedure must be established for—

Extending a copy of each invoice at finished-inventory cost, as well as at selling price, or by some other means determining the cost of the quantity of each product item shipped during the month

Summarizing these costs of shipments in terms of the cost of sales accounts provided in the account classification and the finished-inventory control and subsidiary accounts that must be credited

Journalizing and posting the summarized amounts

Analyzing the variances from standard cost. A most important and unique feature of the standard-cost method is the computation of the differences between the actual costs incurred for the operations of a period and the costs allowed for these same operations as determinable from the cost standards. Inasmuch as a main purpose in making these comparisons is not merely to disclose the amount of these differences but also to establish responsibility for them, standard-cost variance analyses are made (1) on a departmental rather than on a product basis, and (2) in a manner to distinguish between the cost differences for which the foreman is directly if not solely responsible and the cost variances for which he can be held only remotely, or not at all, responsible.

Every cost amount is the product of a cost and a price factor. Actual costs are the product of actual quantity times actual price. Standard costs are the product of standard quantity times standard price. The basic form of standard-cost variance analysis follows this pattern for the purpose of determining what portions of the total difference between an actual cost and a

standard cost are related respectively to the underlying quantity and price factors. As an illustration of variance analysis technique, assume the following facts:

The material allowance for the manufacture of one unit of product *M* is 2 pounds of material *X*
The standard unit cost of a pound of material *X* is $1
The standard material cost of a unit of product *M* is therefore $2

These standards are established before manufacture takes place. During a given month the following additional facts develop:

During that month 500 units of product *M* are manufactured
But 1,100 pounds of material *X* is used to make the 500 units of *M*
The actual price per unit at which *X* is issued from raw-material stores is $1.10 per pound
The actual cost of the 1,100 pounds of *X* issued is therefore $1,210

The standard-cost variance analysis proceeds in this manner:

The allowed (standard) cost of the actual output is $1,000 (500 units $\times$ 2 pounds per unit $\times$ $1 per pound)
The total variance from standard cost is $210 (actual cost, $1,210, less allowed cost, $1,000)
A part of this difference is due to the excessive quantity of material used, 1,100 pounds instead of 1,000 pounds. This difference, 100 pounds, multiplied by the standard price, gives $100. This is called the material-quantity variance
In addition, 10 cents per pound in excess of the standard price was paid for each pound of material used. This excess cost per pound is responsible for a total excess cost of $110, which is called "material-price variance"

A reason for isolating quantity from price variance is that the former is the direct responsibility of the department foreman, and should be explainable by him in terms of substituted materials, poor quality of materials, unskilled workmen, bad machine setup or operating condition, or some other operating factor under his supervision and subject to correction. Material prices are normally altogether beyond the control of the department foreman. Therefore their effect on cost variance is removed by the above calculation in order that the foreman may not be considered responsible for a total variance of $210, when $100 more nearly measures his direct responsibility.

Labor time and rate factors may be analyzed in a similar manner. Somewhat comparable variances, called "volume variance" and "controllable variance," relate to overhead expenses. Volume variance is a measure of the amount of the overhead cost of a department that is underabsorbed or

overabsorbed because the actual operating level of the period differs from the volume considered normal in fixing the standard overhead rate. Controllable variance is a measure of the departure of actual expenses from those allowed, at the actual operating level, as shown by the flexible budget. The department foreman may be considered responsible for controllable, but not for volume, variances.

Material-quantity and labor-time variances are best determined daily. They should be identified with the product in the manufacture of which they arise and with the workman who performs the operations and uses the material. Daily reporting of these variances to the department foreman is essential. Control and correction may thus be made immediately effective. Controllable overhead variances, in terms of individual expense items, may also be analyzed and reported daily. Control and correction are less immediately effective in this area, but if these items are reported daily on a cumulative basis for the week and the month, the foreman is kept constantly informed of the trends of his performance. Material-price, labor-price, and overhead-volume variances usually need be analyzed and reported only on a monthly basis.

This type of analysis, applied to each element of cost (sometimes, as to overhead, to each kind of expense) in each productive and service department, can provide an immediate and effective procedure for cost control. Discussion of the causes of cost variances and the means of eliminating them, and the application and follow-up of corrective measures, are useful means of clarifying responsibility and measuring management performance. The above brief discussion can do no more than hint at this usefulness, nor has it revealed the detailed processes used, nor the variation in their application.

These standard-cost variances are frequently journalized and summarized in the special variance accounts referred to in the discussion of the account classification. They are not considered an allowable part of product cost when the standards are set on a basis of current expectancy and attainable good performance. They are, rather, period costs, chargeable directly against revenue, and not deferrable by inclusion in the valuation of in-process and finished inventories. When standards are set on other bases, other dispositions of variances must be considered.

Marketing and general costs. Previous discussion has related primarily to manufacturing activities. Analysis and control are also important in the areas of marketing and administrative costs. Control through standards is more difficult in this field for a number of reasons:

Standardization of the conditions associated with performance, particularly the performance of direct-selling activities, is impossible. Customers

differ, one from another, in personality, location, type of business, size, need for the seller's products, and number of products purchased

It is difficult to secure homogeneous activity units in terms of which performance may be measured. A sales call may require 10 minutes in one case and an hour in another; it may result in an order in the one case, and be purely promotional in the other. This statement also applies particularly to order-getting, rather than order-filling and warehousing activities

In comparison with factory operations, a larger portion of marketing costs are indirect rather than direct. Many are common or joint costs. They cannot be identified directly with products, orders, and customers, and in some cases not with particular activities

Probably also, in comparison with the factory, a larger portion of these costs are fixed, either by nature or policy. Advertising is an example of the latter

Despite these difficulties the analysis and control of these costs must be undertaken. Usually effort in this area differs from that in the factory in two ways: it is made intermittently, rather than continuously, and the cost allocations involved are not introduced into the formal accounting records. A general plan for control follows:

I. Plan the procedure
   1. Analyze the activities involved. The purpose of this step is to facilitate the establishment of homogeneous activity units, and to fix managerial responsibility for the costs incurred in conducting each activity. This step is comparable to departmentalization in the factory. Suggested marketing activities include—
      - Order getting
        - Direct selling by—
          - Salesmen
          - Direct mail
          - Telephone
        - Advertising
        - Dealer aids
        - Territorial-office expenses
      - Order filling
        - Warehouse storage and record keeping
        - Order entry
        - Order assembly
        - Loading and shipment
        - Transportation
        - Invoicing
        - Account posting
        - Credit granting
        - Collection

Supervisory and general activities
Sales supervision
Sales planning and budgeting
Sales and product research
Stenographic

2. Select activity units for measuring the volume of each activity
3. Budget the costs of each activity at various volume levels, distinguishing between variable and fixed costs
4. Select the normal volume of each activity in order to fix a normal activity unit cost. This unit cost is to be used in allocating total activity costs to products, territories, orders, and customers, and as a standard of comparison with actual activity unit cost

II. Operate the procedure

1. Record the actual expenditures made for the conduct of each activity each period, thus establishing responsibility for total expenditure. Record the actual volume of the activity in the unit selected
2. Compare the actual expenditure with the budgeted expenditure planned for the period. Also compare the actual expenditure of the period with the flexible budget allowance for the actual volume of period activity
3. Analyze the differences between the actual and the allowed expenditures
4. Make such allocations of total activity costs, on the basis of either normal or actual activity unit costs, as are considered desirable and informative as a means of estimating the relative profitability of individual products, territories, customers, and orders. If the fixed and variable costs of each activity have been distinguished and separate activity unit rates calculated, the profitability comparisons may be made on both the total and the variable-cost basis

This brief and rigid outline of procedure gives little indication of the difficulties, uncertainties, and perplexities encountered in using cost analysis in this area, nor of the large element of judgment and common sense necessary in interpreting the results. The presence of these problems is not, however, a contraindication of the use of cost analysis, but is, rather, an affirmation of the need for its use.

Cost reports. Cost reports take many forms and are designed for a variety of uses. They must be adjusted in content and scope to various executive levels. This aspect of cost reports is discussed briefly below.

The department executive or foreman is in direct contact with the operations of his department. Reports to him must be immediate and detailed. He should know daily the actual performance of each workman, in comparison with standards. Daily reports of actual and allowed time taken

by each workman on each job or product, and the allowed and actual consumption of materials, are desirable. Some companies also inform him daily of his actual and allowed variable overhead expenses, by individual expense item. Weekly and monthly summaries are also prepared to show the cost of off-standard performance in respect to material, labor, and overhead. Daily reports and period summaries of scrap, spoilage, waste, and reoperation costs, analyzed by causes, are also prepared.

Divisional and functional factory executives are more or less remote from the daily details of operations. Reports to them are prepared as summaries to show the performance of the various departments under their jurisdiction. They are interested in comparisons of actuals with budgets and with standards, in totals for the period, without reference particularly to the performance of workmen on individual orders and products. Reports to these executives are broader in scope than to department heads. They are also made on a daily and cumulative basis for the week, month, and year. The latter type of report must emphasize trends of performance. These men are also interested in indicators of the volume of work in progress and on order, number of employees, and future needs for men, material, and equipment.

Sales executives are also concerned with cost and other reports related to such matters as the following:

The detailed analysis of marketing activity costs; the comparison of actual and allowed costs for the actual volume of each activity in a period
The comparison of actual and budgeted costs for each sales territory
The trends of factory unit costs in comparison with those used to fix catalogue prices
The detailed comparison of actual and estimated costs for special orders
Analyses of amounts by causes for sales returns and allowances
Analyses of profitability by products or product lines, territories, customers, and orders, made on a total normal- or actual-cost basis, or on a variable-cost basis

General executives are interested in over-all performance and trends in terms of the budgeted program. Monthly, quarterly, and annual comparisons of actual operating costs and output, in comparison with the budget, are important. The coordination of production and sales; the control of the flow of funds into receivables, inventories, and plant; the work ahead, expressed in terms of required materials, men, and plant facilities; the position of the company in the industry—these and many other matters are covered in reports to top management.

Special cost analyses. Beyond the cost analyses and reports originating in, and forming a part of, the formal cost accounting procedures, many special cost analyses are prepared as the need arises. Some of these have been

referred to previously. Almost every matter that requires management decision and action has cost implications and aspects. Many of these matters relate to the future, and cost incurrence and cost effect must be estimated. A few out of the many subjects that may require special cost study are listed below:

Product design and redesign
Product simplification
Material specification
Material procurement
Material storage
Manufacture or purchase of parts
Plant location
Plant construction
Plant layout
Equipment purchase
Equipment rearrangement
Equipment replacement
Production lot size
Shutdown, or operation at a loss
Transfer of production from one plant to another
Wage payment and incentive plans
Wage rate changes
Change of working conditions
Waste control
Quality control
Distribution channels
Territorial coverage
Customer selection
Order-size restrictions
Sales pricing
Policy changes of all kinds

5. *Conclusion*

Some of the ways in which cost accounting can assist management in its major tasks of planning, organizing, coordinating, and controlling the activities of a business have been described above. Intelligent profit planning, through an understanding of cost-volume-profit relationships, selection among alternative methods and machines, budgeting, inventory valuation, sales pricing, cost control, the placing of responsibility for cost incurrence and cost variance, policy formulation, the resolution of many questions—decision and action on these and other matters requiring management attention are made possible or greatly facilitated by a knowledge of costs—

past, present, and expected—as they are recorded in formal cost procedures and are disclosed by adequate cost analysis.

In conclusion, the following sections summarize the characteristics of major kinds of costs, and indicate the applicability of cost accounting and analytical procedures to other than manufacturing industries.

Characteristics of major kinds of cost. All the objectives of a cost system cannot be attained by using a single type of cost. The costs needed to value the inventory are not identical with costs needed for control or for setting sales prices. Actual, standard, budgeted, and incremental costs are major types commonly used. Some of these costs are used in the formal cost records; others only in special cost studies and analyses. The following classification is presented in order to summarize some of the differences among these varieties of cost:

I. Accounting costs. These costs are included in the formal accounting records.
   A. Historical outlay costs. These are actual costs, so-called because they are based upon expenditures actually made.
      1. Capital, or plant asset costs. These are costs of assets useful over more than one period. The total original cost is prorated over the estimated life of the asset.
      2. Operating costs. These are the current expenditures for material, labor, and factory services, including the proration of plant asset costs through depreciation procedures.
         a. These costs must be identified with—
            The object for which the expenditure was made, such as material, direct labor, indirect labor, operating supplies, insurance.
            The department responsible for the incurrence of the cost.
            Variability—whether the cost is fixed in amount irrespective of the volume of output, or is variable, that is, changes in amount with changes in volume.
         b. These costs may be classified as direct and indirect from the standpoint of the department with which they are associated.
            Direct department costs are those originating in the department, such as the costs of material used, of labor, and of operating supplies.
            Indirect department costs are those first incurred in other departments, usually called service departments. These costs are then prorated or distributed to the departments using the service. Examples are prorated power, heating, and supervisory services.

c. These costs may be classified as direct and indirect from a product standpoint.

Direct product costs are those incurred for the materials and labor embodied in the product, and for the overhead cost of a department that works on one product only.

Indirect product costs are made up of the overhead costs of producing departments that work on more than one product. Such costs are common to the several products worked on, and they must be assigned or allocated to these products, usually on a basis which measures the amount of time or effort given to the manufacture of each product during a period. This allocation is made through a departmental overhead rate. Overhead rates are expressed as dollars and cents per direct-labor hour, per machine hour, per dollar of direct-labor cost or as a percentage of the latter, and in other ways.

d. The factory cost of each product item, therefore, is composed of the costs of—

Each item of material used in its manufacture, including waste materials.

Each kind of direct labor identified with the item in the several departments of the plant where production takes place.

Overhead allocated to the item through the overhead rates of all departments where production takes place. These overhead rates include direct departmental expenses, and elements of all service department costs that have been prorated to each producing department.

B. Modified historical outlay costs. Actual overhead costs vary inversely with volume of output, because some overhead items, particularly depreciation, insurance, property taxes, and salaries, are constant or fixed within the normal operating range. As a result, product unit costs decline when output increases, and increase when volume shrinks. The higher unit costs include the effect of not using some of the plant capacity. To overcome this effect, the actual overhead costs of a period are frequently not used in calculating the costs of the products made in the period. Instead, departmental overhead rates are calculated on what is considered a normal basis. Estimated normal departmental expenditure is divided by estimated normal direct-labor hours, or by the estimated number of normal units of whatever basis is used to allocate

overhead costs to products manufactured. The actual overhead expenditures of each period must of course also be recorded. The effect is to "normalize" the overhead element in product costs over the year, or even over a longer period. As a result the amount of the overhead cost of each department that is allocated to the products made in that department in a given period is greater or less than the actual overhead cost incurred in that department for the same period. If the former exceeds the latter, the difference is described as overabsorbed overhead; in reverse circumstances, the difference is underabsorbed overhead. The resulting product unit costs are generally considered to be superior to unit costs that include overhead on the basis of current actual outlay. The establishment of normal overhead rates is based upon either of these processes:

1. The budgeting of the overhead costs expected to be incurred to make the planned volume of the coming budget period, usually 1 year.
2. The establishment of a flexible budget for each department showing the allowed expenditures at different operating points, and the selection of one point as the normal operating level.

C. Standard costs. Actual product unit costs vary from day to day even when the effect of changes in volume has been eliminated through the use of normal overhead rates. Such costs include the effect of variations in efficiency in the utilization of material and in the application of labor; that is, they include the effect of avoidable wastes. The inclusion of this cost of waste and inefficiency may be undesirable from the standpoint of the uses made of product unit costs. The inclusion and concealment of these excessive costs, in total operating costs and in product unit costs, is certainly undesirable from the management standpoint of controlling costs. What is concealed is not known. If costs of products are to be reduced, the losses due to waste and inefficiency must be made known in terms of the causes and persons responsible. Therefore, it is desirable to determine what costs ought to be, either under ideal operating conditions, or under reasonably attainable conditions. The latter is the better basis from the standpoint of cost control. The calculation of what costs ought to be requires the determination of—

1. The quantity of each kind of material that should be used in making each product, including an allowance for unavoidable waste and spoilage.
2. The prices that are expected to be paid during the coming period for each kind of material.
3. The allowed labor time for the performance of each operation.

4. The allowed labor rate for each operation. This may be a rate per hour if payment is made on a time basis, or it may be a standard piece rate.
5. The amount of the standard overhead cost of each department to be allocated to each product made therein. This amount may differ from the overhead described above, in the discussion of modified historical costs as determined by flexible budgeting procedures, only in that the normal overhead rate is multiplied by the standard instead of the actual units of the basis used to absorb overhead.
6. The summation of these figures, as they relate to each product, gives the total standard unit cost of that product.

Standard product unit costs are determined, by element and in total, before the beginning of a period, before manufacture takes place. In this respect they differ radically from historical product unit costs which can be determined only after manufacture has been completed. Calculation of product unit costs is the principal task of historical cost accounting methods. In a standard cost system, this work is done in advance. As a result the cost accounting effort during the peroid is directed toward the control of costs, regulating the expenditure to the output. This control is accomplished by a process that is very simply described, although the details involved may be very great. The process, reduced to its main elements, requires—

1. The predetermination of the standards, and the standard unit costs, as just described.
2. The recording of the actual expenditures of each department, as incurred each month, properly identified as to the nature of the item to which the cost attaches.
3. The detailed calculation of the quantities and costs of material, labor, and overhead that each department is allowed to use in the manufacture of the actual output of the period.
4. The detailed comparison of the actual quantities and costs with the allowed quantities and costs for the purpose of disclosing differences (also called "variations" and "variances"). These differences are caused by the wastes and inefficiencies that still exist, which are now brought to the attention of management, in terms of responsible persons and causes, so that corrective action may be taken.

D. These three types of cost—historical, modified historical, and standard—have these—

1. Major points of similarity
   a. All are utilized in the formal cost records.
   b. All, with minor differences, are concerned with the total

outlay required to make product, as distinct from the incremental or differential cost of its manufacture.

2. Major points of dissimilarity
   a. Standard product unit costs are predetermined, and are calculated before manufacture. Historical costs can be calculated only after manufacture is completed.
   b. Standard product unit costs represent what the costs should be under the defined conditions. They represent a goal and a measure in terms of which actual cost incurrence may be judged. Historical costs are incurred costs and hence reflect the actual operating conditions encountered in the manufacture of each production order or during each period.
   c. Standard cost procedure is directed primarily toward disclosing cost variations. Historical cost procedures are directed primarily toward computing product unit costs.

II. Statistical costs
   A. Definition: Statistical costs are contrasted here with accounting costs. The former are part of the formal cost system; the latter are not. Statistical costs include a wide variety of computations.
   B. General types of statistical costs include—
      1. Total and unit cost computations that follow the accounting pattern as to inclusion and method of composition. Examples are—
         a. Budgeted costs. These are estimates of future departmental, selling, and administrative expenses that customarily follow the accounting classification of expenses.
         b. Computations of product unit costs using future expectancies as to replacement cost of materials, proposed labor rates, or other elements.
      2. Cost computations that depart from the accounting pattern. Examples are—
         a. Incremental cost. This is the amount of cost associated with a change in volume. How much more or less will total cost be, if the output of a product is increased or decreased a specified amount? This type of cost is useful in fixing special selling prices and in establishing short-term sales policies.
         b. Differential cost. This type of cost is similar to increment cost, except that it refers to the cost effect of any kind of change; for example, the modification of a policy, process, method, or way of doing business.
   C. Special types. This group includes all other special cost computations and comparisons made for any purpose whatever.

Other applications of cost-control methods. The preceding discussion of cost accounting for cost control has been directed toward industrial situations. Comparable techniques are widely applicable to all types of business. The following list descriptive of the scope of this applicability is quoted from *Handbook of Cost Accounting Methods*: [7]

Producers of goods
- Agricultural
- Extractive
- Manufacturing
- Construction

Distributors of goods
- Jobbers and agents
- Wholesalers
- Retailers
- Mail-order houses

Service industries
- Transportation—railroads, trucks, busses, steamships, canals
- Communication—telephone, telegraph, radio
- Utilities—gas, electricity, water, heat
- Warehousing and storage
- Financing—banks, brokers, discount companies
- Housing and food—buildings, hotels, restaurants
- Publishing—books, newspapers
- Professional—accountants, lawyers, doctors, engineers
- Recreational—theaters, amusement parks
- Hospitals

The handbook referred to above and the publications of the National Association of Cost Accountants contain descriptions of the use and application of cost accounting and control procedures to many individual companies and industries.

[7] J. K. Lasser, Editor, D. Van Nostrand Company, Inc , New York, 1949, pp. 37–38.

Section 15

HOW TO AVOID BUSINESS FRAUD

BY

JOHN B. THURSTON

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HOW TO AVOID BUSINESS FRAUD

1. Fraud as a major business problem

Fraud costs American businessmen the staggering sum of between $500,000,000 and $1,000,000,000 a year! Forgery alone, according to the best available figures, results in an annual loss of approximately $300,000,000. Precise calculation of fraud losses is impossible. The *public* history of frauds contained on police blotters and in court records, together with the *private* history of frauds found in the files of bonding and insurance companies, is only *part* of the story. An appalling number of frauds are buried in corporate and other private files, and never reach the public, even in the shape of statistics. And many frauds go undiscovered. Regardless of statistics, the important thing for a businessman to recognize is that the threat of fraud overhangs *his* business, be it large or small, and that he must take positive steps to combat it.

The word "fraud" is used here in a broad sense to cover all classes of crime whereby property belonging to one person is willfully and wrongfully diverted to another's use. Legally, "fraud" is an intentional perversion of truth to induce another to part with some valuable thing belonging to him, or to surrender a legal right. Here the word "fraud" is used as first defined, and covers larceny, embezzlement, and forgery as well. This section deals largely with the crimes of embezzlement (a wrongful taking of personal property not accompanied by trespass) and forgery (the fraudulent making or material alteration of a writing to the prejudice of another's rights). "Misappropriation" and "defalcation" are words used frequently in popular conversation and writing about fraud. However, these words have no strictly accurate technical meaning.

In modern criminology, the study of the methods of criminals is one of the most effective aids in crime prevention and detection. Thus, the businessman, in his fight against the crime of fraud, is best prepared when he knows why honest people steal, who is most likely to commit fraud, when frauds are committed, where frauds are concealed in the accounting records, how frauds are committed, and what methods are most effective in combating fraud.

With this knowledge, the businessman can increase the odds against the potential criminal to such an extent that they will be prohibitive.

2. *Why honest people steal*

A study made by the Chicago Crime Commission, published in 1947, revealed that the major factors leading to fraud are as follows:

Gambling
Extravagant living standards
Unusual family expense
Undesirable associates
Inadequate income

Gambling. The upward surge of gambling since the Second World War has undoubtedly added to the hazard of fraud. A number of the surety companies supplying the basic data behind the Chicago Crime Commission's study estimated that gambling was responsible for as high as 75 per cent of all fraud losses. Wagering on race horses appears to be the most prevalent type of gambling in embezzlement cases.

Gambling may be an indirect rather than a direct cause of fraud. For example, the employee may first feel the impact of a sudden financial drain, such as illness in the family, and commit fraud to meet that immediate need. Gambling may follow to recoup the losses, and then the vicious cycle begins.

No surety company will knowingly approve a bond for a gambler.

Extravagant living standards. Living above their means is ranked next in importance to gambling as a factor in the breeding of embezzlers. Very frequently the living standard is not established by the embezzler himself, but by his wife or children. And, believe it or not, *the employer himself is sometimes responsible* by requiring the employee (a salesman, for example) to associate with a wealthy or free-spending class of people for business purposes. In such a circumstance, the employer should see that the employee's income is adequate or that his expense account is sufficiently liberal to meet the demands made by the employer.

Careless spending habits are similar to extravagant living standards as a cause of embezzlement.

Unusual family expense. Probably the most unfortunate cases of embezzlement are those of employees who commit fraud to meet a sudden and unexpected family expense, such as medical and hospital bills resulting from the illness of a mother, wife, or child. A number of surety companies consider illness of a member of the family as one of the important causes of employee dishonesty. In most of these cases, the *employer* himself cannot escape blame, since, if he had an up-to-date human-relations program, the employee, in many cases, would not have been "forced" to turn into a criminal.

Undesirable associates. Frequently the cause of embezzlement is undesirable associates—"fast" women, friends who drink heavily, speculators or gamblers, and even criminals. Very often the woman in the case is the man's

own wife! Collusion between an employee in a position of trust and a known criminal is not uncommon. Or an employee may be led to embezzle and be framed by a proprietor of a gambling house who lets him win until the time is ripe for the kill. Then the misguided employee must choose between disgrace, prison, suicide, or becoming a fugitive.

Inadequate income. This cause of fraud is to be distinguished from those set forth above. Inadequate income means a wage or salary insufficient to enable the honest, conscientious, and able employee to feed, house, and clothe his family in conformity with the minimum living standard of the economic group in which his family logically belongs. Here again the *employer* is often at fault through failure to reward long and faithful service or through failure to adjust the wage or salary of the employee in light of increased living costs. The old employee frequently justifies stealing on the ground that his employer has been unfair and actually owes him the money he is stealing. The wage or salary of the white-collar workers—those usually involved in fraud—should be increased along with factory wages, and in periods of advancing prices. A number of surety companies consider inadequate income as a major cause of fraud.

Other causes. There are, of course, other causes of fraud. Among these are the following:

Financial pressure due to other business losses
Mental irresponsibility or irrationality
Low moral standards
Improvident investments
Past criminal record
Excessive drinking or drugs
Revenge

Recognition of these causes of fraud will assist the businessman in guarding his assets against the criminal.

3. Who is most likely to commit fraud?

The answer to the question, "Who is most likely to commit fraud?" is easy. *Anyone* from the owner or chairman of the board down to the lowliest sweeper! Recently, the *wife* of the owner of an automobile salesroom and garage was indicted for perpetrating a $40,000 fraud on her husband. The fact is that fraud is usually committed by those having the greatest opportunity.

A well-established composite picture of the embezzler is a faithful employee with 10 years or more of service, married and with a family, around middle age, and, in private life, a "pillar" of his community. Only rarely is he a criminal type. The axiom of fraud investigators is not "Cherchez la

femme," but "Find the old and trusted employee." This means that no businessman is entitled to complacency because employees holding positions of trust have served him faithfully and well for a long time. Experience has shown that these employees are the very ones most likely to commit fraud.

From the files of the Liberty Mutual Insurance Company come these statistics covering a 5-year record of fidelity claims against that company (as analyzed by C. A. Sullivan, Assistant Vice-president):

Fraud committed by—	*Number of frauds*	*Average loss*
Salesmen	1,289	$ 211
Managers (department and branch office)	276	1,171
Chauffeurs and drivers	189	145
Clerks	120	439
Gasoline-station operators	103	174
Cashiers	101	1,844
Collectors	81	132
Agents	71	349
Bookkeepers	38	2,781
Buyers and purchasing agents	24	406
Shipping and receiving clerks	20	2,123
Warehousemen	11	2,183
Supervisors	10	539
Treasurers	9	3,674
Credit men	5	3,615
Presidents	3	40,883
Paymasters	2	10,738
Corporate secretaries	1	5,426
All others	308	299
Total	2,651	519

The foregoing is from the records of just *one* insurance company, and it represents *discovered* frauds. Obviously, many frauds go undiscovered. And many frauds, even where a company is bonded, are not reported either to the police or to an insurance company for personal, public-relations, or other reasons.

Observe from the foregoing schedule that cashiers, bookkeepers, and treasurers are frequent offenders and got away with significant sums.

It is realistic to conclude that many, if not most, of these frauds could have been avoided by an adequate system of internal check and other methods of fraud prevention discussed below. "Opportunity makes the thief."

Another study, by Herman W. Bevis and some of his associates in the world-wide public accounting firm of Price, Waterhouse & Co., was made of 100 fraud cases selected at random from a group of several hundred cases in the industrial and merchandising field (most bank cases were excluded), amounting to $7,100,000. The range in individual cases was from $100 to $750,000. This study showed the following:

Fraud committed by—	*Number of frauds*	*Average loss*
Treasury department:		
Cashiers	35	$ 42,200
Treasurers	3	
Assistant treasurers	2	
Other treasury personnel	10	
Total	50	38,260
Sales department:		
Salesmen	16	17,000
Other sales personnel	3	
Total	19	54,710
Accounting department:		
Controllers	2	
Chief accountants	2	
Tabulating supervisor	1	
Other	6	
Total	11	137,240
Other:		
Presidents	2	
Vice-presidents	2	
Paymasters	4	
Private secretary	1	
Weighmaster	1	
Purchasing agent	1	
Clerk	1	
Total	12	128,250
Collusion	8	136,980
Combined total	100	70,968

While there is a concentration of embezzlers among those provided with the greatest opportunity to commit fraud, namely, treasury and sales personnel who handle cash, both the Price, Waterhouse & Co. study and the Liberty Mutual study demonstrate that no one in an organization can be assumed to lack the opportunity or inclination to commit the crime of fraud.

4. *When are frauds committed?*

It is only rarely that the embezzler strikes suddenly. In the great majority of cases, frauds are committed over a period of time. The Price, Waterhouse & Co. study showed the following:

Duration	*Number of cases*	*Average amount*
Less than 2 years	42	$ 21,000
2 to 5 years	23	128,000
5 years or longer	17	121,000
Duration unknown	18	
Total	100	70,968

It appears axiomatic that the longer an embezzler is at work, the greater his embezzlement becomes. The duration of the frauds from 2 to 5 or more years indicates either that the embezzler is especially ingenious, or that the company is unusually lax in establishing proper safeguards against fraud, or that both circumstances apply.

Manner of discovery is interesting in connection with the foregoing analysis. The Price, Waterhouse & Co. study showed the following:

Manner of discovery	*Number of cases*	*Amount involved*
Internal check	11	$ 900,000
Management inquiries	16	1,500,000
Fortuitous circumstances or just plain luck	36	3,400,000
Public accountants and internal auditors	29	1,300,000
Unknown	8	
Total	100	$7,100,000

While the study did not correlate these statistics, it is interesting to note that the total of the frauds discovered through internal check and those with a duration of under 2 years correspond closely (42 at $21,000 = $882,000, compared with $900,000). While no system of internal check can prevent fraud, nevertheless internal check, if properly designed and operated, usually acts to uncover fraud before it goes very far.

In summary, it is impossible to predict when an embezzler will go into action. However, it is probable that he will strike when the opportunity is greatest. Remember the axiom, "Opportunity makes the thief."

5. *Where frauds are concealed in the accounting records*

While some business frauds can be committed without affecting the balance sheet or income accounts (sale of scrap is an example), these are the exceptions and not the rule. Most business frauds have to be concealed through the manipulation of accounting records or the memoranda behind them.

The Price, Waterhouse & Co. study, referred to above, revealed the following interesting facts: In the 100 cases investigated, fictitious entries were made in 140 account classifications, these appearing on page 533.

It is important to note that 25 per cent of all shortages rested in accounts and notes receivable at the time of discovery. Also of interest is the fact that many of the frauds buried in accounts receivable had been there 2 years and more.

Among shortages resting in profit-and-loss accounts, 14 rested in sales, usually resulting from the diversion of cash sales. (Note the relationship of this to the number of frauds committed by sales personnel.) Payroll padding

Name or classification of account	*Number of cases*
Balance Sheet:	
Cash in Bank	8
Cash on Hand	4
Accounts Receivable (Trade)	28
Notes and Loans Receivable	5
Inventories	7
Intercompany Accounts	2
Accounts Payable	4
Other balance-sheet accounts	8
Total	66
Profit-and-loss Accounts	66
Memorandum Accounts	5
Employee funds not on company books	3
Total	140

was reflected in labor-expense accounts. The larger sums taken by embezzlers, however, were buried in such accounts as material or merchandise purchases, freight in or out, advertising expense, and other accounts which clever embezzlers discovered could be inflated without immediate detection.

6. *How frauds are committed*

The methods used for committing business frauds are so numerous that it would be impossible to list and describe them within the confines of this section. Furthermore, it is questionable that all methods for committing fraud are known or ever will be known. Many clever embezzlers invent their own techniques to meet the circumstances of their particular cases.

However, certain of the methods used repeatedly throughout the years, particularly by beginners, are set forth below. If these are guarded against, fraud losses can be avoided or minimized in many instances.

Overfooting cash receipts
Underfooting cash disbursements
Omitting or delaying the entry of checks in the cash book or entering them for different amounts
"Lapping," usually involving the substitution in a bank deposit of a check made payable to the company for cash, such as that from cash sales
Issuing checks to fictitious payees
Issuing checks to legitimate vendors or payees, where the embezzler forges the indorsement
Issuing payroll checks to employees no longer on the payroll or to fictitious payees (payroll padding)
Forging amounts, payees, signatures, or complete checks
Raising amounts of petty-cash vouchers
Issuing fictitious petty-cash vouchers

Overfooting petty-cash voucher totals when preparing requests for petty-cash reimbursing checks
Stealing stamps from stamp funds
Holding out, understating, or destroying cash-sales slips
Misappropriating cash received through incoming mail
Taking checks or cash paid on bad or stagnant accounts and then writing these off as uncollectible
Manipulating accounts, notes, or loans receivable
Taking finished goods, raw material, or other inventory items where these are readily fungible
Misappropriating the proceeds from the sale of scrap
Selling corporate securities or using them as collateral for loans
Taking tools, supplies, furniture, fixtures, equipment, and other assets for personal use or sale
Obtaining checks or cash for invoices or other originally valid documents which have already been paid once (duplicate payment)
Omitting, understating, or overstating entries to general or subsidiary ledgers from books of original entry
Forging or omitting receiving reports, requisitions, orders, or other documents used as supporting evidence of the validity of a check submitted for signature
Ordering items for company use and then diverting these for personal gain
Granting special prices or privileges to customers or clients in return for "kickbacks"
Favoring certain vendors in return for personal gain

As previously pointed out, the foregoing are only some of the more usual methods used for committing fraud. There are many others.

Fraud may take the form of petty pilfering of small sums from petty cash or stamp funds, or it may take the form of gigantic swindles, as in the McKesson & Robbins case, where top officers falsified transactions to such an extent that the financial statements were grossly distorted, thus deluding creditors, stockholders, and others.

Analysis of cases in the Price, Waterhouse & Co. survey is shown on page 535.

It is important to note that, while there were fewer cases involving disbursements than receipts, the average losses in the disbursement cases were over six times as much.

These losses through disbursements usually involve the use of checks. While everyone knows the ceaseless vigilance maintained by the government in the manufacture of bills and coins, many business concerns pay little attention to the care of blank checks or to the safeguards that should protect every check issued. Where this carelessness exists, check crooks find it an

Involved in manipulation	*Number of cases*	*Average amount*	*Total amount*
Cash receipts:			
Lapping	29		
Other	27		
Total	56	$ 19,336	$1,082,815
Cash disbursements:			
Checks issued to fictitious payees	9		
Checks issued to legitimate payees but with indorsements forged	15		
Other	20		
Total	44	130,522	5,741,970
Theft of inventories, securities, and other assets	7	38,857	272,000
Total	107*	$ 70,968	$7,096,785

* Exceeds 100, since seven cases involved both receipts and disbursements

* * *

easy matter to obtain regular blank checks or to alter checks after they have been issued. Very often the check crook is an outside operator and not an employee. Or there may be collusion.

As stated at the outset of this section, forgery losses amount to approximately $300,000,000 annually. It is obvious that the intelligent businessman will see that every effort is used to safeguard company checks before and after issuance. Ordinary checks are unsafe; payee alterations are easy for the check crook, providing the paper on which the check is made is plain paper or ordinary "safety" paper. Skilled forgers have the requisite chemicals for changing the payee. Also, checks made on ordinary "safety" paper, which is obtainable in the open market, can be counterfeited. With the aid of dishonest or unsuspecting photographers and printers, any desired form of ordinary check can be exactly simulated. Recently a forger cashed $30,000 of fraudulent Relief Administration checks prepared in such a manner. It is possible to obtain special safety paper prepared and controlled under conditions approximating those used by the government, and this should be used for maximum protection.

In addition, check protectors should be used to prevent the alteration of amounts. Where facsimile signatures are used, as in the instance of companies issuing large volumes of checks, these must be carefully guarded.

Check forgery is on the increase. Check crooks even go so far as to plant a confederate in the accounting or treasury department of a company to secure blank checks left carelessly around. The check crook then usually forges a series of payroll checks, cashes these at various points throughout

the city where the company is located, and then departs for a new threater of operation.

In summary, the job of the embezzler is greatly simplified if a company uses ordinary check paper, fails to use a Protectograph, leaves blank checks on top of desks or in open drawers, or otherwise fails to protect checks before and after issuance.

7. What methods are most effective in combating fraud?

The most effective methods for combating fraud are as follows:

Selection of employees. Except for large companies, most employers are lax in selecting employees either for new jobs or for transferral to positions of trust. In far too many instances, an employee is put into a position with little or no investigation. In large cities like New York and Chicago, retail credit reports can be obtained for as little as $10. Little cost is involved in securing business and personal references, and this should be done. Residence should be checked. A *complete* job history should be obtained, with each period of employment or unemployment described from the time the prospective employee left school.

Aptitude tests are growing in acceptance throughout American industry. While no valid test has been developed for revealing a tendency to fraud, other tests will reveal characteristics that indicate the suitability of a subject for a job and, derivatively, whether or not he will be satisfied in it. A satisfied employee is less likely to commit fraud than a man who finds himself unfit to perform his assigned task. Many testing agencies exist which will administer tests inexpensively, if a company cannot afford to carry out its own program or is not staffed to do so.

Training. Any new employee, or any old employee placed in a new position, should be properly trained, either on the job, or through special instruction, or by both means. It is *most important* that the trainee be educated to the whys and wherefores of the system of internal check. An interesting result of the Price, Waterhouse & Co. study, previously discussed, was the discovery that many frauds resulted even where systems of internal check had been properly set up, because those responsible for operating the systems failed to understand their importance. These are some examples:

A shipping clerk was persuaded to turn over c.o.d. collections to the embezzler instead of to the cashier

An official signed checks payable to the embezzler without determining what the checks were for

An employee responsible for reconciling bank accounts failed to investigate reconciling items

An official authorized to approve the write-off of uncollectible accounts

gave his approval to write-offs without verifying that the accounts were bad

A clerk reconciling bank accounts did not compare the payees on the checks with those shown in the voucher register

Another phase of training, where employees are placed in positions of trust, should be to acquaint them with the extreme seriousness of the criminal offenses of embezzlement and forgery. This, of course, must be done judiciously. Many persons regard the subject of criminal law in relation to "office" frauds as of minor consequence. However, if a potential wrongdoer knew the penalty of the crime, in many instances he would not commit it, no matter how propitious the opportunity or how pressing the need for funds.

Adequate supervision. Once properly selected and trained, employees should be adequately supervised. Supervision is particularly important in small companies or other situations where it is not practicable to set up a complete system of internal check and where employees must hold positions of interlocking responsibilities. Under proper supervision, internal checks should not break down.

Enforced vacations. Every employee in a position of trust should be required to take an annual vacation, and at one time—not in snatches—no matter what reason is advanced for foregoing it. Many frauds have been uncovered when an embezzler has suddenly been forced away from the office by illness or accident. In the Price, Waterhouse & Co. study, seven cases were uncovered as a result of the enforced absence from work of the embezzler.

In one of the tables set forth above, it is shown that 29 of the 56 frauds involving cash receipts, or more than half, consisted of lapping operations. Lapping involves the substitution of a check made payable to the company, usually in payment of an account receivable, for currency receipts, usually from cash sales. Once begun, this involves an endless process of manipulation, which usually becomes more intricate and involved as time goes on. The result is that the embezzler balks at taking his vacation for fear that some transaction may arise which will reveal his manipulations.

Rate of pay. As reported by the Chicago Crime Commission, inadequate income is a major cause of fraud. A businessman is shortsighted who places or keeps an employee in a position of trust who is underpaid—or not well paid. The defense in many criminal court cases has rested on the plea that the employer did not pay the embezzler an adequate salary to support his family. The underpaid employee often justifies his fraudulent acts in his own mind on the ground that his employer really owes him the money he is stealing. Obviously, there is no need for the employer to be overgenerous, but he should be fair in setting the rate of pay for employees in positions

of trust, and particularly for the old and faithful. As previously stated, these are the most likely to commit fraud.

Human relations. Several surety companies list illness of a member of the family as one of the important causes of employee dishonesty. Such dishonesty can be avoided if a company has an adequate human-relations program. It is in the employer's self-interest to keep well informed of his employees' personal problems, and to assist financially and in every other way possible to tide a valued employee over critical periods of illness on the part of his family or other crises.

Review of employee living habits. Having taken every precaution in selecting a new employee to ensure that he is a person of integrity, the problem then is to preclude any lapse from this virtue. The record shows that most frauds are committed by honest people who "go bad" on the job. Consequently, periodic checks are necessary. Admittedly, it is a difficult task to check the living habits and personal life of employees, particularly in the larger cities. However, since such checks pay off, they should be made. Obviously, only those employees who are in positions of trust need be investigated.

If the company is a small one, the visit to the home is a friendly gesture. Larger companies use information secured by nurses when they visit homes to check on or assist in illness. Trained investigators are used by large companies. Or, in smaller cities, general observation by responsible officials may be all that is necessary. The treasurer of a large company uncovered a fraud on the part of a storekeeper by observing the expensive clothes (including a mink coat) the man's wife was wearing on the street.

Periodic checks on residence, marital status, etc., can be revealing. Fellow employees are usually aware of a man's gambling or other bad habits, and judicious inquiry can uncover valuable information from this and other sources.

Bonding or insurance. As in the instance of periodic examinations by public accountants, bonding or insurance acts as a deterrent to fraud. However, the basic purpose served by surety companies is to provide reimbursement *once a fraud has been discovered.* Bonding companies also perform a valuable service through their investigation of employees submitted for bonding. Also, certain of the insurance companies investigate the system of internal check and assist in its perfection. An intelligent businessman will not rely on bonding alone but will take positive steps to *prevent* fraud, realizing that the mere existence of an insurance policy is no guaranty that a fraud, once perpetrated, will be discovered or, if discovered, uncovered to its full extent. Competent insurance companies can be relied on to recommend the best coverage to fit the circumstances of a specific undertaking. The

fact that *anyone* in an organization may commit fraud argues for a blanket bond.

Comparative financial statements and financial ratios. The use of monthly comparative financial statements and financial ratios is an effective means for revealing embezzlement. Had these been used intelligently in a recent case involving $750,000, the fraud could have been disclosed before it had reached such sizable proportions. Usually, the smaller the company, the more effective management will find this tool.

In larger companies, departmental operating reports can be used effectively. These reports can compare the current results for which the department head is responsible with past results or, preferably, with budgetary standards. The department head will be prompt to notice any unusual items charged to accounts for which he is responsible.

Monthly comparative balance sheets, showing the dollar increase or decrease between one month and another, are effective. Provided with this tool, management is in a position to notice any unusual change in accounts receivable, provision for doubtful accounts, inventories, securities, fixed assets, and other balance-sheet accounts.

The monthly comparative income accounts (or profit-and-loss statements) should be compared on a percentage basis. All income-account items should be interpreted in percentages of net sales for each month. Then unusual or out-of-line items will stand out; for example, increases in postage expense, bad-debt losses, labor expenses (payroll padding), and the like.

Finally, financial ratios can be effective in revealing unusual changes. Management can then investigate these and determine the cause.

Periodic audits by public accountants. Most business enterprises, even small ones, have their books audited periodically by public accountants. Regular audits act as a major deterrent to would-be embezzlers. Competent public accountants frequently unearth frauds. In fact, the knowledge of an impending audit not infrequently flushes an embezzler from cover. However, where a balance-sheet audit is concerned—and this is the most usual type—the scope of the examination is not such as to ensure the discovery of fraud. Therefore, while the public accountant can be relied on for significant assistance in preventing or discovering fraud, the businessman must take other positive steps to prevent fraud losses.

Internal auditing. Internal auditing is one of the most practicable means for protecting corporate assets against fraud. Testimony to its efficacy is borne by the fact that leading bonding companies reduce their premiums by *5 per cent* for a company that has internal auditing.

Internal auditing plays important roles in observing personnel and in maintaining the system of internal check in proper operating condition.

Also, the existence and continuing activity of a strong internal auditing organization, in and of itself, acts as an effective deterrent to fraud.

Many case histories exist of frauds uncovered by internal auditors. In one company, having many small branch offices, the internal auditor discovered over 100 frauds in a single year. While most of these were small, had they not been found promptly, they might have developed into major losses.

Next to preventing fraud, the most important thing is to uncover it once it has been committed. Probably no single device is as effective as a thoroughgoing program of internal audit. If management has authorized the establishment of a fully staffed internal auditing organization of soundly trained personnel, it has the best known modern device for disclosing fraudulent acts.

Finally, it is not enough to disclose the fact of fraud. Once it is disclosed, skillful investigation is required to develop all its ramifications. In fact, unless well done, a fraud investigation may reveal only some of the facts and fail to discover all the stolen property or all the criminals involved. Once the investigation is started, if it is not carefully planned, others concerned in the fraud may have time and opportunity to cover up their tracks. The internal auditor is in a position to develop a complete and thoroughgoing program *before* the investigation is begun, to ensure complete results.

Where a company is too small to justify a full-time internal auditor, either some responsible employee already on the payroll can periodically perform the necessary internal-auditing function, or the public accountant can be asked to broaden his program to cover important items which he would omit in the course of his regular balance-sheet audit.

Internal check. While all the foregoing are important factors in preventing and/or detecting fraud, internal check is the most positive and effective.

"Internal check" is the term used to describe those features of organization, methods, and facilities which are employed to prevent or detect errors and frauds by (1) so subdividing or allocating work that no one person has sole control over any transactions, assets, or the records established to account therefor; (2) so establishing the flow of work that one employee, acting independently, automatically verifies the work of another and/or carries the work forward toward or to a logical conclusion without duplicating unnecessarily the work already performed; and (3) providing physical and mechanical facilities of such a character and nature that the work performed by each employee is verified and/or protected to the maximum extent practicable.

A complete system of internal check is impossible in many small companies, and in many situations existing in large companies. Where it is

impossible, ex post facto examinations or other protective measures should be established to assure adequate protection against fraud.

The next part of this section consists of a check list of important danger points which should be protected in a comprehensive system of internal check.

8. Check list

In order for a system of internal check to be effective, the answers to the following questions, under most circumstances, should be in the affirmative. It is recognized that in small companies, or in branch offices of large companies, it is not economically feasible to allocate functions to various employees or otherwise establish the system of internal check to fit the ideal pattern. In such instances, if the question is applicable, the negative answer to any question serves the constructive purpose of raising a red flag, thereby warning management that the flagged spots must receive constant attention and surveillance.

General

Is the cashier, or other person responsible for handling receipts and disbursements, precluded from handling or making entries to the general ledger or any of its subsidiary ledgers?

Is the ledger keeper precluded from handling any cash transactions?

Is each journal entry prepared in permanent and controlled form and approved by a responsible executive other than the cashier or ledger keeper?

Are the trial balances checked to general and subsidiary ledgers by public accountants, internal auditors, or someone other than the ledger keeper?

Are annual holidays enforced?

Are clerks rotated between jobs to avoid the possibility of collusion?

Are cash sales checked carefully every day by someone other than the cashier or person making up the daily deposit?

Are documents of original entry used for posting purposes to the fullest extent practicable?

Are surety bonds obtained for all officers and employees in positions of trust?

Are the accounts audited periodically—at least annually—by a recognized public accounting firm?

Are monthly comparative financial statements and financial ratios prepared and analyzed by a responsible executive?

Are employee living conditions checked periodically?

Cash in general

Is the function of receiving money divorced from the function of disbursing money?

Are the functions of receiving and disbursing money divorced from the accounting therefor?

Are monthly bank reconciliations made by someone completely divorced both from the receipt and disbursement of cash and from the accounting therefor?

Are transfers between bank accounts carefully audited?

Cash disbursements

Are all disbursements made by check?

Is a special safety paper used which cannot be altered by a skilled forger?

Are all checks prenumbered and accounted for, including voided or spoiled checks?

Are blank checks guarded with the same care as currency?

Is a Protectograph used to prevent the forging of different amounts, and is it used before the check is signed?

Are double signatures used for checks in excess of a stated sum (say $250 or $500, depending on circumstances)?

If facsimile signatures are used, are these kept under adequate control to prevent their misuse?

Is the presigning of checks, even for emergency use, forbidden?

Are all checks put into the mail after final signature without allowing them to return to the person who prepared the check or authorized the payment?

Is advance payment to creditors forbidden?

Is the personal delivery of checks or cash by employees to creditors forbidden?

Is the issuance of checks to "cash" or "bearer" forbidden?

Are checks printed with a special clause voiding them if not presented within a specified number of days?

Are blank checks safeguarded at all times?

Are bank reconciliations made the first of each month by a responsible employee other than the one making up the daily deposit, the one responsible for preparing or signing checks, and the one responsible for accounting for cash receipts and disbursements?

Are canceled checks compared with the entries in the voucher register and/or cash book as to names of payees, dates, amounts, etc.?

Are all outstanding checks followed up properly, with those outstanding more than 60 days referred to a responsible executive?

Are all canceled checks carefully scrutinized for unknown or unfamiliar payees; irregular indorsements; lack of proper bank cancellation (perforation or stamping); alteration in date, amount, or payee; or improper signature?

Are branch- or local-office bank accounts on an imprest basis, and properly controlled through regular auditing or other routines?

Are check signers and disbursing cashiers precluded from having any-

thing to do with the preparation or approval of vouchers for payment?

Cash receipts

Are all employees who are responsible for receiving cash (branch managers, salesmen, deliverymen, etc.), required to remit these to the head office daily?

Are all remittances received at the main office, not by field representatives?

Are all receiving cashiers, salesmen, or others responsible for receiving currency forbidden access to any ledgers or statements concerning customers' accounts?

Are receiving cashiers precluded the opportunity of opening mail?

Is incoming mail received and opened by an officer (the corporate secretary, for example) or employee other than the treasurer or employee responsible for preparing and/or making the deposit or for the accounting records?

Are the receipts of checks, currency, money orders, and stamps recorded on a duplicate list by the person opening the mail?

Is a copy of that listing, together with the receipts, turned over to the cashier and the duplicate retained for subsequent checking?

Where cash registers are used, are the totals checked daily by someone other than the cashier? Is the clearing key unavailable to the cashier?

Is the cashier's working space physically enclosed and prohibited to all other personnel?

Are duplicate deposit slips presented with the deposit, certified by the teller, and mailed back by the bank to the company's head office to the attention of someone other than the employee who prepared or made the deposit?

Are deposit slips checked to the cash book? Are cash-register tape totals regularly reconciled to deposit slips?

Are all receipts deposited *intact* daily?

Petty cash

Are all petty-cash funds on an imprest basis?

Are the amounts of petty-cash funds established at the lowest practical point?

Are petty-cash vouchers prenumbered and prepared in ink, and do they have the amount written out as well as indicated numerically?

Are petty-cash slips examined and approved by a responsible executive before a reimbursing check is issued, and then immediately stamped or perforated "Paid" to avoid reuse?

Are reimbursement checks drawn to the order of the petty-cash-fund custodian by name (not "Petty Cash," "Bearer," "Cash," etc.)?

Are sundry receipts (receipts from stamps, telephone charges, employee purchases, scrap, etc.) kept separate from petty-cash funds, and are such sundry receipts properly controlled and accounted for?

Are custodians of petty-cash funds required to balance cash funds daily?

Are all cash-fund custodians forbidden to make advances to employees or others without proper approval, including the approval of the employee's immediate superior, and are all such advances evidenced by a proper receipt prepared in ink, with the amount written out as well as indicated numerically?

Are all cash-fund custodians forbidden to accept any i.o.u.'s?

If personal checks are cashed from these funds, are they properly approved before cashing? Are they deposited daily and is the cash returned to the fund?

Is a postage meter used, or, if not, are stamp funds kept at a minimum and under the control of a responsible employee? Are stamps or meter refills purchased by checks made payable to the postmaster? Is the postmaster or postal clerk required to acknowledge the stamps purchased from him by signing a suitably prepared list of such stamps?

Are cash and stamp funds audited frequently, preferably on a surprise basis?

Sales and accounts receivable

Are all cash sales recorded on serially numbered sales tickets, slips, or other memorandum forms and properly accounted for? Are all blank forms properly controlled?

Are salesmen precluded, to the fullest extent practicable, from receiving money for sales made?

Are salesmen required, to the fullest extent practicable, to deliver goods sold to a wrapper who acts as an inspector?

Are cash or other automatic sales registers, with totals controlled by special locks, used to the fullest extent practicable, with the locked total inaccessible to the operator of the register?

Are all credits, discounts, or rebates allowed by the salesman, collector, or deliveryman properly acknowledged by the customer's signature? Are they approved by someone in authority? Are they audited periodically?

Are sales invoices for credit sales serially numbered?

Are all sales-invoice pricings, extensions, and footings checked by the accounting department?

Does the shipping department provide the accounting department with a copy of the shipping order after shipment? Is this order checked to the sales invoice?

Are all new accounts approved by the credit department?

Is the credit department provided with a monthly copy of the accounts-receivable trial balance?

Are trade-accounts-receivable subsidiary ledgers balanced monthly with the general ledger control accounts?

Are miscellaneous accounts receivable, such as amounts due from offi-

cers and employees, sale of fixed assets, sale of scrap, and nonrecurring or nontrade transactions excluded from trade accounts receivable?

Are accounts receivable aged regularly by a responsible employee other than the cashier or ledger clerk? Is a schedule of such aging furnished the credit department?

Is the write-off of a bad debt approved by a responsible official not directly responsible for either the accounting records, cash, or credits, and only after personal contact with or knowledge of the account? Is a record maintained of items written off by this official and of subsequent recoveries entered against it?

Are customers always charged *subsequent* to shipment and never in advance thereof?

Are monthly statements of account mailed to all customers? Are these issued by the credit department or checked by a responsible executive to the accounts-receivable trial balance, and mailed directly, that is, not returned to the employee who prepared them?

Is all incoming mail pertaining to accounts receivable directed to a responsible employee other than the one who originally prepared the monthly statements?

Are independent confirmations of accounts receivable made periodically by correspondence, personal visit, internal auditor, or public accountant?

Purchases

Are purchasing, receiving, storekeeping, and shipping all handled by separate employees?

Are requisitions, approved by a responsible party other than the purchasing agents, required for all purchase orders issued?

Are receiving reports carefully prepared, showing quantity and quality of goods received? Is quality checked by someone independent of the purchasing department?

Are receiving reports checked to purchase orders?

Are both receiving reports and purchase orders checked to the final vendor's invoice after the latter have been carefully audited?

Are all these examined and approved and then submitted to the check signer together with the check prepared for payment of the invoice? After signature, are the checks mailed directly by the last signer?

Are purchases made, to the fullest extent possible, on the basis of competitive bidding?

Is the responsibility for the sale of scrap delegated to someone other than the purchasing agent?

Are requisitions, purchase orders, and receiving reports serially numbered and all accounted for? Are the blank forms properly safeguarded?

Are purchases for employees' personal use segregated and controlled?

Are invoices or creditors' statements carefully checked to the voucher register, accounts-payable ledger, or other records, to avoid duplicate payments?

Are all invoices and supporting documents (requisitions, orders, and receiving reports) stamped or perforated "Paid" immediately after the check in payment receives its last signature and under the control of the last signer?

Are open accounts-payable balances confirmed periodically by correspondence, personal visits, internal audits, or public accountants?

Are returned purchases adequately accounted for and controlled?

Payrolls

Are employees checked in and out of work by a timekeeper?

Are labor reports prepared by a foreman or plant superintendent showing the nature of the work performed and the amount of time required to perform it?

Are payrolls prepared by employees not connected with either of the foregoing, who calculate the amount due each employee on the basis of the timekeeping records and the labor reports?

Are paychecks or pay envelopes prepared by someone other than those responsible for calculating the payments due?

Is the payoff made by someone entirely divorced from the functions listed under the first four items above?

Is an independent record kept of employments and layoffs?

Are unclaimed salaries and wages in the custody of a responsible executive other than the paymaster?

Are all wage, rate, or salary increases approved by a responsible executive and evidenced by a permanent memorandum?

Are all employees paid by check? If not, are those paid by cash required to sign the payroll or give a receipt?

Are the payrolls audited periodically? Are employment applications and exit records tied in with the payroll records? Are wage and salary scales, piece rate, bonus, overtime, and other computations checked?

Are all employees properly investigated before being put on the payroll? Are all references checked? Are retail credit or character reports obtained? Are all gaps in the applicant's employment history investigated?

From time to time, are payoffs made, supervised, or observed on a surprise basis by internal auditors, public accountants, responsible executives, or employees not regularly responsible for the payoff?

Inventories and other assets

Is a system of inventory control exercised over the inventories to the maximum extent practicable?

Are supplies kept physically separate from other inventories?

Are physical inventories taken periodically, at least once a year?

Are all inventories adequately covered by insurance against fire, theft, embezzlement, or other loss?

Are goods issued from inventories only on the basis of properly authorized requisitions?

Is the responsibility for inventories definitely fixed?

Are inventories kept in storerooms or other enclosed areas, with access thereto rigidly controlled, and separate from receiving and shipping rooms or areas?

Are inventories properly safeguarded against breakage, weather damage, evaporation, spoilage, or other physical losses?

Are obsolete materials, scrap, containers, etc., controlled through the accounting records, and the sales thereof handled by someone completely independent of purchasing, storing, or production operations?

Where the finished goods or other inventory consists of items readily disposable on the open market, is a careful check kept of all personnel having access thereto?

Is joint custody by two or more officers, partners, or other personnel exercised over securities (including notes) and other valuables, whether kept in a bank safe-deposit box, company safe, or other location?

Is a detailed record maintained by the accounting department of notes, securities, and other valuables in such custody?

Is the collateral for any notes, or other receivables, in proper custody and properly recorded on the accounting records?

Are notes on hand balanced regularly with the controlling account? Are they confirmed regularly?

Are all securities in the name of the company or properly endorsed?

Are all contracts, leases, mortgages, and other important business documents safeguarded and in the custody of a responsible executive?

* * *

It should be clearly recognized that the foregoing is not a complete list, nor is it applicable to all businesses.

Where a company is small or for other reasons does not have its own internal auditor, the management is well advised to request its public accountant to make a special internal-check survey and to issue a separate report thereon.

The public accountant's certificate states that he has "reviewed the system of internal control and the accounting procedures of the company. . . ." The review of internal check (used here as being synonymous with internal control) is recognized as one of the most important steps in making an audit. However, many public accountants prefer not to make a separate task of evaluating the internal check as a whole but rather to make their review of the controls applicable to the various activities while the related accounts

are being audited. However, as stated in *Tentative Statement of Auditing Standards,* published in 1947 by the American Institute of Accountants,

> The effective boundaries of [an adequate system of internal control] extend beyond . . . the handling and recording of transactions in a concern's accounting and financial departments. The proper area of such a system will include . . . receiving department . . . shipping department . . . purchase department . . . sales department. . . .

While public accountants are required by the auditing standards of their profession to make a survey of the system of internal check, they are not required to issue a report thereon. Hence the suggestion made above that the public accountants be requested to make a special internal check survey which will include *all* departments (not only the accounting and financial departments) and to issue a special report thereon showing the weaknesses in the system of internal check and their recommendations as to what steps can be taken to correct such weaknesses within the limits of prudent economy.

Section 16

HOW TO USE BUDGETS FOR CONTROL OF A BUSINESS

BY

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HOW TO USE BUDGETS FOR CONTROL OF A BUSINESS

This chapter is concerned with the objectives and methods of attaining control via budgeting.

1. Objectives of budgetary control

Definitions. In *Budgeting for Management Control,* budgetary control is defined as "a tool of management used to plan, carry out, and control the operations of a business. As a further explanation, it establishes predetermined objectives and provides the basis for measuring performance against these objectives." [1]

The Budget Executives Forum has appointed a standing committee on terminology which began its operations by attempting to define certain terms such as "premising," "planning," "forecasting," and "budgeting." This committee, though not reaching any conclusions, tentatively arrived at the following definitions: [2]

Premising—the function of predicting the probable future development of economic, political, industrial, intracompany, and other affairs which will have an effect upon the course of a particular business and adopting these as the basis for future planning

Planning—the function of expressing definitive policies and programs of future action on a patterned basis in the light of accepted premises

Forecasting—the function of expressing plans in terms of dollars and statistical figures

Budgeting—the function of expressing premises, plans, and forecasts to operating levels; of informing officers, department heads, supervisors, and other executives of the results each is expected to achieve during the budget period; and what is more important, of measuring results against established objectives

All these definitions are embraced in the definition taken from *Business Planning and Control* [3] and are intended to be embraced by it. "Business

[1] Floyd H. Rowland and William H. Harr, *Budgeting for Management Control.* Harper & Brothers, New York, 1945, p. 1.

[2] "Budget Terminology," *Operations Planning* (published by the Budget Executives Forum), Vol. I, No. 4, 1948, p. 3.

[3] F. H. Rowland, *Business Planning and Control,* Harper & Brothers, New York, 1947, p. 3.

planning concerns the development of a comprehensive business program beginning with the determination of the company objective, planning how to reach the objective, and concluding with the determination of the adequacy of the program developed to achieve this objective." In its broadest conception business planning is synonymous with budgeting, more properly termed "budgetary control." Budgetary control therefore should be construed as a company operating program with not only monetary aspects but a complete plan of execution.

It seems logical to assume that budgetary control should provide the actual techniques of budgeting, which means the manual, budget forms themselves, and all of the procedures involved. It seems equally logical that budgetary control should, of necessity, portray the conditions which exist initially and those which it may be assumed will apply during the budget period or at least in its early stages. Stripped of its mystery this is merely another way of saying that we must know the inherent characteristics of a company we are budgeting and its ramifications. For example, is it a manufacturing company, and does it operate its own outlets, or does it depend on others to perform some or parts of its principal functions? Will it expand or contract or stand still? Few companies remain the same even through one budget period. What is it trying to accomplish? What tools does it have to work with? How are we to make certain the man power of the company utilizes these tools to the greatest effect?

Budgeting has been surrounded by a host of fallacious concepts which tend to limit its sphere of activity to the more commonly used budgets, such as—

The cash budget
The advertising budget
The research budget
The expense budgets

Since it is possible for a company to install one phase of budgeting without the others, let us consider what are the different phases which may be used separately. These comprise, to mention a few of the more prominent ones—

The summary budgets, such as the balance sheet and profit-and-loss budgets
The master budget
The policy budgets, such as the advertising budget, welfare budget, etc.
The sales budget, which most firms use in one form or another
The cash budget
The direct-labor budget
The material and production budgets

The manufacturing-expense budgets
The capital-expenditures budget

In certain lines of business some of these budgets outrank the others in importance, and in such a case the viewpoint is that the budget favored is the all-important one. Such a business may even concentrate on this budget to the extent of excluding all others. It may be said that such a concern using only one or more of these budgets does not have a formalized budgetary control system.

Types of budgets. Generally, the average manufacturing company requires 28 major types of budgets to have complete budgetary control. The use of the word "major" in the foregoing sentence means that we are counting as one type of budget all manufacturing-department expense budgets. Basically these follow the same general pattern.

A list of these general types of budgets is as follows:

1. Sales-order budget
2. Sales-shipment budget
3. Inventory budget
4. Production-requirements budget
5. Direct-labor budget
6. Material budget
7. Direct manufacturing-expense budget
8. Prorated manufacturing-expense budget
9. Administrative distributive expense budget
10. Executive-division expense budget
11. Industrial-relations budget
12. Accounts-receivable budget
13. Purchasing-division expense budget
14. Distribution or sales expense budget
15. Advertising budget
16. Permanent-plant expense budget
17. Perishable-plant expense budget
18. Cost-of-sales budget
19. Cost-of-goods-manufactured budget
20. Prepaid-expense budget
21. Purchase budget
22. Accounting-division expense budget
23. Accounts-payable budget
24. Payroll budget
25. Profit-and-loss budget
26. Cash budget
27. Balance-sheet budget
28. Master budget

The purpose of these budgets is fivefold:

1. To clarify the program
2. To coordinate activities of the various branches
3. To measure efficiency and simplify executive control
4. To aid in financing the business
5. To inform interested parties entitled to have the information as to the company plan upon which these programs are predicated

Advantages of budgetary control. The advantages of budgetary control are—

It establishes a goal at which to aim budgets and a means of measuring the accuracy of the aim

It provides a means for determining when financing is necessary and to what extent it will be required

It forces management to plan the most economical use of labor, material, and expense

It automatically throws up a signal to management by means of variances, indicating the extent between budget standards and actual performance, so that it is possible for management to decide whether it is necessary to take action in accordance with organization alignments and the provisions stipulated in the duty sheets

It defines where one executive's responsibility begins and that of another ends, so that there is no possibility of having this important matter left unsettled

Since it provides for control of the expenditure of funds, it automatically prevents waste if spending is done intelligently and causes the economical use of working capital. It plans to utilize capital most effectively in accordance with budget plans

Basic weaknesses in some budget plans. Some budget plans have fundamental weaknesses, possibly one of the following: [4]

The plan is the personal property of the man who made it. No one else knows much about it or has much interest in it

It is a rigid budget, allowing for no flexibility, and hence will be out of date almost as soon as it is made

It is only a partial budget

Some executive has the itch to change the organization so frequently that no one can keep up with it, and the figures are made worthless for comparative purposes

The process of installation was so long that executives lost interest before results were apparent

2. *Preliminary groundwork*

Preliminary groundwork should not be overlooked in installing budgetary control. It is desirable to review some of the items which constitute preliminary groundwork so that the ramifications of this subject may be considered.

Organization. The matter of preparing organization charts for the company and developing duty sheets for each executive position is one of the first

[4] F. H. Rowland, "Using Budgetary Control as an Operating Plan," *Accounting, Budgeting and Cost Control,* Controllers Institute of America, 1948, p. 20.

steps of budgetary control. As with the other elements of preliminary groundwork, executives in haste to install the budget seldom allow sufficient time to work our this groundwork properly. If they do permit the time necessary to develop organization charts and duty sheets, they seldom allow these to be completed, until future development of budgetary control discloses their absolute necessity. Examination of the duties of the executives of a company where these duties are being recorded for the first time will probably disclose many duplications of authority and some duties that are not the responsibility of anyone, while others are regarded as the pride and joy of at least two executives. This is a problem which should be corrected for effective functioning of the organization. Unless some reason such as the preparation of the budget plan comes along, it is often allowed to continue, thus piling up costs through inefficiency. This condition should be one of the first to be corrected. An office boy cannot be expected to accomplish it, and it is frequently delegated to a minor executive.

Chart of accounts. The purpose of the chart of accounts is to facilitate the collection of accounting data. With reference to budgetary control, these data should be used in accordance with spheres of responsibility as shown on the organization chart. If they are not so arranged, steps should be taken to accomplish this. The larger the company, the more difficult it may be to effect these changes, but it can be done if authority for it stems from a high enough position. Failure to make the necessary changes in the chart of accounts often means continuing extra expense to produce the figures needed for comparison. Frequently, where a company already has a chart of accounts, considerable resistance will be offered by someone in the organization to any alteration, on the ground that it means learning new account numbers or some other pretext. Adjusting the chart of accounts to the needs of budgetary control is frequently not considered by top executives until the excessive cost of budgeting is brought to their attention, stressing the necessity for a prompt revision of the chart of accounts.

Reports. Management reports prepared for executives seem to be a very simple thing to discuss, but in actual practice they are not. Key management reports should show how successfully the executive has carried out his responsibilities. It is usually found, when installing a budgetary system, that too many reports of the wrong kind are prepared and too few of the required type are available. The procedure for revision of executive reports for budgetary purposes is a relatively simple matter. The individual in charge of budgeting should prepare the reports he believes are necessary for each executive and then check these with each one in turn. Without referring to existing reports, ask the executive to play the game with you and go over the proposed reports to see if they supply all the information needed.

When he has done this make a comparison between the ones he is now using and those newly suggested, even going to the extent of marking up the forms any way he wishes. When such an executive has satisfied his yen to make changes, he will probably accept the revised budget reports with minor changes. The reports needed for budget purposes are frequently quite different from those which had been used.

Length of the budget period. It is customary to prepare the budget corresponding to the fiscal period. In some instances it is doubtful whether it is necessary to establish a complete profit-and-loss forecast for more than 1 year. It is usually practical to set up a fairly accurate forecast for periods up to 1 year, but beyond that period the forecast becomes increasingly less accurate. Larger companies generally find it necessary to install a 5-year program or something equivalent to it, feeling that they need long-range viewpoints toward many of their activities. For these reasons we have the short-range forecast and the long-range forecast.

The operating budget should be broken down to correspond with the accounting periods and to tie in with them. Budget reports should be so geared that they can be interlocked with any existing accounting reports. While it is not exactly true that budgeting merely means insertion of current month and year to date columns, in most accounting reports it is safe to say that this is the practical effect of introducing budgetary methods in most companies, assuming, of course, that the purpose of the report is a sound one in the beginning.

Pattern of the business. The present pattern of a business is probably quite different than it was at its inception. Therefore, it is necessary to determine many factors about the plan of business before budgeting is attempted. Certain factors must be made definite by examining the application of the plan to the future. A manufacturing company may be contemplating a change from selling its products through salesmen to opening up its own chain of retail stores. Entrance into the wholesale distributing field may also be contemplated. A change in sales methods may be on the agenda for future discussion, such as a change from bulk distribution to package distribution. Some businesses may contemplate projecting the sale of their product to retail stores through a fleet of delivery trucks operated by salesmen, instead of using a sales force to contact these stores. Other companies may contemplate mail-order distribution, or mail-order companies may decide to go into manufacturing. Each of these changes involves individual alterations in planning and should not be made effective until the financial consequences are determined. The step to be taken, whether it be concerned with entrance into another phase of business relating to the present one or whether it involve merely a change in size, is a part of the major plan

of the company. The question of size is determined by how large a volume of profitable business the company can obtain. Adequate forecasting and budgetary planning should answer these questions.

Budget committee. Whether there should be a budget committee in order to operate a budgetary program adequately is a question which must be answered in each company. Such a committee may be of use not only in affording a review of the proposed plans but also in familiarizing key executives with the budget program. The job of the budget director is first an educational one, acquainting the officers of the company with the budget program. If top executives are members of the budget committee, this problem of education may be considerably simplified. Additional influences for stimulating this educational program throughout the organization can be created by familiarizing these executives with the details of the program.

If the budgetary committee consists of key executives, they should supply pertinent information to the executives installing the budget and also open many closed doors within the company through which such information can be acquired.

First consideration must be given as to whether the committee is to be a working committee or an advisory committee. As an advisory committee, its members should consist of top executives ranging in number from three to six. As a working committee, such a group may ultimately resolve itself into a committee where alternates to the key executives may be provided and asked to substitute in the absence of their superiors. Such a form of committee would seem to be more practical because it enables the key executives to attend when important subjects of interest to them are shown on the agenda of the meeting and permits the actual work to be performed by the alternates in subsequent conferences. The chairman of the budget committee may be the top executive of the company or one of the financial executives, either the controller or the treasurer, unless the company has a budget director of sufficient stature to act as chairman of the committee. While a review of budgetary practices, as portrayed in a recent publication of the National Industrial Conference Board, does not indicate a predominance of budget directors as chairmen of the budget committee, it does seem a practical suggestion where the individual in question possesses the necessary qualifications.

Ordinarily in selecting a budget director the question arises as to whether it is better to choose one who has been an executive in some other department in the company, and who may be supposed to have acquired knowledge of budgetary control in pursuit of his regular duties, or to secure one whose qualifications are those of an executive with a knowledge of budgetary technique but with no acquaintance with the company. As may be sup-

posed, this question is not an easy one to decide. A review of the Budget Executives Forum membership indicates that a predominant number of budget directors were selected for their training in the budget field, although a substantial number also were given their positions from other fields within the company. Thus there is no effective answer to the problem of whether a knowledge of budgeting or of the business is a prime prerequisite. Certainly, if he has no knowledge of the business he must be given sufficient time to learn certain phases of the business before attempting to apply budgetary control. If he has no knowledge of budgetary control, he must be given adequate time to learn the principles of budgetary control and then to apply them, so as not to flounder in installing the budget and so as to avoid serious mistakes. In actual practice it is generally believed better to start with a knowledge of budgetary control.

Budget organization. One of the first questions arising with the starting of a new budget installation is the size of the organization. Generally speaking, it is believed that the budget director should practice budgeting of his own department for economical operation as a first stage toward being a good budget director. He can accomplish this more easily by confining his work to the design and administration of budgetary practices, leaving to the controller's division the insertion of actual performance data, in case he is independent of the controller. This relieves him of expanding his own organization with the necessary staff to supply the actual performance data, and leaves to the controller the handling of his regular functions.

The budget director should have the following qualifications:

A thorough knowledge of general accounting, so as to be able to prepare charts of accounts and manuals describing the contents of the accounts

Knowledge of cost accounting to the extent of being able to install a standard-cost system and to tie budgeting in with standard costs

A knowledge of forecasting methods and the ability to select the method most applicable to his particular company

The ability to analyze organizations, chart the functions of various departments, and establish the duties of the principal executives

The ability to conduct himself in conversation with such executives with the tact and dignity necessary to create good will essential for himself and the budget department

The ability to revise all systems and forms where required to tie in with budgetary programs

The ability to prepare organization charts and duty sheets

The budget director's organization should be limited to a staff capable of assisting him in discharging the functions enumerated in his qualifications.

The budget director's personal staff should be limited in number of em-

ployees, because one of his first duties is to set a good example to the rest of the organization and avoid the building up of a big staff whose work would partially duplicate that of the controller. It is believed that the budget director's staff should include one assistant whose duty it is to make investigations and compile figures, it also being his principal function to see that no document goes out of the budget department except in finished form. He will also need a secretary who can, in addition to her secretarial work, assist in extracting figures from various documents. A chartist will be required who can make scatter diagrams for graphic correlation, assist in forecasting work, and portray the trends which emerge from the budgetary study of the business. This chartist will also be essential in the preparation of budget forms and in the revision of the reports which the various executives feel that they need in the discharge of their duties.

3. Preliminary budget installation

The installation of a complete budgetary-control program cannot ordinarily be accomplished in less than 1 year in the average company doing business of 2 million dollars or more and not using standard costs. Where standard costs have been previously installed, it may be possible to reduce the length of time somewhat. It is easy enough to understand why ample time is required after examining the preliminary steps for the groundwork which must be taken. The following four steps are part of the initial groundwork already discussed:

1. The budget plan itself must be designed
2. The organization charts must be prepared and duty sheets made, outlining the duties of each executive
3. Since executives use operating reports as a basis, operating data must be secured on which to base management decisions
4. It is important that there be a chart of accounts to facilitate the collection of data from these reports in the easiest manner possible

In addition to these points in this part of the preliminary groundwork, certain other essentials appear to account for at least part of this work:

A classification of company products into a reasonable number of product groups. For example, it is essential in a steel business to reduce some 80,000 products to a product classification not exceeding 150 product classes

A market forecast to determine what the sales budget shall be based upon

A variable expense table for each operating department for each 10 per cent variation in activity

Labor and material standards for both cost and budget purposes

These are but a few of the essentials which should be completed and made available during the first year of operation of the budget plan at least, or made available during that time. If the company is of any size, the accomplishment of certain of these steps will take more than a year.

Some of the problems created by the length of time required to install budgets consist of—

The loss of support of the budgetary program by top management because the results were too long in materializing
The loss of interest on the part of departmental supervisors who, having heard of the subject, conclude that the matter has been dropped because nothing further is heard about it for many months
The loss of the benefits to be gained through budgeting for all the months required to install the system

After 60 or 90 days' work on budgeting, the following three steps should have been determined:

1. The organization pattern
2. Modification of its chart of accounts to fit the budget program
3. Determination of the product line and estimated quantity of each product line to be sold

Budget explanation sheets. The preliminary budget plan involves some 18 budgets, counting all expense budgets as one budget type. In the preliminary plan it is probably advisable to prepare budget explanation sheets such as the following, which has been selected from *Budgeting for Management Control*: [5]

Subject: Payroll Budget Explanation Sheet—Schedule 121
Definition and Purpose

The payroll budget summarizes the estimated gross earnings by classifications, payments during period, accruals at beginning and end of month, and adjustment for payroll taxes withheld from period of deduction from salaries and wages to period of payment to state or Federal agency.

Items on the budget	*Budget schedule* *From*	*To*
1. Direct labor	104	
2. Over-all administrative	108	
3. Distribution	113	
4. Direct manufacturing	106	
5. Prorated manufacturing	107	
6. Total accrued during month (col. 1 through col. 5)		
7. Accrued payroll—beginning of month		
8. Paid by current payrolls (gross)		
9. Accrued payroll—end of month (col. 6 + col. 7 − col. 8)		

[5] Rowland and Harr, *op. cit.*, p. 169.

Cash disbursement computation

10. Paid by current payrolls (gross)
11. Less taxes withheld—social
12. Less taxes withheld—income
13. Add withheld taxes due and payable—social
14. Add withheld taxes due and payable—income
15. Total cash disbursement for payroll and payroll taxes

Form of the Budget

Column 1 .....Items
Column 2 .....Total for period
Columns 3 to 14 .....Months of period
Column 15 .....Schedule posted from
Column 16 .....Schedule posted to

Comments

The cash disbursement computation must be further adjusted if disbursements are not made in the same month as deductions for insurance, pension fund, and other items.

One of these should be prepared for each budget which is selected as one of the preliminary budgets. After a review of these preliminary budget explanation sheets, it is possible to consider what information is available for their preparation. The following is a typical list of preliminary budgets considered as desirable:

Sales budget
Production budget
Cost-of-sales budget
Direct-labor budget
Material budget
Manufacturing expense budget
Distribution expense budget
Over-all administrative expense budget
Permanent-plant budget
Expendable-plant budget
Accounts-receivable budget
Payroll budget
Purchase budget
Accounts-payable budget
Cash budget
Operations budget
Balance-sheet budget
Master budget

The advantages of the adoption of a preliminary budget plan are fourfold, as follows: [6]

1. It teaches the organization the basic principles of budgeting, leaving the more exact technique to be developed as time and opportunity present
2. The entire organization becomes budget-minded and joins with enthusiasm in participating in the plan
3. Many problems arise which, when solved, will facilitate the more complete installation
4. The organization begins at once to gain some measure of control over its operations and some gauge as to its progress in carrying out its company objective plan

[6] Rowland and Harr, *op. cit.*, p. 176.

The basic differences between the preliminary budget installation and the permanent budget installation are primarily in the manner with which the expense budgets are prepared in the factory. It does not provide for the preparation of a variable budget table for each department, which in itself is a very sizable undertaking. Generally speaking, the preliminary budget plan includes all the summary budgets such as the advertising budget, prepaid-expense budget, cost-of-goods budgets, cost-of-sales budget, accounts-receivable budget, payroll budget, accounts-payable budget, cash budget, bank-balance-position budget, operating budget (profit and loss), balance-sheet budget, and the master budget. In addition thereto, there are the four basic budgets, namely, the sales budgets, production budgets, plant budgets, and administrative and sales expense budgets, as well as an expense summary for the plant itself. These expense budgets will be required in terms of individual accounts.

Types of budgeting. There are various types of budgeting in use other than those embraced in the term "preliminary budget installation" or "permanent budget installation." These types of budgeting represent a partial budgeting of some phase of the organization, such as the cash budget, sales budget, capital-expenditures budget, advertising budget, etc. Some companies may feel that it is necessary to budget one or more phases of their operations. The type of business will dictate with which subject to begin budgeting. Some companies never progress further than the original budget with which they started, because they feel that the type of budget they are using is the only one necessary. Such concerns, however, cannot be said to enjoy the advantages of complete budgetary control. It is therefore quite essential to discuss budgeting to considerable lengths to ascertain whether we are talking about some one phase of budgeting or a complete budget system. In this section almost the entire discussion is confined to the subject of the complete budgetary control of all phases of the business, with particular emphasis on the preliminary budget plan.

Prior year figures. It is customary in companies where they do not have budgetary control to make comparisons of current figures with those of one or more prior years. This type of comparison is scarcely better than no comparison at all, which is about the only thing that can be said for it. The external and internal conditions existing in a prior year may or may not have been better or worse than today's conditions, or in fact, the conditions may bear no resemblance to those obtaining at the present time. If all of the details have changed since the year in question, then the comparison has no value whatsoever, since there is no single element upon which to make the comparison. Secondly, any comparison of accounting data which involves reflections of the prior year's figures frequently necessitates a rear-

rangement to validate today's comparison. Changes of territory, reassignment of customers, and revision of prices are but a few factors to be accounted for to make the comparison valid, and the adjustment for these is seldom worth the clerical cost. Thirdly, there is little merit in the prior year's performance to justify its serving as a standard against which to compare the current year. Perhaps it was better and perhaps it was not better, and it could only have been done under the circumstances prevailing at that time.

Forecasting. There are various methods of forecasting what the sales of a company are expected to be during an ensuing period. These methods range from various types of opinions to the more formidable statistical methods. The National Industrial Conference Board, Inc., in Bulletin 25 entitled "Forecasting Sales," describes these methods in considerable detail. In here we shall merely present a summary of the essential points:

The "jury of executive opinion" method provides for securing opinions of top executives of the company to determine their opinions as to the volume of the business, the amount of profit, etc.

The "sales-force composite" is made up of a sales forecast obtained by securing the opinions of sales executives, managers, and/or salesmen which reflect the opinions each obtained from his principal customers

The "trend and cycle analysis" is a complicated method based upon a study of the underlying factors influencing sales and generally requires a trained economist to handle the figures

The "industry forecast" is a method of forecasting the total industry and then arriving at the company's share of this business

The "product-line analysis" is predicated upon combining forecasts of the individual product lines to arrive at a total sales forecast

The "end-use analysis" involves a forecast prepared from a study of the major consuming industries

A "correlation analysis" is a statistical method of measuring the relationship between sales and other activities that can be observed to help in forecasting sales

Without discussing the various types of correlation, it seems advisable to discuss a more elementary correlation called "graphic correlation." For this, the forecaster need not be a professional expert, providing he has at his elbow someone who can present his graphs with a reasonable degree of skill. Referring to the method outlined in *Budgeting for Management Control,* or in the author's own book *Business Planning and Control,* this method is very easy to utilize. It involves two basic steps, namely:

1. The procurement of a barometer of business which can be correlated with a curve of the industry. To make the procedure simple and not involving the knowledge expected of a skilled economist, this barometer

of business, such as the Federal Reserve Index of Production or any other of the innumerable business indices, should be obtained with a forecast for the ensuing year. In this way, the individual beginning his forecasting work is not taken into situations of forecasting involving skill beyond that which he can easily acquire.

2. Having obtained a correlation with a business barometer which has a forecast, the next correlation required is that of the industry in which the company selected is a member, with a curve of the individual company's own sales. The forecast of the industry sales can be projected on the company's sales trend by maintaining the relationship between the two as was done originally in the case of the industry sales and that of the business barometer.

Sales budget. The sales budget, being the cornerstone of budgetary control, is the approved program of the company with regard to sales operations. It is expressed in units to be sold, sales dollars, and unit prices.

The sales budget should first begin with product classes and be established on a basis such that the product classes account for approximately 90 per cent of the sales quantity, or dollars, or both, of the anticipated business. This budget, when approved, should be subdivided in the various ways according to the requirements of the company. Through a seasonal trend variation in volume of business between one month and another, it is possible to develop a monthly budget. In relatively few businesses are sales not affected by some seasonal factor.

It is desirable to make other divisions of the sales budget, such as by salesmen, and to tie this in with a sales-incentive program in order to stimulate the sales of those product classes in accordance with the company's manufacturing facilities, the competition and ease of sale, and the gross profit obtained on each product class. Generally speaking, each product should carry its own gross profit, and loss items should be eliminated, if possible. The budget may be further subdivided monthly into key customers, those customers being selected who account for 90 per cent of the over-all volume of the company. This may result in key customers who do more than $5,000 a year business each with the company. Thus we have all the elements for a selective sales plan whereby the company sales budget will be the guiding program for the sales department, which will know what the company expects it to do and when it is expected to do it. The sales-incentive plan will provide extra compensation to stimulate salesmen in achieving the performance of the specified program.

The various sales reports of the company should compare the budget with actual performance, usually on a "current month" and "to date" basis. If desired, a special report may be compiled for key customers and the per-

formance in each territory, showing the difference between budgeted and actual sales and gross profit due to the change in mixture of sales, the differences caused by changing of sales prices, and finally, the over-all difference between budgeted and actual, due either to failure to achieve the budget volume or to having exceeded it.

Production budget. The production budget reflects in terms of products the number of units to be produced to satisfy the requirements of the sales budgets, taking the desired inventory and shipment dates into consideration. The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Requirements for period
Column 3 ..... Beginning inventory
Column 4 ..... Net requirements (col. 2 − col. 3)
Column 5 ..... Desired ending inventory (finished goods)
Column 6 ..... Production requirements for the period (col. 4 + col. 5)
Column 7 ..... Allowance for spoilage
Column 8 ..... Units to be placed in production (col. 6 + col. 7)

A separate schedule is prepared for each month of the budget period.

The production budget will generally be prepared in the plant and forwarded to the budget department. As a rule it will be prepared by product class rather than by individual items. In most companies of any size, the volume of items in the production budget would be too great if they listed the individual items. In smaller companies it will be possible to show all the items. The figures on the budget will be entirely in terms of physical units to be produced and the budget will contain no dollar figures.

The director of manufacturing or whoever may receive the production budget must determine the practicability of processing the sales budget as initially established. In so doing, he will consider the following:

- The possibilities of producing the proposed budget with the equipment on hand
- Whether additional facilities are necessary and, if so, whether these can readily be obtained
- The possibility of so scheduling production required by the sales budget as to maintain balanced operations and ensure stabilized employment conditions
- The processing time required by the sales budget
- The scheduling of the sales budget to meet delivery dates

The consideration of work in process involves studying processing time, because dates on the sales budget which are order dates are undoubtedly months ahead of the dates on the production budget, which are related to shipment dates. The problem of reworks and their effects on scheduling and processing time must receive attention. In addition, it is essential to consider

both opening and desired closing inventories each month. Unit production cannot be determined without taking into consideration an allowance for scrap. Where the process is such as to require assembly or subassembly, separate schedules are required to show production of these, in order that arrangements can be made to fulfill the minimum requirements of subassembly or assembly stocks, so that these will be ready when required for assembly of the over-all product.

Cost-of-goods-sold budget. The cost-of-goods-sold budget summarizes the cost of products shipped to customers during the budget period. The budget lists the following columns:

Column 1 .....Items
Column 2 .....Total for period
Columns 3 to 14 .....Months of period
Column 15 .....Schedule posted from
Column 16 .....Schedule posted to

In companies using standard costs it is relatively easy to build this budget. The budget itself can be shown only in quantity for both the current month and the period to date. A separate posting will be made for each anticipated month's production. The cost of goods for the period will consist of the multiplication of units produced by the standard cost. In cases where an actual cost system is used, the problem of securing the cost of goods is slightly more difficult, because it necessitates calculation of the average cost of each item at the conclusion of the month, whereas in a standard cost system the cost may be taken from the standard product cost sheet.

Direct-labor budget. The direct-labor budget assembles labor charges to the extent necessary to produce the units stipulated in the production budget. This budget supplies the cost of direct labor for the cost of goods and the payroll budgets. The budget lists the following columns:

Column 1 .....Items
Column 2 .....Total amount for period
Columns 3 to 14 .....Amount (for each month)

The data for this budget are secured from the direct-labor assembly chart.

This budget summarizes the over-all direct-labor charges for the productive departments. In all probability, it will be necessary to prepare this budget by means of an organization assembly chart which shows the standard labor required for each operation per quantity of the unit to be produced. In that case, it may be necessary to prepare a separate labor budget for each productive department and list the productive hours of each job classification required in getting out this work. In that case, these departmental budgets can be summarized on the over-all direct-labor budget, or the product can be costed at the standard cost on the cost-of-goods budget,

and an analysis of the standard cost figure for each department broken down into its component parts of direct labor, direct material, and overhead. It is only in the case of an average cost system that the direct labor will be calculated from actual direct-labor cost sheets, and summarized on a direct-labor assembly chart.

Payroll budget. The payroll budget summarizes the estimated gross earnings by classifications, payments during the period, accruals at beginning and end of month, and adjustment for payroll taxes withheld from period of deduction from salaries and wages to periods of payment to state or Federal agency. The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from
Column 16 ..... Schedule posted to

This budget summarizes all the payroll classifications ranging from direct labor to administrative and sales departments. The accruals of all of these classifications are shown as of the beginning of the month less the amount of the accrual at the end of the month.

The cash-disbursements computation is made by deducting from the current payroll the withheld amount for social-security taxes and income taxes, and by adding accounts-payable items for the amounts withheld, the result being the total cash disbursements for payroll purposes.

Accounts-receivable budget. The accounts-receivable budget forecasts the monthly accounts-receivable position based upon the sales shipments, the cash collections, and the bad-debt factor. The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from
Column 16 ..... Schedule posted to

The collection estimate is based on past experience plotted on a collection lag chart.

The calculations for accounts receivable must take into consideration the estimated sales for the period less the returns and allowances, and the amount of advances amortized, leaving the net additions. The cash collections and discounts are computed, as are also the accounts charged off. It is necessary to take into consideration the reserve for doubtful accounts, beginning with the balance at the beginning of the month, and the provision for addition to the reserve.

Purchase budget. The purchase budget summarizes purchase requirements in dollars for use in the cash budget and serves as a control over the activities of the purchasing department. Items appearing thereon are raw materials, mill supplies, purchased parts, stationery and other supplies, etc. The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Requirements (from raw material budget)
Column 3 ..... Beginning inventory (units)
Column 4 ..... Desired ending inventory (units)
Column 5 ..... Purchase requirements:
(*a*) Quantity
(*b*) Estimated cost

A separate monthly budget is prepared for each group of items such as raw materials, supplies, etc., with a breakdown by individual items for each group.

Cash budget. The cash budget is the forecast of cash receipts and disbursements, and lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from
Column 16 ..... Schedule posted to

The receipts generally included are the following: accounts-receivable collections, notes-receivable collections, advances from the United States government, advances from sources other than the United States government, transfers from restricted funds, bank loans, and other receipts. The cash disbursements ordinarily consist of accounts payable, payroll, notes payable, taxes, interest, royalty payments, securities purchased, dividends paid, and other cash-disbursement items. The net change in the cash position is the difference between total cash receipts and summation of all disbursements. By combining the net change in cash position with the balance at the beginning of the period, the cash at the end of the period is obtained.

Permanent-plant budget. This budget estimates expenditures for buildings, alterations thereof, equipment, and all changes and additions to plants. This budget contains the following information:

Sequence in which the work is desired
Specifications
Details as to the appropriation covering:
Replacement of existing equipment which is worn out
Replacement of obsolete equipment with modern cost-reduction equipment
Additions as expansion of the present facilities

New-product equipment for the purpose of producing new products not heretofore manufactured
Additions to buildings and leaseholds

In many cases, the equipment is not to be paid for in one payment, but necessitates several installments as each phase of the work is completed. In that case, the budget includes the following columns, or shows the following information:

Unexpired balance from the previous year
Appropriations for the year
Total available
Columns for payments each quarter or each calendar month for a 1-year or 2-year period
Schedule from which this budget is posted
Schedule to which it is posted

This budget should be received in time for it to be reviewed by the budget director in sufficient detail. That means that it will be made up by the plants in September or October and be reviewed in headquarters in November or December. Even though it may be a difficult task for the plant engineer to estimate the cost of each item on the plant budget in detail so far in advance, yet it is essential that he anticipate the amount of the appropriation in time to have it approved. Equipment expenditures must be included in the cash budget in sufficient time to permit the company to raise the necessary money, either by bond issue, from profits, or by other means. Plant engineers have an annoying habit of not only desiring to withhold advance estimates for such appropriations, but also offering requisitions for new-equipment expenditures from time to time shortly in advance of the time they are wanted, a practice which cannot result in a satisfactory cash budget.

Distribution division expense budget. This budget covers what is ordinarily termed "sales expense." The only difference between the terms "distribution expense" and "sales expense" is that the former term is used when the expense includes a marketing research expense. This budget includes all advertising expense. The form of the budget includes the following columns:

Column 1 .....Account
Columns 2 to 4 .....Total:
(*a*) Activity budget
(*b*) Expected variation
(*c*) Budget
Columns 5 to 40 .....Months of the period:
(*a*) Activity budget
(*b*) Expected variation
(*c*) Budget

This budget may be set up on a central basis for the headquarters division of sales and prorated, much the same as general overhead is in a plant, over the various sales territories, on a standard-cost plan for distribution applied to the company's activities. Ordinarily, a separate sales budget is set up for every sales territory, with established relationship between budget for expense and the sales of the territory.

The "expected variation" is an adjustment to the activity budget to allow for the time it takes to bring expenses down to the desired level. This adjustment is necessary in all items involving cash in order to arrive at a more realistic budget. The amount is determined by experience subject to progressive tightening. Performance reports, however, need not disclose the expected variations to the responsibilities involved.

Administrative budget. The administrative budget may be constructed in total for the administrative departments, or a separate budget may be established for each subdivision, depending on the size of the company. This budget includes the accounting division, purchasing division, industrial-relations division, and each of the separate departments in the executive office. In case budgets are built for each subdivision, it will probably be necessary to perform several allocations in connection with such items as rent, which must be prorated to each subdivision on a floor-space basis. The question arises as to the necessity of prorating administrative expense between sales and manufacturing, on the theory that a certain portion of the administrative activity is established for the benefit of the manufacturing department. It is generally believed seldom worthwhile to make such a proration. If the company is one having a number of sales territories, it will usually be found satisfactory to consolidate the administrative budget with the sales-headquarters budget for the purpose of allocating the expense to the various sales territories. The budget lists the following columns:

Column 1 ..... Account
Columns 2 to 4 ..... Total:
- (*a*) Activity budget
- (*b*) Expected variation
- (*c*) Budget

Columns 5 to 40 ..... Months of the period:
- (*a*) Activity budget
- (*b*) Expected variation
- (*c*) Budget

The remarks on "expected variation" made in the distribution division expense budget also apply to this budget.

Accounts-payable budget. The accounts-payable budget forecasts the monthly accounts-payable position based on (1) the purchase budget, (2) the advertising budget, (3) the permanent-plant budget, and (4) the perish-

able-plant budget. These budgets all become additions to the balance of the accounts-payable budget at the beginning of the period.

In some cases it may not be essential to prepare this budget. Its omission may lead to problems, because there is no provision for accounts payable arising from other sources than the purchase budget.

Estimated payments are offset against the total payables as the terms of payment and the working-capital position dictate. The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from
Column 16 ..... Schedule posted to

Operating budget. The operating budget in some companies is also called the "profit-and-loss" budget. The term "operating budget" is used to summarize the activities of the company during the budget period and lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from
Column 16 ..... Schedule posted to

Most of the important items on this budget are derived from budgets previously prepared. Gross sales are derived from the forecast of sales and are adjusted for discounts, returns, and allowances to arrive at net sales. The cost-of-sales budget supplies the amount to be deducted to arrive at a gross profit figure. Administrative expenses are supplied by the departmental expense budgets included in this group, such as executive expense, purchasing expense, accounting expense, and industrial-relations expense. Sales or distribution expenses are also obtained from a budget independently prepared. The net operating profits are derived from the deduction of the administrative and distribution expenses from the gross profit. Other items comprising financial income, such as interest and dividends received and financial expense, such as interest paid, bad debts, and loss on assets sold, are shown below the net operating profit to arrive at a net profit before income taxes. Deducting an estimated amount for income taxes, the balance is the net profit from operations for the period covered.

This is the budget which is used to study the possibility of readjustment of company earnings when the forecast earnings fail to come up to expectations.

An analysis of gross profits by products should be made to permit a selective sales program. Management may find it necessary to eliminate unprofitable

items, to embark on a more pointed sales program, or even to develop new products. A review of administrative and sales expenses may result in sizable savings, thereby permitting the desired profits.

Balance-sheet budget. The balance-sheet budget is in effect the proof of the accuracy of all other budgets. If the budget committee were to omit this budget from the list to be prepared, it would have stopped just short of completing its job. While it is merely a refinement of the budgetary system, it is actual proof of the accuracy of the subsidiary budgets. Each company will have to decide for itself whether the balance-sheet budget should be prepared only for the period of the operating budget or for each month of the entire year.

The balance-sheet budget lists estimates of assets, liabilities, and capital projected for the budget period. It affords (1) the opportunity of checking the accuracy of the other budgets, (2) a basis for a preview of the forecast balance-sheet ratios, and (3) a basis for determining what amount of bank loans is needed and for how long a period. The budget lists the following columns:

Column 1	Items
Column 2	Beginning balance
Column 3	Adjustments—debit *
Column 4	Adjustments—credit *
Column 5	Forecast—end of month *

* Repeat for each month of budget period.

The sources of entries for monthly adjustments are the entries on the various budgets.

The balance-sheet budget is sometimes used to determine the cash budget. This is considered a short-cut method whereby all other items appearing thereon are derived from prepared budgets or estimates and the balancing amount is cash. This method avoids the intricacies usually involved in forecasting cash which is affected by many accounts. It avoids the necessity for a purchase budget, which in some instances is very complicated and not entirely satisfactory as to accuracy and promptness.

Master budget. Confusion sometimes exists with regard to the term "master budget." It is often confused with the balance-sheet budget, but it is not the same budget. The master budget is in reality not a budget, but a restatement in summary form of the important figures contained in the other budgets. It gives—

The operating statement in summary form
The cash position at the beginning and end of the period, together with data on receipts and disbursements in total
Key account balances, such as accounts receivable, inventories, current

assets, accounts payable, accrued taxes and expenses, current liabilities, net working capital, and net worth items

The operating statement in summary form usually shows net sales, cost of sales and gross profit, followed by total administrative and selling expenses, to arrive at a net operating profit. After including financial income, financial charges, and estimated income taxes, the net profit is shown.

The budget lists the following columns:

Column 1 ..... Items
Column 2 ..... Total for period
Columns 3 to 14 ..... Months of period
Column 15 ..... Schedule posted from

4. Permanent budget installation

The budgeting discussion as applied to the compilation of the master and summary budgets, and those needed for the preliminary budget installation, is necessary in order to give consideration to the succeeding budgets required for the permanent budget installation. The permanent budget installation requires not only all the budgets previously discussed for the preliminary budget installation, but also various labor, material, and expense budgets for the manufacturing departments. This phase of budgetary control requires considerably longer to install, since it involves development of standards for every department.

Expense standards. Expense standards are essential because—

They serve as a basis for supervisory incentives
They enable budgets to be computed quickly without reference to historical records
They permit calculating variations from standards, for those accounts which affect cash
They establish the 100 per cent level needed for overhead distribution
They assist in measuring performance in a manner which avoids refiguring the budget if the rate of operation is not the same as originally forecast

Expense standards find their principal use as a part of the variable-expense table. This table consists of a list of accounts for each department, plus a separate tabulation of figures for each 5 or 10 per cent variation of activity in the department, this variation ranging from a low of 20 per cent to a possible high of 200 per cent, the range depending on the particular circumstances of any company. Thus it is only necessary to know the budgeted rate of operation for any department to determine what its budget should be.

Reference to the budget table for any department in question will enable the budget director to readily select a new set of budget figures applicable

to the actual rate of operations, if this differs from that forecast, for insertion on the monthly departmental performance report which compares actual with budget.

Regardless of how completely budgets may originally have been established, the rate of activity is bound to change in some department, perhaps all, before two or three months have passed. Without the use of these budget tables, it is necessary to refigure the budget allowances in each case. Some writers have advocated that budgets should be fixed throughout the year on a monthly or a 12-month basis, whereas practical experience has shown that what is needed is a flexible budget, one which permits items to be different in each month or in selected months according to the seasonal variation and the activity of the department. The budget table permits the use of a flexible budget with a minimum of work, because when this flexible budget table has been determined it is only necessary to refer to the table of each department to determine not only the allowances for the originally planned rate of operation, but also to the level of expense and the amount that should be budgeted for the rate actually run.

The variable budget table includes fixed, semivariable, and variable expenses. They are determined by the level of operation according to the plan the company decides to use. There are several bases which may be utilized, and a selection must be made from one of these. These various bases are (1) sales-quota levels, (2) anticipated normal expense level, (3) most favorable expense level, (4) breakeven level, and (5) company-objective level. It is believed that this terminology is fairly self-explanatory. The company-objective level appears to be the most satisfactory plan, because at the 100 per cent level of the table the expense level is based on a rate of operation which the company will not necessarily attain initially, but as it approaches its expected goal it will be unnecessary to revise the standards as the operating rate changes.

There are many reasons in favor of this company-objective plan, such as—

It supplies the most favorable unit cost figures
It implies that facilities will be adjusted to the company objective even though they may be now deficient as to kind and number or there may be excess capacity
It does not require frequent revisions as most other plans do
It is a reasonably long-range plan, assuming that activities are adjusted according to this program

Basis of measurement of activity. There are several well-known bases for measuring the activities of various departments such as units produced, direct-labor hours and direct-labor dollars, or, in the case of departments

heavily populated by machines, machine-hours. The basis most usually favored seems to be man-hours.

Analysis of the standard variation in departmental expense. Various authorities utilize different mediums for determining departmental expense. Some do it by individual items, others by a group of items, and still others for the department as a whole. The scatter-diagram method has been found to be a very effective one. This method is illustrated in Exhibit A. Before making a scatter diagram, the following points must be decided upon:

What is the basis of variance?
What level of activity is to be 100 per cent capacity?
Should graduations of the base be in 5 per cent or 10 per cent steps?

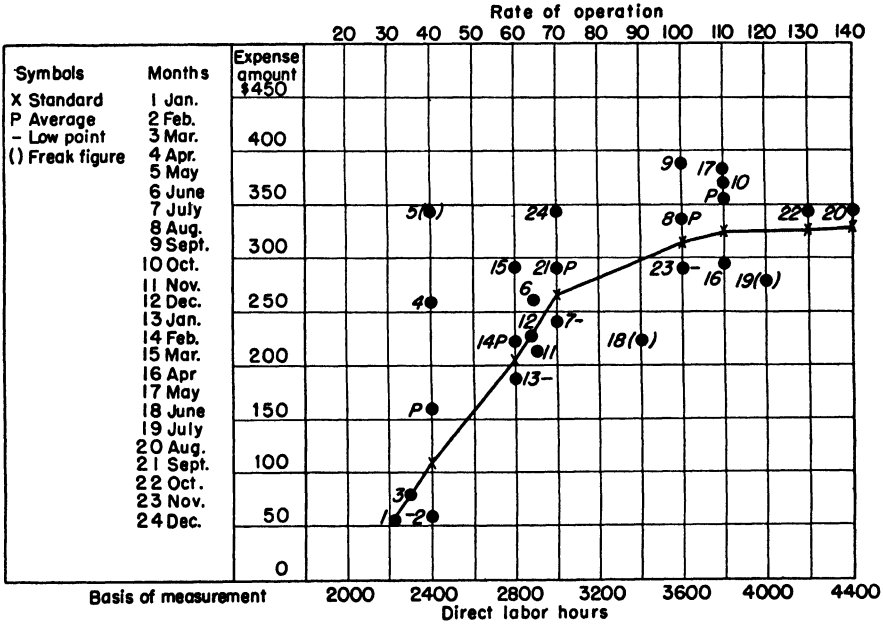


Exhibit A. Scatter diagram showing variation data of expense for twenty-four months.

The scatter diagram has the expense amount serving as a basis of measurement at the side and a scale of labor hours as the base. At the top is shown the rate of operations corresponding to the direct-labor hours. Ordinarily, it is the practice to use two or three years of monthly figures for the purpose of plotting a dot representing an average for various rates of activity. The object is to get, for as many as possible of the horizontal activity lines, at least three points—a high, low, and medium. In preparing this chart the practice is to eliminate exceptionally high and low points from consideration

and to obtain the three points of high, low, and medium. Points are placed on the nearest 5 per cent line. The elimination of exceptionally high and low points is determined by investigating whether or not each of these is a repetitive expense; if not, it can be eliminated. If it is liable to be repetitive, it, of course, cannot be eliminated. Frequently these excessively high or low points can be analyzed only after a talk with the foreman of the department in question.

The average of the remaining dots on each horizontal line of activity is then made by observation and marked *P*, and the corresponding low point is marked by a dash. An *X* is then placed at the mid-point between the average *P* and the low point. These points marked *X* on each horizontal line of activity should be connected by a curve or whatever type of line it may turn out to be, such as a series of steps. In connecting these *X* marks, if there are no dots on some of the horizontal lines of activity, the *X* on the two adjacent lines with *X* points are connected.

It has been contended by some authorities that instead of attempting to plot a line by this means, it would be better to draw a straight line by inspection through the density of the dots. It appears that a line drawn as has been indicated, and resulting in a step line rather than a straight line, is more in keeping with actual facts. In the case where a new business is being established or where the period being reviewed provides no previous experience record, the scatter-diagram method cannot be employed initially, but may be built up over a period of months for possible use in some subsequent budget period.

However, if there has been a year or more of operation, a scatter diagram can be prepared, but it will scarcely have sufficient data to prepare a sound chart. In that case, it will depend on an experienced plotter to be able to prepare a chart that will give some basis for the variable budget table.[1] As a matter of fact, many items of expense can be set up on an estimated basis for the current rate of activity by the budget director in conferences with the individual foremen. For indirect wages, for example, the simple expedient is to count noses and establish definite job classifications and group personnel under these classifications, with a provision for increases or decreases at certain predetermined rates of activity.

In new undertakings, it is not possible to build variable budget tables of expenses immediately. An estimate on a departmental basis should be made, and later, when the different expense accounts applicable have been determined, departmental expenses can be broken down also on an estimated basis. This process of estimating amounts and kinds of expenses has often proved decidedly effective in improving the accuracy of the original over-all budget.

Variable budget tables. After the data regarding expense have been determined, a table for each department is prepared showing the rates of activity from 20 to 200 per cent, or whatever may be necessary. The accounts pertaining to the department are shown on the left-hand side of the table, the basis of measure of labor dollars or whatever they represent is shown at the base of the table under the "total" expense for each rate of activity shown, and the amounts of each account for each rate of activity are shown in the proper activity column opposite the account named.

The use of the variable budget table means that department foremen are not obliged to read curves but can determine the budget allowance from the table where previously it has been figured out for them.

Raw-material budget. In addition to all the budgets included under the preliminary installation, there are a number of other important budgets to be compiled in connection with complete installations. Of these, the raw-material budget and the direct-manufacturing-expense budget are most important.

The raw-material budget assembles material charges to the extent necessary to produce the units stipulated in the production budget. This budget supplies the cost of direct material for the cost-of-goods-manufactured budget and the purchase budget. The budget lists the following columns:

Column 1 .....Materials
Column 2 .....Unit
Column 3 .....Total quantity for period
Column 4 .....Estimated excess allowance
Column 5 .....Revised total quantity
Column 6 .....Unit cost
Columns 7 to 18 .....Quantity and cost for each month

It covers raw materials for all commodities enumerated on the production-requirements budget. The estimated excess allowance is based on the variances shown between standard and actual.

Direct-manufacturing-expense budget. The direct-manufacturing-expense budget assembles all expense chargeable to productive departments and includes the following columns:

Column 1 .....Account
Column 2 .....Total:
(*a*) Activity budget
(*b*) Expected variation
(*c*) Budget
Columns 3 to 14 .....Months of the period:
(*a*) Activity budget
(*b*) Expected variation
(*c*) Budget

Budget sheets are prepared for each section. These are summarized by departments and then for the division. The activity budget is to be taken

from the variable expense table for the estimated rate of activity. The estimated variation is computed from experience and the total budget entered in the third column.

In every new installation, for a year or two after it has been started, it is probable that the company will not be able to operate at budget. The budget director can secure the expected difference between budget and actual, and for a beginning period can allow for an expected variation by adding to the budget amount whatever the anticipated variation may be. In this way, departments which are unaccustomed to working against a budget are allowed this extra amount of variation in addition to the regular budget, thereby modifying early failure and permitting them to meet the budget more gradually.

Performance reports. After all necessary budgets have been established, the next step is to use them in preparing performance reports. These reports compare actual expenses and revenues with the appropriate budget allowances. The budgets shown in the forecasts prepared in advance of a period may not necessarily be the ones with which to compare actual data. The budget allowance should correspond to the rate of activity involved, and the difference between the forecast budget and the activity budget represents the amounts due to change in volume.

In general, the performance report should show current-month and to-date figures. Where desired, the units involved may also be shown. The items listed should be the same as shown on the forecast budget.

Usually, the mere presentation of performance reports is not very effective for management purposes. Where these reports are voluminous, executives are not enthusiastic about wading through a mass of data to pick out the high lights that require their special attention. The budget executive is in the best position to point out the situations that are of interest. He should interpret them to the best of his ability after ascertaining underlying reasons through more detailed data obtained by investigation. Furthermore, reports should be made promptly.

This brings up another point that the budget director should keep in mind. By the time the accounting department has processed data for use in reports, the information is frequently too late to allow management to influence trends and cut short unfavorable developments. To circumvent this contingency, the budget director must exercise some ingenuity. He must develop daily or weekly reports on some particular phases that are of prime interest and continue these reports only so long as they are of any use. He must go to original sources of information, such as daily time reports, and obtain data in hours and minutes. If desired, he can use an average rate to cost up the items covered. An approximation is usually sufficient for man-

agement purposes. The same may be done with data on personnel, which for most enterprises constitutes the avenue of largest expenditures.

Budget flow charts. It is most desirable to show how the various budgets are related to each other and to indicate the flow of contemplated cash expenditures provided in each budget into a summarization of total cash requirements on the one hand and receipts on the other. In Exhibit B, page 580, the dotted lines indicate the operating budget flow and the solid lines the cash budget flow.

Breakeven charts, profitgraphs, and profit-and-loss charts. It has proved most advantageous for a budget executive, before he embarks on a budget program for any organization, to study its profit structure, that is, to ascertain the approximate amount of fixed charges, the variable rate of expenses, the breakeven point, the margin of safety, and the approximate profits or losses at various rates of activity. This important study can be accomplished by the development of breakeven charts, profitgraphs, and profit-and-loss charts. Furthermore, comparisons can be made with competitor organizations and whole industries, to show the relative position of the company studied.

Breakeven charts vs. profitgraphs. In the determination of policies, a clear concept of the profit structure of any business organization is most essential. In recognition of this, industrial engineers usually, as a first step, develop the relationship of volume and profit. By utilizing correlation charting, the profit structure may be graphically described and the breakeven point determined. Graphic presentation permits a ready form of analysis of profit variations in relation to other factors, such as volume, unit selling price, and costs. Until recently the terms "profitgraph" and "breakeven chart" have been used interchangeably, but the modern profitgraph is a simplified breakeven chart in which the lines of variable and fixed costs are eliminated and only one line of profit, which is the difference between the sales and cost lines, is shown.[7] This distinction is illustrated by Figs. 1 and 2, page 581.

Classification of breakeven charts. Breakeven charts may be made in a number of forms, the variations resulting from the method of presentation rather than from any fundamental differences. These variations fall into three major classifications: [8]

1. Charts showing the fixed and variable expenses separately for each of the main types of expenses such as manufacturing, selling, administrative, etc. (Fig. 3, page 582)
2. Charts showing total fixed charges at the bottom, with variable expenses shown as further additions to expenses (Fig. 4, page 582)

[7] Theodore Lang, editor, *Cost Accountant's Handbook*, The Ronald Press Company, New York, 1944, p. 103.

[8] Rowland and Harr, *op. cit.*, pp. 142–143.

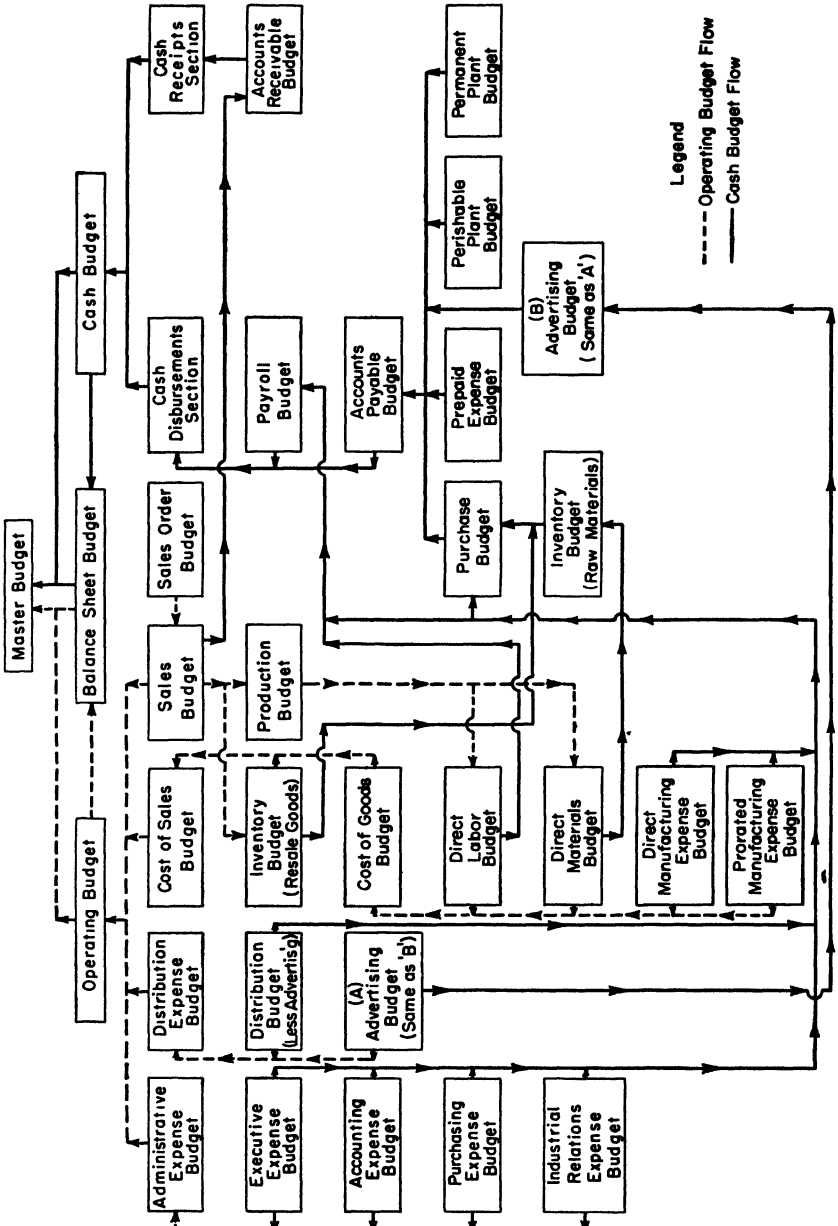


Exhibit B. Budget flow chart for typical company organization.

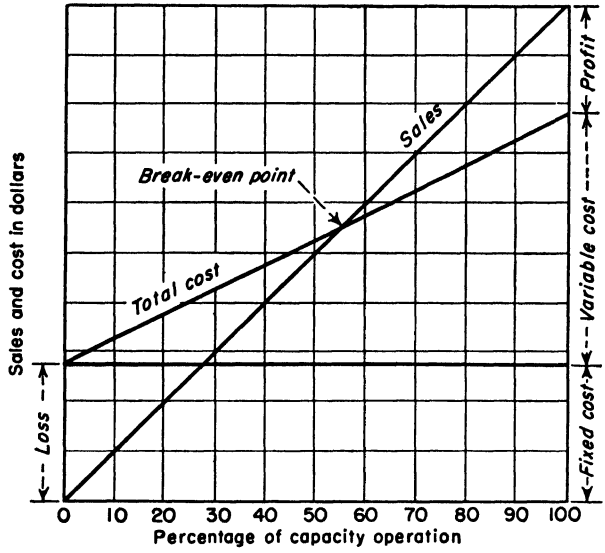


Fig. 1. Breakeven chart.

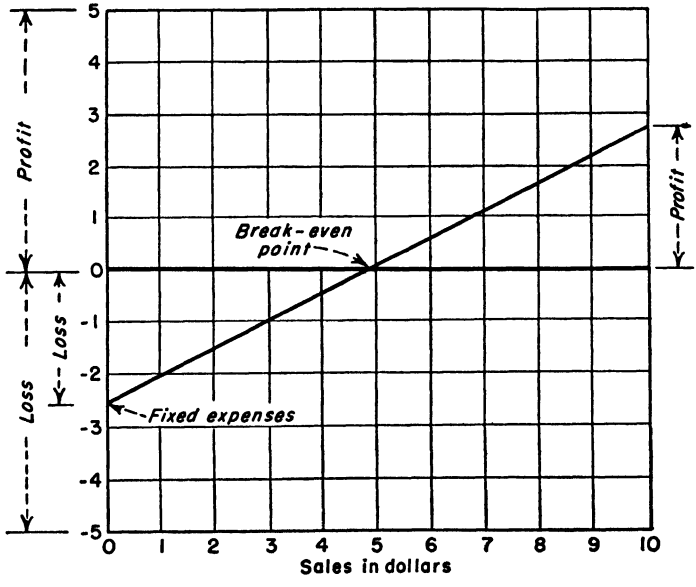


Fig. 2. Profitgraph.

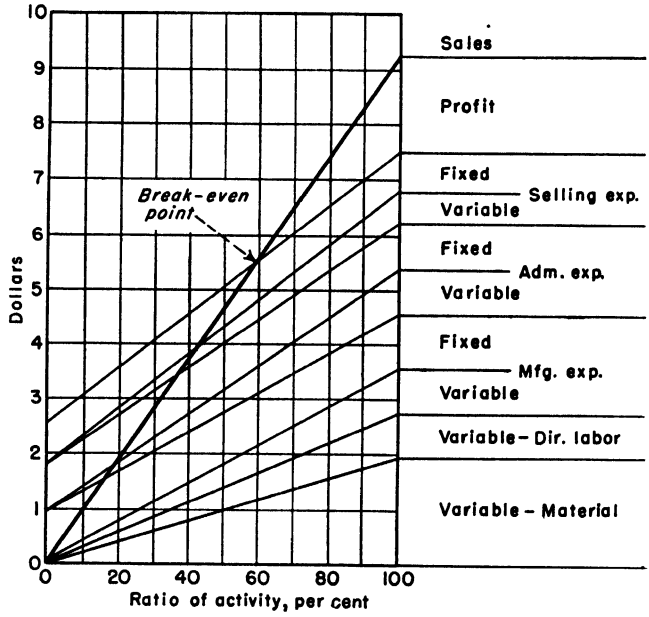


Fig. 3. Breakeven chart by major expense class.

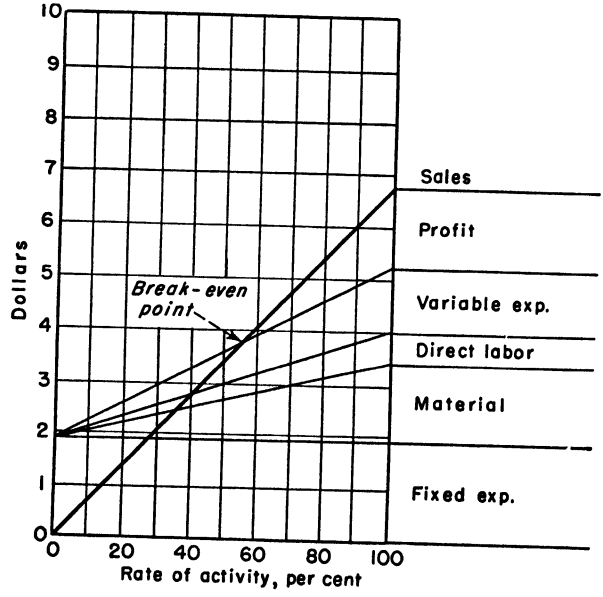


Fig. 4. Breakeven chart with fixed expenses at bottom and variable above.

3. Charts showing variable expenses starting at zero with fixed expenses added above the accumulated variable expenses (Fig. 5)

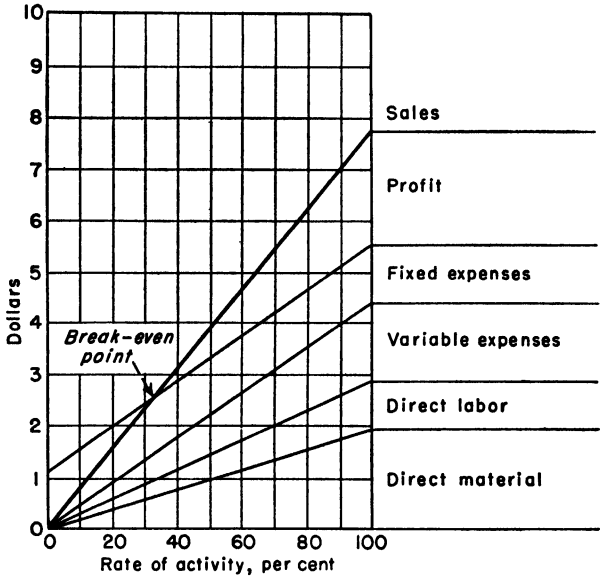


Fig. 5. Breakeven chart with variable expense at bottom and fixed on top.

The third type of breakeven chart, with variable expenses at the bottom and fixed expenses on top, had been utilized as a profit-realization chart designated as a "profitgraph" by C. E. Knoeppel in 1909.[9] This type of chart may be elaborated upon to show per cent earnings on capital invested, the per cent return at the budgeted level of activity, the per cent that each class of expense shown on the chart bears to the sales dollars, the rate of activity required to attain various levels of return on invested capital, and the critical levels of activity at which preferred dividends, common dividends, and interest are not earned (Fig. 6, page 584).

The profitgraph and management planning. The modern profitgraph, Fig. 2, has found increasing acceptance because of the trend to emphasize profits rather than expenses. The desired profits are first budgeted for a given sales level, and expenses are limited to the difference between the two. To make such a procedure feasible, the profit structure under prevailing conditions must be known. The profitgraph indicates the profit to be expected at any sales level. Therefore, if the desired profits do not agree

[9] C. E. Knoeppel and E. G. Seybold, *Managing for Profit*, McGraw-Hill Book Company, Inc., 1937, p. xiii.

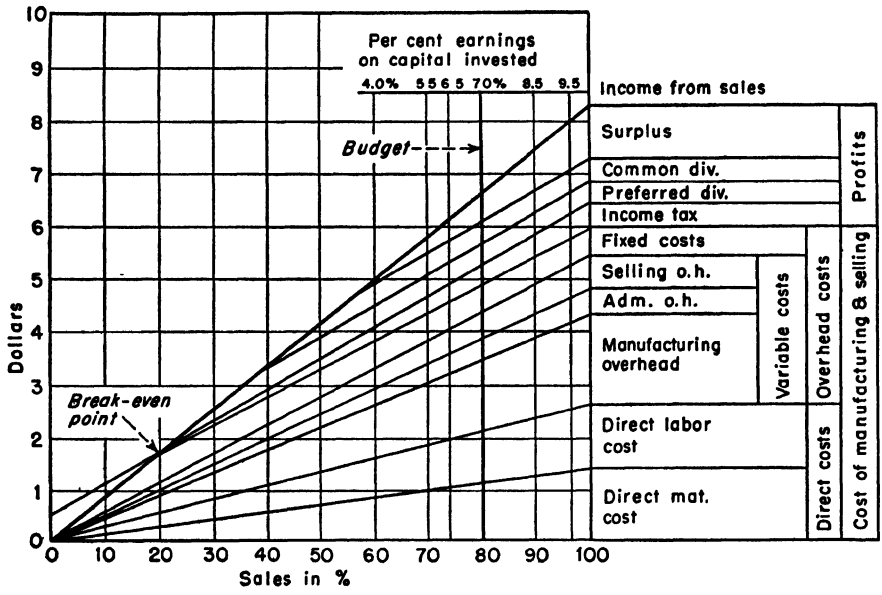


Fig. 6. Profitgraph.

with the indications of the profitgraph, management must take action to change the profit trend by reducing fixed, variable, or both types of expenses or by increasing the amount of sales revenues.

Management must take into consideration the capital invested in the enterprise and set a fair return based on the risks involved. This is paramount when new capital is to be invested in an enterprise. When this is not the situation, then this concept is subject to modification in view of competitive conditions, the phase of the business cycle at the moment, or the long-term trend of the particular field of business of the company. The next step is to examine the fixed and variable expenses and decide on changes to be made which would result in their reduction. This may involve changes in plant capacity, substitution of lower cost materials, refinancing to reduce interest payments by obtaining lower rates or issuing equity securities, consolidation of departments to reduce supervisory costs, purchasing parts from outside vendors, manufacturing parts now purchased, change of wage rates, adoption of piecework basis, and a host of other considerations.

Should results fall short of the desired profit objective, management must give consideration to revenues by increasing or decreasing unit prices, by adding or dropping products sold, and by selective sales planning. The effect of unit price changes on profits may readily be ascertained by portrayal in a profitgraph, provided the physical volume of sales is not affected. How-

ever, the effects on consumer reception, which is not so easily appraised, must also be evaluated to estimate the net results of such a change. The effects of the addition of new products or the elimination of unprofitable items can be shown on a profitgraph to cover a wide range of sales. If management decides to push the more profitable items at the expense of the less profitable ones, the profitgraph lends itself to portrayal of these effects on the profit structure.

If, after all possible measures affecting sales and expenses have been exhausted, the desired results fail to be realized on paper, then the only alternative remaining is to be reconciled to a lower rate of return on sales and invested capital, to a level that is attainable. If it can be shown that no profits are likely, a decision to liquidate may be advisable to save some of the remaining equities in the enterprise.

Building breakeven charts. To build a breakeven chart, expenses must be classified as constant or variable with respect to sales or activity. Constant expenses are of two kinds, namely, fixed charges and regulated expenses.[10] Fixed charges are due to—

"Costs to possess," such as interest on mortgages and rent
"Costs of capital recovery" or depreciation

Regulated expenses arise from—

The operation of the business and the nature of the factory, including such expenses as heating, lighting, connected-load charge of purchased power, and maintenance and repair
The determination of executive policy, such as executive and supervisory compensation and advertising

Variable expenses are those which are in direct proportion to production and sales and include material costs, direct-labor costs, and commissions on sales.

Those expenses known as semivariable expenses, which include both fixed and variable elements, must be analyzed to segregate the components. By plotting the expense in question against sales or direct labor or some other base that controls the expense and fitting a straight line to these points by the method of least squares, by inspection, or some other appropriate method, the fixed element is indicated by the point where the line crosses the zero point of the base. Fitting the line by inspection is defended by some on the grounds that the error of judgment results in an insignificant variance in the variable expense, and that the stand-by expense is itself a matter of opinion.

There is a simple and effective method for determining the best line going

[10] Walter Rautenstrauch and Raymond Villers, *The Economics of Industrial Management*, Funk & Wagnalls Company, New York, 1949, pp. 87–89.

through a pattern of points in a scatter diagram.[11] The two series of statistics are arranged in columns, and the independent series is designated X and the dependent series Y. An arithmetic average is computed for each and a point M located on the chart to represent these two averages. The next step is to set up two more columns designated x and y adjacent to X and Y columns, and place therein the difference between each statistic and the applicable average. Next set up two more columns, x^2 and xy and insert the proper values, carefully observing the plus and minus signs in the multiplication of x and y. These two columns x^2 and xy are totaled and the values used in the following equation:

$$a = \frac{\Sigma xy}{\Sigma x^2}$$

where a represents the slope of the best line through point M, and Σ is "the sum of." By applying a to some assumed value of x in the equation for a straight line, $y = ax$, and solving for y, a point N can be obtained by simply adding the x and the y values thus obtained to the corresponding values of point M. It will almost always be found that the trend line passing through points M and N crosses the Y axis at some point above zero, which amount represents the fixed element. This amount may be determined by inspection or by solving the equation for a line of regression, $y = a + bx$, in which y is the dependent series of statistics such as selling expenses, x the independent series such as sales, a the fixed amount, and b the ratio of the trend line. Values of either point M or N may be used, together with the a value previously computed, to obtain the value of b, the fixed amount. This same equation may be used for budgeting the allowable expense for any given sales figure, once the values for a and b have been determined.

An illustration will clarify the procedure. The *ABC* Company sales and selling expenses are plotted in a scatter diagram for the years 1933 through 1940. From a graph (not shown) it can be seen that 1938 is definitely out of line and it is therefore dropped from further consideration as far as the determination of the trend line is concerned. The computations for determining the best fitting line for sales and selling expenses are given in the illustration on page 587.

After all expenses have been classified as to fixed and variable elements, any of the breakeven charts illustrated in Figs. 3, 4, and 5 may be drawn with no great difficulty. It should be noted that the base is shown as the rate of activity, and the sales line starts at zero activity and rises to the amount that can be realized at 100 per cent output. Where the total expense line

[11] George V. Trundle, Jr., Editor, *Managerial Control of Business,* John Wiley & Sons, Inc., New York, pp. 88–90.

Computations for Determining Best Fitting Line for (1) Sales and (2) Selling Expenses

Year	Sales, thousands X	Selling expense, thousands Y	Difference between average and actual x	Difference between average and actual y	xy	x^2
1933	12,866	1,058	−16,607	−558	9,266,706	275,792,449
1934	17,817	1,313	−11,656	−303	3,531,768	135,862,336
1935	21,223	1,425	− 8,250	−191	1,575,750	68,062,500
1936	29,605	1,597	132	− 19	− 2,508	17,424
1937	38,007	1,809	8,534	193	1,647,062	72,829,156
1939	33,509	1,758	4,036	142	573,112	16,289,296
1940	53,284	2,355	23,811	739	17,596,329	566,963,721
Total	206,311	11,315	.. ....	... ...	34,188,219	1,135,816,882
Average	29,473	1,616 = M				

$$a = \frac{\Sigma xy}{\Sigma x^2} = \text{slope of line (ratio of selling expense to sales)}$$
$$= \frac{34,188,219}{1,135,816,882}$$
$$= 0.0301001$$

$y = ax$ (equation for a straight line)
$= 0.0301 \times 50,000,000$ (assumed value of x)
$= 1,505,000$

For determining point N:

	Sales (x)	Selling expense (y)
Point M	29,473	1,616
Add..... ..	50,000	1,505
Point N	79,473	3,121

For determining the fixed expense, use point M or N; in this case N is used.

$y = a + bx$ (equation for line of regression)
$3,121 = a + 0.0301\ (79,473)$
$a = 3,121 - 2,392$
$= 729 =$ fixed amount

crosses the sales line is the breakeven point. Instead of the rate of activity as the base, the output in sales dollars can be used.

The profitgraph and the P/V technique. By using the profitgraph, Fig. 2, the over-all fixed charges may be approximated on the chart without the

necessity of classifying individual expenses as fixed or variable. This method of determining fixed expenses appears valid, when underlying conditions remain relatively stable, as usually obtains over a period of months at a time, long enough for providing adequate statistics as a basis for the chart.

The profitgraph has been successfully used as a management tool for a long time. The analysis of the profit structure by means of the profitgraph has resulted in a special technique known as the "*P/V* technique." [12] A hypo-

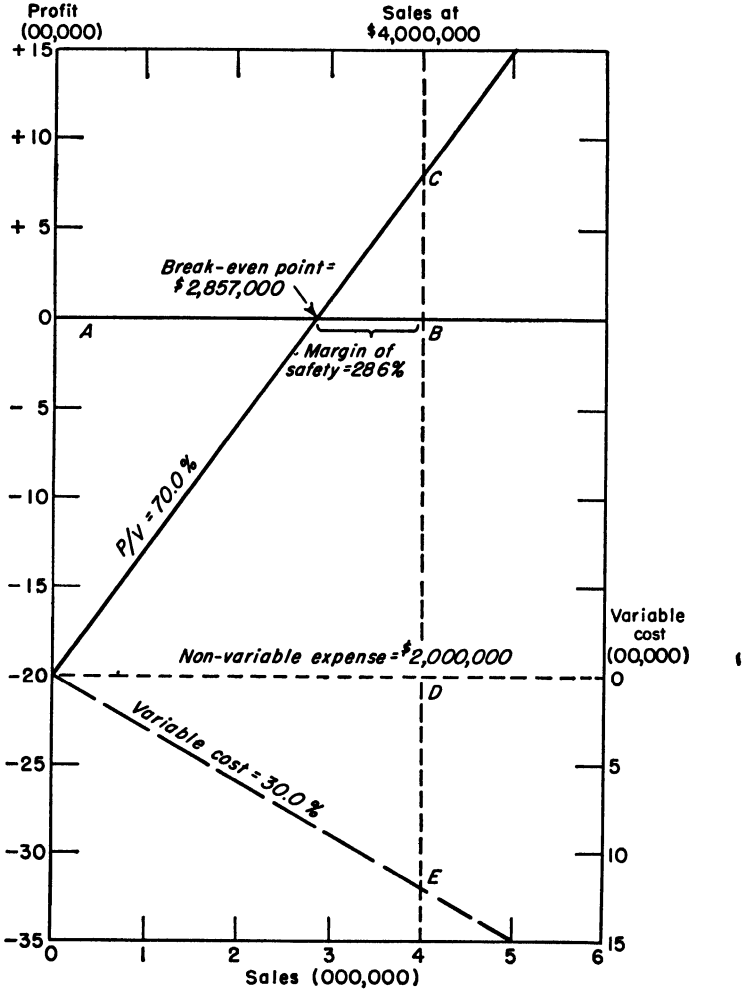


Fig. 7. Analysis of the profit structure.

[12] Stevenson, Jordan & Harrison, Inc., *Analyzing the Profit Structure*, Monograph 1, 1940.

thetical situation is presented in Fig. 7 to aid in its explanation. The technique for analyzing the profit structure is as follows:

1. Plot monthly profits against sales to determine the profit path; under normal conditions these dots will arrange themselves along a narrow diagonal channel. Thus, approximate profits for any sales volume may be established, provided basic conditions remain the same.
2. The next step is to define the profit path in mathematical terms. The slope of the profit path or the profit-to-volume ratio (P/V) may be defined as the amount of profit that will be added per $100 of sales increase. By taking any two points on the profit path, the ratio is readily ascertained, thus:

	Sales	*Profit*
1st point	$5,000,000	$1,500,000
2d point	4,000,000	800,000
Change	$1,000,000	$ 700,000

$$P/V = \frac{700{,}000}{1{,}000{,}000} = 70.0 \text{ per cent}$$

3. The difference between total sales of 100 per cent and the P/V ratio represents the variable costs as follows:

Sales	100.0 per cent
P/V ratio	70 0
Variable costs	30.0 per cent

4. A complete presentation of the profit structure as percentages of sales is as follows:

Profit (for the month)	20.0 per cent
Nonvariable costs	50.0
Total or P/V	70.0 per cent
Variable costs	30.0
Sales	100.0 per cent

5. As a percentage of sales, variable costs tend to remain constant; therefore the P/V tends to remain constant (see Step 4 above). While the P/V ratio tends to remain constant, its component elements, nonvariable costs and profits, will vary as the amount of sales varies. These two elements are complementary and therefore affect each other inversely, that is, as sales increase, the percentage of nonvariable costs decreases to the same extent that the percentage of profits increases.
6. The breakeven point may be obtained by dividing the ratio of nonvariable costs by the P/V and applying this to the corresponding sales dollars as follows:

$$\begin{aligned}\text{Breakeven point} &= \frac{\text{ratio of nonvarying costs}}{P/V} \times \text{sales dollars} \\ &= \frac{50.0\%}{70.0\%} \times \$4{,}000{,}000 \\ &= 71.4\% \times \$4{,}000{,}000 \\ &= \$2{,}856{,}000\end{aligned}$$

7. A valuable profit equation which holds true at any volume of sales is derived from the P/V ratio.

$$\begin{aligned}\text{Profits} &= (\text{sales} \times P/V) - \text{nonvarying expenses} \\ &= (\$4{,}000{,}000 \times 70.0\%) - (50.0\% \times \$4{,}000{,}000) \\ &= \$2{,}800{,}000 - \$2{,}000{,}000 \\ &= \$800{,}000\end{aligned}$$

Most computations of profit are true only at some one predetermined volume of sales.

8. The margin of safety is a measure of the volume of sales above the breakeven point.

$$\begin{aligned}MS &= \frac{\text{profit ratio}}{P/V} \times \$4{,}000{,}000 \text{ (sales)} \\ &= \frac{20.0\%}{70.0\%} \times \$4{,}000{,}000 \\ &= 28.6\% \times \$4{,}000{,}000 \\ &= \$1{,}144{,}000\end{aligned}$$

By referring to Step 6 above, it may be seen that the margin of safety is the complement of the breakeven point:

Breakeven point at 4,000,000 sales.....	2,856,000	71.4 per cent
Margin of safety at 4,000,000 sales.....	1,144,000	28.6
Total sales	4,000,000	100.0 per cent

If management knows approximately how much its business fluctuates in periods of general depressions, it can plan on a margin of safety wide enough to protect against loss during the period of low volume. If it is impossible to reach a sales volume to give this protection, then earnings during good times must be held in reserve for probable losses in order to keep out of financial difficulties.

9. It is interesting to note that the chart of the profit structure is drawn in such a way that sales shown horizontally are analyzed vertically.

Sales (AB)	=	profit (CB)	+	nonvariable (BD)	+	variable (DE)
4,000,000	=	800,000	+	2,000,000	+	1,200,000

A scale applicable to variable costs can be fitted in at the right-hand side to make it easier to read amounts direct from the chart.

To summarize: [13]

The P/V analysis clarifies and illuminates the operating figures of a company better than any other method of analysis. . . .

For the administrative management it aids in predicting future profits under existing conditions and in planning for better profits through betterment of conditions.

For executive management it furnishes the most effective basis for control. . . .

For the sales executive this P/V analysis is of the highest value because it may be used to measure the profit values of sales—by product classes, by territories, by customer classes, by individual salesmen.

[13] Stevenson, Jordan & Harrison, Inc., *op. cit.*, p. 25.

Breakeven chart vs. profit-and-loss chart. The historical pattern of sales-expense-trend experience covering a period of years is known as a "profit-and-loss" chart. In contradistinction to this, the sales-expense trend at any particular time is the breakeven chart. Within certain ranges of sales where constant expenses remain unchanged, the breakeven chart accurately reflects the characteristics of the profit structure of an organization. Unless a business is to undergo a radical change, such as a permanent contraction or expansion of plant facilities, fixed charges, as previously defined, are apt to remain unchanged. Those constant expenses, classified as regulated, are the ones to be adjusted in accordance with significant changes in the sales level. It is therefore necessary to redetermine the breakeven point at intervals depending on the particular circumstances surrounding a given situation. If a series of breakeven points are available, it is possible to portray the trend in a chart and to state this trend in a mathematical equation, $y = a + bx$, where y is total expenses, a is the point of orientation on the y axis, b is the ratio of the total variable expenses to sales, and x is sales. It should be carefully noted that the point at which this trend line crosses zero activity, a, is not to be confused with the indicated fixed charges of the breakeven chart. It is considered merely a point of orientation,[14] and the amount is a component of the mathematical equation describing the trend line.

The profit-and-loss chart is a valuable adjunct to management control. This chart may be made from the annual statements to stockholders, and it is useful in showing the degree of ability of management to adjust expenses and prices to changing conditions to maintain adequate profit margins. The profit-and-loss chart has both the sales line and the expense-trend line. Figure 8 illustrates the profit-and-loss chart. Expenses are plotted against the corresponding sales and a trend line fitted to the scatter diagram. The sales line is located by drawing it through points of equal values on both the x and the y axes; that is, if both scales are on the same basis, the line starts at zero and is drawn at a 45-degree angle.

The difference between the expense-trend line and the sales line represents profits.

The profit-and-loss chart enables the management of one company to compare itself with that of its competitors, and to provide more definite objectives to stimulate its efforts. This type of chart can also be used for analyzing whole industries, data for which have been compiled by various agencies, notably the U.S. Department of Commerce and the SEC. The sales-expense-trend lines can be stated in mathematical equations, thereby facilitating comparisons. In the equation $y = a + bx$, the values for y, a, and x may be read off a chart with a computed trend line, and the equation

[14] Rautenstrauch and Villers, *op. cit.*, p. 95.

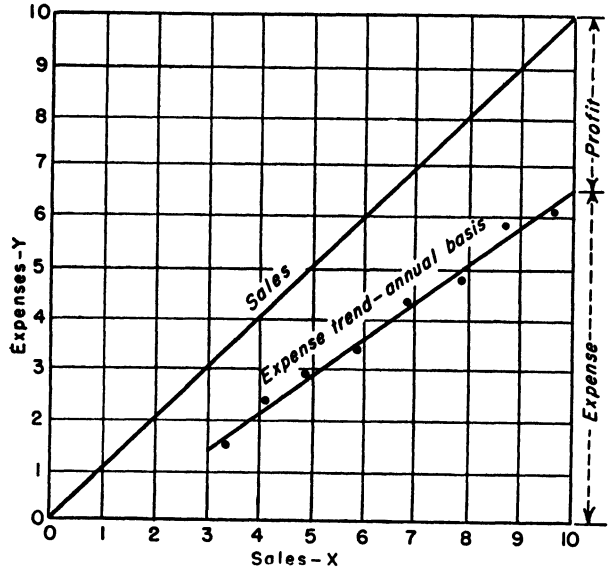


Fig. 8. Profit-and-loss chart.

solved for b, the slope of the trend line. A more accurate way to determine the slope would be to take any two widely separated points on the computed expense-trend line and divide the difference in sales into the difference in the corresponding expenses. This ratio may then be applied to the above equation, $y = a + bx$, and substituting the y value of one of the points used to develop the trend ratio, the equation can be solved for a, the point of orientation on the y axis.

Section 17

HOW TO DESIGN SYSTEMS FOR INTERNAL CONTROL OF A BUSINESS

BY

JOHN J. W. NEUNER

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HOW TO DESIGN SYSTEMS FOR INTERNAL CONTROL OF A BUSINESS

1. Why internal controls are necessary

What is meant by internal control? Internal control is sometimes called "internal check." The term is almost self-explanatory. It means a system established by top management which enables it to have control of what is going on in the business. It also means the organization of the business in such a way that the possibility of concealing fraud, theft, errors, and defalcation in the records of the important current assets is reduced to a minimum, if not eliminated entirely. Every business executive is interested in the problem of internal control for two reasons:

1. An understanding of just where his position fits into the picture of managerial control
2. A knowledge of how the work under his direct and indirect control may be properly supervised and controlled to prevent errors and fraud

Why internal control is an absolute necessity in modern business. Most business firms today have grown to such a large size that it is almost impossible for top management to supervise directly all the business activities. Therefore top management must delegate authority and responsibility for the care and preservation of the assets and property of the business, but *at the same time* it must be sure that this delegation is not perverted so as to cause a loss or theft of the assets of the firm, or to cause undetected errors in the work. Management therefore attempts to preserve the assets of the firm and at the same time create a managerial control by devising a system of *internal control* or *internal check.*

Furthermore, by having a rather complete system of internal check, business is so managed that, with due allowance for minor variations, it may be assumed that the business records are reasonably accurate. This means that when a firm of public accountants has been employed, it will not be necessary to make a detailed audit of every single transaction. Usually a balance-sheet audit or a survey type of audit will be sufficient to present an accurate picture of the operating results of the business operations. Furthermore, this system of internal control or check is necessary because: (1) the large num-

ber of employees which must be hired to keep the business records increases the possibility of fraud or error; (2) the work of this large number of individuals is so interrelated that the errors or fraud of one seriously interferes with the work of another group; and finally (3) the ultimate result of the lack of internal control is such that a business not only may suffer serious business reverses from errors and fraud, but may actually fail. For the sake of illustration let us take several cases in which faulty internal control caused business firms serious financial difficulties and problems:

In the now famous McKesson & Robbins case, the president, Mr. Costa, was able to falsify inventories because of his position and the firm's lack of control, causing losses of millions of dollars to stockholders.

In the equally famous Mergenthaler case, fraudulent activities caused losses amounting to more than $700,000, most of it covered by insurance. In this firm, several years later, it was possible not only to recoup the losses, but also to declare extra dividends (1949). But this was in spite of the lack of internal control.

In the National City Bank, it was possible for a branch manager to defraud the bank of more than $500,000. Fortunately, by the prompt action of the bank and the Federal government, most of this was recovered, and the actual loss was covered by insurance. Nevertheless, a good system of internal check might have mitigated or reduced the possibility of such a loss.

The losses due to the lack of a proper system of internal control amount to millions of dollars a year. It is important to business management to understand not only the need of a system of internal control, but also the various methods of internal control and what should be controlled internally. However, some business firms are so infected by the idea of internal control that the methods and procedures are overdone, with the result that the losses which are eliminated by having a good system of internal control are then converted into expenses due to "too much red tape." So the gains on one hand are eliminated by expenses on the other hand, and all effort is wasted. A careful understanding of the system of internal control must be part of every successful business executive's training and experience. Equally important, if confusion is to be avoided, must be the distinction between *internal control* and *red tape.*

What phases of business require internal control? Business is made up of a series of transactions. These transactions involve the handling of cash, merchandise, payrolls, accounts receivable, other assets, and expenses. These transactions must be appropriately recorded, in addition to the physical handling of the cash, securities, and merchandise. In recording these transactions errors may occur without any fraudulent intent. Furthermore,

fraudulent conversion of the physical assets may be concealed by a manipulation of the records. The systems, procedures, and records must be so designed and operated that errors will be eliminated, or at least reduced to a minimum, and that fraud will be prevented or easily detected before it assumes major proportions. It should be stressed, however, that no matter how perfect the system of internal check, there is still a need for insuring, through fidelity bonds, the integrity of the employees.

The following list indicates the items that require internal checking, with due allowance for the various types of business operations to which they may be applied:

- Inventories
  - In a trading business firm, merchandise and supplies inventories
  - In a manufacturing business
    - Raw materials inventories
    - Supplies inventories
    - Work in process of being manufactured
    - Finished goods available for sale
  - In either a manufacturing or trading business, inventories in branches or in other special locations such as warehouses, shipping centers, etc.
- Expenses
  - Manufacturing expenses
  - Selling expenses
  - Administrative expenses
  - Financial and other expenses
  - Branch-house expenses
- Payrolls
  - Factory payrolls
  - Office payrolls
  - Sales-force payrolls
  - Branch-office payrolls
- Cash
  - Cash receipts and deposits
  - Cash disbursements
  - Petty-cash disbursements
  - Branch-house cash receipts and disbursements
  - Cash reconciliations
- Special assets
  - Notes receivable
  - Securities and investments owned
  - Capital stock certificates

Although this list is not complete, it is indicative of the variety of items which are involved. Other items may be added. It should be noted, how-

ever, that in many ways some of these items overlap. The handling of notes receivable or securities may involve the receipt of cash or its disbursement. Payrolls and expenses involve the item of cash. Inventories may involve the receipt or expenditure of cash. Ultimately, all internal control involves cash or its equivalent physical asset such as merchandise, equipment, securities, etc. This fact must be carefully studied and understood to avoid the confusion arising from the overlapping and interrelation of business transactions.

2. *Phases of internal control*

What constitutes a properly coordinated system of business operations? Satisfactory internal control results from a properly coordinated system. It is commonly referred to as *efficiency* in business operations. Such a system must not only protect the assets of the business firm and record its operations accurately, but it must achieve these results through quick, accurate, low-cost procedures which have been carefully developed and standardized. Actually it covers the entire picture of business operations. A properly coordinated system is made up of the following:

Element of the system	*Description*
Organization	A series of organization charts which indicates the segregation of various business activities. The major charts must be subdivided to indicate the line of authority and responsibility. In some instances this may require job analyses and descriptions.
Forms and records	The use of carefully designed forms and records so that all transactions may be promptly and accurately recorded and controlled. The use of mechanical devices to expedite the work, reduce its monotony, and permit verification of all work as it is done. A series of journals, ledgers, and other accounting records so that a sufficient number of employees may be used in the work to avoid delays and bottlenecks in the recording of the business transactions.
Operating routines	A series of job descriptions, flow charts, and manuals of procedure, so that the work will not only be completed correctly, but will be repeatedly done in the same uniform manner. There must be one best method of recording and completing each business transaction, and this must be uniformly followed to prevent error and to permit prompt verification and control.
Reports	A minimum number of reports are a necessary part of the system of every business firm. The larger the business organization, the more important these reports become for top-management control. Among these reports would be— Budgets and comparisons with the actual operating data. Periodic financial operating reports such as the profit-

Element of the system	*Description*
	and-loss and balance-sheet statements, departmentalized if necessary.
	Statistical analyses of the financial and operating data.
	Manufacturing-costs data if the firm is engaged in activities that require their preparation.

Organization as a phase of internal control. Organization of business activities is best indicated by means of organization charts. Organization should be indicated in three major types of charts: (1) the entire organization, (2) top management, and (3) divisional organization. These charts should be functionalized and should show the line of authority. Different firms have different ideas of the type of organization. Some use the line-and-staff arrangement; others follow an independent departmentalized arrangement. Part of the plan of organization should emphasize these principles of internal control:

Have more than one person involved in the completion and recording of every business transaction. This provides a check on the accuracy of the work, thus reducing the possibility of error

Have the handling of the physical asset—that is, the cash, equipment, or merchandise—separate and distinct from the recording. For example, the actual receipt of the cash by the cashier requires that some other person maintain the cash receipts records. This prevents the manipulation of the records to cover up defalcations, unless there is collusion between the parties

Have as much of the work as possible performed with the use of office machines or appliances, which maintain some mechanical means of proving or checking the accuracy of the work as it is being completed

In the following pages, the phases of organization by means of charts are illustrated. Each illustration will be discussed accordingly. Chart 1 represents the complete organization of a manufacturing concern, with emphasis on the top-management personnel and the type of work that comes under the control and supervision of each major executive. Charts 2 and 3 show a more detailed analysis of the personnel and records of the accounting or controller's department and the treasurer's office, since these two are most closely involved in internal check. A fourth chart is given to illustrate the division of the administrative duties of a smaller firm engaged in the men's furnishings retail business.

The use of printed forms as a phase of internal control. Forms have been labeled the silent partners of business, because they are used in so much of the work. Among the many forms used are purchase requisitions, purchase

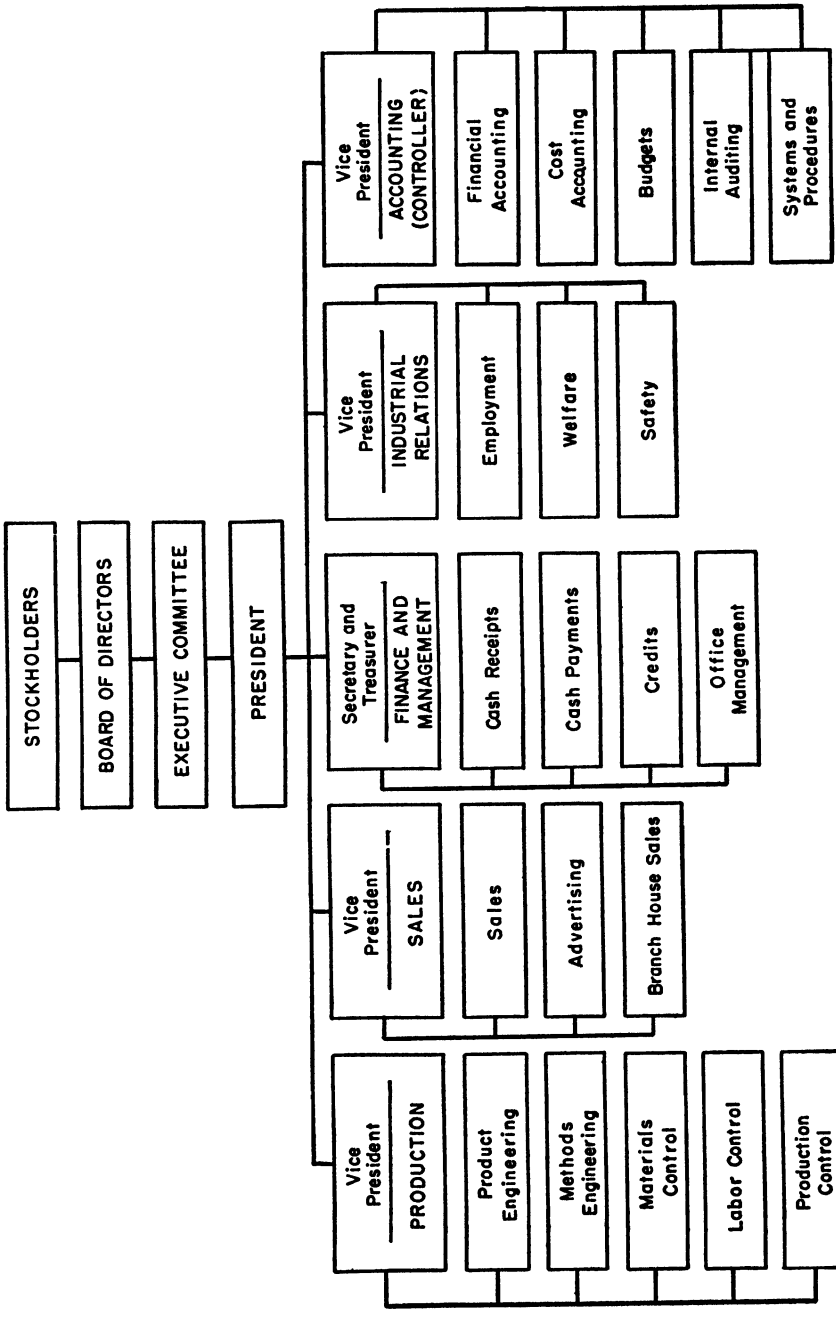


Chart 1. Complete organization chart of a manufacturing firm illustrating the top management personnel.

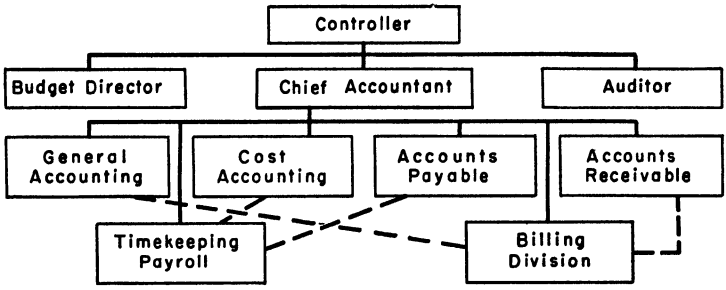


Chart 2. Organization chart of the controller's office.

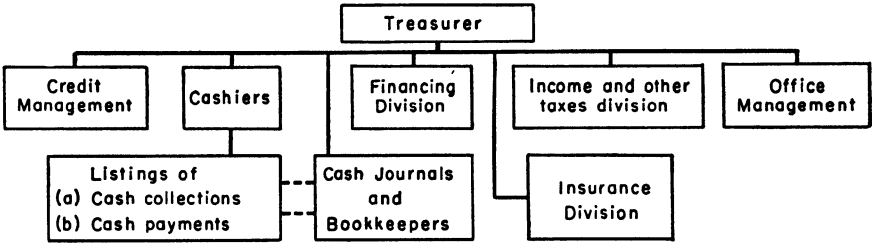


Chart 3. Organiation chart of the treasurer's office.

orders, purchase invoices, vouchers, sales orders, sales invoices, time cards, payroll sheets, and many others. By using manifold copies, time is saved in preparing records which require identical information. However, there are other reasons why printed forms are a necessary part of business procedure, such as—

Information which must be recorded repeatedly on each form may be printed, thus saving the time required in recording it. The numbering of forms consecutively is but one illustration

All information which must be recorded will be properly indicated, thus eliminating the possibility of its omission. Space must be provided on the forms for dates, signatures, listing of items, etc.

The placing of the information will be standardized. The numbers, dates, items, signatures, etc., will always appear in the same position on a set of forms, thus saving time in checking

The use of forms follows the management principle of "Put it in writing." This places responsibility and reduces the possibility of error

By having forms printed in "sets," the proper number of copies will always be prepared

By using differently colored paper for each copy, it is possible to indicate to which person or department the form is to be sent. If forms are

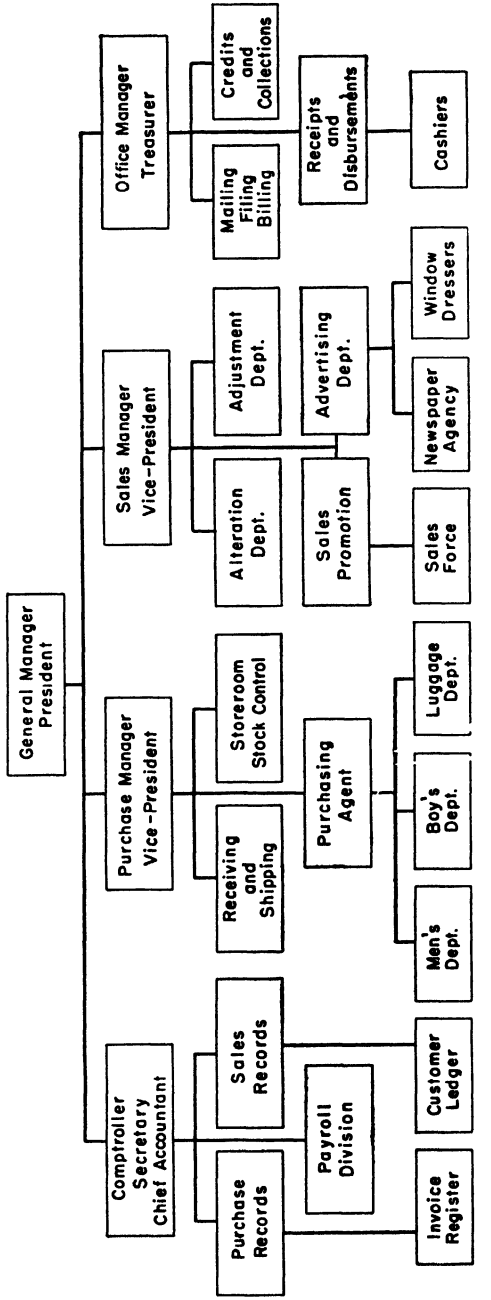


Chart 4. Organization chart—Division of administrative duties, retail men's furnishings business.

missent or arrive in the wrong department, the color of the paper will quickly bring this matter to the attention of the employees

The number of copies to be prepared for each form must be kept to a minimum, yet must be sufficient to expedite business transactions

The number of different forms to be used must be kept to a minimum to avoid developing too much "red tape"

Flow charts should be used to indicate the various operations and departments through which each form must travel. These charts should indicate the points in the business procedure at which internal checking and control are established. These charts must also indicate at what places the handling of the physical asset and the recording of data concerning that asset take place, thus establishing internal control by segregating the *handling* and the *recording* of valuable assets

Operating routines as a phase of internal control. Closely allied with forms and records are the development and improvement of operating routines. These routines may be described by words, diagrams, or flow charts. These routines represent the nervous system of a business enterprise. These routines must be developed for each major business activity. There must be at least one for each of the following:

Purchase of merchandise or raw material
Sale of merchandise
Manufacture of a finished product
Preparation of payrolls
Cost accounting
Maintenance of plant and equipment

Each of these may be further subdivided into routines for the various phases of the activity. For example, the routine representing the purchase of material may be made up of routines for (1) purchase and receipt of material, (2) storing of material, (3) payment for material, and (4) issuance of material. The routine of the sale of merchandise may be subdivided into routines for (1) ordering the merchandise, (2) shipping the merchandise, and (3) receiving payment for the merchandise. And this same analysis procedure must be followed for each of the other important business transactions which occur. Sometimes manuals of procedure are written up describing the exact procedure to be followed for each transaction. All this emphasizes the fact that where transactions occur repeatedly, a definite and uniform procedure must be followed to prevent errors and, by permitting verification, to prevent fraud—both of which are the objectives of the system of internal check.

Since so many of these systems and routines involve the use of printed forms and records, it is necessary to determine answers to the following ques-

tions in preparing the routines, or in analyzing them from the viewpoint of internal control:

What forms are necessary for the routine?
How many copies are to be prepared?
Who is to prepare the forms?
By whom are the forms to be checked, verified, or approved?
To what department or to whom are the various forms to be delivered?
Which of these accounting records are affected by the forms:
  Journals?
  Ledgers?
  Accounts?
  Others?
What mechanical devices are to be used in preparing, sorting, or verifying the information shown on the forms?
In what way do these forms serve as internal check or control over physical assets, or in recording liabilities?

The use of reports as a phase of internal control. As the size of a business organization increases, the number of employees will usually increase accordingly. Top management gets further and further away from the actual business operations. To maintain a certain amount of control, top management must obtain reports regularly. This internal control will be exercised first through the use of weekly or monthly and cumulative year-to-date, income and profit-and-loss statements. However, these are not sufficient. There must be accounting and statistical reports which indicate certain operating conditions and facts. Among these management will find useful reports which present data relating to—

Sales analysis by products, departments, or territories
Corresponding sales returns and allowance analyses
Merchandise-inventory turnover, supplemented by ratio of cost of sales to purchases
Cash receipts and deposits for the week or month, and sometimes daily
Cash disbursements
Analysis of accounts receivable—amounts, state of delinquency in payment
Internal auditor's reports of work done and errors discovered

However, these reports will not serve *directly* in control, but rather indirectly. For example, if the reports of the sales department indicate a relatively fixed amount of sales, but the amount of returns or allowances is increasing, management must investigate to be sure that fraud is not one of the causes. Similarly, if sales are increasing, but the cash deposits are not changing or are decreasing, prompt managerial investigation is necessary. It is only by receiving and studying reports that the danger signs of errors or fraud are

discovered by management. Therefore the use of managerial reports is an important phase of the internal control of a business.

Applied internal control systems. It has just been pointed out that a properly *coordinated system* in business is composed of organization, forms and records, operating routines, and reports. Furthermore, it must be understood that the purpose of internal control is the *prevention of errors and fraud.* To a large extent this internal control is accomplished by a system of "double checking," that is, by having one person handle the physical properties, and another the records; or, if this is not possible, by having more than one person employed in handling and recording each business transaction, thus devising a system of "checking." Both these principles must be remembered in studying the descriptions and illustrations of the systems for the most common types of business transactions:

1. A coordinated system
2. Segregation of work so that more than one person is involved in each business transaction.

The most common types of business transactions or items which will be described and illustrated to emphasize the internal control procedure will refer to

Inventories
Expenses
Payrolls
Cash
Special assets

3. *Internal control of inventories*

Inventories may be variously classified. The nature of the inventory determines the departments affected by it. For example, for a trading concern, there would be *merchandise* inventories; for a *manufacturing* company, *raw materials, work-in-process, finished-goods,* and *supplies* inventories; and for either merchandising or manufacturing concerns, *branch-house* inventories.

The merchandise and supplies inventories of a nonmanufacturing concern (retail, wholesale, or department-store establishment) affect the following departments, whose activities tend to check each other:

Purchasing department
Receiving department
Selling and shipping departments
Accounting department: accounts payable for purchases
Accounting department: accounts receivable for sales

The nature of the internal check for the merchandise and supplies inventories for a nonindustrial enterprise varies in accordance with the size and type of business organization. It may be a small retail firm, a chain of retail outlets, a wholesaler, or a department store. However, in general, the principles of internal check are essentially the same, and the procedure might be described as follows:

Purchasing-department procedure. Where the business is too small to have a purchasing department, the owner or manager personally approves the purchase orders for merchandise to be purchased. If he is thoroughly familiar with the stock of merchandise on hand, no other information need be furnished as authority for placing the purchase order. If, however, as sometimes happens, the manager is not closely in touch with the stock of merchandise on hand, he should require some form of proof that there is a need for the merchandise before approving the purchase order. For example, a list may be prepared either of the material needed or of the material on hand. This can be checked against the merchandise actually on the shelves or in storage before the owner or manager approves the purchase order.

Some firms maintain a perpetual inventory or merchandise ledger. If this is posted up to date, it will disclose the quantity of each item of merchandise on hand and the need for ordering additional quantities.

If the business is large enough to have a purchasing department, the purchasing department places an order with a prospective seller upon receiving a properly prepared purchase request or requisition from the manager of the store or department requiring the merchandise. If it is a competitive commodity, the purchasing agent will send out requests for price quotations on the merchandise wanted before placing the order. When the vendor has been selected, the purchasing agent authorizes the placing of the order.

The important principle to remember in connection with the internal control of the merchandise inventory as it affects the purchasing department is that *nothing should be ordered unless the purchase is authorized by a responsible executive.*

Receiving-department procedure. This department is responsible for the physical handling of the merchandise ordered, when it is received. The receiving clerk is responsible for checking the quantity received. He must examine the merchandise, to be sure that it is in good condition. On the receiving report which is prepared for each shipment received, a complete description must be given indicating the shipper, method of delivery, freight or delivery charges if there are any, order number, and any other pertinent information. Since a copy of this report is usually sent with the merchandise to the stockroom and is used by the stock or inventory clerk in making his

entries on the perpetual inventory cards, if such a record is maintained, it provides for a check or reconciliation of the merchandise purchased and paid for, with the merchandise on hand in the stockroom. The principal feature to be kept in mind in connection with an internal check within the receiving department is that the receiving clerk should not have access to the purchase requisition or to the purchase-order records. This will make it absolutely necessary for the receiving clerks to count, weigh, or measure each item of merchandise, thus ensuring payment only for the quantity actually received.

Accounting-department procedure for the accounts payable. Where the business does not use a voucher system, the receiving report is sent to the accounts-payable division of the accounting department for comparison with the vendor's invoice. However, before the vendor's invoice is sent to the accounts-payable department, the purchasing agent must approve the prices thereon as being in agreement with the quoted prices. The accounts-payable division verifies all extensions and totals on the invoice, before making entries in the purchase journals. If there are any discrepancies in the quantities received as compared with the quantities ordered, or in the prices, the invoices must be held up until proper adjustments have been made.

Most firms today, however, use a voucher system, because it provides a more satisfactory method of tracing all payments made. If no discrepancies exist between the receiving report and the vendor's invoice, the invoice is approved, and the voucher therefor is prepared, entered in the voucher register, and placed in a tickler file for future payment.

The chief factor to be remembered in maintaining the internal check within the accounts-payable division of the accounting department is that no invoice should be approved for payment unless management has first made sure that the merchandise has actually been received in good condition.

Selling- and shipping-department procedure for maintaining internal control over merchandise inventories. Internal control of the purchasing activities is only half the inventory control. The merchandise must be sold, and this decreases the inventory on hand. In establishing a system of internal control for all merchandise sold, every precaution must be taken so that—

- The merchandise actually billed is the merchandise that is packed and shipped
- The proper prices are charged for the merchandise sold
- The accounting records show entries for all sales, whether for cash or on account

When listed in this fashion, it does not seem to be a very difficult task. However, it becomes much more serious and important when the following

illustrations of losses in inventory due to lack of control are considered. Each of these occurred within recent years:

In one store, because of lack of control, employees were able to ship out to friends, without ever charging them for it, a $750 Oriental rug

In another instance, a canoe was removed from the floor of a department store, without anyone's ever making a record or charge therefor

More than $50,000 worth of liquor was shipped from a warehouse, over a period of 2 years, without any entries or charges, because of lack of proper internal control

In one department store, over a period of 3 months, employees were able to remove without detection, until a physical inventory was taken, more than $20,000 worth of merchandise

And in each of these firms, management should have known better and installed proper systems to provide internal control.

For *sales on account,* all orders from customers must be recorded on a specially designed form, adapted to the type of business in which it is used. In a department store, the manifold sales book is usually employed. For wholesalers or jobbers, a more elaborate form is used. This form must be prepared whether the order is given in person to the salesman or salesclerk, or is taken over the telephone. This order must be approved by the credit department, usually by having a copy of the order signed by the department head or by the credit manager. If the sales order calls for standard merchandise usually kept on hand, a set of invoices is prepared in the billing department. The copies of these invoices would serve the various departments in a procedure which might be described as follows:

One copy of the invoice is sent to the stockroom, authorizing the release to the shipping department of the merchandise described thereon. This also serves as the basis of entries on the perpetual inventory or stock-record cards

One copy is sent to the shipping department, authorizing the packing and shipping of the merchandise. Thus it acts as a check against the merchandise received from the stockroom

A shipping report is made in the shipping department, a copy of which is sent to the billing department, thus authorizing the mailing of the original copy of the invoice to the customer. Another copy is sent to the accounting department for entry in the sales journal and the customer's ledger

Thus, there is developed a system whereby the various departments check each other, and also whereby the physical handling of the merchandise and the actual entries for the sales are segregated. This type of procedure is particularly good for wholesalers. Sometimes the firm is not large enough to segregate the stockroom and the shipping department. This organization

reduces the amount of internal check and increases the loss, theft, and error hazard. For a department store, the amounts of the individual sales are not so large, and therefore the procedure is less involved. The sales tickets are prepared at the time of the sale, but the actual wrapping of the merchandise is done by a separate group of clerks. This reduces the possibility of collusion between the sales clerks and the customers, since the packing clerks must examine the merchandise and compare the sales ticket with the price tag on the merchandise. A check list of the forms and the number of copies to be used in the internal control of merchandise bought for a merchandising type of business is given herewith:

Check-list Outline of Forms and Departments for Internal Control of Merchandise Inventory for a Merchandising Type of Business

Forms to be used	*Departments affected*
Merchandise stock cards or inventory sheets. On these cards a maximum and minimum quantity to be kept on hand is indicated. When quantity approaches the minimum the stock-control clerk prepares a purchase requisition in duplicate. If merchandise has not previously been bought, the manager of the department in which it is to be sold authorizes the preparation of the requisition.	Inventory or stock-control department.
Purchase requisitions (two copies) One copy is kept in file in stock-control department and the second is sent to the purchasing department for its action	Stock-control and purchasing departments.
Request for price quotations (two copies). One copy is kept by the purchasing department and the second is sent to each prospective vendor.	Purchasing department.
Purchase order (at least four copies). One copy is kept by purchasing department, one is sent to the vendor, one goes to the receiving department so that it may know what merchandise to expect, and one is sent to the stock control department so that it may know the merchandise has been ordered.	Purchasing, receiving, and stock-control departments.
Receiving list or report (at least three copies). One copy is kept in the receiving department, one is sent with the merchandise to the stock-control department, and one is sent to the purchasing department for comparison with the purchase order and the invoice when it is received	Receiving, stock-control, and purchasing departments.
Vendor's invoice (one copy). First sent to the purchasing department for their O.K. of the type, quantity, and price of merchandise, and then forwarded to the voucher clerk in the accounting department.	Purchasing and accounting departments.
Voucher check (one copy). Prepared in the cashier's department in the treasurer's office and sent to the vendor.	Cashier's department.

A second phase of the internal control of merchandise inventory for a merchandising type of business relates to the issuance or sale of the merchandise. A check list for this second phase follows:

Forms to be used	*Departments affected*
Sales orders. If the firm sells merchandise in large volume, these are prepared in at least four copies: one is kept by the order department, one is sent to the inventory-control department authorizing the release of merchandise to the shipping department, one is sent to the shipping department, and one goes to the accounting department so that it may prepare the customer's invoice.	Order, inventory-control, shipping, and accounting departments.
Cash sales, charge sales, and c.o.d. sales slips. If the merchandise is in smaller volume, either taken by customer or delivered to him, four copies are prepared: one goes with goods to packing and shipping department, one is sent to the inventory-control department, one goes to the accounting department, and one is kept by the salesclerk.	Sales, packing and shipping, accounting, and inventory-control departments.
Customer's invoice or monthly statement. If the sales slip is not treated as an invoice, then a separate invoice is made out at time of sale or a monthly statement is sent out. The former is prepared in the billing department: one copy goes to the accounting department for sales record, and one is mailed to the customer. The latter is prepared in the accounting department which retains one copy.	Billing and accounting departments.
Customer's credit memorandum. This is used when merchandise is returned by a customer. One copy is sent to the customer, one is sent to the accounting department, one goes to the inventory-control department for its record on the stock cards, and one is kept in the billing department where the credit memo is prepared.	Billing, accounting, and inventory-control departments.

In using both these check lists, it should be noted that the handling, the recording, and eventually the payment for merchandise are segregated so that no one person is in complete charge of all the work, preventing loss except by collusion.

Internal control of inventories for a manufacturing concern. For a manufacturing concern, the inventory control affects not only finished or salable materials, but also raw materials and supplies used in manufacturing and the work in the process of being produced. In many ways, the internal-control principles and practices are similar to those used for a trading or merchandising firm. The principles of internal check involve a system of accurate stores keeping, proper purchasing, adequate control and verification of the receipt of the material before payment, and a careful system of with-

drawing stores for use in production. A check list which may be used in examining the system of internal control of stores would involve answers to the following questions:

Stores-control Check List for a Manufacturing Concern

Is the stores keeper responsible for the raw-materials and supplies inventory investment?

Is there a perpetual inventory record of every important item carried in stock in the storeroom?

Has provision been made so that nothing but regular stock items are ordered, unless properly designated major executives have given authority for special purchases, including tools and equipment?

Are all purchase requisitions placed with the purchasing department in a uniform manner?

Are all raw materials and supplies received itemized carefully by the receiving department—that is, by stores item name and quantity—in order that no invoices may be paid unless there is a record that the materials actually were ordered and received?

Has procedure been established so that nothing will be issued from the storeroom without first having a properly prepared and authorized requisition?

Has procedure been established so that each stores item issued on the stores requisition is properly priced and accurately extended?

To set up a system of properly controlling work-in-process inventory, attention must be given to the work and records of the manufacturing department on one hand and the cost-accounting department on the other.

In the manufacturing department, the materials which make up the cost of the work in process are used, workers whose wages are part of the work in process are supervised and directed, and certain manufacturing expenses are incurred. In this department it is necessary to have a system devised so that the materials are actually received and used; so that the workers actually earn the wages charged to the cost of manufacturing; and so that the proper amount of the manufacturing expenses is charged to the work still in the process of manufacturing. A check list of the factors which must be considered in the control of the work-in-process inventories would cover the following:

Work-in-process Control Check List for the Manufacturing Department

Have all the stores requisitions prepared by the shop foreman or the planning department been charged to the work-in-process inventory account?

Have proper time tickets for charging the workers' earnings to the various items being manufactured been prepared and recorded in the work-in-process inventory accounts?

Has a charge for the manufacturing expense or overhead been made for work not yet completed?

Has the manufacturing expense charge been recorded or postponed?

Is this charge a reasonable amount considering the fact that the work is still incomplete?

The cost-accounting department is responsible for recording and summarizing the charges made in the manufacturing department. It is the function of this department, as part of the process of internal check, to compute and summarize the material requisitions, the labor-time tickets and the manufacturing-expense charges, and record these on cost-summary sheets. If the firm is using a job-order cost system, the entries are made on the job-order cost sheet; if on a departmental or continuous-process cost system, then the entries will be made on a departmental or summary cost-of-production report. In a check list of the work of this department, the following questions must be considered:

Work-in-process Control Check List for the Cost-accounting Department

Have proper job-order or process-cost-of-production summary sheets been used to summarize the work-in-process charges?

Are all entries thereon verified before being recorded, to be sure that they are in agreement with the work in the manufacturing department?

Are the entries up to date?

The third type of inventory of a manufacturing concern requiring some form of internal control is the finished goods. The objective of the internal check is to be sure that all the units completed are actually transferred to the stockroom, and that all issues are properly accounted for. The following is a series of questions which should be checked in setting up a system of internal control for finished-goods inventories.

Check List for Finished-goods Inventory Control

Have all the units completed in the factory been transferred to the stockroom?

If these units must be sent out to salesrooms or warehouses, have daily or weekly reports been made of the number of units thus shipped out?

Have the unit costs been computed and properly recorded for all units finished and received in the stockroom? Are these unit costs reasonable?

Have the proper unit costs been used in charging the shipments of finished units to salesrooms or warehouses?

Has a detailed finished-goods ledger been established and used in maintaining a quantity and value control over the finished goods on hand?

Has the perpetual finished-goods inventory been verified regularly through a physical count of quantity on hand?

Have finished-goods control accounts been set up to check on the perpetual finished-goods inventory?

Internal control of branch-house inventories. For some concerns, the amount of inventory located in various branches or warehouses is large. For these firms, the problem of internal control is important. If the branch manager is permitted to purchase merchandise for his own branch, the problem of internal control is more important and more involved than if the shipments are made from the home of the firm. Where the purchases are made by the branch managers, the internal control set up must furnish answers to the questions on the following check list:

Check List for Branch-house Inventory Control

Are copies of all purchase orders sent to the home office?

Is a copy of the receiving report on all merchandise thus ordered sent to the home office?

Does the home office make careful comparisons of the orders and the receiving reports?

Does the home office check periodically the physical and the book inventory records of the branch?

Are the sales tickets or invoices made for each shipment of the merchandise?

Does the home office receive copies of these sales slips, and reconcile the shipments with the inventory on hand?

Does the branch maintain a perpetual inventory record for all merchandise received and shipped? Is this a quantity inventory (all that is necessary, in most instances), or a quantity-and-price inventory?

Merchandise frauds that might be eliminated by internal control. Although the purpose of internal control is primarily the prevention of fraud, it should not be assumed that that is the sole purpose of this managerial device. Internal control also serves the purpose of detecting and thereby eliminating unintentional errors and mistakes. The errors can be forgiven if they are not repeated; the frauds are never forgiven and must be detected.

The following is a list of the frauds (these relate to merchandise and stock) that may be eliminated by a good system of *internal control*:

Frauds caused by lack of investigation of the character references and experience history of employees. Both these are required by most bonding companies before insuring the honesty and integrity of employees. (One large leather-goods dealer on Madison Avenue, New York, hired a bookkeeper from Hartford, Conn., without investigating her past record. In one year she "milked" the company of a total of $30,000. Had the employer tried to have her bonded, he would have discovered that she had had a similar experience in her last position. The owner committed suicide)

Frauds arising from—

Manipulating the accounts. This is possible only when one person is

given sole charge of all records. It results in embezzlement and fraudulent conversion of all types of assets

Having "fake" purchases entered on the books, and when paid having the cash or part of it returned to the employees involved

Having "overstated" invoices for purchases approved by certain employees, and when the invoice is paid, having the employee receive his "kickback" from the vendor

Having merchandise received, counted, checked, and *acknowledged,* and then immediately taken back by the shipper or his truckman

Having inferior quality material received, and paid for at prices of higher quality material, and then having the resultant "kickback" to employees

Having material recorded on the receiving reports, even though it has never been received

Having incorrect or overstated freight bills paid for from petty cash

Having fictitious inventory records kept (McKesson & Robbins case)

Making payments for merchandise returned, even though it has never been received (R. H. Macy & Co., 1949, $60,000 in electrical goods department)

Employee thefts from warehouses

Shipping merchandise without charging or recording it to any customer's account

Theft of manufactured goods before they have been placed in the stockroom

Conversion of stock by branch managers

4. Internal control of expenses

Classification of business expenses. For most business concerns, the business expenses may be grouped under certain headings. It is necessary that the expenses be properly grouped so that they may be controlled. The classification of expenses for a manufacturing concern would be—

Manufacturing expenses
Selling expenses
Administrative expenses
Financial management expenses

For a large department store, the expenses would be grouped as follows:

Direct selling expenses
Advertising and sales-promotion expenses
Buying expenses
Stock-control expenses, stores and warehousing
Delivery expenses
Administrative expenses

Credit and collection expenses
Financial expenses

Internal control of expenses is established in several ways: (1) by the use of budgets; (2) by the proper record of actual expenses incurred, so that comparisons with the budgets will establish a reliable control; (3) by the control of all payments for expenses to be sure that they are genuine, not inflated; and (4) by attempts to reduce or to keep down the amount of each expense incurred. To understand how each of these is achieved, the procedures under each type of expenses is outlined.

Internal check for manufacturing expenses. One of the first methods of setting up internal check or control of expenses in a factory is the preparation by each department of a budget of its manufacturing expenses. The purpose of this budget is (1) to focus the attention of each department on the estimated amount of the expenses for that department, and (2) to make some comparison of the actual expenses with the estimated. The control is established in the comparison. By making each department estimate its expenses and then checking on each department's performance by comparison with the actual, a definite control is established because the department must account for the variation or difference. The most effective control is established by means of monthly comparisons of estimated expenses with the actual expenses. To illustrate this control, see the actual and the budgeted manufacturing expenses of a department below.

CONTROLLABLE EXPENSE REPORT
Drill Press Department
90% Operating Capacity

For the Month of March, 19___

C. J. Norman Foreman

Expense	Actual This Month	Budget This Month	Difference for Month Between Actual & Budget	Actual Year to Date	Budget Year to Date
Light & Power ..	$150.00	$160.00	−$10.00	$550.00	$610.00
Indirect Labor ..	210.00	230.00	− 20.00	700.00	600.00
Supplies	85.00	100.00	− 15.00	200.00	240.00
Repairs	90.00	100.00	− 10.00	300.00	160.00
Spoilage	50.00	70.00	− 20.00	220.00	150.00
Total	$585.00	$660.00	−$75.00	$1,970 00	$1,760.00

The second method of setting up a control of the expenses of a manufacturing concern is a system which will result in a proper record of actual expenses incurred. For the manufacturing department, this is achieved by the following suggested procedures:

Toolroom expenses: All small tools such as chisels, hammers, etc., not in constant use should be kept in a central toolroom. When a tool is issued, the workman must leave a metal check with his number printed thereon, which is substituted for the tool until it is returned to the toolroom. For tools in constant use, the workman is given one issue, and before additional issues are made, the worn-out tools must be returned. A new issue for a worn-out tool is usually approved by the departmental foreman

Freight and delivery charges: These should usually be charged to the account for which incurred. Copies of incoming freight bills should be attached to the invoices for supplies for which incurred

Shop and factory supplies: These are controlled through the inventory records and are issued only upon properly approved requisitions

Indirect-labor charges: All employees placed in this category should be identified by number, and their presence in the factory verified by time-clock-card records, and a foreman

Expenses involving cash payments: All such expenses should be approved by the superintendent or some departmental executive. Invoices for such payments must be given by the superintendent to the voucher payments clerk

For the selling expenses, it is necessary to set up an internal control as follows:

Salesmen's salaries must be approved by the sales manager before being forwarded to the payroll department

Salesmen's commissions must be computed and verified from the sales records

Traveling expenses: To avoid too much padding of this, many firms either allow a flat rate or a maximum amount for expenses each day or week. It is not expected that this item be controlled too minutely or it will destroy the morale of the employees. However, if no flat rate or maximum limit is set on the expenses, some control can be established by comparing the amounts submitted as charges each week with those of the previous weeks

Subscriptions to trade publications and *dues to trade and professional organizations.* Although these are legitimate business expenses, they should be scrutinized or approved by the sales manager or controller before the voucher is prepared for them. In many concerns definite rules are laid down as to what organizations may be paid for by the

firm, and the procedure to be followed in joining and approving the payment of dues therefor

Office expenses. Certain of these expenses also require a method of internal control. Among these would be—

Telephone and telegraph expenses. Many firms place little or no restriction on the local calls. If it is desired to control these, the operator may keep periodic checks on departmental calls, but since firms for the most part use the automatic dial switchboard for local calls, this control is not only unnecessary but quite unreasonable. For long-distance calls, control seems more important. In many concerns, all long-distance calls are recorded by the switchboard operator by departments. Monthly, these departmental charges are submitted to the departmental head for his approval. He must indicate that each call was a "business" and not a "personal" call. The psychological effect seems desirable, especially in large organizations. For example, in a large bank, there are 4,500 employees in the main office. Telephone and telegraph expenses, unless controlled, may become a large item

Postage and stamped envelopes. This expense item should receive only minor or indirect control. Although the cost may loom large because of the possibility of theft, the cost of the control may be larger than the savings effected. Therefore, control may best be established by using metered mail and having all other postage and stamped envelopes issued by the office manager

Financial and other expenses. A third group of expenses requiring control appear under this heading. These expenses and the method of their control are shown in the accompanying table.

Control of Financial and Other Expenses

Expenses	*Method of control*
Customers' accounts charged off	All credit sales above a certain amount should be approved by the credit manager.
	No customers' accounts should be written off until all efforts, including legal, have been used to effect collection.
	All actual accounting entries made to write off the uncollectible customers' accounts must be made only upon written instructions from the treasurer.
Sales discounts	Rates must be approved by the treasurer in cooperation with the sales manager.
	Periodic reviews or test checks should be made by the internal-auditing department to be sure the amounts and the realization of the discounts are correct and not used to cover up the conversion of cash by employees.

Expenses	*Method of control*
Bank interest and discount	All loans or discounting of customers' notes must be authorized in writing by the treasurer. Payment of loans and notes payable must be approved by the treasurer. All interest and discount computations must be verified.

Expense frauds that can be eliminated by internal control. A good system of internal control can eliminate the following expense frauds:

Paying unreasonable amounts for traveling expenses
"Faking" factory expenses paid from the petty-cash fund or by check
"Padding" factory payrolls for indirect factory workers who are not actually employed or are treated as part-time employees
Improper or incorrect amounts for salesmen's salaries or salesmen's commissions
Computing salesmen's commissions on sales which were not made or on which no commissions are to be paid
Charging personal telephone and telegraph expenses to the business firm
Theft of postage stamps (in one business concern during a national radio campaign, two employees were caught stealing $500 worth of stamps a week—caught after 10 weeks of success)
"Fake" postage payments—stamps not actually bought
Recording sales discounts on past-due accounts and pocketing the difference
Recording interest charges which were not incurred
Recording payments of charges not actually incurred, for freight and delivery

5. *Internal control of payrolls*

One important phase of the entire problem of internal control affects payrolls. Although payrolls may be divided into types such as factory payrolls, office payrolls, sales payrolls, administrative payrolls, and part-time-employee payrolls, the basic problems are essentially the same for each type. The departments in a business organization affected in payroll preparation and control are listed below, together with the reasons for their importance in the matter of internal control:

Departments Affected in Internal Control for Payrolls

Department	*Nature and importance of department's work*
Timekeeping	Because of the requirements of the wages and hours laws, the work of this department has taken on added importance. Unless timekeeping is carefully controlled, workers who are paid on an hourly basis may be paid for work not done. Control of the work of this department should prevent payment of wages to persons not even employed.

Department	*Nature and importance of department's work*
Payroll	Checks or verifies the work of the timekeeping department. Computes and checks accuracy of work of timekeeping department, and computes earnings and payroll-tax deductions of workers. Controls must be set up to ensure that the workman actually receives the amount of money shown as earnings on the records.
Accounting	Segregated into the vouchers-payable division and the cash-payments division. Controls cost and managerial analyses of payrolls. Maintains income-tax records for employee earnings.

How a system of internal control is set up for the timekeeping department. The following table gives a comprehensive list of the procedures used to establish a system of internal control so that the workers will not be fraudulently overpaid, and so that nonexisting employees will not be added to the payroll and their earnings taken by other employees.

Procedure followed	*Internal control established*
1. Selection of efficient time-recording devices, which include individual time-clock cards, dial time recorders, continental time clocks.	Avoids crowding at checking-in-and-out gates. Sufficient number permits more careful supervision of time-clock punching.
2. Each factory worker is given an identification number and badge.	Faciliates supervision at checking-in-and-out gates. Serves as identification within the factory when presence of workers is verified.
3. Each morning and each afternoon, a time clerk must check the presence of each worker in the factory and record the necessary information in a time book.	This prevents one worker from punching the time card for another who may be absent. It also verifies the departmental location of each worker. This is important if different departments have varying wage rates. It acts as a check against time cards or time sheets.
4. The timekeeping department must be sure that there are enough time clocks, located so that workers will be admitted with a minimum of delay. This department must also provide watchmen at each gate.	Prevents errors in handing out cards. No one should be able to punch more than one card.
5. It may be desirable to have the office workers sign a time book, thus keeping a record which may be used in the event that any questions are raised under the wages and hours laws.	Provides written record of time actually worked. Psychologically encourages workers to be on time and not leave early.

Internal control through the payroll department. One of the simplest methods of defrauding a firm is through the payroll. Falsifying the time records

and later, through collusion, improper payroll records may cost a firm thousands of dollars. How then may a form of internal control be set up? An outline of the procedure which may be followed to create this internal check is listed:

Internal-check Procedure for the Payroll Department

Procedure to be followed	*Internal control established*
1. Comparison of time tickets received daily from each worker with the timekeeper's time records and with time-clock records.	Check and verification of each report to assure reliability of information and proof of worker's presence.
2. Verification of earnings of each worker.	Double check on accuracy of computations.
3. Checking and approval of payroll sheet by paymaster.	Fixes responsibility for payroll of factory workers.
4. Preparation of payroll analysis—bills and coins required for payroll.	Facilitates the preparation of pay envelopes, and acts as a check on accuracy of the payroll.
5. Preparation of receipts of payment to be turned in by worker receiving payment.	Usually a stub attached to the envelope must be signed and turned in upon receiving payroll. It is one of the best forms of internal check unless there is collusion between worker and payroll department.
6. Distribution of pay envelopes by persons other than those responsible for preparation of the payroll	A form of internal check by having the accounting record and the physical handling of the cash segregated.
7. Use of bank checks wherever possible in making payment to workers. This is particularly true of office workers, and should be extended to the other workers if possible.	A check is a better form of receipt of payment than the actual cash The indorsement offers some chance for tracing payment, particularly if cashing of checks is made through the bank offices rather than a check-cashing firm or some local bar or store.
8. All increases in pay rates must be in writing by a special officer.	This avoids inflating payrolls.

Internal control of payrolls through the accounting department. Internal control of payrolls is achieved in part through the segregation of the preparation of the payrolls, the distribution of the cash or checks, and the recording of the payrolls. It is with the third of these, namely, recording the payrolls, that some degree of internal control is established. The accounting phase of the payroll work is composed of (1) preparation of payroll sheets from time cards, (2) computation of tax and other deductions, (3) preparation of voucher for total payroll, (4) recording of the voucher in the voucher

register, and of the check in the check register, (5) posting to the employees' earnings records, and (6) annual preparation of the income-tax reports of earnings and deductions, whether this be on Form W-2 or Form 1099. Erroneous reports will quickly come to light when the employee complains or the governmental income-tax department checks on the information shown on tax returns. To outline the internal control achieved in the matter of payrolls through the *accounting department,* the following schedule is given:

Internal Control of Payrolls through the Accounting Department

Procedure used in the accounting department	*Internal control effected*
1. Receipt in the payroll department from the employment department of employment notice and rate-of-pay authorization.	Prevents anyone being put on payroll without official notice. Approves the rate of pay.
2 Withholding-tax deduction form is sent to payroll department.	Authorizes withholding-tax status.
3 Other deductions authorized on special forms sent to payroll department.	Puts in writing and fixes responsibility for all other deductions.
4. Compares payroll sheets with time-clock cards or records.	A form of internal check to assure presence of workers.
5. Compares time-clock cards with time-keeper's morning and afternoon check of presence of workers.	Additional check on presence of workers.
6. Makes analysis of denominations to be used in preparing payroll.	Ensures reliable filling of pay envelopes.
7. Has pay envelopes prepared and filled by others than those who prepare time records.	Segregation of payroll functions.
8. If possible have workers paid by checks.	Easier to verify payment through indorsement.
9. Whether paid by cash or by check some form of receipt must be obtained. Pay envelope stubs may be used or a detailed statement on face of check.	This acts as receipt of payment.
10. Occasional payoffs to be made by auditors or others in rotation of personnel, especially if unannounced.	This provides a form of internal check and has a psychological effect on employees responsible for preparation and distribution of payrolls.

Payroll frauds that can be eliminated by internal control. A good system of internal control can eliminate the following payroll frauds:

Paying wages for nonexistent employees placed on payroll by dishonest managers or employees, who pocket the money
Having employees "kick back" part of the wages which have been paid to them but which have not been earned by them
Overpaying employees for time not actually worked
Errors in computing payrolls so that workers get more than their earnings
Pocketing unauthorized deductions from employees' pay
Deducting more than the necessary amount of taxes from the payroll and pocketing the difference
Overstating the tax deductions in the records and pocketing the differences

6. *Internal control of cash*

The subject of internal control of cash must be subdivided into two distinct yet closely related phases—namely, (1) cash receipts and (2) cash payments. Of all the internal checks provided in a business organization, that for cash is most important because of the temptation to take cash and the ease with which it might be taken without immediate discovery of its loss. A good psychological effect to discourage unauthorized taking of cash is established when the employees know that a reliable system of internal control and check is in operation.

Internal control for cash receipts. *From cash sales and c.o.d. sales.* The basic principle involved in this form of internal control is the *segregation of the handling of the goods from the handling of the money.* The steps to be followed in achieving this might be tabulated as follows:

Internal Control for Cash Receipts from Cash and C.o.d. Sales

Selling department	*Cashier's department*	*Bookkeeping and accounting departments*
All cash sales must be recorded on prenumbered sales slips.	Cash with copy of slip sent to central cashier's department. Deposit slip is prepared daily and a copy is sent to the bookkeeper.	Total of cash-sales slips received from cashier's department must be compared with bank deposits made. If in agreement, entries are made in cash-receipts journal.
If sales slips are not in use, then all cash sales must be recorded on cash-register machine.	If a central cashier is in charge of the cash-register machine, a formal cash-register receipt must be given to each customer.	Again, cash in the register must be checked against totals recorded and locked in machine totalizer, and then compared with bank deposits before

Selling department	*Cashier's department*	*Bookkeeping and accounting departments*
		being entered in cash-receipts journal. Definite procedure should be established as to who is to make bank deposits and when they are to be made.
On c.o.d. sales, special sales slips are prepared, one copy going to the cashier's department and the other to the shipping department. The shipping department prepares the drivers' daily c o.d. delivery report from the c.o.d. sales slips. Daily, either the cash or the merchandise must be checked. Cash is delivered to the cashier's department where it is checked against copies of c o.d. sales slips.	Daily cash turned in by drivers for c.o.d. sales is checked against c.o.d. sales slips or report from selling department. Deposit slip is prepared regularly and a copy of it is sent to bookkeeping or accounting department. Where feasible, rotation of personnel in the cashier's department and the accounting department may be a means of internal check.	Compares deposit slip with c.o.d. sales reported before entering in cash-receipts journal. It may be that this comparison is made simultaneously with that of the cash sales

From customers making on-account payments. The procedure followed varies because many of the payments are received in the mails. If the customers pay their accounts in cash and in person, a formal receipt must be given to each customer, the duplicate of which must be so controlled as to prevent alteration or substitution. This is done by having prenumbered receipts, and using special carbon paper and special paper to discourage erasures or alterations.

The procedure to follow where most payments are received in the mails should cover the following:

Where possible, mail-opening operations should be performed by two or more individuals, one opening, and one counting and listing the cash receipts

Persons handling this kind of work should be bonded, if the firm does not have a blanket bond covering all employees

Listing of cash, money orders, checks, etc., received should be on a duplicate record, one copy with cash being sent to the cashier's department, and the duplicate to the bookkeeping and accounting department. On this listing should be shown: date of receipt, name of sender, amount, and nature of receipt such as cash, money order, check

The bookkeeping and accounting department uses its copy of the list as the source of entries in the cash-receipts journal and for posting to the cus-

tomers' ledger. It is also used as a means of checking on the deposits made by the cashier

Internal control for cash disbursements. Internal control for cash disbursements is just as important as that for cash receipts. Unauthorized conversion of cash is just as possible through false payments or through recording the incorrect amounts as through the immediate conversion of cash receipts before they are actually recorded. Cash disbursements for payrolls have been discussed previously. Internal control for the disbursements for other transactions may be established as follows:

All purchases of equipment or inventory, as well as the payroll previously indicated, must be attested to by a responsible executive before the accounting department uses the invoices, or bills, or payrolls in the preparation of the voucher

A good system of internal control of cash payments presupposes the use of a voucher system, and the making of all payments except petty cash by check

In addition to the proper approval of the purchase or payroll, a definite routine of making the payments must be followed. This approval should not be given by the same person who authorized the purchase originally

Where possible, all checks should be mailed to the creditor named in the payment

All paid invoices and canceled checks must be kept for future reference

Use of cash reconciliation of bank balance monthly as means of internal check. By having this made either by the external auditors, or by someone in the controller's office, it is possible to establish some degree of internal control over cash and confirm the accuracy of the balances in the cash records

Cash frauds that can be eliminated by internal control. A good system of internal control can eliminate the following cash frauds:

"Lapping" accounts. (This is discussed separately on page 625)

"Juggling" accounts receivable by not crediting a customer for a payment, and pocketing the amount involved

"Fake" cash payments for sales returns and allowances

Incorrect or false payments of freight and cartage bills

Payment of wages to nonexistent employees

Overpayment of wages to employees because of improper calculations, whether intentional or not

Payment to nonexistent creditors for merchandise never received

Payment to existing creditors for merchandise never received

Payment to creditors for incorrect invoices

Payment to creditors for full amount of invoice, although a purchase discount should have been taken

Theft of cash received by mail from customers
Theft of cash received by mail for cash purchases
Paying for false petty-cash expenditures
Discounting the firm's notes without recording cash received
Selling capital stock without making any entries
Inflating payments for various expenses
Falsifying various cash expenditures

7. *Internal control of special assets*

The procedures described above summarize the internal control methods set up by many firms to promote accuracy and honesty in the accounting records and in the handling of the physical assets and liabilities. There are, however, a few special problems which require attention if this outline of internal control is to be complete.

In some firms, embezzlement of cash received from customers covered up by a practice known as "lapping"—converting cash received from a customer to personal use, and covering this up later by crediting the account of the customer by using the cash received later from another customer. This is a continuous process and while it may ultimately be discovered, it has been known to extend over a long period of time. For example, in one large building-and-loan association, by manipulating 17 depositors' accounts in this manner, a clerk was able to cover up more than $100,000 of illegally converted cash. As a precaution in this matter, internal controls may be set up as follows:

In a merchandising business, have one person record the sales charges to the customers' accounts, and another the credits for cash received. The cash should be handled by the cashier but the entries by the bookkeeping department. This has already been indicated

In banks, duplicate deposit slips have been widely used, with the handling of cash and depositors' accounts segregated. More recently, recording commercial deposits by means of locked machines in which control or audit sheets are used, together with a printed receipt of deposit given the depositor, has proved effective

In smaller business firms which cannot afford the subdivision of activities indicated above, the use of an accounts-receivable ledger control account, and the issuance of detailed monthly statements to all customers, acts as a means of safeguarding cash received from customers and reduces the possibility of "lapping"

In some firms it is necessary to prevent the discounting of *customers' notes* to obtain unrecorded cash. To achieve this, the handling of the notes should be centered in the treasurer's office, with a memorandum of the receipt of all notes being sent to the customers' ledger clerk for his entry. Thus any

internal or external audit must reveal the presence of the notes or the cash received therefor.

Internal checks for *securities owned* must be carefully set up. This is especially true if they are in the nature of temporary investments. A detailed procedure for internal control of securities owned might include the following:

- Authority to purchase any securities must be set forth in the minutes of the board of directors
- The voucher prepared in payment of these securities must clearly indicate the reference to the minutes of the board of directors under which it is authorized
- Records should be set up counterchecking each other: in the accounting department, a posting to the securities account from the voucher register; in the treasurer's office, a record of securities owned
- Securities should be deposited in the firm's safe-deposit box kept in a bank. If possible, access to the box should always require the presence of two executives of the firm, whose names should be recorded in the minutes of the board of directors, a copy of which has been transmitted to the bank's safe-deposit staff

8. *Limitations of internal-control procedures*

In the foregoing pages, the procedures of internal control have been specifically outlined. It should be remembered that even the best systems are ineffectual against a clever person who through the authority of his position can cover up his frauds or misappropriations. This was illustrated in the now famous McKesson & Robbins case. Furthermore, it should be remembered that the large majority of employees are by nature honest, and only when a loose or careless system of control is in force does temptation exert its greatest influence, starting with a small, insignificant, and undetected conversion, and later developing into a large, irreplaceable, and almost obvious fraud or loss. It must also be emphasized that most of these losses or frauds are discovered by mere chance or accident, not by any foolproof system of internal control. Because of this, many firms rely upon insurance and bonding procedures to protect them from such losses. The insurance and bonding companies usually examine the nature of internal controls and external audits so that changes may be made to reduce the possibility of loss. This in itself is desirable, though it may be more expensive than some business firms feel they can pay. Therefore, the best suggestion that can be offered to the businessman is that a reasonably sound system of internal control will reduce to a minimum, by means of its psychological effect on the employees, the possibility of the honest employees (who constitute the majority) intentionally converting the firm's property to their own illegal use.

Section 18

HOW TO CONTROL BUSINESS PAPER WORK

BY

GEORGE S. VANDERWENDE

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HOW TO CONTROL BUSINESS PAPER WORK

1. Convert your paper work to working papers

Why do forms need to be controlled?

Forms are the beginning of records. Records are the beginning of files. Files cost money and take up space. Space means more money added to the cost of doing business. Control your forms and you control costs. What's more, you make a start toward converting paper work to working papers

Forms take clerical work to fill in, handle, process, and file. Clerical costs are a real expense in business. Simplify your office work through forms control, and you take another stride toward the conversion of paper work to working papers

Forms help to shape customer attitudes. Good customer relations--including public acceptance of your business practices—is good business. Advertise your good business methods through good easy-to-use forms, and you complete the jump from paper work to working papers

Conversion from paper work to working papers means lower cost; faster, simpler service to your customers; more repeat business; better profits

How, you may ask, do I go about putting forms control to work? What if my business is a small one—perhaps just getting started? Or perhaps a good-sized concern using many kinds of forms? How does the problem differ?

A form is a form, whether the company using it is a one-man concern or a giant corporation. Certain principles apply in any event. For example, no matter how small or large the organization, some responsible person or group needs to give careful study to each and every form that is to be used. As businesses grow, so do the needs for forms and the number of new ones. If you don't start early to control your forms, the forms will control you. Business forms should not be permitted to grow like Topsy, if they are to be real working papers.

The basic elements of forms design and arrangement, and the analysis of the working procedures to which the forms relate, remain essentially the same in a firm of any size. So do the requirements for readability and clarity

in the captions and instructions included in forms. So also the need to avoid "overlapping" forms and uneconomical practices in the purchasing or printing, as well as in the storage and distribution.

It is chiefly in organizing and assigning responsibility to meet those needs that the forms control problem grows more complex in the larger enterprise. So, while the forms problem may be well handled as a part-time chore of the proprietor himself in a small concern, a full-scale forms control program with clearly defined divisions of responsibility among many people may be necessary in the large firm.

In order to avoid unnecessary repetition, the subject is dealt with here in a manner suitable to small or large business. The various topics are organized and identified, however, so that the small-business operator can readily identify the parts that are most pertinent to his problem. If your business is one that uses a large variety or a large quantity of forms, you will probably be concerned with every topic. If your business is a small one, using only a few forms, you may want to skip the topics that deal with organizing a forms control program, and concentrate on those that deal with forms themselves and their procedural analysis. To simplify selective reading, the outline below provides a handy check list and reference guide to the main body of the chapter:

Steps in Establishing and Maintaining a Forms Control Program

1. *Establishing the program.* The success of a forms control program is largely dependent upon its effectiveness at the start. For an effective program the following steps should be undertaken before any attempt is made to operate the program:

a. Get top-management support. The program should not be undertaken without topside support. To ensure cooperation of all parts of the organization, the program should be sponsored by the president, a vice-president, the comptroller, or some similar official (see page 639).

b. Assign responsibility for operation of program. Control over the program should be vested in an office operating across departmental lines, preferably in a company-wide methods-and-procedures group—never in a purchasing department (see page 636).

c. Define organizational scope of program. A decision should be made as to whether the program will be limited to the parent organization or home office or will be extended to other units such as branches and subsidiaries (see page 640).

d. Recruit qualified personnel. Results of the program will depend upon careful selection of personnel with experience in forms control and methods

work and with a knowledge of printing production. The staff should include personnel qualified in forms analysis, forms design, drafting, varityping, and filing. The number needed depends on the size of the operation. Forms control is a technical process and should not be assigned to pensioners, clerks, misfits, and inexperienced personnel (see page 637).

e. Announce establishment of program. An official statement should announce the establishment of the program, review its purpose and aims, indicate the organizational unit responsible for its operation, and request full cooperation (see page 640).

f. Collect samples of all forms, together with usage and cost data. All parts of the organization, including stockrooms, should be asked to furnish a minimum of two samples of every form, regardless of how produced, plus estimated annual usage and cost during the past year (see page 641).

g. Establish numeric and functional files. One set of samples should be filed in folders by function. Another set should be filed numerically, a separate folder for each form number (see page 643).

h. Establish file of usage and cost data. The annual usage and cost should be entered on a separate card for each form (see page 644).

i. Establish standards of design and construction, including form numbering system. Standards for type, rules, margins, sizes, paper stock, finishing operations, and methods of reproduction should be established, and a form numbering system should be developed (see page 644).

j. Coordinate program with other operations. An adequate inventory control of stock forms, realistic minimum stock balances, a procedure for prompt issuance of low-stock notices, and a schedule for requisitioning to equalize stockroom work load should be developed. Arrangements should also be made to develop a schedule for the procurement of printing on routine and emergency basis, and to provide for the purchase office or the printing plant to refer to the forms control office any suggestions for changes in specifications and any requisitions received direct from ordering departments. A determination should be made of the commercial printers best qualified to produce forms of various types and quantities on the most economical basis (see page 666).

2. *Operating the program.* Once the machinery described above has been established, the following steps can be taken to operate the program:

a. Review all forms requested. A forms contact representative should review each form requested to determine necessity, to consolidate like or similar forms, and to determine adherence to standards. Subsequent review of these points should be made by the central forms control office if necessary.

b. Apply standards to forms. Forms control representatives should apply approved standards currently to new forms and to revisions and reprints of existing forms. The central forms control office should apply such standards to the forms it handles currently if the work has not been done previously. Either the forms control representatives or the central forms control office, or both, should also undertake as time permits the application of standards to groups of forms by function or department.

c. Prepare specifications for reproduction of forms standardized. For each form standardized, printing or reproduction specifications should be prepared to include form number and title, method of reproduction, finished size, number of pages, number of sides, margins, paper and other materials, construction, special operations such as numbering and perforating, padding if any, and wrapping and labeling.

d. Maintain forms control files. The numeric and functional files of forms should be maintained on a current basis by adding new forms, replacing revised forms, and eliminating superseded and obsolete forms. The cost data files should be maintained on a current basis. This is achieved by entering immediately the quantity ordered and, as soon as available, the costs for each order.

e. Issue list or catalogue of forms. Periodically a list of forms should be issued, with the forms listed in (1) numeric sequence, (2) alphabetic sequence by title, and (3) functional sequence. If the list is included in a catalogue, a reproduction of each form should be shown on a separate sheet together with pertinent information.

f. Review forms periodically for currency. The functional and numeric forms files should be reviewed periodically to eliminate deadwood. Forms not ordered in a specified period should be referred to their sponsor to determine whether they are obsolete.

3. *What will it cost?* No fixed figure of cost can be stated. The size of your business, the number of forms used, the number of clerical, sales, or shop employees required to fill out forms as part of their day's activity, the type of business you operate—all have a direct bearing on the extent to which you may invest in savings through better forms. Commercial forms manufacturers having recognized forms-design representatives can offer smaller companies excellent means of savings. The more progressive printers are also available for advice and assistance. The larger the demands because of the number, type, or uniqueness of the forms or because of business problems, the greater the need for personnel on your own staff or the use of consulting forms engineers. The cost of printing forms is not the starting point of savings, although reductions in printing costs are possible in a forms control program.

2. *Objectives of forms control*

It takes a lot of forms to keep the wheels of industry turning. In industry as in government, it is a rare transaction or procedure which does not require the use of at least one form.

It has been estimated that in industry for each dollar spent in the purchase of printed forms, from $10 to $100 is spent in the clerical processes accompanying the use of the forms, not to mention the cost of the total procedures in which the forms play a part, or the cost of space and equipment required in the filing of them, or the storage space required to house the supplies of blank forms.

Thus, a question often more pertinent than the merits of the form itself is the necessity for or the efficiency of the procedure which requires its use. This section accordingly stresses control over the substance, design, and utilization of forms as a means of uncovering and solving problems of procedure.

The step-by-step techniques for devising forms are not treated fully. The problems of developing a forms control program are treated in some detail, the accent being on forms work as a single gear, meshing smoothly with all the other gears in the management mechanism to increase the efficiency of the whole machine.

The forms control function. From the procedural viewpoint, forms are something more than their dictionary definition as "printed or typed documents with blank spaces for the insertion of . . . information." They are pieces of paper predesigned to facilitate work. More specifically, they are devices by which management seeks *uniformity* and *simplicity* in the recording, transmitting, reporting, and data-processing elements of a company's operations.

A working definition. From the same point of view, then, *forms control* may be thought of as the management function which gives four broad assurances:

1. The assurance that unneeded forms do not exist
2. The assurance that needed forms are so designed that they actually accomplish the uniformity and simplicity specified in their definition
3. The assurance that forms are produced and distributed economically
4. The assurance that old forms are periodically reviewed, and proposals for new or revised forms studied to identify and solve problems of organization and procedure

Objectives. While accomplishing the elimination, consolidation, and simplification of forms, *forms control* should contribute to the same result in procedures and should help to improve relations between company activities

and with the public if activities are in this direction. Three broad objectives may be separately recognized, though they are not separately achieved in practice.

1. *Savings through better procedures and work methods.* Since forms are used for performing work they frequently dictate the way work is laid out. By their very design, forms often determine how work flows through a department, an office, or a number of offices. Well-designed forms should help increase production, promote accuracy, and develop smooth work flow, with a minimum of duplication, backtracking, and overlapping. When a form is studied in the light of related forms and procedures, possibilities arise for improvement that go beyond the specific actions of entering information on the form or taking data from it in some prescribed sequence. The very nature of the information called for by a form may tell much about work load, work flow, and work content that is far more significant than the immediate act of making entries.

2. *Savings through standardization and printing.* Standards of design, paper stock, printing, or duplicating, along with improved methods of estimating, stocking, controlling inventory, and distributing, offer quick and obvious returns. Not only do analyzing forms and applying standards usually result in lower paper and printing costs for a given number of forms, but, also, by revealing possibilities for eliminating or combining forms, these steps should help to cut down the number of different forms needed and the accompanying stocking problems.

3. *Better service and public relations.* Combination and simplification, better work methods, greater accuracy, and faster production all have an important bearing on getting the work done. An adequate forms control program, besides improving service internally, should assure that forms required for use outside company activities reflect the logic, simplicity, and clarity of purpose that are necessary to outside acceptance and cooperation.

Scope. Coming properly under control are not only the major activity forms of an organization but also many such incidental working tools as tabulating sheets, tally cards, route slips, transmittal forms, telephone memorandums, tags, checks, and labels.

Characteristics—not names—determine coverage. The fact that a printed instrument may be called something other than a form—such as a contract, a lease, or a form letter—does not exclude it from forms control.

Form letters seem to be especially subject to misunderstanding in this connection. While the presence of the word "form" in the term "form letter" does not make it so, the fact is that many form letters are also forms. Quite a few would serve their purpose more efficiently if converted completely

from letter style to regular form layout, for there is little to be gained by farfetched attempts to preserve an illusion of the personal letter in obviously routine work papers.

Regardless of what it may be called, if a form is used in quantity and is primarily a working paper requiring significant entries on it, transcriptions from it, or procedural handling of it for either internal or external company use, it should be subject to forms control. It probably will benefit by the application of forms design standards and at the same time throw light on procedural problems.

A seven-point forms-control program. While all companies need some type of forms control, and while certain basic elements are common to every forms control program, questions of organizing such a program vary as the programs of individual companies vary. The number of forms in use, although an important item of consideration, should not be the sole criterion of determination.

Elements of the program. Primarily forms control should supplement the practical knowledge of line operations with the objective approach and questioning attitude of industrial analysis and the technical know-how of forms design, production, and distribution. These several elements may be translated into the following essential activities in what might be called a seven-point program:

1. Recording or registering the form
2. Analyzing its purpose, content, and related procedures
3. Applying design standards
4. Assigning identification
5. Determining specifications for reproducing the form
6. Developing specifications for storing and distributing the supply produced
7. Evaluating the control program itself

Whatever the specific assignment of responsibilities, these seven points should work out somewhat as below.

Registration. Each request for a new or reprint form is channeled to a central point to be recorded and assigned for analysis. Essential data on numbering and identification, previous or proposed form revisions, volume, use, and production are available at this registration point, along with copies of all the forms used by the company.

Analysis, purpose, content, procedures. Every request for a new or reprint form is analyzed, its necessity questioned. The purpose and content of the form are evaluated, its effect upon work methods and procedures studied. By close cooperation between operating people and industrial engineers, new forms and procedures are developed or old ones improved. As procedural

and organizational problems going beyond forms usage are revealed, they are scheduled for further attention.

Design, standardization. Staff with special knowledge of forms design assists in laying out the form. Content is transformed into items which are spaced and arranged to accommodate desired entries, meet the needs of the writing method to be used, mesh properly with procedures, and assure readability. Determination of size, typography, color, and paper stock is made accordingly.

Identification. Title, number, approval date (and expiration date, if any) are assigned as positive identification, linking the form to its function, operating unit or program, and showing that the form has been authorized for use. Forms can be identified as those that must be retained and those of short or temporary life.

Production specification, printing, duplicating, binding. Efficient and economical production methods are determined. Appropriate evaluation is placed upon the use of specialty forms and special bindery operations such as punching, stapling, perforating, folding, collating, carbon interleaving, etc., as against individual cut forms in relation to savings in preparation and use.

Distribution determination. Specifications for effective storage and distribution are developed. Methods of determining current supplies, establishing minimum stock levels, purging obsolete forms, and setting distribution patterns and controls are essential elements at this stage.

Evaluation, measuring results. A running record of results is accumulated as forms control work progresses. Before-and-after data (showing clerical, printing, and other savings) are gathered as changes in forms and procedures are made. These facts, with recommendations, are reported to top management for use in appraising the forms control program and in shaping future policy on it.

Responsibility. The forms control program branches out; it merges with, and depends on, many other company activities. Varying degrees or kinds of responsibility for the different elements of forms control, therefore, must be carefully defined and carefully placed, so as to be clearly understood by all concerned at each level.

Center of responsibility. Experience has shown that the forms control program is likely to be most effective if primary responsibility for it is centered in a specific individual or unit of the office-methods staff or of a similar office, whatever it may be called, having responsibility for organizational and procedural problems. This is true regardless of the organization level involved—headquarters office, department, office or factory, or branch establishment. The responsibility should cover the preparation of directives and

control procedures, the establishment of standards, the recording of requests for new or revised forms, the searching of files for duplications, the recommendation of procedural studies involving forms, and consultation with other units on such matters.

Since the office-methods staff is bound to encounter many forms problems in dealing with the procedures of which forms are a part, to assign forms control to that office is to add a major tool to its procedural working kit. Conversely, both forms work and organization and methods work will suffer if an attempt is made to separate the improvement of procedures through forms analysis from its corollary, the improvement of forms through procedures analysis.

Fixing primary responsibility for the forms control process in an office-methods unit, however, does not alter the staff status of that unit; in forms control, as in its other activities, its job is to serve the line operators. Nor does fixing forms control responsibility in the office-methods unit minimize the contribution that files, statistical, drafting, printing, and duplicating personnel, outside the unit, must give in the design and production of forms.

Level of responsibility. The problem of determining at what level or levels to centralize forms responsibility is a very real one in many large concerns. Decision will always depend on such factors as the size of the concern, location of its offices, and diversity of its operations.

Two balancing principles should be kept in mind:

Control should be centered at a level high enough to give the broad perspective needed for review, coordination, and across-the-board improvement

Control should remain close enough to program (either in the headquarters office or at points in the field) so that forms can be planned, designed, or revised in the light of actual program needs and with an intimate understanding of operating problems

In a large company, forms control programs may be required at two or more levels—headquarters, departmental, office or factory, and, under certain circumstances, in the field. Assuming that responsibility for office-methods work has been placed at the appropriate level, similar responsibility for forms control would ordinarily be appropriate at the same level.

If the program is established at the departmental level, responsibility should still be maintained at the company level for—

Control of company and interoffice, factory, or branch forms

Stimulation, coordination, and evaluation of the control activity within the office, factory, or branch

Staff resources. Staff requirements for the forms control program are determined by the amount of forms control work to be done, the relationship

of this program to the total office-methods program, the availability of the needed knowledge and skills within the various units concerned with forms development or use, and the volume of other work claiming office-methods staff time.

In the absence of an adequate forms control program, a frequent problem is that of overparticipation in forms development by operating personnel. To the extent that they use time and energy in those tasks of forms development which can be more efficiently performed by technical specialists, they do so at the unnecessary expense of their primary responsibilities. On the other hand, it would be no less a mistake to assume that the whole burden of forms development can be shifted to the forms control staff. There can scarcely be a substitute for the first-hand knowledge of operating personnel in determining forms content.

Sources of technical aid. In addition to constant collaboration with program-developing and line-operating people, participation in forms problems should come as needed from any of several points in the company.

Statistical personnel may need to be consulted frequently concerning statistical reporting, sampling, and tabulating standards which many forms must meet.

Editorial or information specialists, if available, may help make forms more readable and understandable, especially if for outside-company use.

Drafting staff may be called upon to do the final drawing of many forms and may be a source of advance suggestions on layout.

The office responsible for printing or duplicating should be a source of technical information needed in advance for making design specifications consistent with economical printing or duplicating practices.

Other persons outside the forms control staff may need to be consulted on questions of intercompany relations, which may require consideration before final decisions are made on certain forms.

Thus, no company can expect to have at hand in any single unit all the knowledge and all the services needed in developing, producing, and controlling forms. If the volume of forms is great enough, it may be feasible to provide for certain of those needs within the forms control unit itself. For example, a draftsman might be assigned to specialize in drawing forms. The need for drafting service, however, is not peculiar to forms work. The same is true of most other supporting services. Short of very exceptional volume and stability in the flow of forms work, therefore, it is rarely profitable to add technicians directly to a forms control unit or even to an over-all office-methods unit, to provide those services.

It is in these same staff services that some of the savings of forms control should be realized. Advance attention to design problems and printing

limitations, for example, should simplify the work of drafting and duplicating staffs, when forms come to them for processing, just as the time of operating personnel is saved by relieving them of technical details in developing forms. In addition, duplicating work load is reduced by the elimination of nonessential forms and the consolidation of others.

Control staff. Certain activities, however, do accompany the primary control responsibility. The recording or registration of forms, the analysis of forms content for procedural implications, the development and application of standards of design, the relating of forms design to appropriate printing or reproduction processes, and the control of storage and distribution practices impose staffing (or training) considerations upon whatever unit is given primary responsibility for forms control.

These activities may call merely for special attention to forms by office-methods staff already working on other administrative problems. Such existing staff, possibly supplemented (on a full-time or part-time basis) by a design technician, may well suffice if the forms control program is to be developed gradually and is to depend for its intake upon requests for new forms and reorders for old ones. On the other hand, if the company is large, if its control plan is new, and if complete long-range coverage is anticipated, a separate compact working unit may be feasible. This arrangement has paid dividends in several large companies.

The job of designing forms and preparing them for printing or duplicating may require only the part-time attention of an office-methods engineer or it too may be the full-time responsibility of an individual or a unit, again depending on whether the volume of forms work justifies that degree of specialization.

To the extent that necessary abilities may be lacking in an organization, they will have to be provided either by training or recruitment; or, if needed only occasionally, by getting temporary assistance from outside the company. Any office-methods engineer should already have at least the basic qualifications for forms work, and should be able to absorb any forms design training needed in a relatively short time by tapping available published sources (see page 678). Other companies and private engineering firms offer possibilities to be explored, also, in seeking short training periods to familiarize employees with sound practices of forms design.

Top-management participation. No matter how well conceived the forms control plan may be in other respects, the plan will not become a reality—or will not remain so—without a certain minimum of top-management support. Forms control authority, like that for any other program cutting across all segments of a company, should stem from the top. Not only must top management make the decision calling for such a program; it must take certain

steps as a basis for that decision and certain continuing steps to see that the resulting program is effectively carried out.

Among other things, it is up to top management to—

Call for, and weigh the results of, such preliminary survey and analysis as may be necessary to determine the nature and extent of the forms problems within the company

Formulate and issue a policy directive which will—

Clearly specify the scope of the forms control program in terms of organizational units and classes of forms included (with any necessary exemptions expressly designated)

Clearly fix responsibility for participation in the program (both the centralized primary responsibility and all aspects of collaboration)

Make its positive endorsement and vigorous backing clearly understood throughout the organization

Require, review, and act upon periodic reports of the program's results as a basis for any needed correction in forms control policy.

A preliminary survey within the organization discloses the volume and variety of forms involved, and brings to light some of the more obvious cases of overlapping, duplication, and procedural discrepancy. Ordinarily this is enough to show the need for a forms control program, as well as to suggest its initial scope and direction. In addition to internal facts and figures on potential savings and improvements, experience in other companies can be drawn upon as needed to reach a decision. From such facts, a clear statement or simple visualization can be developed to help get the story across all along the line.

The sheer volume of forms in some companies may be so great that it may be wise to confine the program at first to those forms offering the more obvious and immediate savings in paper, printing, and processing. This does not mean, however, that benefits even in the beginning should be limited to the production aspect of the forms problem. It means only that the number of forms dealt with may have to be arbitrarily limited in getting the program started. Every form that is brought under control should be considered in conjunction with the procedures involved in its use.

3. Establishing the program

Once top-management policy and backing have been clearly established, the cornerstone for a forms control program has been laid. With responsibilities firmly fixed, the framework has been raised. A structure exists in which to carry out the regular processes of (1) registration, (2) analysis, (3) design standardization, (4) identification, (5) production specifications, (6) distribution determination, and (7) evaluation—processes found necessary to any fully useful forms control program.

But before production can begin the machinery must be installed. The staff member or unit made primarily responsible must do certain nonrecurring setup work before the regular processes can be set in motion to make the program a going concern.

The machinery required by forms control need not be elaborate. Many of the common tools of management can profitably be applied to this activity. The basic equipment peculiar to forms control, however, consists of—

A collection of all the company's forms, made available for use in—
  A functional file
  A numerical file
A set of company forms-design standards
A forms-identification plan
A forms control procedure
A set of forms control records

If staff members need training in the methods of forms design or forms production to prepare them for responsibilities newly assigned under the program, such training can be started while the preliminary collection and classification of existing forms is under way. In fact, this work may well be a part of the training process.

In any event, the development of suitable design and production standards, or the adaptation of standards developed elsewhere, is a delicate task. Because many persons in an organization have a rightful interest in the design, typography, and general appearance of forms, and because frequent changes of standards are costly and confusing, staff members made responsible for establishing the standards must be familiar with the necessary technical considerations before attempting to do the job (at least sufficiently familiar to evaluate the advice offered by specialists in related activities).

Similarly the adoption of an identification plan and control procedure should not be attempted until thorough familiarity with the problem and any necessary training in technique have been provided. The process of collecting and classifying the forms should contribute much to such familiarity and training.

Collecting forms. If not done in the initial directive establishing forms control policy and responsibility, a follow-up instruction should request all forms-using and forms-originating units to submit copies of all their forms. If the volume is large, it may be necessary to schedule the submittal of forms by different units at different times.

The units should supply not only samples of all forms in current use but also copies of any obsolete forms which have not been officially rescinded. All temporary and all permanent forms, numbered and unnumbered, regardless of origin or method of reproduction, should be included.

It is important not to omit copies of such predesigned working papers as—

Tabulating cards and paper, including ruled-stock forms
Preprinted duplicating masters, tags, labels, and checks
Memorandum sheets, routing slips, and other communication forms
All formlike form letters

Although some of the papers submitted may not meet the forms definition, any doubt should be met by submitting them for determination.

General forms used by many or all units of an organization, however, may not need to be submitted by each unit. Unless the method of use varies significantly in the different units, it should be sufficient to get copies only from the highest organization level using them or from the office that controls the manner of use.

Standardizing the method of submitting forms facilitates handling, classification, and filing. Accordingly, with respect to all forms included in the call, the using units should be requested initially to—

Furnish two copies of each form, if the form is a single sheet
Furnish two complete sets, if the form is part of a set
Furnish two complete books, if the form is padded or bound
Identify each form by number or title, if identification is not printed on the form
Show name of unit or units which use each form
Show approximate quantity of each form used—daily, annually, or otherwise—and the quantity on hand
Identify the instruction which prescribes or authorizes the form, and indicate any change expected or needed in such regulation or directive
Include or refer to instructions for use, if they are not contained in full on the form itself
Show distribution of the form (in its blank state)
Explain writing method used for fill-in (hand or machine), number of copies prepared at one writing, and routing of completed copies (specifying those who use or act on the information recorded)
Show relationships to other forms (those used in conjunction, those to or from which data must be transcribed, and those known to call for some of the same information from another source or similar information from the same source)
Specify any mechanical equipment in which the form must be used (for posting, tabulating, counting, or special filing)
Explain any recognized need for change or revision in design or use
Submit forms unfastened and unstapled
Cancel or void any negotiable forms or other prenumbered forms, or else submit photostats instead of actual forms
Include name of using unit on package

In many instances operating manuals or other instructional materials will include much of the information required to show the complete purpose and use of the forms to be submitted. Submittal of, or reference to, appropriate pages of such materials, therefore, may often minimize the amount of information to be especially prepared in submitting samples of forms.

Classifying the forms. As the forms are collected they must be sorted, classified, and filed to make further reference and analysis as orderly and time-saving as possible. Two files are needed, the functional and the numerical.

The functional file. The functional classification helps in collating forms which serve similar working purposes and which, by reason of similarity of content or purpose, may be susceptible of consolidation and standardization.

In establishing the functional files, the first broad division might well be that between administrative and operating forms. Beyond that grouping, varying degrees of analysis are required to determine appropriate subgroups.

The extent and nature of such classes and subclasses depend upon the size of the organization covered, the degree of administrative specialization, and the number of forms involved within the various possible classifications.

Once established, however, the functional file permits comparison of existing or proposed forms with all other forms employed in the same or related activities. The file brings together in one place data which the office-methods staff can use in simplifying, combining, eliminating, or evaluating forms. The functional grouping tends especially to show up duplications.

Only one master copy of each form should be kept in the functional file; but care should be taken to see that notations have been made on the form to show the names of all units using it, the procedural purpose, the quantity used by each unit, and other pertinent information available at the time the form is received.

The numerical file. The numerical file should include a separate folder for each form. These folders, arranged in form-number sequence, should serve as a cross reference to or from the functional file, and as a repository for explanatory material accompanying each form. It may be sufficient to establish this file gradually, setting up the individual folders as the forms are taken up for detailed analysis and procedural study, or as requests for revision or reprinting are received. In any event, forms cannot be given regular places in the numerical file until they have been assigned form numbers.

In order to provide a complete picture of each form, its evolution and work setting, each numerical file folder, as soon as possible, should contain—

A copy of the form itself and of any previous editions

Notes on the form's history, with any rough drafts or work papers that show significant stages of development

A copy of, or reference to, the instructions or other issuance upon which the form is based
A copy of the request for approval, including such data as the name of the originating or using unit, manner and rate of use, suggestions for improvement, or notices of pending changes in procedure
A copy of the requisition for duplicating, including available data on cost, process, and specifications
Complete documentation relating to official approvals of copy, and pertinent correspondence or conference proceedings
Any available information on contemplated revisions

Establishing standards. Efficiency in the procedure of which a form may be a part can hardly be guaranteed by anything so pat as a set of standards. Certain yardsticks are necessary, however, as means of assuring that all forms have the physical or graphic features required for—

Simplicity and efficiency in those fill-in and routing procedures that may be influenced by the arrangement of items on the forms
Visual efficiency in reading, using, filing, and finding
Uniformity and general adequacy in appearance
Economy in reproduction

Before the forms control program can become operative, therefore, the staff primarily responsible should work closely with operating units and the company's reproduction or printing services to develop a set of standards which will be realistic in terms of program responsibilities, staff limitations, and forms volume.

Because of the many variables among companies, few general standards are possible. It is possible, however, to point out some of the factors which must be considered in determining a company's individual standards and to touch upon some of the practices which other companies now operating successful control programs have found effective. For purposes of illustration, a skeleton set of hypothetical standards is shown starting on page 672.

The review of forms in the functional file serves as a base from which to work in considering the applicability of various possible standards. While forms are being compared for classification or other purposes, notes applicable to paper or design specifications should be made on the file copies.

The standards selected should be applicable to as many of the company's forms as possible and should anticipate future requirements.

Once they have been determined, the standards should be circulated throughout the company to guide all those who initiate forms or participate in their development.

Factors to consider. The physical aspects of forms most readily standardized are—

Size and shape
Weight and grade of paper
Colors of paper and ink
Typography and format
Mechanical characteristics (such as punching, binding, perforating, carbon interleaving)
Methods of reproduction

Considerations in the selection of standards for each of those features are outlined below.

SIZE AND SHAPE. Company standards for form sizes should be such that all forms can be cut without waste from a minimum number of standard paper sizes. In limiting permissible form sizes, however, consideration must be given to requirements imposed by office machines, files, binders, envelopes, or other equipment and supplies commonly involved in the use of forms.

WEIGHTS AND GRADES OF PAPER. Similarly, the weights, grades, and finishes of paper should be reduced to a reasonable minimum. Factors to be considered include—

Suitability of paper surface
  For duplicating processes involved
  For writing methods used in making entries
  For erasures which may be necessary
  For safety (protection against unauthorized alterations in entries made on certain forms)
  Visual efficiency (considering volume and conditions of use)
Suitability of weight, thickness, and durability
  For number of carbon copies required
  For handling required in use
  For any office machines in which used
  For relative permanence of record required
  For filing methods and space required in storage (for both unused forms and completed records)
Cost as related to other factors

All existing forms should be sorted according to the approximate grades and weights of the paper on which they are printed. By application of the above factors, all unsuitable and unnecessary varieties should be excluded, with substitutions made as appropriate.

COLORS. The use of colored paper in existing forms should be analyzed to determine if color is necessary in each instance. All colored forms in use should be sorted and examined individually to see whether color (1) increases efficiency in distribution, or (2) makes handling easier for the person

filing, referring to, or filling in the form. If color is found advisable, variations should be reduced to a few basic shades.

A similar routine should be followed in selecting standards for ink colors. The use of color, either in paper or more especially in ink, is justifiable only if the additional cost is balanced by improved performance and efficiency. Technical advice again may be needed in selecting color standards, for some color combinations in paper and ink reduce legibility critically. Poor color selection can thus increase inaccuracies and waste in clerical processes.

TYPOGRAPHY AND FORMAT. It is important to avoid hard-and-fast criteria for the arrangement of forms content. The sequence and arrangement of items on a form must be determined by individual analysis of the working procedures involved. Standards of layout, therefore, become (1) general principles to be followed in analysis and (2) statements of alternative locations permissible for certain mandatory items such as title and form number.

Matters of type face and spacing, on the other hand, can be more precisely treated.

A review should be made of the type faces available on typewriters and any composing machines (such as the Vari-Typer) in the company, along with the letterpress faces recommended for various uses by a competent printer. On the basis of this review, a standard selection can be made which will—

Make for visual efficiency in forms use by assuring legibility and permitting ample variety in type size and weight for purposes of differentiation and emphasis among various copy elements

Promote uniform appearance among company forms, by limiting the styles of type to be used

Reduce direct costs, by excluding hand-set or other special composition, by prohibiting purely ornamental all-around borders and typographic nonessentials, and by simplifying the task of specifying type when requisitioning forms

Similarly, uniform spacing provisions can be established in accordance with the different writing methods to be used for fill-in; and relative locations of item numbers, captions, check boxes, and instructional notes within the individual blanks on a form can, within limits, be predesignated.

MECHANICAL CHARACTERISTICS. Extra make-ready, press time, and bindery work can add materially to form costs. Although such extra operations often pay off in the more efficient use of forms, the forms-control staff should be alert to eliminate frills.

In order to keep these extra expenses at a minimum, the company should develop standard instructions on such details as these:

Prenumbering .....Permissible only if sequence control or strict accounting for each copy is required.
Punching .....To fit standard binders or special filing equipment used in the company.
Stapling .....Standard number and location, varying by class or size of form.
Perforating, folding, carbon interleaving, collating, and padding .....Only on individual justification based on economy in use.

REPRODUCTION METHODS. One of the biggest sources of unnecessary cost commonly found in forms production is the use of reproduction processes not suited to the *quantity* of forms required. Similarly, one of the major causes of inefficiency in forms is the production of forms by processes not capable of a *quality* suited to the conditions under which the finished forms have to be used. Often, for example, forms are run off by stencil duplicator when the quantity would have justified the letterpress process and the legibility, usability, and appearance would have been improved by it. Quite often many hours at the drafting table are devoted to drawing the finished version of a ruled form for office offset reproduction when skilled compositors could have set up the form from a rough sketch in a fraction of the time and with better results. Conversely forms are sometimes sent to the printer for costly composition and presswork when, with a few minor paste-up alterations of an existing printed form, the quantity needed could have been run by the offset method at a fraction of letterpress cost.

Here, especially, should the advice of the company's reproduction staff or a competent printer be sought in determining company standards. Although general standards are available for use in selecting reproduction processes for varying quantities and conditions, these need to be considered in the light of the equipment available to the specific company and with special reference to the writing surfaces needed in forms use.

Adopting an identification plan. Every form should bear a title, a number, and an issuance or revision date, in addition to company name and location. The title should identify the form clearly for the user. Number and date should identify the form positively for control purposes. Titles are originated as a rule by operating units, subject to review and possible improvement by the forms control staff. Numbers are assigned schematically by the forms control staff itself.

A plan for the assignment of titles and numbers should be established, like design standards, before the forms control program goes into operation. Once the plan is formulated, each form-using unit should be given an explanation of it, preferably along with a copy of the design standards.

Titles. Although a definite system of form titles cannot be determined in advance as can a numbering scheme, certain criteria can be predesignated to

aid units in suggesting acceptable titles at the time they request forms. Titles should be brief and yet specific. Words used should be few; yet they should show the precise subject (usually first) and precise function by careful choice of words. The subject designation in the title should be as specific as the subject-matter limits of the form itself.

In the titles "Materials Receipt," "Purchase Order," and "Sales Invoice" there is not much room for doubt about either subject matter or purpose.

Additional guidance may be provided in advance by preparing a glossary of terms having general acceptance for use in titling common types of forms. One such glossary is included on page 677.

Numbers. The numbering system should be simple, logical, and uniform to help form users understand the plan as a whole and remember individual form numbers.

A complete form number (including any affixes) should serve as—

A symbol of the authority under which the form is issued
A control symbol showing that before issuance the form has been checked against
  Existing forms for possible duplication or overlapping
  Design and production standards for economy and suitability in use
A positive identification code logically indicating—
  The originating unit
  The activity or function served
  The relationship to other forms in the same activity, process, or procedural series

The steps to be taken in establishing or overhauling a numbering system include: (1) determining the adequacy of present numbering practices within the company, (2) identifying any changes needed to assure a sound basic numbering pattern, and (3) gearing the numbering system into the total forms control procedure.

DETERMINING ADEQUACY OF PRESENT NUMBERING. Certain observations concerning the adequacy of existing form numbers will have been made during the original assembly and classification of forms for the functional and numerical files. Further review and comparison may be necessary, however, to assure the spotting of any duplications in existing numbers and to evaluate the pattern of numbers as a whole.

Special effort should be made to determine the extent to which form-number sequences correspond to procedural sequences and tie into instruction manuals and inventory or other records.

DETERMINING DESIRED BASIC PATTERN. Although there is room for considerable discretion, the determination of a specific numbering scheme may depend to a large extent upon such factors as—

The quantity and variety of forms coming within the program
The nature and scope of control authorized
The frequency of activity and organizational changes within the company
The extent to which key form numbers are already firmly and favorably rooted, especially in major procedural uses
The nature of related control and accounting codes already existing in the company
The need for consistency with the numbering system for standard company-wide forms

Whatever scheme is selected, the two basic elements, numbers and affixes, are subject to certain common considerations.

Base numbers assigned in sequence are the foundation for any forms-numbering system.

Assignment of form numbers in blocks is not recommended. In starting a register, it is impossible to predict how many different forms will be printed for each group or block set up; and when a block of numbers has been used it may be necessary to set up a new block of numbers for the same class of forms, increasing the possibility of confusion and error. Forms for large organizational groups can be identified by descriptive affixes for each division and still have the basic numbers assigned in sequence.

Affixes may be used to differentiate company-wide forms from those used within subordinate units of the company, such as departments, branches, divisions, or field offices, or to designate specific functions, such as *personnel, accounting, sales, or purchasing.*

Such affixes may be made up of the initials of the company or organizational unit, abbreviations, code letters, or code numbers. Although usually used as prefixes, decimal or other number codes are frequently added as suffixes to denote function, program, or procedural series.

INTEGRATING NUMBERING PATTERN INTO FORMS CONTROL PROCEDURE. If major numbering changes in a variety of long-established forms are found necessary, it usually is wise to convert on a gradual basis by assigning new numbers as stocks of the various forms are replenished and as program and procedural changes within the agency provide convenient opportunities. Allowances for such necessary expediencies will have to be made in setting up the forms control procedure. When revising form numbers, it is often desirable to show the old number with the new number, placing the old number in a subordinate position. After the new number has become known, the old number may be dropped completely. It is important, however, to make the transition as rapidly and as uniformly as such necessary considerations will permit.

Dates. Though it is the simplest element in forms identification, issuance

and revision dating is nevertheless important. For example, the current version of a form may be quite different from its earlier counterpart, though title and number may be identical. Without the revision date, positive identification may be difficult and operating complications serious.

The forms control staff should be responsible for supplying the appropriate date before any form goes to press. Ordinarily it should follow the form number, preferably below it. Enclosing the date in parentheses avoids confusion with the form number. Abbreviations to conserve space may be desirable, as "(5–51)" rather than "(May 1951)." Revision may be indicated by the abbreviation "Rev." The date then would become "(Rev. 5–51)."

Developing a control procedure. The numerous procedural steps into which the seven basic forms control activities (page 635) may be divided are much the same in substance wherever the complete program is in effect. Yet these detail steps vary among companies in terms of who performs the specific tasks, how certain steps are combined, and the order in which they occur. Whatever the individual variations, the procedure should be clearly outlined and thoroughly understood throughout the company before any attempt is made to put the program into effect.

The order of steps in such a procedure may be approximately as follows:

Initiation procedure

Each request for the initiation and approval of any new form or the revision or renewal of any old one is made in writing, preferably on some standard form such as the *form design and approval request* shown in Fig. 1. Each request is accompanied by—

Any information (in addition to that called for by the request form) needed to show content, purpose, and use of the proposed form

A sketch of the proposed form

Registration and review

Receipt of each request is entered in the *forms control log* (Fig. 2, page 652)

If the request is for revision or renewal of an existing form, the numerical file is checked to see if recommendations have been received for changes in the form

Numerical and functional files (together with any available file of other-company or commercial samples) are checked for—

Any existing form that may serve the purpose of the requested form

Any related forms to be displaced, revised, or consolidated

Analysis

Consultation is held with units which would use the form or be affected by it as to handling, retention requirements, and content

Work involved in using the form is analyzed to determine the need for

FORM BSC -1000
June, 1950

BEST SELLING COMPANY
FORM DESIGN AND APPROVAL REQUEST

THIS BOX FOR USE OF FORMS CONTROL UNIT
APPROVED FORM TITLE
FUNCTIONAL FILE CODE | FORM NO. | DATE OF FORM

FROM: DATE

TO: Forms Control Unit: Office Methods Division

PROPOSED FORM TITLE | PROPOSED FORM NO. | OLD FORM NO.

EXPLAIN BRIEFLY THE PURPOSE AND NEED FOR FORM. *(Attach two copies of proposed new or revised procedures with which form will be used.)*

WHAT PUBLISHED AUTHORITY DIRECTS USE OF FORM | WILL INSTRUCTIONS FOR USE OF FORM BE ISSUED. NO ☐ YES ☐ *(If "yes" attach two copies of instructions)*

LIST BY FORM NUMBER ANY FORMS SUPERSEDED, REVISED, OR ELIMINATED BY THIS FORM. *(Attach two copies of each.)*

NAME OTHER UNITS OF THE COMPANY CONCERNED WITH SUBJECT MATTER OF FORM AND NOTE CONCURRENCES OBTAINED.

LIST BY FORM NUMBER ALL FORMS TO OR FROM WHICH INFORMATION WILL BE TRANSCRIBED TO OR FROM THIS FORM.

NUMBER OF COPIES PREPARED AT ONE WRITING

COPY	ROUTING TO	USE
1		
2		
3		
4		
5		
6		
7		
8		
9		
10		

ENTRIES WILL BE MADE BY ☐ PENCIL ☐ INK ☐ TYPEWRITER ☐ OTHER *(Specify)*

HANDLING OF FORM WILL BE ☐ LIGHT ☐ MEDIUM ☐ SEVERE

TO BE FILED IN FOLDER ☐ *(Prese type fastner in top center margin)* RING BINDER ☐ *(Three holes in left margin)* OTHER ☐ *(Specify)*

RETENTION PERIOD OF RECORD OR FILE COPIES
YEARS ACTIVE FILES | YEARS INACTIVE FILES | YEARS AFTER WHICH FORM MAY BE DESTROYED

SIZE OF FORM | PAPER

HORIZONTAL	VERTICAL	TYPE	WEIGHT	COLOR
INCHES	INCHES			

QUANTITY OF FORMS REQUESTED

INITIAL DISTRIBUTION	NOT OVER 6 MONTHS STOCK	ESTIMATED 1 MO. SUPPLY	TOTAL REQUESTED	BASIS
				SHEETS ☐ SETS ☐

QUANTITY ON HAND *(Outside of stockroom)*

QUANTITY	NO. OF MONTHS SUPPLY	METHOD OF DISPOSAL
		DESTROY ☐ EXHAUST USE UNTIL REVISED FORM IS AVAILABLE ☐ ☐

REMARKS

NOTE: 1. For initial distribution to offices outside of Home Office furnish shipping addresses and quantities to each. 2. Attach a sketch of the proposed form to this request, or the old form with revisions indicated. Furnish detailed specifications for location, type, size, style, color, etc. of paper, ink, binding, stitching, padding, punching, perforation, preprint numbers, overprinting, machine registration and spacing, etc.

REQUESTING OFFICER'S SIGNATURE	DATE	FORMS CONTROL APPROVAL BY	DATE

Fig. 1.

FORM BSC 1001
NOV. 1949

FORMS CONTROL LOG
(Requests for New, Revised and Reprint Forms)

DIVISION: Service

PAGE: 1

DATE RECEIVED 1950	REQUESTING OFFICE	FORM TITLE AND NUMBER	ASSIGNED FOR REVIEW TO	TYPE OF FORM			ACTION TAKEN			FORM NUMBER ASSIGNED
				NEW	REV.	RE-PRINT	REJECTED	APPROVED AS SUBMITTED	APPROVED WITH REVISION	
1/2	Personnel office	Interview blank No. 614	Smith		✓				2/12	OS-202
1/2	File room	Cross index sheet	Smith	✓				1/4		OSA-101
1/3	Service section	Request to install telephone No. 207	Brown			✓		1/5		
1/8	Duplicating	Requisition	Smith	✓						

Fig. 2.

further study of procedures or methods; a check list (Fig. 3) is one method of assuring that all the problems have been considered

Determination is made of the need for issuance or revision of procedural instructions to accompany the form

Development

Those responsible for records and files are consulted for advice on questions of form size, paper weight, and quality

Standards of design, paper stock, and reproduction method are checked and any necessary design changes made

Preliminary copies may be reproduced for clearance or pretesting

Clearance

To assure compliance with reporting standards and to see that concurrence is obtained from any other office or department that may be concerned, clearance is carried out as appropriate with units concerned with the use and the policy or procedural effects of the form

After final approval the form is prepared for reproduction or printing

Issuance procedure

A number is assigned the form, along with issuance and approval dates, and entered in the form number register

The quantity and delivery specifications are checked against the estimated rate of use

The distribution pattern is checked

Specifications for printing or reproduction are made out

Final recording procedure

After reproduction, stocking, and distribution, the form is included in the company forms catalogue

Record is made in the functional and numerical files

The minimum stock level (reorder point) is established

When the forms control staff receives notification from the stock-control point that the minimum stock level has been reached and reorder is necessary (see Fig. 4), a number of simple steps should be carried out.

The numerical file should be checked to see if any suggestions for revision have been received

Determination should be made on whether any changes are pending in procedure, program, or organization which might affect the form

If revisions are required, appropriate steps, among those outlined above, should be taken before an order to replenish stock is approved

Selecting necessary tools. In addition to the major equipment—the forms classification, standards, identification plan, and control procedure—a few essential working tools are to be selected before regular processing begins. These tools are certain forms and records designed to simplify performance of the steps in the control process.

CHECK LIST

For . . . . . (Name) . . . . Date .

Address. . . . . .

Person Interviewed . . . . . Position . . . . . .

Using Department . . . . . Manager . . .

Prepared By . . . . . .

Sales Dept.	Invoices Credit Memo Orders Acknowledgements	Shipping Dept.	Bills of Lading Express Receipts Delivery Receipts Packing Slips Shipping Notices	Administrative	Inter Office Memo Check Vouchers Tabulating Forms Teletype Forms Addressograph Forms Statements
Purch. Dept.	Inquiry for Price Purchase Orders Receiving Records	Production Dept.	Manufacturing Order Requisitions Stock Records		Ledger Sheets Loose Leaf Equip. Visible Records

1 No and Name of form covered in this survey . . . . . .

2. How many transactions or what quantity of this form is used per day . Month . Year . . .

3 How is form now written Hand Typewriter Billing Machine Tabulator Teletype Addressograph

4 Name of machine . Spacing Vertical . Feed Front Pull Out
Horizontal. . . Back Feed . . .
Front Feed .

5 Number of parts in form now used . . . Average number lines per set .

6 Number of parts needed .

7 Is form completed at one writing . If not, when, and by whom .

8 How is form filed: Numerically, Alphabetically, Post Binder, Vertical File

9 Can this form be combined with any other form . .
. . .
. . .
. . . . .

10 Are shipments made complete . What is percentage back-ordered . .

11. Is composition arranged for minimum of typing lines. . .

12 Are most important items prominently placed . . .

13. Is the information shown in comparable sequence with preceding and/or succeeding form . . . .

14. Is all recurring information PRINTED, leaving only variables to be filled in . . . . .

15. Is colored paper used to facilitate distribution . . .

16. Does form have Code No . . . . . .

17. Can form be re-designed for combination with other forms or for economy . .

18. How many persons required in writing this form . . . . . Do they have other duties . .

19. Is order writing and invoicing done in same Dept. . . . . By same persons . . . . . .

20. Can items be extended before billing . . . . . .

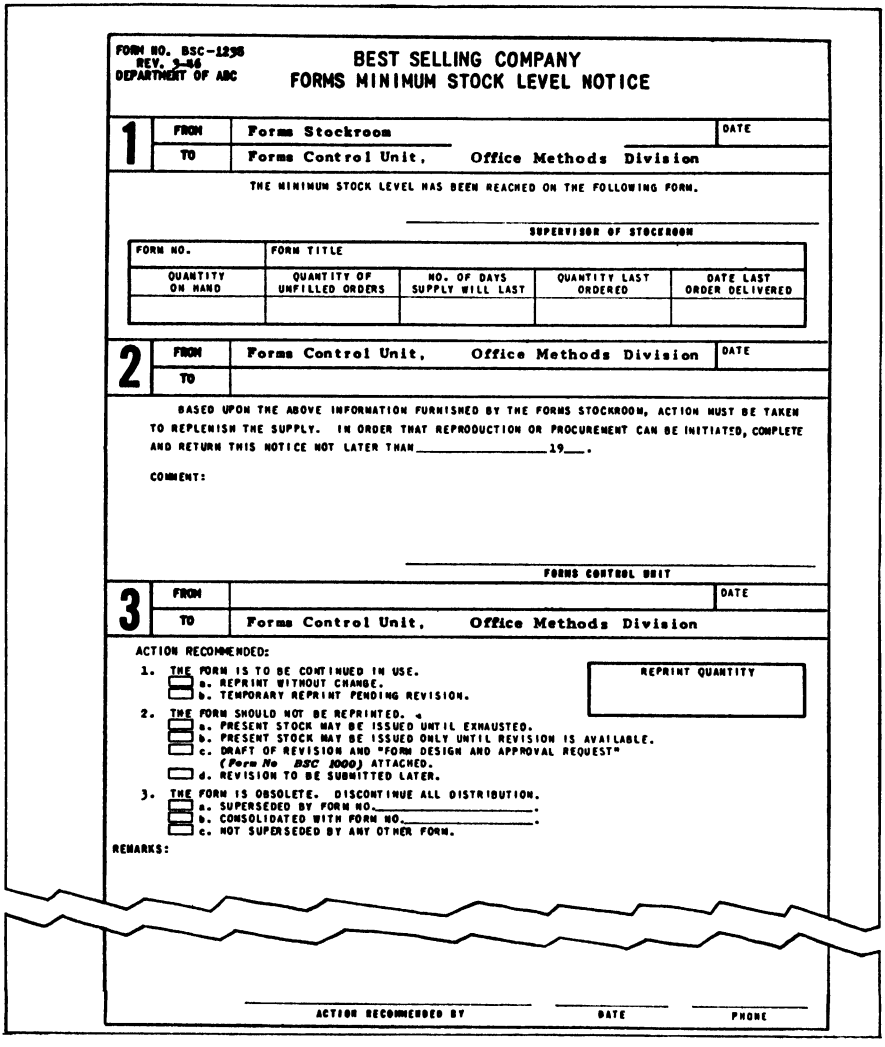
21. Is work evenly distributed throughout day . . Or come in peak loads .

22 Can any copies be eliminated. . . . . Or used for more than one purpose . . .

23. Have we checked with actual user of form for suggestions . . . . . .

24. Have we obtained samples of the form now in use . . . . . .

Fig. 3.



FORM NO. BSC-1256
REV. 9-46
DEPARTMENT OF ABC

BEST SELLING COMPANY
FORMS MINIMUM STOCK LEVEL NOTICE

1 FROM Forms Stockroom DATE
TO Forms Control Unit, Office Methods Division

THE MINIMUM STOCK LEVEL HAS BEEN REACHED ON THE FOLLOWING FORM.

SUPERVISOR OF STOCKROOM

FORM NO.	FORM TITLE			
QUANTITY ON HAND	QUANTITY OF UNFILLED ORDERS	NO. OF DAYS SUPPLY WILL LAST	QUANTITY LAST ORDERED	DATE LAST ORDER DELIVERED

2 FROM Forms Control Unit, Office Methods Division DATE
TO

BASED UPON THE ABOVE INFORMATION FURNISHED BY THE FORMS STOCKROOM, ACTION MUST BE TAKEN TO REPLENISH THE SUPPLY. IN ORDER THAT REPRODUCTION OR PROCUREMENT CAN BE INITIATED, COMPLETE AND RETURN THIS NOTICE NOT LATER THAN _____ 19__.

COMMENT:

FORMS CONTROL UNIT

3 FROM DATE
TO Forms Control Unit, Office Methods Division

ACTION RECOMMENDED:

1. THE FORM IS TO BE CONTINUED IN USE.
   ☐ a. REPRINT WITHOUT CHANGE.
   ☐ b. TEMPORARY REPRINT PENDING REVISION.

REPRINT QUANTITY

2. THE FORM SHOULD NOT BE REPRINTED.
   ☐ a. PRESENT STOCK MAY BE ISSUED UNTIL EXHAUSTED.
   ☐ b. PRESENT STOCK MAY BE ISSUED ONLY UNTIL REVISION IS AVAILABLE.
   ☐ c. DRAFT OF REVISION AND "FORM DESIGN AND APPROVAL REQUEST" (Form No BSC 1000) ATTACHED.
   ☐ d. REVISION TO BE SUBMITTED LATER.
3. THE FORM IS OBSOLETE. DISCONTINUE ALL DISTRIBUTION.
   ☐ a. SUPERSEDED BY FORM NO. _____.
   ☐ b. CONSOLIDATED WITH FORM NO. _____.
   ☐ c. NOT SUPERSEDED BY ANY OTHER FORM.

REMARKS:

ACTION RECOMMENDED BY DATE PHONE

Fig. 4.

Two general classes of forms are used in carrying out the forms control program: (1) those which flow to or from the forms control staff, either to request action or to report facts relating to the program; and (2) those used only by the forms control staff, either as work sheets or as continuing control and progress records.

In the first category are such forms as the Form Design and Approval Request, Fig. 1, and Forms Minimum Stock Level Notice, Fig. 4. The request

form is initiated by form-using units when they want a new form developed or an old one revised. The stock-level notice is initiated by the stockroom or supply unit when the supply of any form reaches a predesignated level. Like the request form, the stock-level notice is a signal for review and action by the forms control staff, so that any appropriate design or procedural changes can be made before additional forms are printed. This is further discussed on page 659.

In the second category are such work sheets as the Forms Analysis Chart of Recurring Data, illustrated in Fig. 5, a form to simplify the cross comparison and simple item analysis of related forms; and the Form Design Layout Sheet, Fig. 6, a form to simplify the spacing and sketching of form layouts. Then, as a separate group in this category, there are the internal records for control purposes. Aside from the files, these include such records as the Forms Control Log, Fig. 2; and (not illustrated here) a form-number register and a forms catalogue.

The Forms Control Log (Fig. 2) is a chronological record of incoming and outgoing forms, their assignment for analysis, and the action taken on them. The log serves as a basis for compiling a monthly report of work load and progress, and shows the status of any form under consideration. Date-stamping the written request from the initiating office serves to identify the form in question so that reference can be made readily to the corresponding entry in the log.

When the volume of forms to be controlled is large, greater flexibility and easier reference may be achieved by maintaining a log on individual vertical or visible file cards. This method has the advantage of permitting records of completed forms to be pulled, with only records of forms being worked upon retained, and may be of assistance in the development of a forms catalogue.

The Form Number Register is a record of form titles and numbers assigned. A simple notebook or ledger will serve the purpose. The form title, date, and name of the initiating office are entered opposite the assigned form numbers as forms are approved. The number register and catalogue can be consolidated when straight numerical sequence of form number assignment is followed.

A Forms Catalogue completes the list of forms control tools. This usually is of loose-leaf construction. Supplied to the operating units for reference in planning and requisitioning forms, such catalogues have been found to reduce duplication and the use of nonstandard forms. This catalogue can be one of several types: numerical and alphabetical by form-title listing; or a reduced-size facsimile of each form, arranged numerically by form number; or a combination of these types.

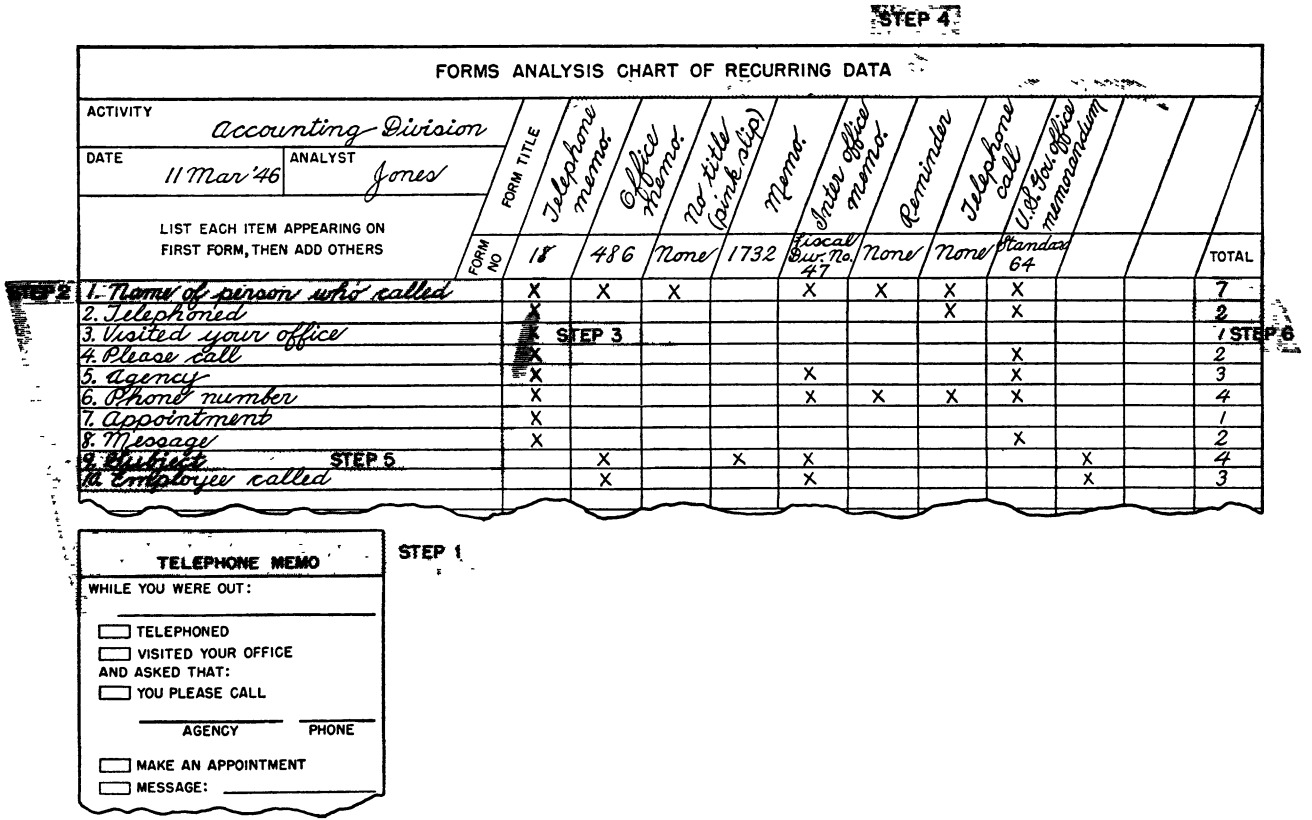

STEP 4
FORMS ANALYSIS CHART OF RECURRING DATA
ACTIVITY
Accounting Division
DATE
11 Mar '46
ANALYST
Jones
LIST EACH ITEM APPEARING ON FIRST FORM, THEN ADD OTHERS
FORM TITLE
FORM NO
Telephone memo.
18
Office Memo.
486
No title (pink slip)
None
Memo.
1732
Inter office memo.
Fiscal Svc. No. 47
Reminder
None
Telephone call
None
U.S. Gov. Office memorandum
Standard 64
TOTAL
1. Name of person who called
2. Telephoned
3. Visited your office
4. Please call
5. Agency
6. Phone number
7. Appointment
8. Message
9. Subject
10. Employee called
STEP 2
STEP 3
STEP 5
STEP 6
TELEPHONE MEMO
WHILE YOU WERE OUT:
TELEPHONED
VISITED YOUR OFFICE
AND ASKED THAT:
YOU PLEASE CALL
AGENCY
PHONE
MAKE AN APPOINTMENT
MESSAGE:
STEP 1

Fig. 5.

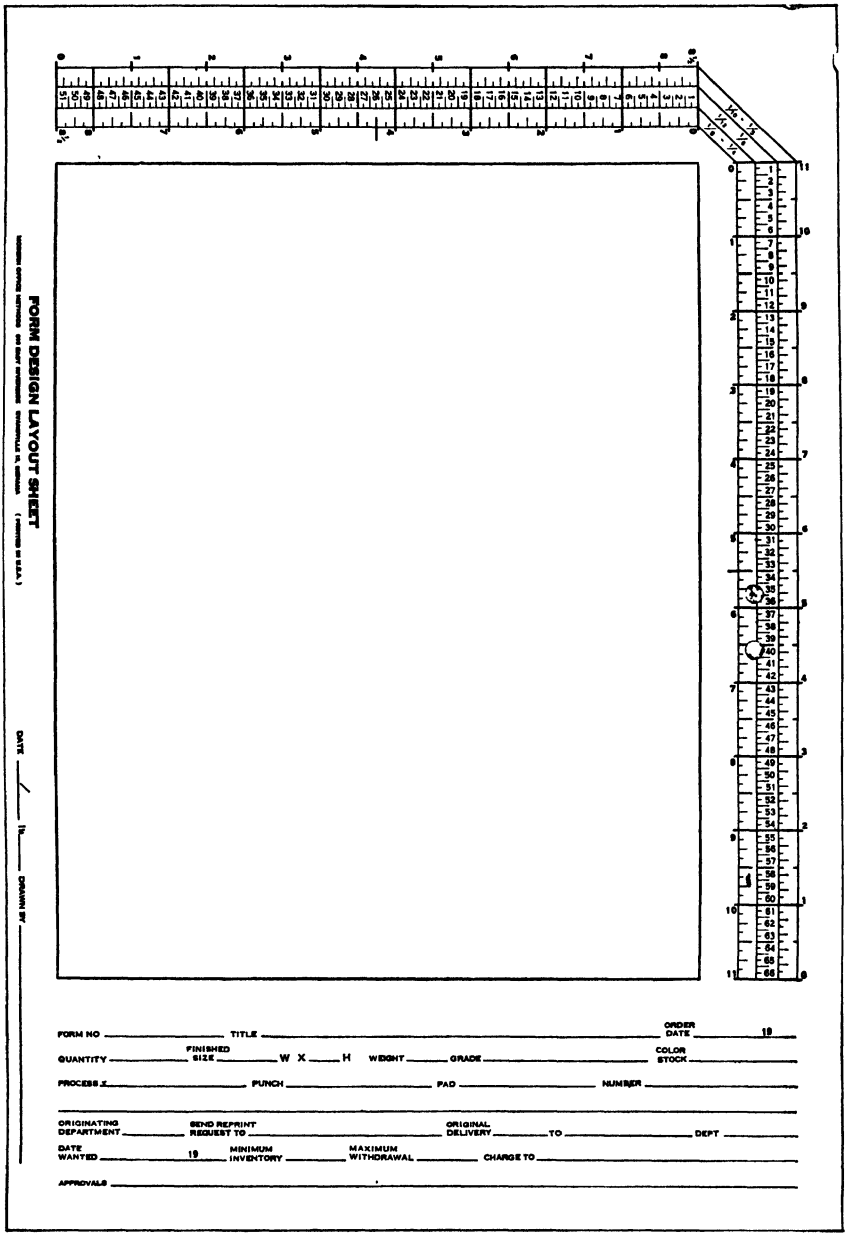

FORM DESIGN LAYOUT SHEET
DATE
DRAWN BY
FORM NO
TITLE
ORDER DATE
QUANTITY
FINISHED SIZE
W X
H
WEIGHT
GRADE
COLOR STOCK
PROCESS
PUNCH
PAD
NUMBER
ORIGINATING DEPARTMENT
SEND REPRINT REQUEST TO
ORIGINAL DELIVERY
TO
DEPT
DATE WANTED
MINIMUM INVENTORY
MAXIMUM WITHDRAWAL
CHARGE TO
APPROVALS

Fig. 6.

4. Administering the program

With the structure up, "machinery" in place, and tools at hand, it takes administrative teamwork to make the forms control program pay the limit in operating dividends.

As has been already pointed out, a written procedure tailored to the needs of the individual company is a *must* in every instance. To regard the procedure as a complete blueprint, however, would be a dangerous oversimplification. The written procedure can be a blueprint only for the simpler parts of the process. As such, it can help make bothersome details less bothersome, help clear the way for the more critical tasks, and in doing so, help promote the teamwork necessary to bring the right knowledge and analytical skills to bear upon form problems at the right times. To expect more would be unrealistic.

In actual practice the necessary analytical processes tend to telescope into each other. The degree to which they do so depends on the complexity of the specific problem and the experience of the person dealing with it. Various aspects of a form—its design, its tie-in with work methods, the duplicating specifications it imposes, its distribution requirements—may all actually be in process of analysis at the same time, with standards being applied throughout the process. These critical activities, therefore, are not discussed here in terms of any precise procedural sequence, though for convenience they are discussed separately.

Registering and reviewing forms. Among the simpler yet usually quite rewarding stages of analysis is the review carried out in conjunction with the registration of each request for either the approval of a new form or the renewel or revision of an old one. This stage, before intensive effort is made to refine the design of a form, brings to light possibilities of combination and elimination.

Cross comparison of forms. In the initial review a critical cross comparison, or simple item analysis, of related forms may be made. The principal tools for the purpose are a questioning attitude and a chart, such as the forms-analysis chart of recurring data already shown. Because it spreads out on a single sheet in simple cross classification the individual items of information sought on any two or more forms, it aids in quickly visualizing possible deletions and combinations.

Thus, in Fig. 5 it appears that three of the eight forms listed—the telephone memo, the reminder, and the telephone-call form—might well be consolidated. More detailed analysis may be necessary, however, before a final determination is made on such possibilities—particularly in dealing with complex forms.

Purge of obsolete forms. Not only should the work of eliminating or combining some activity forms make others obsolete and subject to disposal, but stock inventory reports, routed to the forms control staff and reviewed in connection with the registration and cross comparison of active requests, should provide a fertile source of information on slow-moving, obsolete, or inactive forms.

It is advisable, in addition, to set up a system whereby the using units regularly submit information concerning forms which they have ceased using, so that prompt action may be taken to discontinue stocking them. Conversely the forms control staff should notify using units when forms are officially declared obsolete, and all such changes should be reflected immediately in the forms catalogue and in any procedural manuals or other instructions affected.

This process of review and comparison should not only reduce the number of forms by logical consolidations but should quickly identify those which lapse into disuse as a result of policy or operating changes.

Analyzing forms and their functions. If the major values of forms control are to be realized, however, it is important that forms be approached from a viewpoint broader than the mere analysis of recurring or duplicate data. If a form guides or regulates the way work flows through an office, or between offices, it is important to ask how well the form is designed to give this guidance. If economical work methods are to be followed in filling in or using the form at the various way points in its journeys, it is important that its construction make such economical work methods possible, and that it be as nearly self-explanatory as possible.

In order for design to contribute to efficiency of method, forms must be subject to functional analysis. They must be examined in relation to the specific working purposes they serve (or fail to serve) and in relation to the specific working methods by which those purposes are sought. Once this process has carried the analysis properly into the area of methods and procedures, opportunities inevitably appear for procedural study and improvement beyond the point of forms usage itself.

Such analysis requires a thorough knowledge of the flow of each form, the writing method, and types and sources of information either drawn from or added to the form as it moves from desk to desk. On the basis of such facts, the content, layout, and design can be adjusted so that they serve the form's purpose efficiently and economically. Forms with similar purposes can be related and the procedures to which they apply can themselves be standardized or simplified. This analysis should be carried out with an attitude which asks—

Does the form help to get the job done promptly, at a minimum cost in man-hours and with a maximum of service, accuracy, and utility in terms of the completed record or transaction?

In asking and getting answers to such questions, the office-methods engineer can look at a form profitably from four viewpoints: (1) the writing method, (2) the procedure, (3) the design, and (4) the copy.

Certainly these are not mutually exclusive. The conditions under which a form must be used may arbitrarily govern the writing method or means of fill-in. The writing method in turn may govern many aspects of procedure and design. Thus, the fill-in process is itself a part of procedure (either within the company or outside), and the first three viewpoints mentioned —writing method, procedure, and design—are merely different approaches to the same problem. The value of each is in double-checking the others.

Writing method (fill-in). The end use, the quantity used, the number of copies filled in at once, the number and complexity of required entries, the work steps involved, as well as the working conditions under which the form is used, are primary considerations in evaluating writing method.

Such tasks as entering data, copying, computing, or tabulating may be handled by different persons or may be combined in a single job. The decision to separate or combine tasks frequently depends upon the writing methods available.

If handwriting is selected, special considerations may apply. Should cut or loose forms, padded forms, unit sets with interleaved carbon, or continuous autographic-register forms be adopted to facilitate the handwriting method?

Likewise, if machine-writing is selected, questions must be answered concerning size, mechanical specifications, and limitations of the specific machines involved. Specified grades and weights of paper may be required. Arbitrary spacing may be imposed.

All such questions must be settled before final determinations on either procedure or design can be made.

Procedures. In addition to the procedural aspects of making entries on a form are all the activities leading up to and growing out of the act of making entries. Usually these are less routinized and hence even more in the need of simplification than are the immediate tasks of making out the form. These are the "nine-tenths of the iceberg below the surface." They are among the *operating implications* which staff people may tend to overlook in developing forms.

Among these additional procedural and work-load aspects are: (1) the processes of tallying, searching, assorting, assembling, and computing which may be necessary before required data can be entered on the form; (2) the

making and routing of extra copies; (3) the excerpting or transcribing of selected data from the completed form for any collateral records involved; and (4) the ultimate review, interpretation, and end action without which the form and all the activity generated by it would be meaningless.

Process charts can be used for following forms in their procedural movements and for analyzing the activity engendered at their various stopping points, just as they can be used to trace and analyze the movement of workers, materials, and components in a manufacturing process. Many types of charts are in use. Selected types, including a forms-distribution chart, are illustrated in Fig. 7. It is not the purpose here to introduce new tools for the procedural analysis that should accompany forms control, but rather to stress the more apt and economical application of existing tools as part of the hand-in-glove relationship of forms control to total office-methods activity.

Presupposing the use of existing office-methods tools consistent with the nature and importance of the procedural problems met, the approach is the same whether the work is handled by personnel who specialize in forms work or turned over to other office-methods staff.

Answers to such questions as these must be found:

What work is done, and *why*? Is all of it necessary? Does each step serve a recognized purpose and produce a desired result?

Who performs each step, and *why*? Organizationally and occupationally, are these the appropriate persons? Can tasks be rearranged, simplified, or combined for more efficient staff assignments?

Where is the work performed, and *why* there? Can it be combined with similar work at another point to produce a greater volume and a more stable work load?

When is the work done, and *why* then? Why are the steps done in that particular order? Can peak loads be leveled off by better scheduling, to permit better staffing, more effective control, better quality, and higher average production?

How is the work done and *why* that way? Can the method be improved? How about layout, setup, motion sequence, mechanical aids?

By finding answers to these questions, the office methods staff is able to determine whether the form helps in the performance of a necessary function of the company. It is able to see more clearly how unnecessary copies of forms can be eliminated; how different forms can be combined so that they can be written in one operation; how the amount of information required —and hence the work of obtaining it—can be curtailed.

By identifying or arranging common work steps in different procedures and then combining them, it is often possible to assure a more even work flow and to level off peaks and valleys in work load.

CHART SELECTOR

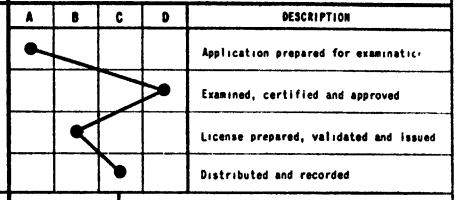
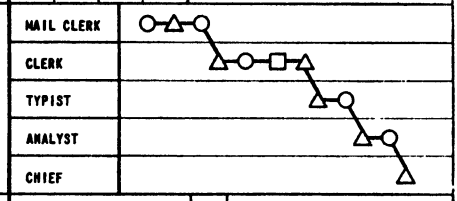
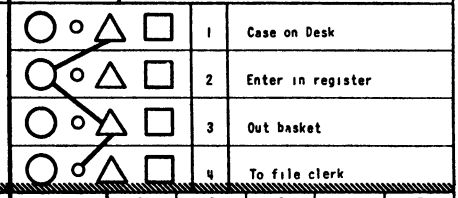
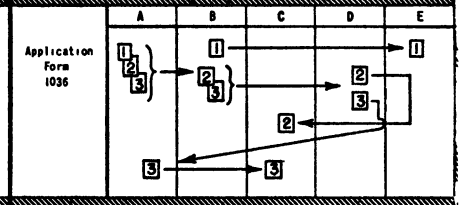
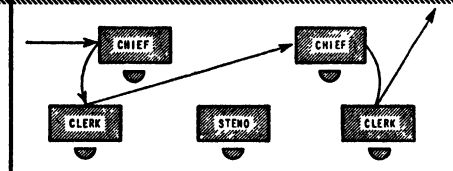
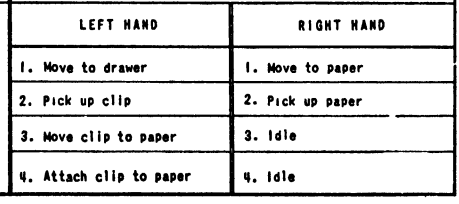
OBJECTIVE	CHART TO USE	ILLUSTRATION OF CHART
To study the sequence of major operating steps in an activity and the organization units performing them.	**WORK FLOW CHARTS** give a general description of the steps in one column; other columns represent organization units. The connecting lines show the flow of work.	
To analyze the detailed steps in a flow of work that is quite complex or involves several organization units.	**MULTI-COLUMN PROCESS CHARTS** show steps in greater detail than on a work flow chart -- symbols are used to describe steps.	
To study the detailed steps in a relatively simple procedure such as one within a single organization unit.	**SINGLE-COLUMN PROCESS CHARTS** are often drawn on printed forms, work flow is shown by connecting the appropriate symbols.	
To study the flow of copies of a multi-copy form.	**FORM DISTRIBUTION CHARTS** show the number of copies in the first column. The flow of each copy of the form is traced from unit to unit.	
To improve the layout of the office so that unnecessary steps can be avoided.	**LAYOUT FLOW CHARTS** involve a diagram of the office made to scale -- the flow from desk to desk is shown by arrows.	
To simplify the steps in an operation performed by one employee.	**OPERATION CHARTS** are of several types; the one shown in the next column is commonly used to study the motions of each hand.	

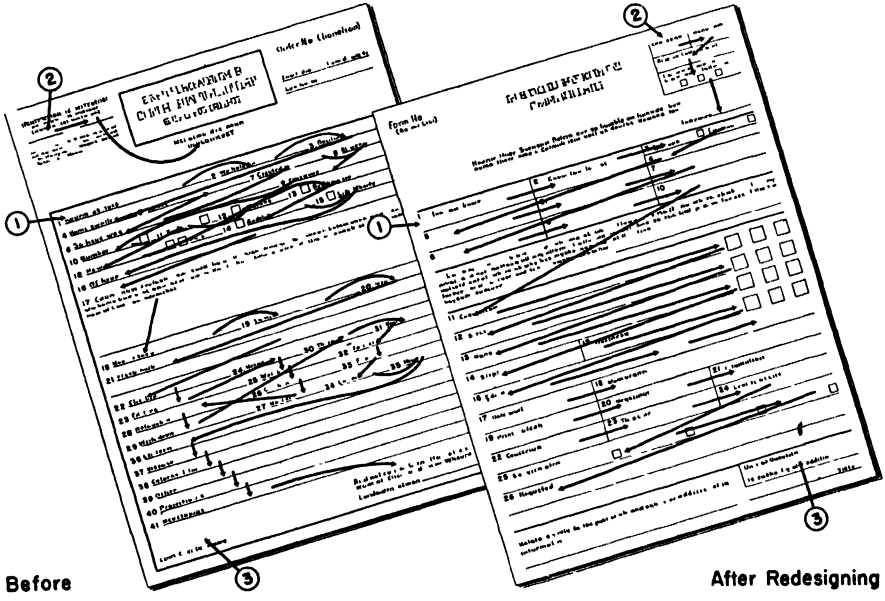
Fig. 7.

Design. The design of a form should evolve primarily from the methods and procedures of its use. To that extent design and layout considerations are products of procedural and writing-method analysis, or in fact, a continuation of such analysis.

Similarly, copy determinations—the wording used for item headings and for explanatory and instructional notes embodied in the form—should be made in the light of the uses and users of the form.

It is predominantly in the design development, proceeding from the functional design analysis, that standards are applied. In terms of function, the following questions may help to evaluate the effectiveness of design:

Is the sequence of items easy to follow? Does the order of items on the form correspond to that of source records from which information is to be drawn? Are the items laid out to make reference and clerical work as accurate and as fast as possible? Hit-or-miss arrangement invites mistakes and



Before After Redesigning

Exhibit A.

lowers the quality and quantity of clerical output in transcribing or recording. Logical sequence, including the planned grouping and boxing of related information, speeds up such work and also simplifies reference to the completed form by the end user. See Exhibit A.

Does arrangement make for continuous execution? Has the line-flow concept been observed (will hand or typewriter proceed from item to item with

a minimum of travel)? By whom, and in what order, will data be entered? If by different persons, will they each have to hop, skip, and jump all over the form, or are the items grouped as nearly as possible to avoid searching, backtracking, and eyestrain?

Does the design reduce the amount of writing to a minimum? Writing, either by hand or by machine, takes time. Is maximum use made of such devices as check boxes and preprinted alternatives?

Does the design take advantage of writing-machine characteristics? Is the form designed for use in types of machines known to be available where the form is to be used? Would a slight change make it equally usable in a wider range of equipment? Do vertical and lateral spacing on the form match spacing of the machine? Is the bottom margin ample to permit use in the machine without slipping?

Is the design consistent with the files or binders to be used? Will identifying data be readily visible in the file? Are adequate margins allowed for binding?

Does the design simplify identification, distribution, and control? Will titles, numbers, or colors facilitate routing, dispatching, handling, and checking? Will such devices assist in locating misplaced or delayed forms in the work process? Will arrows, pointers, fists, leaders, or other visual guides draw attention to points of special importance? Or are such devices misused or overused, serving only to clutter up the form and distract the user?

Is space used economically? Are unneeded borders eliminated to allow continuation of writing into margins? Has an analysis of completed forms been made over a period of time to verify space requirements for individual items? Have unneeded sections been eliminated in favor of either a smaller form or more space at those points where actually needed? Is there a simple and logical provision for the overflow or continuation of information to a designated space if regular spaces prove inadequate in certain instances?

Does layout achieve proper visual effect? Will all copy be legible under conditions of use? Are logical relationships among subject headings borne out by correspondingly related type sizes and positions? Has recognition been given to visual habit patterns in determining sequence and position of items? Have pointers, guide lines, leaders, and type variations been judiciously used to facilitate eye movement?

Copy. Even if the use of a form must be based on detailed instructions in a separate sheet or procedural manual, the form itself should be made as nearly self-explanatory as possible without overburdening it with detail. This need is met partly by the layout and arrangement of elements on the form, as already mentioned, but chiefly by the literal content of the copy itself.

"Copy" placed on the form to aid the user is of importance increasing with the complexity of the form. Even in very simple forms, however, wording can be a stumbling block. In fact, the time consumed in filling out forms—especially forms not used repetitiously—may be multiplied over and over by omissions, complexities, and ambiguities of wording. When hundreds of thousands of persons use a form, even a few lost minutes by each can total weeks and months of lost time—not to mention losses in worker morale and public good will.

Applying form standards and getting results. It has been pointed out that standards for the design and reproduction of forms should be developed before any attempt is made to put a forms control program into operation. Once developed and circulated among all form-using units, the standards should find continuing use within those units as the need arises for new forms or the revision of old ones and as the first rough sketches take shape preparatory to any formal request to the forms control staff. In the forms control unit, the standards are applied throughout review and analysis, but especially in the final stages as design and copy are made ready for duplicating or printing.

Specific needs of an operation or procedure, such as the use of a window envelope, will frequently dictate many aspects of design. Certainly the relationship of form to procedure should have been agreed upon by the forms control staff and the using units, and a list of all required items determined, before any final application of standards is attempted.

The sketching out of completed forms is simplified by the use of design guide sheets (Fig. 6). There are many types of design guide sheets, generally preprinted so that they can be photographically reduced or enlarged to various standard form sizes. The sheets are calibrated in sixths and tenths of an inch, vertically and horizontally, so that spaces on the form can be ruled off quickly and with assurance that they will conform to standard typewriter line and letter spacing. Forms to be used for tabulating, bookkeeping, or special equipment should be designed on special guide sheets obtainable from manufacturers' representatives.

Controlling storage and distribution. Sound storage and distribution practices applicable to forms will assure that—

Operating units are supplied with forms when, where, and in the amounts necessary

Storage space is conserved: (1) by limiting the supply of forms on hand to feasible time-period requirements; and (2) by disposing promptly of obsolete forms

Production costs are minimized by ordering in economical quantities

Coordinated approach. Storage and distribution of forms normally are the job of an office services, publication and distribution, or similar service unit. The primary responsibility for formulating the storage and distribution pattern and the stocking and reordering procedure, however, may well be centered in the forms control program. In any event, that work, like most other work in the development and control of forms, requires close coordination among the units concerned.

In all cases, the general pattern of storage and distribution must be considered along with design and reproduction specifications, for the factors are largely the same.

Taking inventory of existing forms and reducing working stocks within individual using units are the first steps in bringing form supplies under control. A directive instructing operating units to return to a central location all forms in excess of actual needs for a given period should clean out desks and bring supplies into the open. Except for current working requirements, the supply of forms should always be stocked at central locations in order that inventories can be kept at a reasonable operating minimum. Initial quantities of new forms can be estimated in the usual way, by the initiating units, and reviewed by the forms control staff. After this initial supply has been determined, an account of actual usage should be maintained by the stockroom, along with current inventory records of all other forms. Such inventory and rate-of-use information then provides the basis for establishing realistic minimum stock levels, distribution patterns, and reorder procedures.

Determining quantities to stock. The factors to be considered in deciding how many of any given form to order and store at any one time are perhaps obvious. It is essential, however, that none of the more important factors be overlooked. Included among them are—

Volume and rate of use
Place of use
Physical characteristics (size, shape, weight)
Method of reproduction or printing
Place of reproduction or printing
Economical production quantity
Economical shipping quantity
Probable deterioration
Possible obsolescence
Availability and cost of storage space

The chief problem is to take advantage of the low unit cost of volume production while at the same time avoiding undue use of storage space and undue risk of loss through obsolescence or deterioration. Forms are seldom as "permanent" as they are expected to be. Changes in activities or

methods, requiring changes in forms, cannot be anticipated long in advance. The obsolescence of forms in storage and in distribution pipe lines often wipe out savings expected from volume purchases.

Establishing minimum stock levels. Aside from determining economical quantities for ordering or reordering purposes is the problem of assuring that reorders are placed at the right time to prevent any lapse in supply to using units. This is the problem of determining the "minimum stock level" for each form—the inventory balance which denotes the reorder point. Factors entering into such determinations include—

Volume of use
Rate of use
Place of use
Time of use (one-time, periodic, or continuous)
Time required for reproduction or printing and delivery

The time required for reproduction or printing is particularly important and quite likely to be underestimated if controls are lax. This time will differ according to the method of reproduction, place of reproduction, and complexity of specifications. Printed forms ordinarily require more time than forms produced by office duplicator. Forms ordered from another location usually require more time than those produced locally. Multipage, padded, or specialty forms normally require more time than single-sheet forms (cut forms). Forms that call for an extra color of ink or for extra bindery operations require more time than those that do not.

Alternative reproduction processes, as well as decentralized production facilities, should be considered when appropriate, as means of reducing delay in stock replenishment and permitting the establishment of stock and reorder points at levels which are reasonably low but still safe.

As soon as issuances from stock bring the supply down to the designated reorder point for any form, the stockroom should notify the forms control staff (see forms minimum stock level notice, Fig. 3) so that any possibility of revising or discontinuing the form can be considered and a reorder placed if appropriate.

Establishing distribution pattern and procedures. In the local distribution of forms, it is common for the using units to requisition initial quantities from the stockroom. Alternatives are for either the stockroom or the reproduction plant to make the initial distribution on advice of the forms control staff. The choice of the procedure to be followed will depend on what operating units are concerned with the form, their locations, and their individual requirements, as well as the distribution facilities available to the duplicating plant or stockroom. After the initial working supply is distributed, subse-

quent distribution is by requisition from the using units to the stockroom.

On those forms which have been standardized for company-wide use, a company headquarters can maintain bulk stock of forms and fill field-office requisitions on a monthly, quarterly, or semiannual basis. (In the case of forms peculiar to such an office, or of forms used in small quantities, it may be advisable to ship in annual quantities.)

On the other hand, if quantities used in the field are large, it may often be more economical to have forms produced with distribution handled on a decentralized basis, rather than pay shipping charges from headquarters. This practice bears consideration particularly if field or local changes must be made in forms or if volume use of certain forms is concentrated in a few areas remote from the headquarters office. In any event, the cost of shipping should be added to the cost of centralized production before comparing the total cost with that for decentralized production. The reproduction or printing method desired and the availability of facilities for such reproduction in the field, as well as the availability and relative cost of storage space in the field, are not to be overlooked either.

Companies using many forms often follow a combination of these two patterns. Some customarily have all printed forms centrally produced and distributed, while duplicator-processed forms may or may not be, depending upon their complexity of design, the volume and extent of their use, and other factors.

Before coming to a decision on such questions, however, all possibilities should be reviewed. For example, if facilities for the desired reproduction or printing process are economically available in the field but the complexity of design or the composition costs make it undesirable to decentralize the total production job for certain forms, it is possible to retain the advantage of centralized composition and at the same time the shipping advantage of decentralized press work and distribution by having printing plates or mats, offset plates, or negatives, or preprinted or die-cut master stencils prepared at a central point and sent to field locations to be reproduced or printed locally.

Still a third pattern may be advisable in certain instances. A form which may have to be widely used, but only for a brief period, may be advantageously printed at a central point and distributed directly to all using offices.

Whatever distribution pattern is adopted, however, the procedure should be such as to assure accountability in terms of such considerations as have been outlined here. If field production, storage, and distribution are involved, the procedure for such accountability must necessarily provide for regular reporting of form supplies and usage to the central control unit, and for occasional redistribution and balancing of stocks. In fact, the more

decentralized the storage and distribution activity, the stronger the central reporting system should be.

Evaluating the program. A plan for evaluating results of the forms control program should be developed at the time the program is begun. Probable benefits should be identified and a procedure established for estimating, recording, and reporting such results.

Among the many units of measurement which may be used for the purpose are money, man-hours, and storage space.

Among the areas susceptible of such measurement and reporting are—

Improvements in procedures which reduce backlogs, shorten total processing time, or reduce spoilage

Improvements in writing methods that save time in typing or writing, clerical processing, tabulating, filing, and finding (particularly where such tasks are done in great volume)

Improvements in design that mean savings in paper, printing, storage, and distribution costs

Many of the more valuable results will be intangible and amenable only to subjective appraisal. This fact alone, however, makes it all the more important that those results which can be measured should be and that reports of such measurement be reviewed regularly by management in estimating the total dividends, spotting the inadequacies, and charting the future course of the forms control program.

Figure 8 shows a simple form as an example of the type of information which can be used for the monthly reporting of forms control progress.

Keeping perspective. There is no escaping the fact that forms are necessary, often in large numbers. Without them, paper work would be many times its present volume. Yet there are forms that are not necessary, and these too may exist in large numbers. *They should be eliminated.*

Among those that are necessary, many are unnecessarily expensive, in terms of either their production cost or their procedural use—if not both. In addition, many forms may be found expensive from the using standpoint because of attempted economies in the printing. *These should be "procedurized," simplified, and standardized.*

Savings to be realized by these means are considerable indeed. In general, however, forms are a reflection of the work methods, operating procedures, and management know-how which give rise to their use. If a company's forms constitute a simple, orderly plan showing clear and related purposes, there is reason to believe that its personnel—knowing what they are doing and why—may be giving fairly efficient service. If, on the other hand, its forms constitute an unintelligible tangle of red tape, it is pretty safe to

BSC FORM NO. 1234 (4-46)
DEPARTMENT OF ABC
OFFICE METHODS DIVISION

BEST SELLING COMPANY
FORMS CONTROL PROGRAM
_____ (MONTH) PROGRESS REPORT

1.* FORMS SUBJECT TO FORMS CONTROL PROGRAM		LAST MONTH	THIS MONTH
2. FORMS REVIEWED (ACTION COMPLETED)		LAST MONTH	THIS MONTH
3. ANALYSIS OF WORK LOAD: A. NUMBER OF FORMS ON HAND PENDING REVIEW		START OF MONTH	END OF MONTH
B. ACTION TAKEN ON REQUESTS	REJECTED	APPROVED WITH REVISIONS	APPROVED AS SUBMITTED
C. FORMS CONSOLIDATED		NUMBER OF OLD FORMS	RESULTING NEW FORMS
D. FORMS ELIMINATED		BY CONSOLIDATION	NOT REPLACED
E. FORMS STANDARDIZED		AT TIME OF REPRINT	BY SURVEY, REQUEST, ETC.
4. NUMBER OF MANHOURS EXPENDED			MANHOURS

* INDICATE BELOW OFFICES OR REGIONS UNDER THE FORMS CONTROL PROGRAM.

5. REMARKS: (REPORT SAVINGS EFFECTED IN PRODUCTION OR DISTRIBUTION COST, MANHOURS, ETC.)

CHIEF OF FORMS CONTROL SECTION

Fig. 8.

assume that its methods and procedures—its service or relationships to the public—are in much the same shape.

Therefore, great as may be the savings from eliminating unnecessary forms and getting all necessary ones properly related to existing procedures, *forms control offers a still greater value as a means of detecting the need to treat the procedures themselves.*

Here, then, are the orientation and the challenge to which it is hoped this material has held in outlining some of the principal considerations necessary to the establishment of a forms control program.

There are limitations, to be sure. The ideal of standardizing all forms and bringing them all under strict production and distribution controls, to avoid the waste, confusion, and inefficiency that are bound to attend uncontrolled practices, is a worthy goal. Yet, if well grounded, the staff having responsibility for bringing such controls into practical application will not, in its zeal, forget that forms control, like any other staff function, exists only to serve major operating objectives. *It is no end in itself.*

There are times when forms that are essential to major operating obligations must be developed, produced, and widely distributed almost overnight. The intrinsic value of the forms in question—though representing many dollars—may be insignificant compared to the overriding values of the operating objectives at stake. In such a contingency the risk of not having enough forms may so far outweigh the calculated risk of having too many that ordinary standards of production, storage, and distribution may have to go by the board. Any unused forms resulting may be a cheap premium for the operating insurance bought.

On the other hand, without the effective balancing of a strong forms control program, pressures to justify exceptions on such grounds usually get out of hand. Certainly, therefore, complete consideration to all aspects (function, design, identification, production, storage, and distribution) and all their procedural and public relations implications must be given on the basis of regularized review and analysis, with a minimum of exceptions.

With vigorous topside support, clear placement of responsibility for each step in a well-defined procedure, and close coordination to utilize the scattered talents that must be drawn upon, the centralized review and analysis of company forms will pay off in double dividends.

5. Common standards for forms design

As an aid to companies in developing their own standards for the physical aspects of forms, the following pages contain standards that have been selected from those now followed by many industrial activities. The list covers seventeen characteristics found adaptable to standardization. A large

company may wish to develop more explicit criteria in the light of its own circumstances and to expand the number of different items covered as it gets under way, so that specialized classes of forms—form-type form letters, accounting forms, and others—may have specific criteria for their design.

Such standards should be applied by the initiating unit when drawing a rough sketch of the form to be submitted with the forms requisition, and by the forms control staff in reviewing the request and sketch or in making up a new design, as well as in making any necessary adjustment of specifications before forwarding the requisition for duplicating or printing.

Cut form sizes

- Any size that can be cut from 34 by 44 inches without waste, particularly sizes 4¼ by 5½, 8½ by 11, 17 by 11, 17 by 22, 22 by 34
- Normal file-card sizes: 3 by 5, 4 by 6, 5 by 8
- Post-card size: 3¼ by 5½
- Considerations:
  - Avoid crowding content
  - Conform to dimensions of storage and filing facilities (*i.e.*, legal size, letter size, etc.)
  - Fit to standard office machines for fill-in (*i.e.*, typewriter, bookkeeping machine, etc.)
  - Fit to standard-size envelopes

Paper weight and grade

- Operating unit ordinarily should specify one of the following four:
  - Mimeograph, 16- or 20-pound (basis 17 by 22) [1]
  - Card, 180-pound (basis 25½ by 30½)
  - Sulfite, 16-pound (basis 17 by 22)
  - Bond (25 per cent rag), 16-pound (basis 17 by 22)
- More precise specifications may be made by forms control office
- Variations permitted on special justification
- Selection should be based upon—
  - Handling requirements
  - Writing method
  - Number of copies to be made at one writing
  - Length of time the form will be retained
  - Printing requirements (*i.e.*, printing on two sides, by a given process, etc.)
  - Filing and storage space requirements (affected by thickness of paper)
- The above considerations may be required to apply on each copy of multiple copy forms

Color of paper

- Specify color only when needed for emphasis or for more efficient filing, routing, or sorting

[1] Dimensions refer to sizes on which weights are based; not necessarily to sizes stocked by the printer (see "Cut form sizes," above).

Reduce the need for colored paper by use of sorting symbols, bold headings, heavy ruled lines, or other devices when possible

Exceptions permissible for specific organization or operating requirements.

Color of ink

Specify other than black ink only when fully justified by volume and increased efficiency in use of the form and when the more economical possibilities of colored paper are inadequate

Two-color printing should be avoided except under extreme justification

Identification and heading

Heading may be centered across entire top of form, or centered in space to the left of any entry boxes placed in upper right. (Upper right should be designed for file or other ready-reference entries if needed)

Within space decided upon, arrange generally as follows:

Form number and issuance or revision date—upper left corner

Company name and location—upper left (under form number) or top center (depending on its importance in use of form)

Form title—center of top (under company name and location, if that item is centered). Use conspicuous type

Exception: Run identification across bottom of vertical-file-card forms unless needed for file-reference purposes

Instructions

Well-designed forms require few instructions other than captions and item headings. When required, instructions usually should be—

Set in two or more narrow columns rather than full-width lines

Listed as numbered items rather than in paragraph style

Placed as near items to which they apply as possible (unless length would detract from effective layout)

When instructions are segregated on form, they should be placed—

At top right or top center, if concise and applicable to the whole form

At bottom, if that will make possible more economical use of space

On reverse, if no space available on face

Address

If name and address are inserted prior to mailing, position of name and address should be suitable for window-envelope use

Forms requiring return should be properly identified as provided above

Forms intended for use in window envelopes must conform to postal regulations, which in general provide that nothing other than name and address, and possibly mailing symbol, shall appear in the window. The form must fit the envelope to avoid shifting of the address. Standard-size envelopes only should be used

Preprinted names or facsimile signatures

If form is to be stocked for continuing use, personal names or signatures of officials should be preprinted only on special justification, to avoid having large numbers of forms made obsolete by change of officials

Preprinting of titles only, and the use of rubber stamps or automatic signature inscribers, are alternatives to be considered.

Form arrangement

Align beginning of each writing space on form vertically for minimum number of tabular stops

If box design is used—

Serially number each box in its upper left-hand corner

Start caption in upper left-hand corner, to right of number, leaving fill-in space below caption

Draw box size to provide sufficient space for fill-in

Place essential information where it will not be obscured by stamps, punches, or staples, or be torn off with detachable stubs

Group related items

Include "to" and "from" spaces for any necessary routing

Provide for use of window envelopes, when appropriate, to save additional addressing

To the extent practicable, provide same sequence of items as on other forms from which or to which information is to be transferred

Arrange information for ease in tabulating or transferring to machine punch cards, if those are involved

Check boxes

Use check boxes when practicable

Place check boxes either before or after items, but all in the corresponding positions within any line series

Avoid columnar grouping of check boxes if possible, because of poor registration when carbon copies are required. Place check boxes before first column and after the second column when there are two adjacent columns of questions

Margins

Printing margin

Printed all-around borders usually should not be used, since they tend to increase production problems and costs

In any event an extra margin of $\frac{3}{8}$ inch, or not less than $\frac{3}{10}$ inch, from edge of paper should be allowed on all four sides for gripping requirements in printing and as a safety margin for cutting

No printing—neither border nor text—should be permitted in that space

Binding margin (printing permitted, but no fill-in items should be within these margins)

For press-type fastener, side or top, 1 inch

For ring binder, 1 inch

Fill-in margin

Top typewriting line, at least $1\frac{1}{3}$ inch from top of paper if possible

Bottom typewriting line, not less than $\frac{3}{4}$ inch from bottom

Hand fill-in permissible above or below these lines

Space requirements for fill-in

Typewritten

Ten characters to the horizontal inch, to accommodate both elite and pica typewriters

Three fill-in spaces to the vertical inch, each space being double typewriter space

Handwritten

One-third more space horizontally than for typewritten fill-in

Three spaces to the vertical inch, each space double that of typewriter space

Rulings

Use heavy 1½-point or parallel ½-point rulings as first and last horizontal lines, between major divisions, and across column headings

Use ¾-point rulings across bottom of column headings, and above a total or balance at the foot of a column

Use hairline rulings for regular lines and box lines when no emphasis required

Use ¾-point rulings for vertical subdivision of major sections or columns

Use leaders as needed to guide eye in tabular or semitabular items

Signature and approval date

Single handwritten signature usually goes at bottom right of last page. Allow ½ inch (three single typewriter spaces) vertically and 3 inches horizontally

Two handwritten signatures normally go left and right at bottom of last page

Space below the ¾-inch bottom typewriter margin generally reserved for handwritten signatures and dates

Two-sided forms

Two-sided forms ordinarily should be printed head to foot (top of front to bottom of back), especially if top-punched for binder use

If punched in left margin for binder use, two-sided forms should be head-to-head

Three- or four-page forms (one sheet folded once) should be head to head throughout if open-side style, and head to foot if open-end (so that, when opened for use, head of third page follows foot of second page)

Head-to-foot open-end forms are preferable for machine fill-in

For multipage forms, separate sheets of proper page size should be used instead of larger sheets folded to page size, unless the larger sheets can be cut economically from standard paper sizes and run on standard printing or duplicating equipment

Prenumbering

Use prenumbered forms only if accounting or control is required for each form or document

Place number in extreme upper right corner

Punching

For standard press-type and three-hole ring binders:

Distance from edge of paper to center of hole should measure 3/8 inch

If two holes are punched, for press-type fastener, the distance between centers should be 2¾ inches

If three holes are punched, distance from center to center of adjacent holes should be 4¼ inches

Consult printer for slotted, square, or other unusual punching, if necessary

COMMON TERMS USED IN TITLING FORMS

In selecting a combination of words for the title of a form it is important to indicate clearly and briefly the subject to be dealt with by the form (*e.g.*, "office materials") and the function or purpose of the form (*e.g.*, "receipt"). One way to avoid misunderstanding is to rely on words known to have commonly accepted meanings among the group that will use the forms. Certain "function words" recur frequently in the titles of the more common types of administrative forms, and thus tend to become more or less standardized. Some of these are listed below, each with a brief notation on the purpose which a form would be expected to serve if its title included the word indicated. It will be observed that these notations are in no sense definitions; they merely show purpose or function in terms of forms usage.

Terms	*Purpose of form*
Acknowledgment	To make known the receipt of
Agreement	To offer and accept in writing
Application	To request something
Authorization	To permit an action
Check list	To verify, or to remind of action or data to be considered
Claim	To demand as due
Contract	See "Agreement"
Estimate	To forecast or calculate approximately
Follow up	To remind of uncompleted action (tickler file or follow-up letter)
Identification	To name
Instruction	To explain how (not to order or direct)
Inventory	To report or record a periodic count of stock on hand on a certain date
Invoice	To bill or charge for
Itinerary	To list places to be visited, showing arrival dates or times
Notice	To transmit an unsolicited statement of action or status
Order	To order (procure) purchased materials, work, etc., or to order (command) to travel, duty, etc.
Pass	To permit or license to pass, or to go and come
Permit	To permit or license to perform a specific act
Receipt	To acknowledge delivery or payment given by recipient
Record	To retain an account of facts or data
Report	To transmit an account of action or status
Request	To ask for
Requisition	To formally request

Terms	*Purpose of form*
Routing slip	To send an attachment along a circuit of persons or places
Schedule	To outline regularly recurring events or write a plan of future events
Stock record	To record stock on hand
Transmittal	To send an attachment to another person or place

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The above list is by no means complete. Among many equally useful

references that could be added are other publications of the American Management Association, the Life Office Management Association, the National Office Management Association, and the Society for the Advancement of Management, as well as booklets on the subject available from industrial firms, including paper and forms manufacturers. Articles in such magazines as *Office, Purchasing, Hospitals,* etc., devoted to specialized activities are rich in useful references of material assistance to forms staffs.

Section 19

HOW TO BUY BUSINESS INSURANCE

BY

LEO ROSENBLUM

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HOW TO BUY BUSINESS INSURANCE [1]

Introduction

This section deals with your insurance. It answers such questions as: What risks do we face? Can they be covered by insurance? Should we buy such insurance? How much do we need? How can we get the right coverage at the right price? With what kind of company should we insure? Are savings in premiums possible? How can we effect them?

Important matters concerning your insurance are pinpointed in this section. Problems which may arise when you make claim are considered. Insurance plans adopted by particular businesses are set forth. Methods of rate reduction are enumerated. A check list of common types of coverage is presented. How taxation affects your insurance is discussed.

1. Insurance—what it is; what it does; how premium rates are figured

The purpose of insurance is to indemnify people who undertake risk and suffer loss. The insurance policy defines the risk and states the conditions under which the insurance is written. It also makes clear the procedure of settlement of losses.

Under an insurance policy, after a loss the insurance company need not put the policyholder in as good a condition financially as if no loss had occurred. In property insurance the measure of loss is the replacement or reproduction value of the property at the time of the loss, after reduction for depreciation and obsolescence.

Public policy limits insurance contracts to liability for indemnity for loss. The contracts must not be used as a means of moneymaking and profit. The most the policyholder can collect from the insurance company is the amount of coverage provided under the policy.

The company is not required to make reimbursement for sentimental values. Nor are anticipated profits, lost when business is interrupted because of some casualty—for example, a fire—collectible from an insurer unless special coverage has been arranged for, and additional premium paid.

The insurance contract is a personal one. Generally, it cannot be trans-

[1] Appreciation is expressed for the assistance rendered by David I. Rosenblum, of the New York Bar, and the Honorable Monroe Flegenheimer, member of the New York State legislature, insurance educator, and insurance consultant. They read the first draft of the major part of this chapter and made valuable suggestions.

ferred without the company's consent. But there are some exceptions to this rule, for example, life insurance contracts and marine insurance contracts. And in other cases the insurer may alter the personal nature of the contract by endorsement. Therefore, if you contemplate assigning your insurance contract, make sure that the company will honor the assignment.

As a buyer of insurance you know that it substitutes certainty for uncertainty. In effect, policyholders pool their hazards. As a result they lose the fear that expensive, perhaps catastrophic, losses may occur. This fear is replaced by confidence that the insurance company will usually make prompt settlement. The period of interruption of business is reduced; the date of return to full business activity is brought very close.

You can determine exactly what the cost of insuring your property will be. It is the amount of the premium.

Some firms prefer to be self-insurers. They do this out of the desire to save money. These firms plan individually to absorb, as costs of doing business, any losses they may suffer from fire, burglary, or other casualty.

From time to time the self-insurers set aside funds as a reserve against losses. The amounts reserved are based on an estimate of losses to be expected. The reserve procedure should be actuarially sound.

However, if an uninsured firm sets aside no funds whatever to meet losses, it cannot properly be called a self-insurer. It would be merely a firm with no insurance.

Another important problem encountered by the self-insurer is the setting up of a satisfactory claims service.

Self-insurance is relatively uncommon. In fire insurance the procedure is practical only where a company has a large number of properties, widely distributed. In health, accident, and life insurance, self-insurance is even less common. This is so because to operate safely and effectively, coverage of this type must take in a very large number of people; otherwise it is not practical.

When a plan of self-insurance is in effect, the firm should buy catastrophe insurance or excess insurance. This is indemnification which becomes available when losses exceed stipulated amounts, those which the self-insurer estimates it will be able to carry without assistance. Insurance companies known as excess insurers accept risks over and above the part which the self-insured firm is prepared to assume.

The contract of insurance is called the policy. It shows the names of policyholder and insurance company, the type and amount of insurance, and the premium and period of coverage, and it enumerates the general rules and conditions which are applicable. The policy also contains the special clauses

and endorsements which relate to the particular type of property or hazard insured.

Policies covering the same items should be written so that the descriptions and coverages are identical. Naturally, this does not refer to amount, term, and expiration date, which will usually vary from policy to policy.

Policies written in the fashion recommended are referred to as concurrent policies. Those not so written give rise to a situation of dissimilarity of coverage known as nonconcurrency. It often raises problems, at the time of adjustment of losses, which could have been avoided had the policies been concurrent.

Most policies contain a section listing exclusions from the coverage. These are the perils or hazards, situations, persons, or things which are not covered under the policy. In fact, even the term "all risks," as used in describing certain insurance policies, is not intended to be interpreted literally. It refers to contracts which provide insurance against all perils except those specifically excluded under the policy.

Insurance policies often contain supplementary sections called "endorsements" or "riders." These are written, printed, or stamped modifications or amendments of the conditions of the policies. There are many types of endorsements. They include changes in term or rate, coverage of specific incidents or events, eliminations or increases of items or amounts covered, assignments or changes of title and interest, and corrections of errors.

There should be no duplication or overlapping of coverage of the same items and risks in many different classes of policies. This would be wasteful. Although premiums would be paid in duplicate, only one recovery could be had.

To be eligible for insurance you must have an insurable interest in the item covered. This means any interest that may sustain loss as a result of a risk against which insurance is available. To permit insurance without such interest would be to allow gambling.

Premium rates quoted for insurance are the result of considerable actuarial work. They vary with the exposure and are based upon underwriting experience. The insurance companies try to set the rates in such way as to cover losses payable and the expenses of doing business, and to earn a fair profit. Under some circumstances the premium rates may be influenced substantially by your company's loss experience.

Many insurance policies are obtained on the basis of a deposit representing the estimated amount of premium due for a given period of time. These policies provide for periodic audit to determine the additional sum due the insurance company or the refund or credit to be given the insured.

Insurance companies consider carefully the physical hazards and the pos-

sible moral hazards offered by the risks presented for coverage. But it appears that the companies will occasionally write policies on unattractive risks as accommodations to valuable brokers or agents. This is done in the expectation that it will bring other, much more desirable, business, or that it will make possible the retention of profitable business already on the insurance company's books.

Insurance coverage is not offered on the same terms and conditions in all sections of the country. Underwriting rules and company practices often vary in different areas, states, or territories. Some types of coverage are available in certain sections and not in others; some policy clauses are mandatory in certain territories, permitted in others, and not allowed in still others.

2. *The coverages available*

As a businessman you require no extended discussion about the merits of insurance. You know that it offers many advantages. It substitutes certainty for uncertainty and thus reduces worry. It makes possible measuring, in advance, the possible cost of risks, such as those from fire, burglary, or accident. Banks and commercial credit grantors insist that borrowers be covered adequately against the more common risks. And insurance companies offer consultation without charge concerning safety methods and other means of minimizing losses.

The types of insurance available are many and diverse. Although the policies covering specific classes of risks differ from each other in detail, they are similar in principle. Each contract describes the types and the amounts, or limits, of the risk insured, as well as the conditions under which the insurance is in effect.

It is understood, of course, that the comments made in this section concerning forms and coverages apply to states where they are permissible.

Many combination policies are available. They provide coverage against a large number of classes of loss, under one policy. Examples are: comprehensive automobile liability policy, comprehensive general liability policy, and broad form money and securities policy.

Classified in the most simple fashion, insurance companies fall into these groups: fire and marine; life; casualty and surety. These companies write the following types of coverage:

Accident and health
Automobile: fire and theft, collision, bodily injury, and property damage
Boiler and machinery
Burglary, robbery, and theft
Business interruption and loss of use
Fidelity and surety bonds
Fire

nland marine (inland transportation)
.iability
.ife
)cean marine
Plate glass
Sprinkler leakage and water damage
Workmen's compensation
Miscellaneous forms

Looking at the field of insurance from the point of view of the causes of osses, we find these divisions:

Damage to, or destruction of, physical property
Liability to others—both the public and employees—for personal injury or death or for property damage
Business interruption—inability to earn the customary profits, or the fixed charges, because the premises were damaged or destroyed, or because supplies were interfered with
Miscellaneous causes, including the criminal activities of others

It would be well to consider the causes of losses at greater length. Your property may suffer damage from fire, lightning, sprinkler leakage, explosion, wind, hail, riot, civil commotion, malicious mischief, earthquake, breakdown or explosion of your machinery or another's, vehicle or airplane damage. This damage may affect your plants—buildings, equipment, merchandise, plate glass—your sales branches and warehouses, stocks at suppliers' premises or with distributors, equipment being installed at customers' premises, motor vehicles, or merchandise in transit.

Liability to others may arise because of injury to their persons or proper., or invasion of their rights. It may be caused by your manufacturing activities, actions of your employees, contact with your vehicles, or explosion of your machinery and equipment.

Profits may be lost or fixed charges not earned because of interruption to business. This may be attributable to direct damage to your property or may be caused by such incidents as breakdown in supply of utilities, for example, electricity or water power. The interruption of activities may cause damage to materials in process, under refrigeration, or in specially heated rooms.

Criminal activities may bring about loss of money, securities, merchandise, or other valuable items. The loss may be caused by outsiders or employees.

State laws have generally limited fire companies and casualty companies to the writing of the following coverages:

Fire companies. Fire, lightning, windstorm, explosion (except boiler explosion), earthquake, war risk, business interruption, rent insurance, automobile fire and theft, inland marine (inland transportation), and ocean marine

Casualty companies. Public liability, burglary, plate glass, boiler and machinery, workmen's compensation, fidelity and surety, accident and health

Both fire and casualty companies. Automobile property damage, collision, sprinkler leakage, and water damage

Until recently, in most states, fire insurance companies were not permitted to write liability policies, except through affiliates organized for such purpose, and at consequent additional cost and expense. Nor were casualty insurance companies permitted to write fire policies. But multiple-line underwriting—popularly called "package" policy—bills have now largely removed this restriction.

The increase in recent years in the availability of all risks policies and package policies constitutes recognition here of the need for combination policies, and cognizance of the conveniences they offer. Their utility was recognized earlier abroad. Foreign countries have for a long time permitted the issuance of a single policy insuring all the risks covered by fire and casualty insurance companies.

At present forty-six states permit the issuance of package insurance policies. A stock or mutual fire or casualty company may thus issue a single policy, covering fire, liability, workmen's compensation, burglary, automobile, and other forms of protection. In New York State, for example, effective July 1, 1949, and provided certain financial requirements are met, fire, marine, casualty, and surety companies may issue a single policy providing full coverage except for these lines: life insurance, annuities, title insurance, and insurance of life of property.

Multiple-line underwriting laws were designed in part as a convenience to purchasers who wish to place all their insurance business of the types indicated with one insurance company in one transaction. Policyholders will generally find it more economical and more convenient to have a single policy, rather than several policies, covering a number of types of risk.

These laws will also help provide an increase in capacity for writing insurance, since companies with large surpluses may use them to expand their operations into branches of insurance other than those in which they have been operating.

Within each of the major groups of insurance are many types of coverage. Clearly it is not feasible to discuss all these in a single section. But consideration is given herein to the major types of insurance which may be needed by you—those which are most likely to be of interest. And present practices and problems in underwriting are also discussed. Ocean-marine insurance, a highly technical field and one of little concern to the average businessman, is considered only briefly.

You must make your selection of insurance from among several hundred classes available. Perhaps you will seek the advice of an insurance broker, agent, or counselor. He will know the field of insurance and will recognize hazards requiring coverage. Through your cooperation with the insurance advisor will be selected the special coverage needed because of the problems offered by your business.

It is to be noted that many policies whose titles might appear to indicate overlapping coverage represent quite different protection. For example, a truckmen's cargo policy covers the truckman's legal liability to a shipper for a cargo in the former's care, while a transportation policy covers a shipper's interest in his merchandise.

A check list of types of business-insurance coverage, which may be used as a guide, will be found on page 750.

Your insurance loss may be a direct loss, that is, one which is the direct outcome of such incidents as fire, burglary, collision, or sprinkler leakage, to cite a few. Or it may be indirect or consequential, that is, one which results because of the occurrence of some other event.

To illustrate, a fire might consume or damage your business premises. This would be a direct loss. But such direct damage or loss might also cause an indirect loss—as a result of the fire your business activities would be interrupted. The loss from this interruption caused by the fire would be a consequential loss. You may buy insurance against it; your purchase would be called "business interruption insurance."

Recently a group of insurance experts studied the insurance desirable in the case of a theoretical manufacturing enterprise of considerable size. Their study demonstrated how complex the selection of the required types of coverage may at times become. The theoretical business, whose sales totaled 10 million dollars a year, operated four factories, six regional sales offices, and several warehouses.

The printed account of the experts' discussion required some forty-five pages. And about six months later the experts reviewed their recommendations and discussed related problems. These supplementary deliberations were summarized in approximately thirty additional printed pages.

It is clear, therefore, that you must review your insurance periodically. New coverages are often introduced and rates on those already available vary from time to time. The new coverage may be broader, for example, under all risks policies, yet total premiums may be but little more, or sometimes even less.

Certain insurance may prove, through experience, to be unnecessary, because the prospect of risk has dwindled. It may be eliminated, with consequent economy. Or perhaps insurance only recently unobtainable or

considered to be excessive in cost is now obtainable or feasible price-wise.

Some kinds of insurance are needed only in certain areas and not in others. For example, earthquake insurance may be sought by west coast businessmen, and tornado insurance in the areas where this phenomenon occurs.

Also, special coverage is needed in particular circumstances. For example, where a lease provides that the lessee return the premises in the same condition as when he took occupancy, and there is no exclusion except for damage through the elements, the lessee should take out insurance against riot, civil commotion, and explosion. And owners of buildings should obtain coverage for the cost of removal of debris in cases where there is possibility that total loss will be sustained, and this insurance is not already provided under their policies. As further illustration, a clothing manufacturer may obtain insurance which will cover for the reduction in value of the remaining parts of suits of clothing, when one part, the trousers, jacket, or vest, is destroyed or damaged.

Many special forms of insurance are available, but the circumstances under which they apply may be restricted. So be sure to read your policy carefully and to make notations or summaries concerning what is covered and what excluded.

The forms prescribed frequently vary among the different territories, and the rules and procedures of rating organizations, as well as the premium rates, are not uniform from state to state, nor necessarily from area to area within states. You should try to become familiar with the forms and rules of your own area.

Perhaps, because your risk offers unusually great hazard, insurers may be unwilling to cover it at the standard or commonly available premium. In such case the insurance department of your state may authorize upward adjustment of the standard premium for your risk. Or, if coverage is not available at any premium, the statutes may authorize your broker to obtain it abroad, or you may make such effort yourself.

There is constant need for new types of insurance. For example, while radioactive materials are in wide use in industrial laboratories, at this writing it is reported that no insurance protection is available against damage or loss from radiation.

The following notes, arranged alphabetically by subject, relate to specific coverages available:

Accident and health insurance aids in protecting people against the hardship of loss of earnings that may result from accident or illness. The coverage provides benefits in case of illness or disease, or injury or death from accident. Frequently it is made available to the employees of a company under a group

plan, at a lower premium cost per policyholder than that for policies written individually. And commonly the employer contributes part of the premium or pays all of it. (Also see *Cash sickness* insurance, below.)

Accounts receivable insurance is used widely. It covers losses caused by a company's inability to collect outstanding receivables because the receivable records have been destroyed or damaged as a result of an insured hazard. Accounts receivable insurance is to be distinguished from credit insurance. The latter covers against inability to collect from debtors because they have become insolvent or have failed.

Accounts receivable insurance is obtainable on a monthly reporting basis. Coverage is not needed if duplicate records—written, typewritten, photostatted, photographed, or duplicated in any other fashion—are maintained in a safe place, away from the original set.

Assessments of additional premiums may be levied against the insured before or after losses occur if the insurer is a mutual company, although most mutuals issue nonassessable policies. Stock companies, on the other hand, charge a fixed premium and do not generally pay dividends to policyholders. But insurance may be taken out against the possibility of additional assessments by the mutual company.

Automobile insurance may be subdivided into the following major classifications: liability to people for bodily injury, property damage liability, collision damage, fire and theft. And there are many subclassifications, forms, and endorsements—as well as a comprehensive policy—to provide for the manifold requirements of owners or operators.

Automobile liability insurance protects you against financial loss caused by claims for personal injury and damage to other people's property arising out of your ownership or use of automobiles. You may have overlooked some of the following liability coverages:

Nonownership liability. Your employees may be using their own cars on your business

Hired-car insurance. You may be using hired automobiles. If the renting agency carries liability insurance, there will be a substantial reduction in your premium

Other coverage. Trucking firms or other independent contractors may be operating their own cars while engaged on your business. Here, too, if the owners are insured your own premium will be less

Be sure that you are adequately protected against claims or losses arising in these situations.

Under certain automobile liability policies, provision is made for automatic coverage for 30 days of automobiles acquired after the beginning of the policy period. To retain the insurance beyond the 30-day period, you

must report the acquisition. The automatic coverage is available only if all your cars are covered by the same company; if not, it applies only to automobiles which replace those already insured.

The number of automobiles you own is important. If it is large enough, that is, five or more, you may obtain fleet insurance at a reduction in premium. But the cars must be owned by one insured under one direct operating management. If the risk is large enough to qualify, experience rating may be available.

There has been much controversy concerning the respective merits of automobile fire and theft policies containing an "actual value" clause and those containing a "stated value" clause. The latter states the maximum amount of settlement in case of theft or complete destruction.

A point to be considered is the direction in which prices are moving. If commodity prices are going up, clearly an actual value clause would be advantageous. But there is something further to be said for the actual value policies. In insurance, generally, the valued type of policy is comparatively uncommon, and policyholders appear to be reasonably content with the settlements effected by them under the more common nonvalued policy.

Bailees, for example, fur-storage warehouses, tailors, cleaners, dyers, and similar businesses, may obtain insurance against loss or damage to property of customers. Where property is received by a bailee for servicing, the limits of liability of the insurance company at individual locations, in total, and in transit, should be adequate.

Some bailees' customers' policies cover losses of goods entrusted to a bailee whether or not the latter is legally liable for the loss and irrespective of whether or not the loss is due to his negligence. Though there are some exceptions—for example, the furriers' customers' policy—bailees' policies are generally written on the basis of the bailee's gross receipts, which must be reported monthly.

The rates on bailees' customers' policies, other than those issued to dyers, cleaners, and launderers, vary with the type of merchandise, the fire rate, and the type of coverage sought, including the perils to be insured. An application form must be submitted. It provides the information needed by the company in deciding whether to write the risk, and in establishing the rate.

It is to be noted that a special form of policy is available for tailoring and pressing shops and hand laundries whose gross income is small. The policy is sold at a fixed total premium.

Boiler and machinery insurance covers loss caused by accidents to boilers, machines, pressure vessels, engines, steam turbines, electric generators, pumps, electric motors, compressors, transformers, power lines, fans, and similar objects and equipment. Indemnity is provided for the damage caused

by accidents to the insured equipment and other property, and to the property of others where the insured is liable; ordinary maintenance costs are excluded. The policies do not limit the total amount which the insured may receive during the policy period, although the maximum amount payable for any one accident is noted.

The insurance may be subdivided as follows: property damage, bodily injury, and indirect loss. The first class insures against damage to the insured's property, and provides expediting coverage—which is the cost of rapid repairs to the insured's property—and supplementary expense coverage, if the latter two are desired. In addition, it makes provision for liability for damage to the property of others.

Covering the indirect loss are use and occupancy insurance, outage insurance (indemnity for the time the equipment is out of operation), and insurance against consequential damage.

It may well be that your engineers will suggest the installation of stand-by equipment. Under some circumstances this may render unnecessary obtaining use and occupancy insurance.

Bonds may be classified, broadly, in this manner: fidelity, surety, blanket (including fidelity), forgery, and miscellaneous. Bonds which guarantee to indemnify you, as employer, for your employees' defaults are known as fidelity bonds; those under which some other financial obligation is assumed by the insurance company are known as surety bonds.

A more detailed classification of bonds is as follows: bail; bankers' and brokers' blanket; bid; building and loan blanket; commercial blanket; contract completion or performance; court: fiduciary, guarantee; crime; executors and administrators; Federal: export, immigrant, internal revenue, permit; fidelity; fiduciary; forgery; fraternal; fraud; insurance company blanket; license and permit (local government); lost instrument; maintenance; position; public official; public warehouse and grain elevator; schedule; small loan companies blanket; state license; statutory; sundry guarantee; surety.

Blanket fidelity bonds are generally preferred to, and are fast outdating, name or position schedule bonds.

In computing the premium on blanket fidelity bonds, employees of industrial and manufacturing plants are generally divided into these groups:

Class A—the employees who handle money
Class B—the non-money-handling employees in the office
Class C—the factory workers

The premiums vary with the groups, since the hazards differ for each. It is desirable to check the accuracy of classification of your employees. This step may result in considerable economy in premiums.

The need for coverage against dishonesty by employees cannot be overemphasized. There have been many recent accounts of large losses of this type attributable to defalcations carried out over long periods (see also *Fidelity* insurance, below).

Bridge property damage and use and occupancy premium rates vary with the type of bridge, its age, the type of construction, and the location. So that it may be in a position to compute the premium rate, the insurance company will either ask for an engineer's inspection report or obtain its own. The insurer will also require blueprints or drawings and photographs of the structure.

Building policies generally also cover improvements to buildings.

Burglary insurance, as the term is generally used by the businessman (though it is not correct technical usage), includes theft and robbery coverage. There are numerous types of burglary insurance, namely, safe, open stock, safe deposit, inside holdup, messenger robbery, paymaster robbery, merchants' protective policies, bank burglary and robbery, storekeepers' burglary and robbery, office burglary and robbery, all-risks policies, and others.

Burglary policies protect the insured only if entrance was effected forcibly; protection is not usually in effect against sneak thievery unless additional coverage has been obtained, at an additional premium. Theft insurance policies do not require proof of forcible entry.

Mercantile open-stock burglary insurance covers the loss of merchandise or equipment through the burglarizing of business premises. This policy includes a coinsurance clause which may make necessary contribution toward the settlement of losses unless adequate insurance coverage has been taken out.

Office burglary and robbery policies provide broad coverage against burglary and holdup to small business places which do not handle merchandise. The premium is very low; coverage may be extended by endorsement, at an increase in premium, to cover gold, platinum, and other metals and articles used by dentists. The policy covers, to a stated limit: inside and outside holdup; kidnapping and safe burglary; office burglary, robbery, theft, and larceny; burglary of night depository or home of custodian; damage to property and premises.

Paymaster robbery insurance provides coverage against loss of payroll as a result of the robbery of its custodian. Endorsement is available providing extension to payrolls of all risks coverage of the sort made available by the broad form money and securities policy.

If you are eligible for it, you will find a broad form, or all risks, money and securities policy valuable. It insures against loss from almost any cause

(there being a number of exclusions), including burglary, robbery, holdup, destruction, or disappearance. The coverage is much broader than the comparatively limited protection offered by safe-burglary or messenger-robbery policies.

Business interruption insurance is of particular interest to merchants and manufacturers. Every business which occupies or uses buildings, machinery, equipment, or merchandise should consider obtaining it. Also called "use and occupancy" insurance, this coverage protects the policyholder against loss caused by the suspension of business as a result of physical damage to the property occupied, resulting from fire or other insured casualty. Under the terms of the policy, the disaster must have occurred at a place described in the policy.

This is the object of business interruption insurance: as far as possible, during the period in which the insured's property is being restored, he should be placed in the position, profitwise, in which he would have been had the loss not occurred.

The most common business interruption policies are the two-item form and the gross-earnings form. The former covers as one "item": net profit and continuing expenses, excluding ordinary payroll; and, if the insured desires it, ordinary payroll may be covered as a second "item" for a period of at least 90 days.

The gross-earnings form covers gross earnings, reduced by noncontinuing expenses. Thus payroll which continues following the damage to property, including ordinary payroll, is insured. The gross-earnings form carries co-insurance clauses of 50, 60, 70, or 80 per cent. The minimum percentage of coinsurance under the two-item form is 80 per cent.

Selection of the type of policy is generally determined by your desire relating to the coverage of ordinary payroll. If you do not wish to insure ordinary payroll continuing during the period of suspension of business, the two-item form might be selected, but you will buy coverage only under Item 1 of this form. However, this will require your classifying employees into two groups at the time of purchase of the insurance, namely, essential and ordinary.

Choice between the forms should be made only after considering, among other factors, the premium rates (which are not uniform throughout the country), the percentage relationship of ordinary payroll to gross earnings, and the coinsurance requirements.

To avoid penalty under the coinsurance clause, sales, costs, and expenses should be checked often, to provide greater assurance that the coinsurance requirements are complied with. Other methods are to obtain a premium adjustment endorsement, under which premiums are returned where there

has been overinsurance, or to provide for the inclusion in the policy of the agreed amount contribution clause, under which there is no coinsurance penalty if the coverage is maintained at the agreed amount. The clause is available only to manufacturers or merchants whose premises represent superior risks.

Cash sickness insurance legislation has been enacted by a number of states. This provides for weekly benefits (out of a state fund contributed to by employers, employees, or both, or provided by insurance company coverage), to employees for disabilities resulting from nonoccupational injury and sickness. In states where such legislation is not in effect, many employers have arranged with insurance companies for group policies to be paid for by the employer or by both employer and employee.

Casualty insurance is concerned, for the most part, with losses arising out of the insured's legal liability to third persons. It is commonly divided into these subclassifications: liability; workmen's compensation; accident and health; and burglary, robbery, and theft. Each of these is discussed in this section.

Cattle floaters cover all livestock except horses. The terms of the policy may generally be arranged to suit your requirements.

Comprehensive insurance policies provide coverage, under one contract, against all the hazards of the types covered by individual classes of insurance policies, except risks which are excluded specifically.

A number of comprehensive policies are common, namely: "three D" policy (dishonesty, disappearance, and destruction); bodily injury and property damage (including automobile liability); personal liability; storekeepers' liability; farmers' personal liability; general liability.

The latter policy includes coverage of—and is based on the rates for—these classes of liability insurance: manufacturers' and contractors'; owners', landlords', and tenants'; elevator; protective; contractual; and products. The comprehensive general liability policy may also be obtained with the exclusion of contractual and products liability, and property damage coverage may also be omitted.

These policies are not all risks policies. Items excluded may often be included by endorsement at an additional premium, or may be written separately. The exclusions exist to make it practical to write the remaining coverage at a premium which will be attractive to a large number of potential users of the comprehensive policy.

In some states blanket or comprehensive crime coverage policies are available. Such policies cover the dishonesty of employees, as well as burglary, robbery, theft, holdup, larceny, forgery, fraud, and other enumerated risks, both on and off the premises. Other states, not sanctioning the writing of

comprehensive crime coverage policies, permit the issuance of a blanket fidelity bond, and of a comprehensive "three D" policy.

Several types of comprehensive crime protective coverage are available to small businessmen. These provide for a small or moderate total coverage, subdivided into specific amounts for each of a specified list of types or causes of loss. The premiums are modest. Small merchants and storekeepers commonly use such coverage because it is economical and practical.

In addition to business interruption insurance, common forms of protection against loss of income are *contingent business interruption* insurance (which indemnifies for loss due to the interruption of the insured's business by a casualty at the premises of another firm, for example, a processor, subcontractor, or supplier), profits and commissions coverage (against loss of such income because of the loss of the goods from the hazards insured against), rents and rental value insurance, tuition fees insurance, and selling agents' commissions insurance.

Rents and rental value insurance covers loss of rent income or loss of the rental value of the use of property caused by the damage or destruction of the property through an insured cause.

Tuition fees insurance is available to schools. The indemnity provided under the policy is paid to schools prevented, because of fire or other insured casualty, from earning tuition and other fees on the operation of the institution.

Another type of consequential coverage available to you is that covering loss caused by failure or interruption of the supply of current from a public utility, through accident to its equipment. Your production processes may be interfered with or failure of refrigeration may result in spoilage of your product. Thus if you are a restaurant operator, or a meat or provision dealer, you may suffer considerable damage through the spoilage of foods because of the failure of refrigeration.

Although many firms have only small credit losses, the possibility of an unexpected loss of considerable size often warrants taking out *credit insurance*. Coverage is obtainable on sales to specifically designated debtors, or on all customers, up to a specified amount to each. The amount of credit insurable in the latter case is related to the credit rating of the customer as published in certain credit rating manuals.

The experimentation in *crop insurance* at present being undertaken on a large scale by the Federal government is of particular interest to farmers.

Demolition insurance indemnifies an insured where, following a fire or other insured event, local authorities require the demolition and removal of the structure remaining after the loss, because it constitutes a hazard. This insurance reimburses the insured for the remaining value thus destroyed. In

some areas the increased or excess cost of repair or rebuilding of the property damaged, to meet local ordinance, is also covered under demolition insurance.

A number of states permit insurance companies to write *depreciation* insurance on buildings and building service equipment. This coverage is also known as "replacement insurance." In the event of loss, for example, by fire, the insurance company pays the cost of restoration, without making any deduction for depreciation.

The policy conditions generally include that rebuilding must actually take place and that the new building must be located on the site formerly occupied by the one destroyed and must be of similar construction.

Some states prohibit such insurance as violation of anti-valued-property laws; others are silent on the question.

When depreciation or replacement insurance is endorsed on fire policies, in some territories the entire policy—both the original fire coverage and the endorsement—becomes subject to a 100 per cent coinsurance clause.

Under *electric and neon sign* insurance policies, coverage is obtainable against fire and other damage or loss to signs and to street clocks.

Elevators should be covered under these classes of insurance: public liability, property damage liability, collision, and medical payments.

Employees' insurance—group health, group life, life insurance, and pension trusts—has become increasingly important to business. Many enterprises carry one or more of these coverages.

Accordingly, the subject is discussed at greater length in "The insurance you need," under the caption "Employees' insurance—group health, group life, life insurance, and pension trusts," beginning on page 717.

Errors and omissions insurance protects mortgagees against unintentional failure, through error or omission, to have insurance in force on the property under mortgage.

Excess insurance is coverage which becomes available to the insured after the loss has reached a certain amount, or insurance available after the coverage provided by other insurance has been exhausted.

Extra expense insurance, a type of consequential coverage, indemnifies for extra costs, charges, and expenses suffered in conducting business while the premises which were damaged are under restoration. For illustration, a business house might suffer such extra expenses as these during the period its premises were being restored: moving, cost of repairing or altering new premises, advertising and mail costs to notify customers of new location, overtime pay to employees during moving and reorganization period.

Fidelity insurance policies provide coverage against the dishonesty of employees. It is desirable to take coverage with large loss limits even though

your system of internal control is good and your accounts are audited periodically.

You must make your choice from among individual bonds of the name or position types, schedule bonds, blanket position bonds, and commercial blanket bonds. The individual bonds of the name type cover specific individuals; those of the position type, all the individuals who occupy the position under consideration.

Blanket position bonds provide coverage of each employee to a maximum of an agreed amount; commercial blanket bonds provide protection up to a specified total, without regard to the number of employees involved.

Fine arts policies cover public or private collections of paintings, etchings, pictures, tapestries, and other works of rare, historic, or scientific value, or of artistic merit. Illustrative of the items which may be covered are statuary, marbles, bronzes, antique silver or furniture, rare glass or books, manuscripts, porcelains and bric-a-brac, art or stained-glass windows, murals, trophies, and valuable rugs. Reporting forms are obtainable covering art galleries, museums, dealers, or other commercial risks.

Coverage is provided against all risks. The policies are written on a valued basis, and evidence of value is required.

The *fire* insurance contract currently in use is a uniform or standard contract which has been adopted in over forty states, with statutory variations in some cases. Because of the importance of this form and its widespread use, the policy is reproduced in this section as Illustration 1 (pages 769 and 770).

Numerous forms or clauses are used to modify the basic fire contract. Some are permissive in nature; some impose specific duties on the insured; others decrease the liability of the insurer; still others increase it; others relate to the title or interest in the property covered; others limit the amount payable. Typical of these forms or clauses are the following: inventory and iron safe; market value; coinsurance clause; waiver of inventory or appraisal.

Occasionally it will be found necessary to provide a special form for an unusual risk submitted to a fire company.

As to fire insurance, in addition to the basic coverage of building and of contents (that is, stock, furniture and fixtures, and equipment), there are numerous collateral or allied lines of insurance written by fire companies, and many clauses and endorsements enlarging or extending the coverage. These include the following:

Accounts receivable
Additional expense
Aircraft (etc.) property damage
Business interruption
Commissions
Consequential damage
Contingent business interruption
Contingent liability (building laws)

Cost of replacing records
Debris removal
Demolition
Depreciation and increased cost of construction
Earthquake
Errors and omissions
Explosion (off premises)
Extended coverage: direct damage done by aircraft or motor vehicle, explosion, hail, riot and civil commotion, smoke damage, windstorm and tornado, fallen-building-clause waiver
Extra expense
Fire-department service charges
Hail
Improvements and betterments
Increased cost of construction
Inherent explosion
Interest and amortization charge
Leasehold improvements
Leasehold interest
Legal liability (common carrier, warehouseman, and others)
Malicious damage and vandalism
Market value clause
Metal smokestacks, awnings, etc.
Patterns and dies
Premium insurance
Profits and commissions
Rain
Rent and rental value
Replacement
Riot attending a strike
Riot and civil commotion
Selling price clause
Sprinkler leakage
Standing timber
Storage charges
Tornado and windstorm
Trees and shrubbery
Tuition fees
Unearned premium
Use and occupancy
Vandalism and malicious mischief
War damage

In fire and allied lines it is possible to include in the policy a clause providing that in the event of loss, the property damaged will be valued at the price at which it is sold, or could be sold, reduced by discounts and any costs or expenses with which it would have been assessed if loss had not occurred.

Fire insurance on improvements and betterments protects a tenant's interest to the end of his lease in improvements made to an owner's property. In view of the complex questions which may arise relating to the respective rights of lessor and lessee, it may be desirable to obtain one policy covering the interests of both.

Fire policies do not protect property in case of loss from explosion, unless a fire results from the explosion. Thus if explosion hazard exists, explosion insurance is obtainable, under a separate policy.

Other methods of coverage are available, however. In some jurisdictions an explosion clause may be attached to the fire policy; in others, the extended coverage endorsement (discussed below), including coverage against explosion, is added to the fire policy; in still others, protection is provided under a riot and civil commotion policy.

Multiple-location fire coverage is available to an insured having two or

more locations, without regard to whether they are in the same state or in different states. Insurance may be obtained under a single policy for furniture and fixtures, improvements and betterments, merchandise and supplies. Buildings are excluded from this coverage, as is generally machinery.

Chain stores make use of multiple location coverage because it simplifies the policy record keeping, rendering easier the control of coverage, through the medium of the single policy. The policy is available on a monthly reporting basis, or on a nonreporting, coinsurance basis.

The extended coverage endorsement, attached to a fire policy and obtained at an additional premium, provides for the extension of insurance to cover loss or damage to the insured's property caused by aircraft, explosion, hail, windstorm, vehicles, riot and riot attending a strike, civil commotion, and smoke. A further endorsement broadens the coverage to include the hazards of vandalism and malicious mischief in addition to the items enumerated above. In some territories the extended coverage endorsement is replaced by a substantial equivalent, known as the supplemental contract.

In a community where the local fire department makes a charge for responding to a fire, the insured may obtain coverage under a fire department service clause, which provides indemnification for the cost of obtaining this aid.

Floater policies cover property at any location in a given geographical area, or while in transit within the area. The more common forms encountered in ordinary business are—

Air cargo
Bailee
Bailees' customers
Bicycles and hand trucks
Bridge builders' property damage
Bridge builders' risk
Bridge builders' use and occupancy
Bridge and tunnel
Camera and projection machine
Cleaners and dyers
Contractors' equipment
Department store
Exhibition
Film
Fine arts
Floor plan
Funeral directors
Furriers' and fur storers' customers
Garment contractors
Horse and wagon
Installation risks
Installment sales and leased property
Jewelers' block
Laundry
Lodge paraphernalia
Miscellaneous movable articles
Motor-truck cargo
Movable equipment
Musical instruments
Neon and electric signs
Ocean marine
Parcel post
Patterns and dies
Physicians' and surgeons' instruments
Processing risks
Processors' risks
Professional instruments
Radium

Registered mail and express
Rolling stock
Rug and carpet cleaners
Salesmen's samples
Scheduled property (various)
Scientific instruments
Silverware
Stamp or coin dealers
Theatrical properties
Trailer contents
Transit floater
Transportation
Trip transit
Wool growers

Property of a mobile or floating nature, for which more specific forms have not been provided, may be covered under special floater forms. The premium rates vary, depending on the nature of the property, the use to which it is put, where it is usually kept, how it is transported, the coverage desired, and the specific fire insurance rates applicable to the property. The policies usually contain a 100 per cent coinsurance clause.

Floater policies are available covering merchandise shipped on approval, or goods rented or loaned to others. In such cases the coverage is in effect while the goods are in transit as well as while they are in the possession of the recipient.

Scheduled property floaters cover specifically designated or specifically identified moving or floating property while in transit and at temporary locations. The perils covered are enumerated, and include fire, theft, tornado, and transportation risks. This type of coverage may generally be extended to cover your particular needs. The policies are based upon a proposal form and are written on a 1-year or 3-year basis.

Salesmen's floaters are available covering samples of merchandise incidental to your business while in the charge of named salesmen. These floaters do not cover jewelry and furs. They carry a 100 per cent coinsurance clause, and may be written for 1 year.

Merchandise in the possession of a dealer and in transit at his risk, which is subject to a floor plan type of borrowing from a lending institution to pay for the merchandise, may be covered under an all risks floater, known as a "floor plan merchandise" policy. The goods at risk are identified by name, serial number, style, or in similar fashion. The insured must submit a detailed application or proposal before rates will be quoted by the insurance companies. Under this policy monthly reports of values at risk are required.

General cover is the term applied to insurance on goods—and on supplies, furniture and fixtures, and improvements located in stores and warehouses —at a number of locations under one policy. The specific amounts of insurance in effect at each location change to correspond with the figures reported periodically by the insured.

Inland marine insurance, speaking generally, is coverage on items which are in transportation inland at least part of the time. This transportation

coverage insures, for the most part: (1) items in transit elsewhere than on the ocean, and (2) personal property of certain types, wherever located.

Liability policies protect property owners and others against damage claims because of injuries to persons or property.

Property damage liability insurance covers against claims for damages to the property of others caused by the insured. Bodily injury insurance provides coverage against claims arising out of the death of, or injury to, individuals who are not employees of the insured.

Under liability policies the insurer undertakes to defend lawsuits against the policyholder for injuries or death occurring under conditions covered by the policy. The insurance company will also pay all legal expenses and court costs, necessary premiums on bonds required as a result of accidents insured under the policy, and the judgments, if any, assessed against the insured—all to the limits provided in the insurance policies.

There are many types of public liability policies. They include:

Automobile
Automobile nonownership
Comprehensive
Contractors and subcontractors
Contractual
Druggists
Elevator
Employers
Explosion
Farmers
General
Malpractice
Manufacturers
Medical payments
Owners, landlords, and tenants
Personal
Physicians, surgeons, and dentists
Products
Safe deposit
Sports
Sprinkler leakage
Storekeepers
Teams
Workmen's compensation

Under public liability policies, the officers, directors, and stockholders of the corporation may be included in the coverage without additional premium. This endorsement should be worded so as to extend the coverage to the successors of those at present included in the policy.

One of the significant recent changes in public liability insurance is the availability in many states of a comprehensive policy. One contract can now be obtained protecting the policyholder against all liability except that specifically excluded under the policy.

Even though your liability be only to take reasonable care of goods left in your custody by others, it would be well to insure yourself against suit for carelessness or negligent handling.

If you are a manufacturer or contractor and seek coverage against liability arising out of your work, be prepared to submit this information to the insurance company: location of work; description of work; estimate of wages

or payroll during the policy period; information whether any other insurer has canceled a similar policy or declined to write such insurance within the last year; indication whether operations similar to those for which coverage is being sought are being conducted elsewhere by you, with designation of places.

Owners', landlords', and tenants' public liability policies provide coverage on claims resulting from the existence, use, or maintenance of buildings or property. The claims arise because of accidents to people other than the insured's employees.

Provision is often made in public liability policies for automatic coverage of new operations or new locations. There is generally a limitation on the period of time within which the insured must report the changes if coverage is to continue.

Products-liability insurance protects a manufacturer or seller against damage claims arising out of the use or handling of products which are produced, sold, or distributed by him. The claims must generally be based upon events which occurred away from the insured's place of business. There are some exceptions, however, including, principally, food-handling risks.

The manufacturer, distributor, or retailer may be sued for damages sustained as a result of negligence in the manufacture of the product, or as a result of use of the product, with disastrous results, for a purpose for which it had been warranted to be suitable. Coverage can be written separately or through endorsement of the public liability policy. Distributors may be included in the manufacturer's or dealer's policy by endorsement.

Under the policy the insurance company will pay whatever sum, within the limits of the policy, the insured is legally liable to pay because of injury, illness, or death, or because of the destruction of property resulting from the use or handling of the product in question. Coverage is not restricted to food and drug and related products. There have been suits involving electrical apparatus, children's games, chemicals, machinery, ladders, hearing aids, and children's uniforms made of inflammable materials.

In obtaining products liability coverage, consider the desirability of simultaneously obtaining insurance against claims based on sales consummated before the date of writing the coverage, and on sales made abroad as well as in this country.

A hotel or department store which operates a beauty parlor may obtain a beauty-parlor malpractice liability policy or appropriate endorsement of its comprehensive general liability policy. Likewise, if it sells food for consumption off the premises, a products liability policy may be obtained or a products liability indorsement added to the general liability policy.

Life insurance may be taken out by a company covering major officers,

with the company as beneficiary. On the demise of an officer, the proceeds of the policy help tide the company over the period during which it suffers financial loss caused by the loss of his services. Or a company may pay the premiums on life insurance policies covering an officer, the beneficiary being his estate or an individual he has designated.

In still other cases life insurance may be taken out to make money available to the company for the repurchase of the stock or partnership interests of deceased officers or partners. The subject of personal insurance bought by business is treated in comprehensive fashion under the heading, "The insurance you need," beginning at page 708.

Livestock insurance is available covering cattle and farm horses. A special form insures valuable animals like race horses, polo ponies, and saddle horses. The coverage provides indemnity for the death of the animals.

A *loss of profits* policy may be obtained by a manufacturer to cover the difference between the cost and sales price (the latter after deduction of selling and similar expenses not incurred) of manufactured goods destroyed or lost. This is necessary because insurance policies generally provide for payment of cost of replacement only.

A *lost or destroyed instruments* bond must generally be supplied when it is desired to obtain a duplicate of a valuable security (stock certificate or bond), paper, or document in replacement for one which is lost.

The *market value* of goods, rather than their replacement cost, may be covered by insurance under some circumstances.

A *medical payments* clause is a desirable addition to all automobile bodily injury liability policies. For a small premium the insurance company will pay, up to an agreed amount, all medical and hospital bills arising out of injuries received while driving an automobile, or while a passenger in, alighting from, or entering an automobile. If fatality result, funeral expenses are likewise included.

Neon-and-electric-sign floater policies cover advertising and display signs of neon, electrical, or similar type. The signs may also be insured on an all risks basis as a supplementary endorsement of a plate glass policy, issued by casualty companies, which provides fewer exclusions than the inland marine neon and electric sign floater policy.

Ocean marine insurance covers losses from hazards of the sea. The coverage, of many types, is generally divided into three classes, namely, hull, cargo, and freight charges. Insurance is available against numerous risks, including fire and explosion, stranding or sinking, collision, general average, and salvage charges. Marine insurance policies are also obtainable covering on an all risks basis.

A special all risks *paraphernalia* floater covers flags, banners, uniforms,

religious articles and vestments, lodge and other paraphernalia. It is important to note that the policy must be endorsed with the insured's warranty that the property covered will be kept in a locked room, compartment, or other such place when not in use. The policy may not be written for a period longer than 1 year.

Parcel post policies cover, on an all risks basis, merchandise incidental to your business, while in transit by parcel post, registered, or unregistered mail, or in the custody of the Post Office Department within the limits of continental United States, the Dominion of Canada, and Alaska. The coverage is available for small shippers on a coupon policy basis (detachable coupons being inserted in the package or with the invoice), or, for large shippers, on an open policy basis (with provision for monthly reports of shipments).

The coupon book type costs a given sum per coupon, in books, or units, of 100, 200, and 500 coupons; the rates on the open policy coverage vary with the type of commodity, annual shipment volume, and loss experience.

Examples of the types of goods frequently covered are trimmings; cloth, grey and finished goods; general merchandise; photographic supplies; books, magazines, and similar materials; property sent out for processing.

Patent or patent infringement insurance covers loss resulting from infringement by others of the insured's patent or from suits against the insured for infringement of patents belonging to others.

Plate glass insurance provides coverage of a host of items other than plate glass windows, among them, mirrors, showcases, shelves, neon and electric signs, and partitions.

Power plant insurance is obtainable, providing protection against accidental injury to your power plant. In addition to covering equipment for generating power, it insures power storage and distribution equipment.

Where, during *processing*, a company ships its merchandise from one of its plants to another, blanket coverage (insurance on one or more items of property at one or more locations) over both plants might be desirable, rather than specific insurance at each plant. This is the case because, while it might develop that the total coverage was adequate, the value of the merchandise at risk at one of the plants might exceed the coverage in effect there.

Raw materials or unfinished goods in the hands of processors, such as bleacheries, spongers, dyers, or tanners, for treatment, may be covered against loss or damage by either owner or processor.

Many kinds of *property damage* policies are available, among them the following: aircraft, automobile, contractors or subcontractors, contractual,

elevators, explosion, manufacturers, team, vehicle and rail tunnels (also see *Liability,* above).

Radium all risks floater insurance is available, 3-year coverage being obtainable. A complete proposal or questionnaire is required for each risk.

Rain insurance covers against the loss of income or against expenses actually incurred as a result of rain, sleet, or snow.

Sprinkler leakage insurance covers against loss because of accidental leakage or flow from a sprinkler system.

Standard fire policy (see *Fire* insurance, above).

Surgical and scientific instruments commonly carried by physicians and surgeons may be insured under all risks floater policies. The insurance may be written for as long a period as 3 years.

Theatrical properties floaters cover scenery, costumes, and theatrical "props" which travel about with the troupe, used in the production of named plays, while anywhere in the United States and Canada, except at the customary business place of the insured. The coverage is against fire and lightning while on location, and against specified risks while being transported.

Title insurance protects the owner or mortgagee of real estate against loss attributable to defects in title to the property.

A shippers' *transit* floater is recommended in cases where manufacturers, distributors, or others ship merchandise by a public carrier. The public carriers operating in interstate commerce are required to be insured, but there are some circumstances in which they are relieved of liability for loss or damage to the goods carried. Further, they may insist upon contractual limitation of their liability.

Transportation policies serve companies shipping or receiving goods within continental United States and Canada, by railroad, railway express, public truckmen, and Atlantic coastwise or Atlantic gulf steamers. The policies are designed to fit the needs of the specific policyholders. Coverage is available on various bases, including, under some conditions, all risks.

The policy used is an inland transit policy, to which may be affixed a number of classes of transportation forms, thus making possible coverage of a multiplicity of risks. Common forms of the transportation floater are those for shippers, those for motor-truck carriers, and parcel-post and registered-mail policies.

Trip transit, or single trip, policies cover individual shipments of goods, belonging to the insured, while in transit by railroad, railway express, and public truckmen from and to places specifically named in the insurance policy. The perils insured against are enumerated in the policy.

Unearned premium insurance is available covering prepaid premiums lost

to the insured when claims under the policy are paid. For example, if a 3-year term policy were taken out and after a short time settlement in the face amount of the policy were made, the prepaid premium would generally be considered consumed under certain types of policies, and the insured would have to pay another premium to reinstate the insurance.

Workmen's compensation and employers' liability insurance represents coverage to provide the benefits prescribed by law for employees who are injured during the course of their work. Credit is obtainable in computing the premium for satisfactory loss experience.

3. The insurance you need

In Sec. 2 the types of insurance available were considered. The present section is designed to help answer such questions as these: What insurance do we need? How much should we take out? Can we drop any of our present policies?

An insurance program must be tailored to fit the needs of a particular company. Thus your coverage must be arranged to fit your special requirements. The insurance program of another firm in the same business will be of interest and may be used as a guide, but the special requirements of your own firm must be given principal consideration. The suggestions below will help you decide what insurance is needed, what may safely be omitted, and whether self-insurance is practical in your case.

How much insurance you need, and what classes, depends on the kind of business you run, its size, and the types of risks you encounter.

In considering whether to buy a particular type of insurance you must ask yourself these questions: What will this insurance do for us? How much should we acquire? What will it cost?

Every business is confronted by risks. A prudent firm will take steps to lessen the risks as far as possible. Protection may be obtained against many of them. It is better to be safe, by being insured adequately, than to find, when a loss occurs, that you are underinsured or without insurance.

The query, at the time of buying insurance, "How much will this extra insurance cost?" yields at the time of loss to the more disturbing queries, "Did we have enough insurance?" or, "Were we covered for this type of loss?" Overeconomy at the time of placing insurance often proves to be unwise.

Therefore, you should consider purchases of coverage in the order of their importance. Some classes of insurance, says the Department of Commerce of the State of New York, are essential; others, desirable; still others, available. The essential ones are those without which a business might suffer a catastrophic or financially destructive loss; the desirable coverages protect

against types of losses which occur frequently but whose occurrence would not be as serious; the available group protects insureds against losses less serious in nature and less frequent in occurrence.

In summary, buy every form of coverage you may need, in limits high enough to protect you, taking into consideration your financial standing and your ability to pay for the insurance.

Some business risks should clearly be insured, for example, fire, burglary, public liability, and, as to automobiles, liability, property damage, fire and theft, and collision. But other risks can readily be carried by the insured, without significant financial inconvenience in the event of loss.

An illustration might be plate-glass insurance, in the case of a business which has only a few showcases or a few small windows. Or, as another example, where only occasional shipments are made, representing only low values, it is questionable whether these shipments need be insured. The possible losses are small, and could easily be borne by the firm affected.

All the hazards must be considered. You will be perplexed by these questions: Should we cover the *probable* loss? Or the *possible* loss? Generally, you should insure the largest possible single loss. Its occurrence might be disastrous financially. The comparative infrequency of occurrence will be reflected in the premium cost.

You must also recall that under the laws of some states certain risks or liabilities must be covered or evidence of financial responsibility be presented.

Sometimes the added coverage you seek may be obtained by endorsement of a policy already in effect; on other occasions a new policy is needed. If the insurance you want is unusual, it may be possible to arrange for special coverage to meet the situation, the insurance companies quoting rules and rates upon being supplied with data of the following sort: location and description of the property; values involved; enumeration of the risks; your loss history.

When you appraise your needs, to determine whether you are properly and adequately protected, consider carefully the nature of your business, the values at risk, and the types of possible risks or hazards to which you may be subject, including not only those which arise within your company but those which affect you although they come from outside your business.

Look into your contracts with customers and suppliers for situations which may require insurance; consider the indirect and contingent, as well as the direct, risks. Give thought to the probable frequency of loss and the amounts of money which may be involved.

It may be that the process of surveying or inventorying your quarters, operations, assets, and commitments will suggest to you ways of minimizing the losses, as well as safety measures which may bring down insurance rates,

economies in stores keeping, and methods of eliminating duplication of work or of present insurance coverage.

Check your list of assets and exposures against the notes and suggestions in this chapter, and against the list of types of coverage beginning on page 750. Look over the specimen insurance plans which are presented beginning on page 739.

In deciding what insurance you will need, these factors, among others, must be considered:

Activities: What do you do? What products do you make? Sell? Or what services do you offer? How do you ship your products? Do you use trucks? Automobiles? Do you own them? Rent them?

Financial affairs: How much are your total assets? How are they subdivided? How much do you earn? What are your costs and expenses —types, amounts? Which costs and expenses are fixed? What are the approximate amounts?

Facilities: What facilities do you use—buildings, machinery? Where are they located? What are their descriptions—dimensions, layout, type of construction? Do you own them? Lease them? What did they cost? When? What are they worth now? Where do you get your power? Do you have elevators? What type? Do you have a railroad siding?

Staff: How many people do you employ? What are their duties? Do they handle money? Do they use their automobiles for your business? Does the manufacture of your product present occupational hazards? Possibility of occupational disease? Do you make available group life insurance or other benefits?

Surveys of insurance coverage are often undertaken in behalf of business firms by insurance brokers or agents, or by special insurance consultants. These reviewers summarize the coverage, indicate whether it is adequate, and suggest additional insurance when they consider it necessary.

The survey should answer these questions, among others: Is coverage omitted on any property owned? Is coverage maintained on property no longer owned or controlled? Are there any defects in the present coverage? Are the forms correct? Are the amounts reasonable? Inadequate? Excessive? Is there duplication of coverage—two or more policies of different types, for example, a fire policy and a floater policy, covering the same items?

Are the properties insured described the same way in all policies? Are the policies written so that they are concurrent? Are the best forms in effect? Are all the endorsements correct? Are the premiums computed correctly?

Are there any suggestions for revision of present coverage? Acquisition of new coverage? Where a policy is not of the standard form, and another

company offers a different coverage in the same type of policy, have the comparative merits of the two forms been checked?

Have changes in the object insured, or in the insured company itself, which must be reported to the insurers, been so reported? Have there been changes in personnel which will void the fidelity bond?

In addition, specific questions relating to the coverage must be answered, for example: Do the fire insurance policies include the extended coverage endorsement? Are the coinsurance requirements being met?

The task of analyzing an insurance program is rendered complex by the continuous development of new forms of coverage. At the same time, new types of hazards continue to appear. Therefore periodic surveys of coverage are desirable.

If your organization is large enough to make it possible, place your insurance matters in the charge of one executive, but also obtain the services of a good insurance broker or agent. If your firm is small, you will have to lean particularly heavily on the guidance of your broker or agent.

In the course of the study of your insurance problems you will learn something of the insurance companies' problems. The companies have found that, perhaps in part as a result of the increase in commodity prices, juries tend to give higher verdicts than formerly in claims against insurers. You will also ascertain that the companies have more applications for insurance than they can handle, particularly for large "lines" or amounts of insurance, and are therefore more reluctant than ever to cover businesses with poor loss records.

However, it has been reported that in fire insurance the yearly premium volume is now increasingly less than in recent years and the buyer's market is returning. But even in fire insurance, coverage is difficult to obtain where large concentrations of value exist. This is true, for example, of warehouses in which are stored furs, liquor, or tobacco.

Estimates, for insurance purposes, of values of machinery and buildings are frequently approximations. Therefore, it is not always desirable to buy coverage which barely meets the coinsurance requirements of a policy. The possible saving in premium may be more than offset by the discovery, at the time of loss, that the computed figures were too low.

It was reported by a prominent adjuster that in 50 per cent of the losses handled by his firm the insureds were coinsurers to a serious extent, and few policyholders avoided making some contribution to the loss settlement. This was caused by failure to keep insurance values abreast of changes in commodity price levels.

You should therefore consider the possible increase in value of your property since acquisition, and the effect of such increase on your ability to

meet the coinsurance requirements. If a building or other property bought in a period of low prices is insured on the basis of its original cost, it may well be that your present insurance coverage is too low.

Consequently it is desirable to have a margin of safety in valuation where a coinsurance clause is in effect. Some firms insure their property up to 90 or 100 per cent of the estimated full value, despite the existence of an 80 per cent coinsurance requirement. They consider the extra insurance a desirable margin of safety against error in evaluation and rise in price level since the last date of evaluation of the assets. Where a policy contains the 100 per cent coinsurance clause be sure to insure for the full amount at risk.

Make frequent checks of the value of the insured items. This will reduce the possibility of paying premiums for coverage no longer needed, and will help avoid the more serious possibility, failure to maintain insurance at a figure high enough to cover values at risk. One of the most practical ways to keep your building and equipment adequately insured is to obtain an appraisal by a reputable appraisal company. Thereafter the appraisal company can keep the figures up to date with relatively little difficulty.

As an alternative, relating to buildings, you might, from time to time, make estimate of the average cost on a cubic-foot basis, using periodic indices of construction costs. Then obtain enough insurance to cover the estimated cost of replacing the building after consideration of estimated depreciation.

Depreciation insurance, commonly called "replacement-cost insurance," may also be obtained in certain states. Under its terms, in the event of loss the insurance company pays the cost of restoration, without making any deduction for depreciation.

In deciding how much insurance to carry, do not place your entire reliance upon book, or ledger, figures. It may have been your company's custom, for example, to charge off as an expense, immediately upon acquisition, the cost of small tools, dies, and minor items of fixtures and equipment. Yet a considerable total of these items may be in use. Periodic inventory of all the company's assets will result in recalling such nonbook assets to mind, thus paving the way for their inclusion in the insurance coverage.

Note that renewal of policies at the same figures as the maturing policies may be improper because of the rise or fall in value of the items covered, either because more were acquired, or because some were sold, or because prices rose or fell.

Always read your policy, including the sections in fine print. And make notes on your readings. This will help you remember what your policy covers and what it excludes. You will discover such things, for example, as that a windstorm and hail policy does not cover damage to the interior of the

building from rain, sand, snow, or dust unless wind or hail first damages the walls or roof of the building, the rain, sand, snow, or dust then entering the building through the openings caused by the action of the wind or hail, to cause the damage.

At times a binder will be obtained in your behalf pending writing of the policy, or decision by the insurance company whether to accept the risk. Ask your broker or agent to confirm the facts to you in writing, including the name of the insurance company which is bound. It would be well to have this information a matter of formal, written record, in the event that a loss should occur before the issuance of the policy.

The following notes, arranged alphabetically by subject, will further assist you in deciding what coverage you need:

Concerning your *automobile* policies, be sure that limitations on distance of operation and designation of place of principal garaging are kept up to date. Otherwise difficulties may develop in adjusting your losses.

Obtain property damage liability coverage as well as insurance against bodily injury to others. And consider taking out medical payments insurance whenever it is available, particularly since the premium is low.

Many states have passed financial responsibility laws relating to personal injury and property damage claims against operators of automobiles. As soon as an operator has had an accident involving damage exceeding a comparatively small sum, evidence of such financial responsibility must be presented. Insurance coverage is accepted for this purpose.

Make certain that you are covered against liability arising as a result of your employees' use of their own cars during the course of their work.

Automobiles operated for use by the public must generally carry insurance against injury to people or damage to property.

Bailees' customers' policies are an important coverage. The furriers' customers' policy, for illustration, is an all risks contract covering furs or fur-trimmed garments, the property of customers, accepted by furriers or fur stores for storage, repairing, alteration, cleaning, or remodeling. The insured must issue a receipt under which he agrees to effect insurance on the furs, and must retain a carbon copy, available for inspection by the insurance company. He must also make monthly reports of the values at risk on the last day of each month.

These policies may be endorsed to include coverage for materials added and for storage and repair charges which have been earned, and to cover the furrier's legal liability in excess of the amount stated on the receipt issued to the customer.

A *blanket position bond* large enough to cover the maximum likely to be

involved in a loss is often used. In addition an excess commercial blanket form may be desirable, lest there be an unusually large loss.

Under *boiler and machinery* policies, certain equipment subject to the hazard of explosion, but excluded from explosion coverage under the fire policy, may be insured. This equipment includes boilers, pressure vessels, pipes, turbines, and steam engines, among other items.

Both direct and indirect loss may be covered. The latter includes use and occupancy insurance, consequential loss coverage, and loss attributable to power interruption, or to explosion off the premises.

As part of the benefits of the contract, the insurance company supplies a boiler inspection service. The suggestions of the safety engineers often help prevent losses.

Where property is leased, under some circumstances nonownership boiler and machinery coverage is desirable. The explosion of a boiler, pressure container, or machine not operated or controlled by the lessee might cause damage to his merchandise and fixtures. And where a plant adjoins others and there is a possibility of loss because of explosion at the adjoining plants, off-premises boiler coverage is desirable.

It would be well to consult an engineer to ascertain whether you need boiler and machinery use and occupancy insurance. Would the explosion of a boiler seriously handicap operations? Would the breakdown of an apparently unimportant item of plant equipment hold up production seriously?

Or, on the other hand, if your power equipment failed, could you obtain power elsewhere at a cost approximating that of operating your own equipment? Engineering analysis can best help you determine what the hazards are, and to what extent general plant operations will be affected by the nonfunctioning of particular parts of the plant.

Business interruption insurance, often called "use and occupancy insurance," may be needed. Fire, explosion, windstorm, or cutting off of facilities of supply might bring about the discontinuance of earnings of a prosperous company for a long period.

If your company has a number of plants whose operations are interdependent, business interruption insurance, when written, should be taken on the entire enterprise. If this is not done, prorating the earnings of the various plants may be difficult.

The manufacturers' form of business interruption insurance covers the loss of profits on unfinished merchandise. Additional coverage, called profits and commissions insurance, is available, insuring against loss of profits on the factory's finished product. The nonmanufacturing, or mercantile, form covers loss of net profits on all merchandise, as well as those fixed charges which continue; additional profits and commissions coverage is not needed.

You may be dependent upon certain sources of supply for the product on which you work. Consider the desirability of obtaining contingent business interruption insurance to cover the loss that might result from the cessation of operations at suppliers' plants.

Do you have any key equipment, the sudden breakdown of which would cause damage or loss to other equipment, merchandise, or property? The failure of power equipment, where there was no auxiliary supply available, or of refrigeration or air-conditioning equipment would be illustrations. Insurance should be taken out not only against damage to the equipment itself, but for consequential loss or damage, that is, the loss or damage to the other property and the loss of earnings.

Selling agents often take out consequential coverage policies, which provide indemnification against loss of income because of the stoppage of business—through some insured casualty—of the manufacturers whom they represent.

In placing insurance, any *contingent liabilities* you may have assumed, for example, under "hold harmless" agreements, must be considered.

Crime or dishonesty insurance will be needed. Frequently the best coverage will be a comprehensive policy, which provides a blanket fidelity bond, as well as coverage against forgery, burglary, and robbery, and sundry other specified criminal acts. Such policy is advantageous because one contract covers a multiplicity of possible causes of loss.

In addition, the possibility of uninsured exposures is reduced. Where a business operates many branches, each property or risk insured under a separate policy, and many of the principal classes of crime insurance covered under individual policies, it is possible that risks may be overlooked at some of the locations. This is much less likely under a comprehensive policy. Where it is obtainable, a term comprehensive policy, for example, one for 3 years, will prove economical.

But in other circumstances some of the coverage of the comprehensive policy may not be needed, and therefore it may be less expensive to obtain several policies covering specific risks. Thus where products are very bulky or heavy, and the prospect of burglary is slight, open-stock burglary and theft coverage may not be needed. But a blanket position bond, forgery insurance, money and securities coverage, payroll robbery insurance, and possibly safe deposit box insurance would commonly be required.

Where a comprehensive policy is not available or not feasible, be sure to take out mercantile open stock burglary insurance to provide coverage against loss of goods through burglary when the premises are closed. Also, obtain holdup insurance on custodians, bank messengers, and others in an amount adequate to cover the maximum in any single loss. It is desirable to

attach a theft endorsement to the mercantile open stock burglary policy, since this will render unnecessary, as a condition to obtaining indemnity under the policy, the existence of visible marks of forcible entry.

Examine your burglary policy. The coinsurance percentages required are not uniform among the various areas or territories.

In the case of gasoline filling stations, for an additional premium, coverage under the inside holdup policy may be extended to embrace the entire area immediately surrounding the building housing the station.

For a small businessman, crime coverage of the package type, with low limits for each of a number of items of coverage, is often more practical than individual policies, each containing a higher limit and providing for a separate premium. In one policy may be provided insurance against larceny and embezzlement, inside and outside robbery, safe burglary, counterfeit bills, bad checks and money orders, damage to cash registers, doors, merchandise, and other items. Policies are also available providing coverage of each of the above subdivisions, but with higher limits under each subdivision.

Dishonesty coverage is important. Even a small business may find itself in financial difficulty as a result of a forgery, defalcation, or other act of dishonesty. Partners may be confronted with the necessity for making good a business-sustained dishonesty loss out of their individual personal assets. Corporation executives who overlook this coverage in behalf of their companies may be charged with negligence by the stockholders.

You will desire a guide to determining how much insurance is needed. Compute how much money an employee might take, or the value of the merchandise he might falsely certify, through connivance with others, that the company had purchased, or how much he might pad or inflate payroll or work-hours reports.

Then, consider the estimate of experienced casualty underwriters that the average embezzlement is carried on for a period of 3 to 5 years before detection. These specialists have found that the amount an embezzling employee takes is more than three times the sum of preliminary estimates of the possible loss through such employee. Accordingly, it is recommended that, having estimated how much your employees might obtain through fraud in 1 year, you treble this figure when acquiring insurance.

Even employees who have no direct contact with money may cause considerable loss through dishonesty. With the collusion of the paymaster, or payroll clerk, foremen, or others, the non-money-handling employees may report excessive totals of hours at work, and consequently may receive payment for work not done. Or, products may be reported as purchased and received, when lesser quantities, or none, were actually received.

Do not rely on your auditing system and your belief in the honesty of your

employees, as substitutes for bonding your employees. Experience indicates that the small premium charged for bonds warrants the protection offered. If it were not true that most employees are honest, premiums would be much higher. But the chance exists that some sudden circumstance, an unpredictable irrational impulse, great economic pressure, illness, or unusual expense at home, may cause an employee to commit the unexpected dishonest act.

Special hazards, such as *earthquakes,* should be covered in areas where these events are encountered, for example, on the west coast.

Employees' insurance—group health, group life, life insurance, and pension trusts—is an important morale builder.

The broad classification "group insurance" embraces these classes of insurance: life, disability, accident and health, hospitalization, and surgical and medical, as well as annuities and pension trusts. It represents coverage written on a number of people, under a single contract, although individual certificates, or other evidences of insurance, are generally provided the individuals insured.

Under current practice, group life-insurance policies on your employees are available only if 25 or more people are covered; under earlier practice the minimum was 50.

Another rule provides that if the employees contribute part of the premium, 75 per cent of those eligible to participate must do so; on the other hand, if you, the employer, pay the entire premium, coverage must be extended to all eligible employees.

It is practical to require that new employees go through a waiting period before becoming eligible to join a group plan. This will reduce the number of transitory employees insured. Part-time and seasonal workers may also be omitted from coverage.

Group life, accident, and health insurance may be taken out in favor of your employees, without requiring them to take a medical examination. Generally, the policy is taken on a renewable term basis.

Under most plans if an employee changes his employment he may convert his term policy to an individual policy of the permanent type, at the individual rates, without presenting proof of insurability.

Pension trusts are trust agreements through which an employer provides retirement and other enumerated benefits for his employees.

In setting up a pension plan you will have to consider problems in practical economics, actuarial mathematics, taxation, law, and labor relations. You will need the collaboration of a number of your advisors, namely, your insurance man, your lawyer, your accountant, and perhaps your labor-relations counselor.

The administration of the plan will also have to be considered. What type of institution will be most suitable to manage and supervise the plan?

In appraising the various types of pension plans, these questions will arise at once: What class of plan is best? How much should the pension be? Should all employees be eligible? If not, which should be covered? What should be the retirement age—sixty-five? Should retirement be mandatory then? Or should it be permissive, with mandatory retirement at the age of seventy?

How much will the plan cost? Can it qualify under the Internal Revenue Code? What will be the tax consequences of setting up and operating a pension plan?

Should it be a "contributory" plan, both employer and employee sharing the cost? Or a "noncontributory" plan, the employer alone paying the cost?

Should employees be permitted to join the plan as soon as they are engaged? Should they be admitted to the plan regardless of the type of work they do and the wages or salaries they receive?

What should be the rights of an employee who resigns or is discharged before he reaches retirement age?

What benefits should be available? A given percentage of the salary at the time of retirement? Whatever pension a given annual contribution to the pension fund will buy? Or should there be a maximum limit on the amount of the pension?

Should the number of years of employment before retirement be considered? Should death benefits be provided when death precedes retirement?

There are many types of retirement plans. Coverage may vary from the inclusion of all the permanent employees to a plan under which only employees on salary, as distinguished from those paid hourly or weekly wages, are included.

And the benefits may vary considerably. Some plans provide more liberal death benefits, at the expense of liberal retirement provisions. Under others, all employees receive a pension on retirement, representing the same proportion of their highest pay, for example, 35 per cent, or 40 per cent, without special regard to the number of years of service.

There are a number of ways of arriving at the sum to be given to retired employees as a pension. These include a percentage of the salary; a percentage of the earnings, multiplied by the number of years of employment; a plan under which a given sum of money is set aside each year to buy annuities, the amounts of the pensions rising with each additional contribution.

Benefits under pension plans should generally be determined by the employee's compensation and length of service both before and after the adoption of the plan.

High income tax rates have encouraged employers to set up pension plans and profit-sharing plans. And one result has been that employees have been encouraged to remain on the job—labor turnover is reduced. Also, provision is made for the retirement of elderly employees; young people are stimulated to enter the company's employ. They are attracted by the knowledge that retirement will be possible while they are still in a position to enjoy leisure.

When you set up a plan be sure that your annual contribution is not too large to permit you to continue the plan should business become poor.

It is notable that in September, 1949, reports indicated that 5,000,000 employees in the United States were covered under private retirement pension plans. This was before the huge upsurge in noncontributory plans commencing with those provided by the steel companies.

Remember that the need for pensions is not restricted to workmen, clerks, and other employees of moderate or modest earnings; executives also need pensions. Many plans cover all employees, both those who are wage earners and those on annual salary.

Sometimes employees earning under $3,600 annually are excluded from the plan on the theory that they are covered under the Federal social security plan. But many employers feel that the pension should be such, when added to Federal social security benefits, as to provide greater incentive for effort by employees.

Exclusion of employees earning under $3,600 per year might be contemplated because it would cost less than an all-employee plan. But would it be desirable from the point of view of good relations with employees?

And if such restrictive plan is contemplated, care must be taken that the benefit provisions meet the rules for eligibility under the Internal Revenue Code and the Regulations of the Bureau of Internal Revenue. It might be more expedient to employ a plan providing benefits to those who earn under $3,600 annually and benefits on a desirable scale for higher salaried employees.

In setting up your plan decide how much you are willing to spend for the purchase of pension benefits. Then ascertain what benefits this sum will provide, considering the age, sex, compensation, number of years of employment, and proposed retirement age of your employees.

Or the matter may be put the opposite way: What pension would you like to make available? Assemble the statistics outlined above, to arrive at the cost of such pension. Are you prepared to pay that much? If not, the

benefits must be modified. Is the cost less than the sum you are prepared to pay? If so, the benefits may be increased.

Do your profits vary considerably from year to year? In such case doubtless you would prefer to have the contributions vary in corresponding fashion. While this would be more desirable from your point of view, it would have definite disadvantages from the point of view of your employees, the principal one being the uncertainty or irregularity of contributions.

Keep in mind that there will probably be considerable turnover of employees in your business. Many will probably leave long before they have earned the right to a share in the fund or withdrawal (where you have paid the entire cost of the plan), or to a share in your contributions to the fund (where a "contributory" plan has been used). This condition will make for a reduction in the amount you must contribute to maintain the plan.

These are some important questions about the operation of your pension plan: What proportion of the contributions will be used for the payment of benefits? What part for the expense of maintenance and administration?

What guarantee can be obtained as to cost? Will the contribution rates of employer and employee rise after the initial "guaranteed rate" period?

What provisions can be introduced which will guarantee that if an employee dies soon after he reaches retirement age his heirs will receive, for a time at least, the sum he would have received based on the employer's contributions? Generally, the pension ends when the employee dies, and his estate receives only the contributions which he himself made, plus interest, but reduced by the pension installments drawn.

Are the death benefits overweighted, and the pensions correspondingly less?

The majority of the pension plans adopted in recent years have been of the contributory type. But the proportion of noncontributory plans is increasing rapidly.

Remember, therefore, that the plans cannot be static. They should be reviewed from time to time to verify that they are still feasible and practical. Turns in business may necessitate revision of your plan. But be sure that the Bureau of Internal Revenue acquiesces in the changes in a once-approved plan, lest you encounter income-tax difficulties.

A pension plan must meet these basic requirements to permit the deduction of contributions to the plan on your income-tax return:

The plan must include: (1) 70 per cent of all employees; or, (2) if at least 70 per cent of the employees are eligible, 80 per cent of these 70 per cent must join. But your plan may also be approved if only employees of a given class are eligible, for example, those working in a particular division, or in the office, or those employed on an hourly basis.

But if such classification of eligibles is set up, the plan must not discriminate in favor of the officers, stockholders, or higher paid employees.

The Bureau of Internal Revenue had formerly employed this general rule dealing with pension plans covering both stockholders and employees:

A pension or profit-sharing plan shall not generally be considered to be for the benefit of shareholders if contributions which are required to provide benefits for employees, each of whom owns, directly or indirectly, more than 10 per cent of the voting stock of the corporation, do not exceed, in the aggregate, 30 per cent of the contributions for all participants under the plan. For the purpose of determining stock ownership an individual shall be considered as owning the stock owned by the spouse and minor lineal descendants of such individual.

But a recent court decision has brought about a change. "Now," notes J. K. Lasser, CPA (in *Business Tax Guide*, Simon and Schuster, New York, 1952, p. 115), "there is a rough working rule . . . that benefits to stockholder-executives should be no more than 50 to 60 per cent of annual corporate contributions." In summary, pension plans may be financed thus:

A pension trust may be set up. The necessary accumulations under the plan are assembled, based upon actuarially computed contributions. There are many advantages in employing an insurance company in connection with the funding of the pension plan

Individual annuity contracts may be bought for the employees. As employees' salaries rise, additional contracts are taken out. Thus, the pension available to a specific employee may be based upon a number of contracts. Such contracts are sometimes replaced by ordinary life insurance policies which may be converted into annuity contracts when the employee reaches retirement age. However, the difference between the premium on the policies and the premium under the individual annuity contract is generally paid to a trustee by the employer. It is used, if and when the conversion is made, to provide the additional funds required

Group annuity contracts may be obtained. Such contracts cover the entire group of employees for whom they are written

To consider unfunded plans—where no funded plan is in effect, it is nevertheless a common practice to pension elderly employees. But these employees are often carried on the payroll long past the period when their services are useful to the company.

The maintenance of a pension system, with definite age limits at which retirement will be compulsory, may result in greater staff efficiency. Elderly employees will be pensioned at specific ages. Incentive for hard work, in the form of possible promotion, will be provided younger staff members.

Fire policies: Be sure that yours contain the extended coverage endorsement. For an additional premium the coverage is broadened considerably through the inclusion of protection against a number of additional risks,

namely, loss or damage caused by aircraft, explosion, hail, windstorm, vehicles, riot, and riot attending a strike, civil commotion, and smoke. Endorsements which broaden the fire coverage still further are also available.

The brand and label clause, inserted in the fire policy of a manufacturer, provides for the destruction or marring of the labels on goods manufactured by him which may be sold as salvage by the insurance company following damage covered under the fire policy. This will prevent impairment of the manufacturer's reputation through the availability to the public of damaged goods bearing the producer's label.

Consider adding to your fire policies an endorsement covering employees' tools and wearing apparel.

The *garment contractors'* floater protects the goods of the manufacturer of wearing apparel while they are in transit to the premises of contractors or subcontractors, and detained during processing there. The goods are insured against fire, lightning, water damage, burglary, holdup, and transportation perils. Additional extensions of coverage are available, namely those against consequential loss, strike, riot, malicious mischief, explosion, and theft.

By agreement, coverage may be extended beyond the actual cost to the manufacturer, including labor, to a figure not in excess of market value.

If you arrange for *group* insurance and pay at least part of its cost, the morale of your employees will undoubtedly be improved. The insurance may cover life, accident and health, and disability, as well as pension and retirement plans, and hospitalization coverage (see also *Employees' insurance*, page 717).

Installation floater insurance covering the installation of apparatus, machinery, tanks, and equipment of all kinds in continental United States and in Canada may be obtained by contractors and others. The coverage is effective during installation and also while the equipment is awaiting installation and testing. Rates vary with the time involved, the type of equipment under installation, the method of transportation, and the contents fire insurance rate.

Installment sales floaters are available for dealers who sell on the installment plan such merchandise as furniture, radio sets, pianos, refrigerators, television sets, electrical appliances, machinery, electric and neon signs, and similar property. The following risks are covered: fire, lightning, explosion, windstorm, and tornado at location, and enumerated transportation perils.

Policies, issued on a monthly reporting basis, may be obtained covering the seller's interest, to the amount of the unpaid balance, or the seller's and buyer's interests to the limit of the total selling price. Careful check should be made of the accuracy of the monthly reports, and they should be sent promptly.

The vendor and vendee interest form is a useful selling point, since loss or damage would result in indemnification of both vendor and vendee, in the amounts of their interests.

The *jewelers' block* policy will be of interest. It provides comprehensive protection on the stocks of retail, wholesale, and manufacturing jewelers, while on the insured's premises or other locations, and while in transit in continental United States, Canada, and certain other places.

This is an all risks policy on the insured's stock. In some states, certain other property of the insured may be covered and, to a limited extent, property of others in the possession of the insured.

The insurance companies make careful examination into the affairs of the applicants before granting coverage, the prospective insured being required to submit a proposal for insurance before premium rates are quoted. The policy is limited to a term of 1 year.

Leasehold interest insurance will be advantageous to a lessee under certain circumstances. The terms of a tenant's lease may provide that he may lose possession of the premises if the building be damaged by fire to the extent of a given percentage of its value. If the leasehold rental is less than the prevailing market value, the lessee may lose this difference for the remainder of the period of the lease, since he would have to find other premises, presumably at a higher rental. Similarly, a lessee might lose the profit anticipated on a sublease. Such losses are insurable under a leasehold interest policy.

Where a lessee installs improvements which become the landlord's property on termination of the lease, a single fire policy may be obtained covering the interests of lessor and lessee. The lessee would then be protected against loss of its interest in the improvements—the opportunity to use them for the remaining period of the lease—at the time of the fire.

Liability insurance protects partnerships and individual businessmen and professional men against liability for injuries or damages which they or their employees may cause to the persons or property of others through negligence.

Sometimes one or more operations may necessitate the coverage of several individuals or groups. For example, on a construction project the subcontractor will take out liability insurance, as will the prime or general contractor for whom he is doing the work. The subcontractor will require the direct or primary coverage as the party actually performing the construction work, the prime contractor obtaining protective liability insurance. In addition, the owner will seek owners' protective liability insurance. Thus, all will be covered against possible suits for injury or negligence.

But the owner should also make sure that the contractors have workmen's

compensation insurance and such other coverage as the circumstances require.

It has been noted that, in lawsuits arising out of accident claims, judges and juries have in recent years awarded liberal judgments, apparently in consideration of higher price levels. Yet few insureds appear to have given thought to the increased amounts of liability insurance this will make necessary. In obtaining liability insurance you would do well to get policies providing the highest limits of coverage likely to be required. Raising the limits of liability will cost very little additional premium, yet will provide the comfort of knowing that a large judgment, if awarded, would be met by the insurer, rather than you.

A hotel owner should not overlook the need for adequate liability insurance. A comprehensive general liability policy, including automobile liability —where the combined form is available—is desirable. It should be endorsed as circumstances require, for example, for beauty-parlor malpractice liability and for products liability.

You cannot avoid responsibility by merely posting signs disclaiming it. Such disclaimers evoke little sympathy in the courts. And even in situations where your business firm may not generally be liable for the property or safety of others, a court may decide that you were negligent, and accordingly assess you for the damage or loss which resulted to others.

Obtain insurance against damage to the property of others, for example, neighboring buildings. This will protect you if fire, explosion, or other event occurs which might involve you under a charge of negligence.

If employee social functions, such as picnics, athletic contests, and games, are conducted, obtain coverage against injury to nonemployee spectators.

In appraising the risks which must be insured, be sure to consider the hold-harmless agreements you may have signed. These agreements, which may relate to your relations with suppliers, landlords, customers for whom you are installing equipment, and others, often involve risks on which you are not covered under your insurance policies.

Insurance should be taken out against liability because of accidents involving the motor vehicles of independent contractors, since it might be held that the operators of the vehicles were your agents or employees.

Give thought to the desirability of replacing several liability policies, covering various classes of hazards, by one general comprehensive liability and property damage policy. The premium varies with the exposure. The policy should be written so that blanket coverage will be provided on assumed liabilities, especially where, under purchase orders, hold harmless agreements are made.

Legal liability policies are needed by professional men and businessmen,

for example, lawyers, physicians, surgeons, dentists, osteopaths, opticians, optometrists, chiropodists, accountants, architects, druggists, beauticians, hotel-keepers, bailees, and warehousemen.

A small or medium-sized store will be interested in the storekeepers' liability policy, which makes available general liability, products liability, and medical payments for all retail stores except a small number of classes.

On leasing an entire building the lessee has the principal liability for accidents occurring there, since the building is no longer under the control of the landlord. But the latter retains a contingent liability for accidents or damage caused by structural or hidden defects in the building. The landlord may obtain protective liability insurance; he may, however, have his name added to the lessee's policy for an additional, though lesser, premium.

If a warehouse or other building is leased under an agreement providing for its return in the same condition, except for normal wear and tear and "acts of God," as that at the time of leasing, it is desirable for the lessee to insure against damage by riot, civil commotion, or explosion.

Be sure that all the premises you occupy, whether as landlord or tenant, are adequately covered against liability for accident or damage to others or to their property.

If you are a *mortgagee,* protect your interests in the property pledged to secure your debt by inserting a mortgagee clause or endorsement in the policies which the owner of the property obtains, pays for, and furnishes to you.

Consider carefully the various types of *personal insurance bought by business.* Life insurance, used to advantage in your personal life, offers many benefits in business. These include—

Aiding in the transfer of business interests when the sole proprietors, partners, or stockholders in close corporations die. This is called "insuring your business interest"

Helping sole proprietors, partners, or stockholders in close corporations to retire

Providing money to meet the unusual expense and the loss of profits which frequently follow the death of an important employee. This is called "key-man insurance"

Protecting creditors' interests by insuring the lives of sole proprietors, partners, officers, or key employees

Because insuring your business interest and key-man insurance are probably of most interest to you, we will consider them at length.

Insuring your business interest. When a sole proprietor, or a partner, or a stockholder in a close corporation dies, there is almost always serious interruption to the orderly continuance of the business. Problems like these

arise: The decedent's heirs may wish to take active part in the business, but they may be neither capable nor congenial. In a sole proprietorship or a partnership, part—perhaps all—of the decedent's share in the business may have to be sold to provide money for inheritance taxes. This might cause the breaking up of the business. Or a decedent's stockholdings may be sold to outsiders. This could prove extremely inconvenient; the new stockholder, although anxious to take active part in the business, might lack his predecessor's experience or ability.

Thus, a major problem may be that of keeping the business intact after your death. How can this be done? How can the value of the business be passed on to your heirs without serious impairment?

To answer these questions a third must be posed: Who are the most likely purchasers of your interest in the business? Undoubtedly, these would be your partners, fellow stockholders, employees, or business associates. Assuming that they want to buy your interest, will they have enough money to pay for it?

You can minimize your worry about the question. At the same time, you can reduce the business and financial problems you would leave your heirs.

All this can be done by making provision to help the prospective buyers finance the purchase. Life insurance offers one of the best ways to do this.

Arrange to sell your interest, the transfer to take place after your death. Such contract is called a "buy-and-sell agreement."

It will include the price—or a method of determining it—and the terms of sale. Then arrange for insurance on your life, the proceeds of the policy to provide all the funds needed, or, at least, to help finance the transaction.

Remember that on your death the value of your wholly owned business may fall almost immediately because your services have been lost. And your executors, personally, risk serious financial obligation if they do not liquidate the business as soon as possible.

This is true unless your will instructs or authorizes the executors to continue the business. Even then they may be reluctant to operate it because of the financial risk entailed.

Partnerships generally terminate on the death of a partner. The deceased partner's interest is then converted into cash unless the partnership agreement makes other provision.

Hasty liquidation may prove very expensive. The proceeds of sale may be less than might have resulted from leisurely liquidation.

Thus buy-and-sell agreements, financed by life insurance, provide many advantages. The seller's heirs are assured of fair treatment, since the seller himself participated in setting the value of his interest or the formula for computing it. And the buyer agreed upon the price or formula.

Also, banks and other creditors will consider the company's credit status improved, because the continuance of the business is assured. In the event of an owner's untimely death, partners, trusted employees, or other stockholders would have enough funds to buy the decedent's interest.

To illustrate how the insurance would be employed, in a partnership each partner would insure the lives of the others. Thus, partner *A* would insure *B* and *C*; *B*, in turn, would insure *A* and *C*; *C* would insure *A* and *B*. In a close corporation each stockholder would insure the lives of the others in amounts sufficient to pay for the survivor's proportionate share, or interest, in the decedent's holdings.

Life insurance could also be provided to facilitate retirement of sole proprietors, partners, or stockholders in close corporations. In this case enough insurance would be required to cover the value of the interest or shares of the person retiring. On retirement he would receive the proceeds of the insurance policies in return for the surrender of his interest.

To work out the buy-and-sell agreement, and to decide on the types and amounts of insurance, you will need the guidance of your lawyer, accountant, and insurance man. The lawyer and the accountant will help you arrange your plan so that it will meet current tax requirements as well as those in the foreseeable future.

This table will help you decide what type of insurance to buy:

Object is to provide for—	*Type of insurance desirable*
Purchase of the interest of a partner, sole proprietor, or stockholder in a close corporation.	Straight life insurance.
Retirement of a partner, sole proprietor, or stockholder in a close corporation.	Endowment insurance or limited-payment insurance, *e.g*, 10- or 20-payment life.

Who should be designated beneficiary under the life-insurance policy? The surviving shareholder, partner, or employee? The estate of the insured? Some other beneficiary named by the insured? A trustee?

Where a buy-and-sell agreement exists, the best choice for beneficiary is generally a trustee. He will deliver the proceeds of the policy to the decedent's heirs in exchange for the decedent's interest in the business.

Complications may ensue in the case of a partnership if the partnership itself is named as beneficiary. And a close corporation should not be beneficiary unless it is intended that the corporation buy and own the decedent's shares.

If the widow or other heirs are named beneficiaries under the policies, confusion may arise. Was it intended that they receive both the proceeds of the insurance and the stockholdings or share in the business?

Where insurance proceeds are left to the estate of the decedent or to the corporation in which he held shares, a further complication may arise. The

insurance proceeds may be construed as increasing the value of the decedent's holdings.

In every case, regardless of who is designated as beneficiary, the buy-and-sell agreement should provide that the proceeds of the policy be used to acquire the decedent's interest.

To summarize, in setting up business insurance, follow these guides:

Obtain the help of a broker, agent, or insurance consultant
Discuss the feasibility of his suggestions, legally and businesswise, with your lawyer and your accountant
Ask your lawyer to prepare a buy-and-sell agreement—generally it is best that it be financed by insurance—to take effect at your death or upon your retirement
Arrange to have a trustee administer the plan. The trustee should generally be the beneficiary under the insurance policy. The proceeds should be used for the purpose specified in the buy-and-sell agreement
Review the business life insurance from time to time—at least annually. Ask yourself these questions: Have changes in business conditions made necessary revisions in the buy-and-sell agreement? Revisions in the amount of insurance carried?

Key-man insurance. Almost every business numbers one or more key men among its personnel. Officers, partners, executives, specialists are among this group. Perhaps your firm's staff includes an unusually competent salesman or sales manager, or a production expert.

While these men are associated with your firm, everything moves smoothly. Possibly your key men are employed on terms so attractive that there is little possibility that they will leave their positions.

But a key man may die prematurely. Thereafter your business might run less efficiently—or even lose money.

If your salesman died, his customers might place their business elsewhere. The loss of your factory foreman might be followed by deterioration in the quality of your product.

To protect yourself against these losses, you may insure the lives of your key men, the premium being paid by you. Should one or more of your key men die prematurely, the proceeds of the insurance policies could be used to tide you over the period of disruption to business.

You may use the money to meet the cost of training a new man or to provide the higher pay necessary to attract a qualified replacement.

Key-man insurance has been likened to business interruption insurance. Business interruption insurance relates to the value of property; business life insurance, to the business losses which may result because of the death of a key man.

How much key-man insurance should you carry? The answer depends upon your responses to questions like these: How much loss of gross income might be suffered pending replacement? How much would the new man's salary be? Would it exceed that of his predecessor?

The coverage should be the amount representing fair measure of the probable financial loss to the company through the death of the officer, executive, or other employee.

Usually, straight or whole life policies are taken out. The cash surrender and loan values offer security, in a measure, against future business hazards. In case money is needed to meet an emergency, it may be borrowed on the policies. This applies as well to business interest insurance.

Products liability insurance should be obtained for liability attributable to defects in the products you make or sell. It is possible to obtain coverage in your own policy, at an additional premium, for dealers who handle your products, and who may encounter liability because of doing so. Products liability coverage may be included in a comprehensive liability policy.

Where merchandise values fluctuate, it is desirable to obtain fire insurance and extended coverage under a *reporting* policy. The policy covers all goods, provided that report is made at the end of each month of the total value on hand at that time. For such purpose a perpetual inventory record would be of great value.

If many locations are involved, the insurance may be written under a single policy known as a "general cover contract."

New locations and increases in amount are automatically covered under reporting policies, provided that report of values is made at the end of the month. Such policies are written for 1 year. However, you can obtain a 3-year policy for a specific amount on each location, to be supplemented by a reporting policy for the amounts at each location in excess of those specified for the 3-year policy. This would make possible the economy of the 3-year policy as well as the advantages of the reporting policy.

It is possible to include in the coverage of a reporting policy consigned goods sent to dealers; also, equipment being installed for customers, where title remains in the installer until the job is completed.

Under a reporting policy the premium you pay is dependent upon the values actually at risk. Since the values on hand at the end of each month are reported, it is not necessary (as it is under fixed-amount policies) to conjecture about the extent to which values will vary during the life of the policy. Of course, it may not always be feasible to make monthly estimate of the value of goods on hand.

Be sure to make careful computation and report of your premium liability under your reporting policy. Errors may be expensive should a loss take

place and the previous month-end report reflect an improperly low total of goods or other values.

To consider another matter concerning merchandise, stock in a warehouse which cannot be replaced readily should be insured for the net selling price, reduced by discounts and selling expenses.

Transportation floaters may be obtained, providing insurance on goods in transit, traveling at your risk, either to or from your premises.

Some shippers do not consider these policies necessary, relying on the motor-truck carrier's policies for indemnity. This is often unwise, since such policies may be for limited amounts. Also, carriers are not liable for "acts of God," which term might be held to include such events as flood, hurricane, tornado, earthquake, or lightning.

So, if you ship goods, ascertain whether you are adequately covered under the carriers' policies, or obtain your own. In the latter event make sure that the limits are adequate.

The floaters cover shipments of goods both inward and outward and materials in the hands of processors or with customers on consignment. Be sure that your policy includes all the territories into which your goods are likely to go. And be certain that you meet the coinsurance requirements. Note, too, that a reporting policy may be most practical for your needs.

Coverage of manufacturing operations is not permitted under the transportation or inland marine policy, but processing risks on the premises of others may be covered by endorsement.

Unearned premium endorsements should be added to certain term or annual policies involving sizable insurance premiums. In the event of loss, the portion of the unexpired premium attributable to the amount of loss settled by the company, which premium would otherwise be lost to the insured, is reimbursed.

Valuable-papers insurance, a type of all-risks coverage, may be obtained subject to discounts for safes approved by the underwriters.

The *vandalism and malicious mischief* endorsement should be added to the coverage in effect, for example, to fire policies and use and occupancy coverage.

Be sure that you have *workmen's compensation* coverage effective in all the states required by your business activities. Consider the desirability of insuring executives and other employees who may not be covered at present under your workmen's compensation policy. And where your operations bring employees under the United States Longshoremen's and Harbor Workers' Compensation Act, obtain the coverage needed. For companies which self-insure risks under the workmen's compensation acts, catastrophe coverage is recommended.

General. Individually drawn insurance contracts may be provided for specific problems of insurance coverage. Policies have been written covering tickets for athletic events sent by mail; dispensing units; private railroad cars and equipment; privately owned rolling stock and locomotives; and radio towers.

Be sure to select carefully from among the policies or forms covering the same type of risk. For example, relating to consequential coverage, there are several types of rental forms and a number of business interruption forms. And in many cases special endorsements may be added to policies to make them more suitable for you.

The Interstate Underwriters Board, now known as the Multiple Location Service Office, set up by stock companies to compute fire insurance rates for insuring contents where the insured operated at many locations in more than one state, has discontinued this rate-making service. For a short time no substitute was provided to work out such multiple location rates. By the close of 1949, however, some states had adopted a new plan, known as the Credit and Surcharge Permanent Rating Plan of the Multiple Location Service Office, for rating such risks.

4. With what type of company should you place your insurance?

There are a number of classes of insurance companies. A *stock company* is owned by the holders of its capital stock. To these stockholders belong the profits the company makes. The policies issued are not subject to assessment, nor are the policyholders entitled to share in the company's profits. However, a few stock companies issue participating policies which permit sharing by policyholders in dividends based on the company's underwriting results.

A *mutual company* is owned by its policyholders. They share profits through dividends on the policies, and, if assessable policies are issued, are liable for such assessments. Factory mutual insurance companies write insurance on industrial properties representing risks of high quality. The latter companies are particularly well known for their loss prevention services, designed to reduce the probability of loss.

Reciprocal exchanges are insurers made up of a group of individuals, firms, or corporations, who insure each other's risks. Each obtains insurance on property or against liability, the group engaging an attorney-in-fact to collect premiums, settle losses, and make assessments against policyholders where they are needed to meet losses. Each member of the group assumes a pro-rata share of the insurance granted to the others.

A *Lloyd's association* is a group of individuals who have associated themselves voluntarily for the purpose of writing insurance. Lloyd's of London, or London Lloyd's, is a corporation in London which provides a location

and facilities for the insurance business carried on by broker-members. In addition, Lloyd's assembles and publishes considerable information of assistance to the insurance industry.

At London Lloyd's, groups of underwriters join together to form syndicates which, as units, insure specific risks. The liability of each syndicate participant is limited to his proportion of the total insurance provided by the syndicate on a particular risk. A number of syndicates may join in insuring a specific hazard. The operations of these Lloyd's syndicates are world-wide.

As indicated above, policyholders in mutual and reciprocal companies share in the profits or losses of these companies. This is effected through dividends on the premiums charged, or through assessments. Policyholders in stock companies pay fixed premiums and generally receive no dividends.

If your premiums are considerable, it would be well, when taking out insurance, to consider the net cost per thousand dollars of coverage issued by the companies of the various types. It must be recalled, of course, that policyholders of stock companies cannot be assessed additions to the base premiums when operations of the insurance company are not profitable; but the policyholders of the reciprocal and the mutual (except where the latter issues nonassessable policies) must stand the losses of the company through assessments, just as they share the prosperity of the company through dividends.

If insurance is taken with a company not authorized to do business in your state, you may have difficulty in collecting your indemnity after a loss; you may be compelled to bring suit in the area in which the insurer is domiciled. If the latter is a foreign insurance company, litigation may be very expensive.

Under some circumstances the state insurance department will permit an insured to place a risk with an insurance company not authorized to do business in the state, that is, a "nonadmitted" insurer. One such situation is that when no authorized company will undertake the coverage. This condition is rare.

Excluding life insurance companies, which are for the most part mutual companies, the stock companies, as a group, are conceded to be the largest writers of insurance. In most states the stock companies, and in some cases the mutuals, publish premium rates for particular classes of coverage, through rating bureaus. Some independent companies and groups of such companies publish lower rates, but the insurance-writing capacity of these companies is inadequate, speaking generally, for large buyers of insurance. The writings of reciprocals and Lloyd's associations are small compared with those of the stock and mutual companies.

It is to be noted that mutual companies (outside the field of life insur-

ance) do not usually pay brokers' commissions; moreover, such commissions as are paid are generally at a reduced rate. Usually the mutuals write their business through direct contact with the insured. But some insureds prefer to have their brokers assist them in deciding upon the desirability of placing parts of their coverage with mutual companies. Accordingly, these insureds compensate their brokers on a fee or service-charge basis for such consultation, assistance, and supervision of placement.

Choose your carrier on the basis of its financial soundness and its reputation for prompt, fair settlements. Consider, too, the company's ability to adjust its underwriting rules to meet your business's reasonable requirements in cases where general company rules or policy conditions do not meet your needs.

An insured's search for special coverage may not be successful if his demands are unreasonable. He may either meet with inability to obtain coverage, or obtain policies with a poor company.

In liability and compensation insurance you should consider the engineering or loss prevention services which the various companies offer. The result may well be that you will carry insurance with more than one class of company.

On the basis of their experience, insurance companies find it possible, from time to time, to issue new types of policies. The new insurance may cover risks hitherto not insurable, or may provide broader coverage, in a more comprehensive policy, often at less cost than the policies replaced. In part, competition among companies provides the impetus for newer forms.

5. The insurance company's obligations under the policy

The insurance contract describes the types and amounts of the risk insured and the conditions under which the coverage is in effect. In each case, too, the undertaking of the insurance company is expressed. For example, a Mercantile Open Stock Burglary policy contains the following statement of the insurance company's undertaking:

> To INDEMNIFY the Assured FOR ALL LOSS BY BURGLARY, of merchandise, furniture, fixtures and equipment, from within the Assured's premises. . . .
>
> To INDEMNIFY the Assured FOR ALL DAMAGE (except by fire) to merchandise, furniture, fixtures and equipment in the premises, caused by such burglary or attempt thereat. . . .

From these clauses it can be seen that only loss and damage resulting from burglary or attempted burglary are insured against. The policies provide, as an exception from the coverage, that damage from fire, although caused in the course of burglary or attempted burglary, is excluded. Another section of the policy sets forth in dollars the maximum liability of the company on the risk. And in another clause this reservation is made:

In no case shall the Company be liable for more than the actual cash value of the stolen or damaged property at the time of the loss or damage, nor for more than the actual cost of repairing or replacing such property. . . .

The above provision shows the limitation of the insurance company's liability to the cash value at the time of loss, or to the actual cost of repairing or replacing the property.

Another type of property policy, the fire insurance contract in general use in this country, is a standard policy which has been adopted, with statutory variations in some cases, in over forty states. The policy is reproduced on pages 769–770.

The fire policy provides that the insured will be covered:

. . . to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair. . . .

This clause, too, expresses the limitation of the insurance company's liability to actual cash value. Likewise, it reflects the alternative limitation, noted in the above discussion of the burglary policy, of cost to repair or replace. As with the burglary policy, the insurance company's maximum liability on the risk is set forth.

In some Southern states, fire policies contain an iron-safe clause, which requires that the insured maintain an inventory and a set of books, including all purchases, sales, and shipments, both for cash and credit, from the date of the inventory. These records must be kept in a fireproof safe at night and when the premises are not open for business, or in a place not exposed to a fire which would destroy the building. The clause, which is sometimes called the "record warranty clause," is almost exclusively applied to stocks of merchandise used in trade or business.

Be sure you know not only what your policy covers but what it does not cover. Survey your risks at frequent intervals. Make sure that they are covered under your policy.

A case was reported recently involving a contractor who also did blasting work. During the course of demolishing a building, a blast of dynamite was set off. It caused considerable damage to the walls and foundations of an adjoining building. On belatedly reading his policy the contractor learned, to his dismay, that blasting hazards were specifically excluded by endorsement.

Thus policies must be read carefully. The title of the coverage will not always describe it adequately. For example, under the extended coverage endorsement, the windstorm damage section makes compensation available

only if wind-driven rain, snow, sand, or dust which damaged the interior of a building entered through a break in the walls or roof caused by the wind.

And under the same endorsement, explosion insurance does not cover loss caused by a steam boiler; such loss requires steam-boiler insurance. And further, smoke insurance covers only for smoke from sudden, unusual, and faulty operation of heating or cooling equipment.

Another circumstance furnishes illustration of the need for careful inspection of the policy. On occasion an insured under a transportation policy may delay a shipment of goods in transit to a customer, for packaging or processing. If the transportation policy carried the customary warehouse-to-warehouse clause, in the absence of special endorsement there would be no coverage under the policy during the period while the goods were stopped in transit through the act of the insured.

Where your policy provides for automatic coverage of new locations, after a short period unreported new locations are no longer covered unless specific insurance is written on them. As to automobiles, coverage is automatic only if all the cars owned by the insured at the inception of the policy were covered under the policy, or if the automobile added replaces one already covered.

6. Adjustment of claims

Every policyholder desires an insurance contract whose underwriting conditions are clear, specific, and easily understood. And when a claim arises, he wishes a speedy, fair loss adjustment.

At the time the policy is written, you should be as much concerned with what is not covered under the insuring agreement as with what is covered. Do not assume that the insurer will pay a loss claim not covered under the conditions of the policy solely because you have a long record of premium payments and have never had a loss before. The contract should be very specific as to the character of the coverage and you should read your contract. Make sure that you are covered on the risks against which you seek protection.

If you should sustain an insured loss, notify your broker, agent, or company immediately or as soon as possible. This will enable the company to begin the adjustment or settlement procedure. Under most policies, in the event of loss the policyholder must also protect the property, where damaged, from further damage, and must separate the damaged and undamaged merchandise.

Remember that the recovery under your insurance policy cannot be greater than the amount of the loss. And it is limited to the amount of the policy itself.

If more than one insurance policy is carried against a particular risk, be

certain that the individual policies permit such multiple coverage. Some contracts prohibit carrying additional insurance of the type provided by the policy in question without consent.

Other policies contain "other insurance" clauses. These provide that should there be in effect other insurance on the same property, the company's liability under the policy in question is restricted to the proportion of the loss which is represented by the ratio of the insurance under the policy to the total insurance.

Make certain that your property is described fully and that you yourself are correctly named in the policy. This will help reduce question as to what your intentions as to coverage—as well as those of the insurance company—were when the policy was written.

And make sure that all policies intended to cover the same property against the same risks read exactly the same way. The description of the property, the hazard, the location, the name of the insured—all should read alike, lest controversy develop, when claim for loss is made, concerning the company's obligations under the policies.

Frequently coverages overlap under different types of policies. Here it is generally desirable to have the coverage deleted under one of the policies. If this is not feasible, it would be well to have both policies written by the same insurer if practical. The latter procedure will prevent your being placed between two insurance companies engaged in controversy about their respective liabilities.

When your company enters a new area of business, or changes its method of operation, for example, from distributor to producer, be sure that your policies are endorsed to describe the new type of operation.

Generally, property insurance policies undertake to indemnify for the actual cash value of the property destroyed or damaged. The companies usually have the options of paying for the damage, replacing the item damaged or destroyed with one of like kind, quality, and condition, or of restoring the object to its condition immediately before the loss.

You should be in position to state the value of your property should a loss occur. To ensure proper claim as to buildings, machinery, and equipment, a recent appraisal by a reliable independent appraisal firm will be found helpful.

Another important matter is that of coinsurance. Consider carefully the coinsurance requirements of your insurance policy. Under this clause, to avoid being compelled to meet, or coinsure, part of your loss, you are required to carry insurance bearing a stated minimum percentage relationship to the value of the property insured.

In fire insurance the most common percentage is 80, although higher

ratios are required under some fire policies. If you do not carry enough insurance, as required under the coinsurance clause, your loss will not be paid in full; you will become a coinsurer with the insurance company.

The following table, involving two losses of the same amount, shows how the coinsurance clause operates. Policyholder *A* carried enough insurance; policyholder *B* did not and, in consequence, was forced to sustain part of the loss, or to "coinsure" it:

Facts	*A* (*This insured carried enough insurance*)	*B* (*This insured did not carry enough insurance*)
1. Actual cash value of the property when the loss occurred	$200,000	$200,000
2. Minimum insurance which should have been carried under the 80% coinsurance clause (80% of $200,000)	160,000	160,000
3. Amount of insurance actually carried	160,000	120,000
4. Loss sustained	80,000	80,000
5. Amount to be paid by insurance company (Item 3 divided by Item 2; result multiplied by Item 4)	80,000	60,000
6. Result	The insured collects the loss in full	The insured assumes $20,000 of the loss

From the analysis of several thousand insurance plans actually in operation, it was discovered that large proportions of the firms would be subject to coinsurance penalties in case of loss; had coverage which exceeded their requirements, or which overlapped other coverage; did not have the best possible policy for the risk insured.

It will be fruitful to check the replacement value of your property from time to time and compare it with the amount of insurance carried, to ascertain whether you are covered in at least the amount required under the coinsurance clause in your policy.

Where blanket insurance is in effect, unless a 100 per cent coinsurance clause is used, a prorata distribution clause (also known as the "average clause") will be found in the policy. In the event of a loss, this clause produces the effect of spreading the insurance proportionately to each location. For example, consider this illustration reflecting the insurance in effect under a blanket policy:

Property	*Value of property*	*Insurance in effect*
1	$ 20,000	$50,000
2	40,000	
3	60,000	
Total	$120,000	

If a loss took place, under the prorata distribution clause 20,000/120,000, or one-sixth of the insurance of $50,000 would be applicable to property 1; similarly 40,000/120,000 would be applicable to property 2; and 60,000/120,000 to property 3.

In the absence of the prorata distribution clause, if there were a loss at any of the properties, the total insurance of $50,000 would be available to cover the loss.

Some policies contain clauses limiting the insurance company's liability to the value placed upon the property by the insured in his stock lists or records, or the value designated when such goods are shipped or stored, or the value employed under other circumstances occurring in the ordinary course of business.

If extended coverage is obtained on one fire policy, it should also be obtained on all other fire policies covering the same risk. This is because the apportionment clause in the endorsement provides that all the fire policies must be considered in computing the liability for the loss covered under the endorsement, although any policy lacking the endorsement would not contribute toward the settlement of the loss. The share attributable to such policies would fall to the insured.

Typical requirements of insurance policies covering merchandise are that the insured—

Submit declarations, or an application or "proposal," in connection with the insurance coverage sought
Keep records and accounts

In the event of a claim he must also:

Prepare an inventory of merchandise stolen, damaged, or destroyed, as well as that not stolen or damaged, stating original cost, cash value, and amount of loss
Exhibit books of account, papers, and vouchers
Submit a proof of loss
At the option of the insurance company, present himself and his associates for examination under oath

All the above provisions make available tools for loss claim verification by the insurer.

To elaborate on some of these requirements: As an applicant for some types of policies you will be asked to fill out an application or "proposal" or to make "declarations." All of these contain information concerning the property and concerning you. They include facts needed by the insurance company to decide on the desirability of the risk and to compute the premium rate.

It is important that the answers be correct. The information presented in the declarations or in the proposal may, by incorporation of a copy or by reference, constitute part of the policy which is finally issued. Where the statements made by the insured are held to be warranties, failure to comply with the declarations may cause repudiation of the contract by the insurer.

In some states the force of the warranties and representations is reduced, the statutes providing that a policy shall not be voided for breach of warranty unless the breach materially increases the risk of loss to which the warranty relates. They also provide that a misrepresentation by an insured shall not void the policy unless knowledge of the fact misrepresented would have led to a refusal by the insurer to issue the policy.

Books of account and records are of considerable value in loss settlements. A well-kept set of books and accounts will facilitate determination of the amount of loss and will expedite settlement.

Many policies provide that at the option of the insurance company a claimant must submit to an examination under oath relating to the loss. The object of the provision is to enable the insurance company to ascertain the facts as to its liability, to protect itself against false claims, and to determine whether to defend or adjust the claim.

At the examination the insured gives testimony concerning the causes, circumstances, nature, and amount of the loss sustained. Generally he is asked to describe the items destroyed or lost, as well as those remaining in either damaged or undamaged form, and is queried about his financial condition and the results of business operations.

7. *Some specific insurance plans*

Several specific insurance plans for business and professional people are presented at this point for your use as guides. Remember, however, that your own insurance program must be arranged to fit your particular requirements. The circumstances in which other companies find themselves, even if they are in the same business as you, will generally differ in many particulars from yours.

Small businessman
- Property (fire; burglary)
- Business interruption
- Liability
- Fidelity and surety
- Workmen's compensation

Lawyer
- Fire
- Burglary (safe burglary; office burglary and robbery)

Holdup
Malpractice
Personal injury liability
Forgery and check alteration
Compensation
Bonds (fidelity; fiduciary; litigation)
Automobile

Manufacturer (several branch plants)
Money and securities, broad form
Mercantile open-stock burglary, including theft endorsement
Automobile liability, property damage, fire and theft (including $50 deductible collision, and nonownership automobile liability and property damage)
Paymaster robbery, broad form
Motor-truck cargo floater
Parcel-post shipments
Boiler insurance, and use and occupancy
Transportation floater (covering tools, patterns, and dies)
Commercial blanket bond
Comprehensive public liability (including "occurrence" coverage), property damage, and elevator liability, property damage, and collision
Workmen's compensation
Fire (including extended coverage, vandalism, and malicious mischief); building, stock, contents, and printed matter

Manufacturer (several branch plants and several warehouses)
Property (buildings, machinery, equipment, merchandise)
Fire, supplemented by these endorsements: extended coverage; windstorm and hail; vandalism and malicious mischief; contingent liability from the operation of building laws; improvements or betterments—as tenant; consequential loss or damage; rental value—as landlord; leasehold interest—as tenant; unearned premium; extra expense
Sprinkler leakage
Plate glass
Electric sign
Boiler and machinery
Earthquake (on west coast)
Collision (automobile)
Comprehensive automobile
Money and securities, broad form
Comprehensive dishonesty, destruction, and disappearance
Business activities
Fidelity bonds (contract; depositors' and commercial forgery)
Business interruption

Workmen's compensation
Liability: employers'; motor vehicle (owned; hired; nonowned); comprehensive general liability or specific liability (owners', landlords', tenants'; elevator; products; contractual)
Transportation floater: parcel post; tools and equipment; installation risks; ocean marine; patterns
Credit
Life: officers, partners, major employees
Employees: group life; hospitalization; accident and health

Storekeeper

Property (buildings, equipment, merchandise)
Fire, supplemented by these endorsements: extended coverage; windstorm and hail; vandalism and malicious mischief; contingent liability from the operation of building laws; improvements or betterments—as tenant; consequential loss or damage; rental value—as landlord; leasehold interest—as tenant; unearned premium; extra expense
Sprinkler leakage
Plate glass
Electric sign
Boiler and machinery (and consequential damage)
Earthquake (on west coast)
Collision (automobile)
Comprehensive dishonesty, destruction, and disappearance (or, if a very small business, storekeepers' burglary and robbery)
Fine arts

Business activities
Fidelity bonds (license; depositors and commercial forgery)
Business interruption
Workmen's compensation
Liability: employers'; motor vehicle (owned; hired; nonowned), comprehensive general liability—or specific liability (owners', landlords', tenants'; elevators; products; contractual)
Transportation floater: parcel post; tools and equipment; installation risks; deferred merchandise (installment-plan sales)
Credit
Life: officers, partners, major employees
Employees: group life; hospitalization; accident and health

Public officials

Automobile
Bonds and insurance on government operations and property
Public official bond
Bonds for assistants, deputies, and clerks
Burglary and robbery (including messenger, safe)
Fire

Forgery and check alteration
Securities, all risk

Guide used by banks to check adequacy of insurance carried by borrowers

Fire and extended coverage
Sprinkler leakage
Business interruption; rental value; extra expense; leasehold interest
Customers' goods (as bailee)
Transit (on merchandise)
Automobile: fire and theft; comprehensive; collision; transportation and movable equipment
Workmen's compensation
Public liability: comprehensive or covers such as the following: owners', landlords', and tenants'; manufacturers' and contractors'; elevator; products; contractual; automobile (owned; nonowned)
Power plant (boiler and machinery)
Money and securities: all risks or coverages such as messenger holdup, interior robbery, payroll robbery, mercantile safe burglary
Open-stock burglary
Accounts receivable
Fidelity: commercial blanket or blanket position, or schedule, or individual
Forgery: depositors; commercial
Business life insurance

8. Bringing down the rates

Your objective is to obtain full insurance protection in sound companies at the minimum cost. The "best deal" in insurance buying is the one which provides the coverage you need, in good companies, at the proper price.

Coverage must be tailored for specific sets of circumstances; the insurance requirements of each business differ from those of others. Therefore, obvious limitations exist in trying to apply to one firm the insurance program of another.

The cost of property insurance is arrived at by considering a number of factors, including the kind of property, its location, how it is used, and the hazards to which it is exposed The cost of casualty insurance is arrived at by considering, among other things, the types of possible causes of claim, the probable frequency of their occurrence, and the degree of their severity.

To help assure the stability of insurance companies, and to prevent destructive competition, the various state insurance departments generally require that companies obtain approval of their rate schedules. Groups of companies file schedules assembled actuarially in their behalf by rate-making organizations. Consequently there is much similarity in rates charged for substantially equal coverage.

While economies are obtainable, they are generally attributable to safety devices and loss reduction measures, elimination of hazards, and acceptance by the insured of clauses providing for the reduction of the insurance company's liability and for the corresponding assumption of risk by the insured.

Do not set price as the only criterion by which to judge the desirability of a particular type of coverage. On automobile liability policies, for example, it is unwise to overeconomize at the expense of adequate coverage. High policy limits are obtainable at only a small addition to the premium for the low limits.

Of course, coverage may be obtained against almost any contingency or type of loss, but the cost may be prohibitive. In consequence, you may prefer to take your chances on the occurrence of the contingency.

In consideration of the above comments, there are now presented, arranged alphabetically by subject, a number of suggestions describing possible economies and ways of bringing down the premium rates.

Many fidelity and casualty companies offer the services of expert *accountants* to assist you in your efforts at preventing the occurrence of losses. These specialists examine your company's accounting procedures and methods of internal control to determine whether loose or weak procedures are being followed. Such deficiencies may facilitate record manipulation or other impropriety, which frequently result in defalcations. Other insurance companies offer consultation services on business problems. Make use of these facilities.

The *correctness of computation of your premiums* should be checked. Often the insurance premium is determinable readily by inspection of a published rating manual. If your insurance coverage is extensive, it may be desirable to obtain such manuals from the rating bureaus for use in verifying the accuracy of the premiums charged.

In many areas, when a rating organization sets a premium rate against a specific risk, the composition of the rate may be made available on your request. Your insurance executive or your broker can then verify the computation and ascertain whether possibilities exist for effecting reductions.

Be sure that the classification of your property for rating purposes is correct. A fire-resistant building housing professional offices would take a lower fire rate than a frame building housing a bedding manufacturer or a paint factory.

As further illustration, passenger automobiles used for business take a different rate from those not so used. And the mileage it is anticipated the cars will travel is likewise a factor. Nor are the truck premium rates unvarying—radius of operation and size are considered. The type of business and

the number of automobiles must also be considered; likewise the extent to which hired cars are used.

Under some policies premiums are based on payrolls. The rates vary with the duties of the employees, and are affected by the different degrees of hazard offered. Be sure, therefore, that proper descriptions of your employees' duties are used when the rates are computed. Errors in classification may have brought about incorrect, high premium rates.

In some cases the principal operation performed by an employer determines the premium rate to be applied to the major part of his payroll. This is known as the "governing classification."

It may be possible to obtain *credits,* or returns, of premiums on a prorata basis, for reductions in the amount of insurance during periods when business is less active, or values at risk are less, for example, during off-season intervals.

The inclusion of a *deductible clause* in certain of your policies may make available a substantial reduction in premiums. In offset to the lower premium, this feature provides for the reduction of any claims on the insurance company. Under the provisions of some deductible clauses the insured suffers part of each loss; under others, the insured receives nothing unless the loss is above a certain amount.

This procedure is in accord with one of the basic principles of insurance, namely, that coverage should be provided against losses which the insured cannot bear conveniently. The small losses can generally be absorbed without difficulty; at the same time, this feature cuts the cost of insurance substantially.

As to certain hazards you may desire protection only on large losses. In many cases you may obtain insurance on terms which will meet your requirements. For example, farmers may obtain hail insurance on these varying bases: 25 per cent minimum loss clause; 10 or 20 per cent deductible; 25 per cent accumulative-deductible; premium deductible.

The deductible clause, available on automobile policies, is now also obtainable—for large deductibles—on fire policies.

Consider the *desirability of reducing the scope of your insurance coverage* at a reduction in premium. Of course, the risk you assume by excluding certain coverage must be weighed carefully before you make a decision.

An important *discount* becomes available through the purchase of term policies. In many states various types of policies may be issued for periods, or terms, longer than a year at a discount. The insurance companies have found that the less frequently the renewal takes place, the less it will cost to handle the insurance, and the less competition the company will face in selling the insurance.

The discount or saving is generally one-quarter of the annual premium for each year after the first. Thus the cost would be as follows:

Period of policy, years	*Term rate, number of times annual premium*
1	1
2	1¾
3	2½
4	3¼
5	4

From the above table it can be seen that a 3-year term policy would be written at two and one-half times the annual premium. The saving is 16⅔ per cent. And 5-year term policies, written for four times the annual premium, represent a saving of 20 per cent.

But you should note that if you have a term policy and part or all of the insurance is paid by the insurance company in settlement of a loss, under some circumstances the unearned premium applicable to the settlement may be lost by you. This may be overcome by the purchase of unearned premium insurance, which provides for the repayment of the unearned premium to the insured. The return premium is computed on a prorata basis.

There are other advantages to term insurance. In addition to the economy of lower premium there is the fact that, where experience ratings are applicable, those applied during the term of the policy may be improved or increased but cannot be decreased. And term policies also provide assurance against upward rate changes during the period of coverage.

To earn the full discount on term policies, the premium for the entire period must generally be paid in advance. But you may not be prepared for such a large outlay at one time. In many areas budget plans are available. One such plan permits the insured to obtain a rate lower than the annual rate but not quite as low as the term rate.

In general, the principle of budget plans is to split the total coverage into a number of term policies of substantially equal amount, arranged so that one policy matures each year. Of course, all the policies must be taken out in the same company. The advantage of the plan to the insured is that the term rate is available, on a prorata basis, yet he need not pay the entire premium in advance. He also avoids—in the case of 3- or 5-year term policies—the necessity for payment of a large premium every third or fifth year.

Under still another plan, on a 3-year term policy, coverage may be split into three equal parts, one covering 1 year; another, 2 years; and the third, 3 years. The rates would be, respectively, one-third, two-thirds, and the total of the 3-year rate. As the policies mature, renewals are placed for the full 3-year period. To obtain the term rate, the insured is obligated to place

certain minimum renewals with the companies which provide the original policies.

Another convenient plan is available in some areas. On a 3-year policy, for a 5 per cent increase above the figure of two and one-half times the annual premium, the premium due may be paid as follows: 50 per cent immediately, 30 per cent at the beginning of the second year, and 20 per cent at the beginning of the third year. Still another installment plan provides for payment of 40 per cent, 30 per cent, and 30 per cent of the premium at corresponding dates.

If it is more convenient for you, under some policies premiums may be spread evenly throughout the year. In some cases there is a small charge for payments on the installment plan; in others—generally where the premium is more sizable—there is no supplementary charge. And do not overlook the possibility of saving money by borrowing from a bank to pay the lower premium available under a term policy.

Some types of policies provide premium discount plans yielding economies from the quoted base premiums, varying with the size of the risk. The larger the risk, the higher the percentage of discount available.

The *dividends* which the mutual companies pay to policyholders constitute an important factor which you must appraise in deciding whether to place your insurance with a mutual company or a stock company. The net premium cost to you must be considered.

Also important is the possibility of assessment by the mutual company should the deposit premium be inadequate to meet the losses sustained. And, of course, the stability and general practices of the particular insurance company should be considered.

The installation of *elevator safety devices* may bring about reduction in elevator insurance premiums.

Experience ratings, also known as retrospective ratings, are available for some types of insurance. The net premium charged varies, within limits, depending upon your loss experience. This may be advantageous for insureds who develop substantial annual premiums.

In some territories rates on burglary risks may be computed on an experience rating basis. And some policies make available special premium credits for the provision of safety and loss prevention measures. For example, in messenger robbery policies there may be a rate reduction if a guard accompanies the messenger. Discounts from the rate are available where a private conveyance is used, and a further discount if the conveyance is an armored car.

Give thought to methods of preventing or minimizing losses. Even if your policy does not provide for experience credit, a decline in losses, generally,

will tend to send down premium costs. The experience of your industry as a whole commonly provides a basis for the setting of a rate applicable to all firms in the industry which meet basic requirements. Therefore, it is financially desirable to exercise every effort to keep your loss ratio low.

Keep a record of your premium cost and your loss or claim record, by classes of insurance. This will be useful in negotiating policy renewal or placement with another insurer, particularly where experience rating plans are in effect.

And review your loss experience to see whether you are receiving appropriate credit in the premium computations.

Fire-resistant construction of your property will exercise a favorable effect on the fire premium rate.

Automobile *fleet* insurance is available where five or more automobiles are under the ownership of a single insured and under one operating management. The premiums charged are less than for nonfleet insurance. If collision and fire and theft experience warrant it, experience credits are available; these will result in saving of premium.

A considerable reduction in the rate for *forgery* coverage is available if losses caused by the insured's officers and employees are eliminated from coverage under the depositor's forgery bond.

It is economical to carry your various *group insurance* coverages with one company, under a combined or consolidated policy. The premium rates reflect the fact that the insurance company's overhead will not necessarily increase materially with a doubling or trebling of premium attributable to additional coverage.

In group insurance writings, experience rating and discount procedures vary from company to company. Check should be made of the insurer's computations concerning loss experience and reserves on open claims. It may be possible to obtain further reductions of cost upon presenting the company with evidence of excessive cost based on the figures assembled or on other companies' practices.

The use of an *inland marine floater* policy in place of several policies covering different hazards may be beneficial and economical in many cases. The floater premium may be less than the combination of premiums under the other policies, or the coverage greater for the same premium, or it may even develop that the coverage is greater and the premium less.

Where a number of properties are owned by one individual, firm, or corporation, fire companies may issue a *master contract* covering all the properties. No special or reduced rates are available on this insurance, but it is generally more economical for the policyholder because of the lesser quantity of record keeping and similar paper work involved. In addition, there is

assurance that there will be no discrepancies in coverage from property to property.

Do not overlook, in estimating the premium cost of your liability policy, that under some circumstances discounts are available on policies which include *medical payments* coverage. The latter provides reimbursement for medical expenses incurred by the injured persons, even though there was no negligence by the insured. The discounts are obtainable when the insured employs—or contracts for the services of—a graduate nurse or a licensed physician, to be in constant attendance.

If your policy is subject to a *minimum premium* which is greater than that actually earned by the insurance company based on the rates in effect, you should increase your coverage to at least consume the minimum premium, if the value of your assets at risk warrants such increase.

Try to avoid having *numerous policies* of the same class on a single property, or against a single risk. The work of record keeping is compounded unnecessarily, and the adjustment problem rendered more involved than necessary.

In figuring your *payroll* for the purpose of reporting figures on which premiums are based, be sure to note the total of the overtime bonus, or overtime premium, portion of the total payroll. Generally such figures may be excluded from computation where the premium varies with the amount of the payroll.

Check the *payroll audit* figures on the basis of which your insurance company computes your premium.

Safety measures and devices for the *prevention of losses* tend to contribute to the reduction of premium rates. For example, when accounts receivable records are insured, the provision of certain types of safes or vaults may bring about a downward adjustment in premium rate.

You can help cut premium costs. Rates are set so that they will cover losses and operating expenses, and provide a profit to the companies. But it has been noted that carelessness in the handling of property often results from the knowledge that insurance is in effect. This, it has often been found, tends to result in increase in the number of losses.

Insurance companies in all branches of the industry try to bring about reduction of losses. Casualty companies provide safety literature and seek methods of avoiding accidents; fire companies foster fire-prevention drives, make available lecturers and publications, and undertake studies in fire prevention and control; life companies undertake research designed at increasing longevity and preventing illness, and provide facilities for physical examinations.

Your cooperation in the loss prevention efforts will be fruitful. Inspection

of your plant will probably reveal loss hazards. Appoint a plant safety manager and hold safety courses for your employees.

These specific plant safety suggestions will be of use to you. Give up, as soon as you can, your hazardous or obsolete machinery; provide safety guides or bars; set up a fire and accident safety organization; install, where it is feasible, an automatic fire-detection system wired to the local fire department; set up safety rules relating to smoking in the plant; install sprinklers; have adequate fire apparatus or equipment and adequate water; keep abreast of developments relating to new fire-fighting chemicals; set up special safety rules where the chemical or dust explosion hazard is considerable; provide good plant housekeeping, with particular provision for inflammable rags and dust; arrange for regular collection of trade waste; provide adequate space for machines, equipment, and stock; store hazardous materials safely.

A large risk may face cancellation by the insurance company if cooperation is not extended to its loss-prevention engineers.

If you have a good loss record, try to retain that record. And you should consider the desirability of omitting to make claim for small losses.

It is generally forbidden for a broker, agent, or insurance company to give an insured, either directly or indirectly, an unauthorized discount, or *rebate,* from an established premium. This would result in one insured's obtaining an unfair advantage over another. It would have the effect of setting up a competition among agents and brokers to obtain business through discriminatory lowering of rates.

Reporting policies are desirable under some circumstances. When the total value of merchandise or other assets at risk fluctuates considerably from month to month or period to period, such coverage, if obtainable, offers advantages.

Under a policy providing for monthly reports of values at risk, items acquired between reporting dates are covered automatically. You need not run the risk, as under a fixed-amount policy, of paying too much in premiums, which would be the case where the fixed coverage is in excess of your needs. Also avoided is the danger of being underinsured because of a failure to estimate, on writing the policy, how high the values at risk would go. One major additional advantage is that you will make monthly check of your insurance on this item of fluctuating value.

In some areas the face amounts of certain types of policies may be reduced up to one-half the total, with prorata computation of *return premium,* rather than short-rate computation. And when you cancel a policy and then rewrite it with the same company for an amount and a period at least equal to those which it replaces, the return premium is also computed on the prorata cancellation basis.

Reporting policies provide that the insurance company may *review the insured's records* to compute the premium or to verify the values submitted. Under many types of liability policies whose premiums vary with the total sales or total payroll or other values, deposit premiums are paid. These are subject to supplement based on subsequent report by the insured or audit by the company, or both.

Be prepared, therefore, to make your payroll, sales, or other relevant records available for review by the insurance company's auditors. One indirect advantage often results: the auditors, because of thier extensive experience, will often be in position to recommend payroll and other record-keeping methods which will help simplify your work.

Sprinkler systems and fire-resistant construction tend to reduce the cost of fire insurance on buildings and contents.

Under a fire policy a rate reduction may be obtainable if an approved type of *standpipe* is installed.

Fire risks on *superior properties* may be insured on a special basis. A number of mutuals and associations of stock companies specialize in covering single-occupancy sprinklered properties of high quality from the points of view of construction and protection. These properties must be well maintained and there must be unusually good risk inspection and prevention.

Under automobile policies, coverage may be *suspended* for a period or the automobile may be laid up, or placed out of use, with the return of part of the premium to the insured.

9. *Check list of business insurance coverages*

Accident

Accident and health: accident; death and dismemberment; double indemnity; group; hospital expense; medical expense; partial disability; sickness; surgical expense; total disability

Accountants' liability

Accounts receivable

Additional expense

Additions, alterations, and repairs liability

Advertisers' liability

Air-cargo floater

Aircraft: accident; air carriers' liability; air-meet liability; airport cargo liability; airport casualty; airport fire; airport liability; airport property damage; all risks; bodily injury; cargo; casualty; crash damage; damage; dealers' policies; employees' indemnity; explosion; fire; hangar keepers' legal liability; hangars; hull coverage; liability; lightning; medical payments; nonownership; passenger liability; products liability; property damage liability; public liability; theft, robbery, and pilferage; tornado, cyclone, windstorm; transportation; workmen's compensation.

Aircraft and motor-vehicle property damage

Alienated premises
All risks securities safe-deposit box
Alterations permit public liability
Annual guarantee bond
Annual transit shipment
Annuities
Antiques (fine arts, paintings)
Apparatus and instruments floater
Architect's bond
Armored car and messenger
Articles (inland marine)
Assessment
Automobile: bodily injury; casualty; collision; combined additional coverage; comprehensive; contingent liability; dealers; drive-other-cars endorsement; earthquake; embezzlement or secretion; explosion; fire; fleet; floor-plan coverage; garage; glass; hail; hired car or truck endorsement; legal liability; liability; lightning and transportation; malicious mischief; medical payments; nonownership (employees) liability; open storage lot endorsement; property damage; public liability; riot and civil commotion; rising waters and flood endorsement; theft; vandalism and malicious mischief; windstorm and tornado; wrongful conversion, embezzlement, and secretion
Automobile dealers, repair shop, storage garage, and service station: damage; open-lot storage; theft indorsement
Aviation (see *Aircraft*)

Bailees
Bailees' customers floater
Bailees' floaters
Bandsmen's uniforms floater
Bank burglary and robbery
Beauty-shop malpractice liability
Beverage containers
Bicycles and hand trucks floater
Bicycle liability
Boiler and machinery
Boiler and machinery, use and occupancy
Bonds: annual guarantee; bankers' forgery (lenders' form); bankers' liability indemnity; bid; blanket; blue-sky law; check forgery; comprehensive dishonesty, disappearance, and destruction; construction contract; contract: American Institute of Architects, bid, completion, private construction, proposal, public works, supply; court; customs; executors and administrators; export; faithful performance; Federal permit; fidelity: blanket position, discovery, excess commercial blanket, individual, name schedule, position schedule, primary commercial blanket; fiduciary; financial guarantee; forgery; forgery, bank: depositors and commercial; fraud; guarantee; immigrant; insurance; internal revenue; judicial; lien; liquor; litigation; local license and permit; lost securities; maintenance and efficiency; miscellaneous indemnity; name schedule; official; patent infringement; public official; public warehouse and grain elevator; qualifying; schedule; state license; supply contract; surety: completion, depository, lost instrument; warehouse
Bonds—blanket: bankers' and brokers'; bankers' and brokers' clearing house; commercial; credit union; Federal home-loan banks; Federal reserve banks; fidelity; financial institutions; fraternal order; insurance companies; investment bank-

ers; position; primary commercial; railroad; savings bank; savings and loan association; small loan companies
Bridge and vehicular and rail tunnels: builders' risk; property damage; use and occupancy
Builders' risk
Burglary: inside holdup; open stock; paymaster robbery; safe burglary
Burglary, theft, larceny, and robbery
Business interruption

Cameras, equipment, and projection machine floater
Cargo: air; Great Lakes; inland; ocean
Carriers' cargo
Cash sickness
Casualty
Cattle floater
Charitable institutions public liability
Check forgery
Chiropodists' malpractice liability
Church burglary, robbery, and larceny
Cleaners' and dyers' floater
Coin collection floater
Cold storage lockers
Collision
Combination: comprehensive; crime protective; fraud; merchants' protective
Commercial hull
Commercial travelers
Commissions
Commissions, selling agents
Compensation
Completion bond
Comprehensive: automobile liability; dishonesty, disappearance, and destruction; general liability; liability and property damage; personal liability; property damage; public liability
Conditional sales floater
Consequential damage: garment contractors; garment manufacturers; heating and refrigeration
Consequential losses
Consigned property
Consumption of food, public liability
Contingent: business interruption; commissions; liability; use and occupancy
Contractors': equipment floater; liability and workmen's compensation; property damage; public liability; road machinery and equipment
Contractual liability: public liability; property damage
Cost of replacing records
Credit
Credit-union blanket bond
Crime protection
Crop
Customers' goods

Debris removal
Deferred payments
Demolition, building laws
Dentists' malpractice
Department store transit floater
Depositors': commercial forgery bond; forgery bond
Depreciation and increased cost of construction
Destruction of records
Disability
Discovery bond
Drive other automobiles
Druggists' public liability
Dry goods and department store transit floater
Dyers and cleaners

Earthquake
Electric and neon signs

Elevator: collision; medical payments; property damage liability; public liability
Employers': public liability; workmen's compensation
Equipment
Errors and omissions
Excess: commercial blanket bond; messenger all risks; rental value
Exhibition floater
Explosion liability
Explosion and power plant
Export
Express transportation
Extended-coverage endorsement (fire)
Extra expense

False arrest
Farm
Farm implements and machinery
Farmers' comprehensive liability: personal; public
Fidelity and surety bonds
Fiduciary bonds
Film floater
Fine-arts floater
Fire and allied lines
Fire department service charges
Fireproof storage and transfer companies' trip transit
Flags and paraphernalia floater
Floaters
Flood
Floor plan merchandise floater
Flywheel
Food lockers
Foreign
Forgery and check alteration
Forgery bond
Fraternal burglary, robbery, theft, and larceny
Fraternal protective
Fraud (combination policy)
Fraud bonds: crime protective; single fraud; single merchants' protective
Funeral directors' floater
Fur farms
Furnace explosion
Furriers' block policy
Furriers' and fur storers' customers
Furs

Garage, automobile dealer, and service station liability
Garage comprehensive liability
Garment contractors' floater
Gas company legal liability
Gas cylinders
Gasoline service-station combination policy
General cover contracts
General merchandise floater
General public liability
Glass damage
Golfers' equipment
Government service
Grain
Grain charges
Grain and flour floater
Ground rents
Group: accident; disability; health; hospitalization; life
Growing crops
Gun floater

Hail (growing crops)
Hairdressing (liability)
Handcart
Health
Hired automobiles
Holdup: interior and exterior
Horse and wagon floater
Horses and mules
Hospital liability
Hospitalization
Hull

Import

Improvements and betterments
Income: business interruption; business interruption, contingent; profits and commissions; rental value; tuition fees
Increased cost of construction
Individual bonds: name; position
Individually drawn coverage: dispensing units; privately owned railroad cars, equipment, locomotives, rolling stock; radio towers; tickets for athletic events (mail-dispatched)
Inherent explosion
Inland marine
Innkeepers' liability
Installation risks floater
Installment sales and leased property floater
Insurance-companies blanket bond
Interest and amortization charge
Interior burglary and robbery
Investment bankers' and stockbrokers' blanket bonds

Jewelers' block
Jewelry: furs; installment

Landlords': protective liability; public liability
Laundry floater
Lawyers' liability
Lease contractual liability
Leasehold improvements
Leasehold interest
Legal liability: accountants, architects, bailees and warehousemen, beauticians, common carriers, dentists, druggists, innkeepers, lawyers, physicians
Liability: and property damage comprehensive; comprehensive general; comprehensive personal; miscellaneous
Library floater
License and permit bonds
Life: creditors'; general; key man; officers'; partners'; sole proprietors'
Line grain elevator
Liquor bonds
Litigation bonds
Livestock
Lodge paraphernalia
Loss of profits; of use
Lost or destroyed instruments bond

Machinery
Malicious damage and vandalism
Malpractice liability
Manufacturers': and contractors' liability; bodily injury and property damage; guarantee; output floater
Marine: ocean and inland cargo; hull
Market value clause
Medical payments
Mercantile open stock: burglary; theft
Mercantile safe burglary
Merchandise: on approval; by automobile; installment floater; in transit
Merchants' protective policy
Messenger and paymaster robbery
Metal smokestacks and awnings
Miscellaneous covers (*see* Scheduled property floaters)
Miscellaneous liability
Money and securities: all risk; broad form; destruction
Mortgage interest
Morticians': equipment; floater
Motor-truck cargo: carriers' form; owners' form
Movable equipment floaters
Musical instruments floater

Negative-film floater
Neon and electric sign floater

Nonownership automobile liability

Ocean marine: cargo; charterers' profit; collect freight; duties; hull; liability for loading damage; marine perils; protection and indemnity; riot; strike; war risks
Office and store burglary and robbery
Officers' lives
Oil risks
Open-stock burglary
Opticians' malpractice liability
Optometrists' malpractice liability
Osteopaths' malpractice liability
Outboard motor boats and motors
Owners' and contractors': bonds; protective (contingent)
Owners', landlords', and tenants': liability; property damage

Paraphernalia floater
Parcel post: coupon; open
Partners' life
Patent infringement
Patterns and dies floater
Paymaster and messenger robbery
Payroll robbery
Pension trusts
Personal
Personal injury
Personal public liability
Physicians', surgeons', and dentists': instruments floater; liability
Plate glass
Position schedule bond
Power interruption
Power plant
Premises legal liability
Premium
Primary commercial blanket bond
Principal's protective
Processing risks
Processors' risks floater
Products: liability; property damage
Professional: errors and omissions; instruments floater; liability
Profits and commissions
Projection machine floater
Property: damage liability; in transit; loaned or leased floater
Protection and indemnity
Protective public liability
Public employees blanket bond
Public liability
Public officials bond

Radio towers
Radium floater
Rain and hail
Registered mail and express
Religious articles and vestments floater
Rent and rental value
Repair or replace
Replacement
Retirement
Riot attending a strike
Riot and civil commotion
Robbery
Rolling stock floater
Rug and carpet cleaners' floater

Saddle-horse liability
Safe burglary
Safe-deposit box: burglary and robbery; public liability
Salesmen's: sample floater; stock
Schedule: automobile liability; bonds-name, position; liability
Scheduled property floaters
Scientific apparatus, instruments, and equipment floater
Securities: all risks safe-deposit box liability; all risks on premises; bonds
Selling agents' commissions
Selling price clause
Shippers' transportation floater
Side-track liability

Signs
Silverware
Small loan companies' blanket bond
Smoke and smudge
Special covers
Specie
Sports liability
Sprinkler leakage: and water damage; liability; profits
Stamp: or coin dealers; collection floater
Standing timber
Steam boiler and machinery
Steam or tornado
Stevedores' gear and equipment floater
Storage and repairs charges
Storekeepers': burglary and robbery; liability
Subcontractors': property damage; public liability
Surgeons' malpractice liability
Surgical and scientific instruments

Teams' public liability
Tenants' public liability
Theatrical properties floater
Title
Tornado and windstorm
Town and road equipment
Trailer contents floater
Transit floater
Transportation-location floater
Trees and shrubbery
Trip transit
Truck
Truckmen's cargo
Tuition fees
Tunnels: liability; property damage
Turkey

Unearned premium
Uniforms and paraphernalia
Use and occupancy

Valuable papers
Vandalism and malicious mischief
Veterinarians
Voting-machines floater

War damage
Warehouse bonds
Warehousemen's liability
Water damage
Wave damage
Well-drilling tools
Windstorm
Wool growers' floater
Workmen's compensation

Yachts
Yard improvements, trees, and landscape

10. How taxation affects your insurance

This part deals with the many ways in which taxation touches your insurance. It answers such questions as: What classes of premiums are deductible? For example, are premiums on key-man life insurance policies allowable expenses? Or, premiums on officers' life insurance policies, where the corporation is the beneficiary? What types of insurance proceeds are taxable? Settlements under business interruption policies? The proceeds of fire or burglary insurance claims?

Note that each dollar you spend for insurance which meets the conditions laid down by the tax authorities is deductible for income tax purposes.

Thus, as a practical matter, the actual cost of insurance is a good deal less than the face amount of the premiums, since without this deduction the tax payable would be greater.

As an insurance buyer unquestionably you consider protection against loss of paramount importance. The tax features of insurance transactions are secondary considerations. But you must not overlook the tax laws. Failure to consider them may prove expensive.

The proceeds of insurance settlements for damage to property because of fire or burglary are not taxable under certain circumstances. But these requirements for nontaxability must be followed to the letter. Otherwise, tax may result.

In preparing a buy-and-sell agreement, frequently sole proprietors, partners, or stockholders in a close corporation agree upon the price of an interest in a business, or upon a formula for computing the price. A figure reached at arm's length will generally be recognized by the Bureau of Internal Revenue for estate tax purposes.

But in a closely held corporation or a family partnership, the propriety of the sales price or the pricing formula in the buy-and-sell agreement may be disputed by the Bureau. The Bureau may take the position that the transaction was not entered into at arm's length; that the difference between the value set in the buy-and-sell agreement and that arrived at on appraising the property was a gift.

The proceeds of settlements under certain types of business interruption policies are not taxable as income; the proceeds of other types are taxable.

Under some conditions the premiums on key-man life insurance policies are deductible as expenses.

Contributions to pension trusts are deductible if the pension plan meets the requirements of the Internal Revenue Code. Among other purposes, these provisions are designed to prevent discrimination among employees or groups of employees as to who may participate, what the contributions must be, and the amounts of benefits.

Therefore, before you formally adopt your pension, profit-sharing, or bonus plan, submit it to the Bureau of Internal Revenue for approval.

Note that even though you may have obtained the Bureau's approval of your plan, to be deductible for income tax purposes the contributions in behalf of each participant, when added to the remainder of his earnings, must not exceed a reasonable figure.

A pension or bonus plan must operate for the benefit of your employees; it must not be designed as a means of benefiting officers or stockholders. Nor may it discriminate against officers, stockholders, supervisory employees, or employees who earn high pay.

The plan must be a permanent one. This does not mean that the plan will not be considered permanent because business conditions force its curtailment or abandonment. The plan may have to be modified or dropped because a firm becomes bankrupt or insolvent. Or sharp decline in a company's income might force curtailment.

The rules of coverage are simple. The plan, if the employees are *not* required to contribute, must cover 70 per cent or more of all the employees employed for some minimum period, not exceeding 5 years, or must cover a group that meets the approval of the Commissioner of Internal Revenue as being nondiscriminatory. Under a contributory plan, if 70 per cent or more of the employees are eligible, then 80 per cent of this group must participate. Thus the company would meet the test imposed by law if a minimum of 56 per cent of all employees participate. Excluded from either calculation are those who work part time.

Contributions to the pension fund will not be exempt from Federal income taxation if the trust funds may be "used or diverted to purposes other than for the exclusive benefit of the employees or their beneficiaries, prior to the full satisfaction of all liabilities to the employees or their beneficiaries."

Under some circumstances an employer may deduct his contributions to a pension plan, despite the fact that the plan is not one "qualified" under the Federal tax law.

Pension-fund contributions for services rendered by employees before the plan goes into effect (these are known as contributions for past services) may be deducted for income tax purposes. However, only one-tenth of the premium applicable to the past services may be deducted in each year.

Consider these important points relating to Section 102 of the Internal Revenue Code, entitled "Surtax on Corporations Improperly Accumulating Surplus."

The payment of premiums on key-man insurance bought by a corporation might be considered proper and allowable by the Bureau of Internal Revenue, where the use of the money for other purposes might not. But the taxpayer should buy the proper type of insurance.

Policies having high cash values might be objectionable; those with low values, acceptable. Further, the policies should be owned by the corporation and the proceeds payable to it.

The two charts which follow show how your insurance premiums and proceeds are affected by taxation.[2]

[2] For further discussion of his insurance as it is affected by taxation, the reader is referred to J. K. Lasser, *Lasser's Business Tax Guide*, Simon and Schuster, New York, 1952.

Chart 1. How Taxation Affects Your Business Premiums *

Type of insurance	Coverage	Beneficiary	Premiums		
			Paid by	Deductible on income-tax returns?	Taxable to employees as additional compensation?
Burglary	The business	Owner of business	Owner of business	Yes	
Business interruption (use and occupancy)	The business	Owner of business	Owner of business	Yes	
Fire .	The business	Owner of business	Owner of business	Yes	
Group health, life, accident	Employee	Employee	Employer	Yes	No †
Liability .	The business	Injured or damaged parties	Owner of business	Yes	
Life (ordinary)	Employee or officer	Employee or officer	Employer	Yes ‡	Yes
Life (ordinary) .	Employee	Employer	Employer	No	
Life (ordinary) .	Employer	Employer	Employer	No	
Life (ordinary) (purpose to buy employer's interest)	Employer	Employee (or trustee)	Employee	No	
Life (ordinary)	Debtors	Owner of business	Owner of business	Yes	
Pension, stock bonus, and profit-sharing trusts which: "Qualify"	Employee	Employee	Employer	Yes §	Yes §
Do not "qualify"	Employee	Employee	Employer	Yes §	Yes §
Self-insurance fund	The business	Owner of business	Reserve set aside by business	No (but loss is deductible when it occurs)	
Welfare plan	Employee	Employee	Employer	Yes	No
Workmen's compensation	Employee	Employee	Employer	Yes	No

* If ordinary and necessary business expenses.

† Provided that the beneficiary is designated by the employee.

‡ If in the nature of additional compensation, and total compensation, including this item, is not unreasonable. Note that if the premium is considered a dividend to stockholders (the insureds) rather than reasonable compensation, no deduction would be allowed the corporation, and the premium would be taxed to the insured as additional compensation.

§ If employee's rights are nonforfeitable.

Chart 2. How Taxation Affects Your Insurance Proceeds

Type of Insurance	Premiums paid by	Proceeds received by	Are proceeds taxable to recipient?
Burglary	Owner of business	Owner of business	No, provided that the rules of the Bureau of Internal Revenue are followed *
Fire	Owner of business	Owner of business	Same as above
Group health, life, accident	Employer	Employee	No
Liability	Owner of business	Parties injured or damaged	No
Liability	Outsider (party at fault)	Owner of business	No
Life (ordinary) ...	Owner of business	Employee	No
Life (ordinary) ...	Owner of business	Employer (on employee's life)	No, except where policy was taken over by employer for consideration. In that case the proceeds are taxable to the extent that they exceed the sum of the consideration paid and the premiums paid after acquisition of the policy

* Concerning the proceeds of burglary and fire insurance, where an insured loss through destruction or theft takes place, the proceeds of the policy may, under certain circumstances, receive special treatment for Federal-tax purposes.

The loss is treated as an involuntary conversion of property. Where the insurance company pays, in settlement, a sum higher than the book or carrying value of the asset, no gain will be recognized provided that the sum received is expended to acquire "property similar or related in service or use to the property so converted. . . ."

But such replacement must take place within one year.

Let us consider what happens if replacement is not effected within one year after the end of the year in which the insured realizes a gain on the involuntary conversion. In such case special application should be made of the Commissioner of Internal Revenue for an extension of time.

Type of Insurance	Premiums paid by	Proceeds received by	Are proceeds taxable to recipient?
Life (ordinary) (purpose to buy employer's interest)	Employee	Employee (or trustee)	No, except where policy was taken over by employee for consideration. In that case the proceeds are taxable to the extent that they exceed the sum of the consideration paid and the premiums paid after acquisition of the policy
Life (debtors) ...	Owner of business	Owner of business	No
Pension trusts which "qualify"	Employer and employee	Employee	Employer contributions: Yes, as income in accordance with Internal Revenue Code (if proceeds are not distributed in their entirety in a single year). However, tax is likely to be in lowest income-tax bracket, or perhaps zero, because employee's wage income has ceased If distributed in one lump sum because of the termination of the plan, taxable as ordinary income. If so distributed in one year because of separation from service through resignation or discharge, taxable as long-term capital gain If distributed entirely in one year because of retirement, employee's own contributions are tax-free, the balance being taxable as long-term capital gain Employee contributions: If not distributed all in one year, 3 per cent of total employee contributions is taxable as income each year; the balance is excluded from income until the amount excluded equals the amount of the employee contribution. Thereafter the entire receipts are taxable If distributed all in one year on separation from service, the excess over the total employee contribution is long-term capital gain, except as to certain types of non-trusteed contracts

Type of Insurance	Premiums paid by	Proceeds received by	Are proceeds taxable to recipient?
Pension trusts which are nonqualifying	Employer and employee	Employee	Yes
Rebate on mutual or group insurance premiums	Owner of business	Owner of business	Yes, if the gross premiums were deducted as expenses
Use and occupancy (fire)	Owner of business	Owner of business	Yes, if the policy insured against actual loss sustained of net profits in the business. These proceeds "are not proceeds of an involuntary conversion but are income in the same manner that the profits for which they are substituted would have been" No, where the insurance companies agree to pay a flat per diem allowance as a result of the loss of the use and occupancy of the property destroyed In this case there is *no* recognition of gain when the proceeds are received, if they are expended to acquire other property "similar or related in service or use to the property destroyed"
Workmen's compensation	Employer	Employee	No

11. Some reminders

In the preceding pages we have tried to help you answer such questions as these: Do we have enough insurance? Of the right kinds? Are our policy forms the best ones available? Or can they be broadened?

In this part we shall consider some important supplementary points relating to your coverage.

You should keep a summary showing, for each policy or group of policies: property covered; brief description of the type or nature of the coverage; name of insurance company; policy number; amount; period; date effective and date of expiration; amount of premium; significant clauses, for example, the exclusions; total coverage of each type, that is, fire, burglary, liability, and so forth.

Watch the time of expiration of your policies. Be sure to arrange for new insurance to begin when the current policies expire.

Review your coverage frequently. Changes in types of insurance available take place frequently, and business conditions likewise change. Also, individual enterprises modify the nature and the scope of their activities.

Some common errors in coverage are these:

Fire insurance: Omission of extended coverage, insurance against consequential damage, and business interruption; inadequate total insurance under the coinsurance clause

Burglary, robbery, fidelity: Omission of employees' bonds and protective or burglar-resistant devices; inadequate record keeping

Liability: Policies not comprehensive, common hazards being omitted from coverage; omission of coverage on liability for accidents or for damage to property of others

Read your policies carefully. Pay particular attention to the warranties you have made. Are they correct statements? Are you doing what you undertook to do? For example, if you agreed to maintain a 24-hour guard, or 24-hour watchman service, or other safeguards, are you complying with your undertaking? If not, you may have difficulty in collecting your loss.

Be familiar with the principal provisions of your policies; note, particularly, the exclusions. The liability policy, for example, makes frequent reference to the "accident"; this word is to be distinguished from "occurrence," which is broader, and more comprehensive. Though it is not common to do so, the broader coverage may be obtained for an additional premium.

Standardization of the practices of insurance companies operating in various branches of the industry has tended to introduce elements of stability and consequently reliability. In part, this is because of the elimination, or possibly only averting, of destructive competition. Through the medium of rating organizations operating under state review or supervision, rates are filed for the various classes of coverage.

It may be that your situation is unusual, that it requires a type of insurance coverage which brokers say is not available. Under some circumstances, your broker can submit the unorthodox plan for approval by the state insurance department, following which underwriters may be found locally, or abroad, who will accept the risk.

Do not expect insurance to cover you against all the risks incurred in your business. Some losses are normal business risks, for example, those due to style changes of merchandise, falling off of business because of strenuous competition offered by others, and depreciation, obsolescence, and main-

tenance or repair costs of equipment and apparatus. All these are the everyday hazards of business against which no insurance is obtainable except that provided by your business acumen.

Insurance men report that frequently claims are made for losses not covered under the policies. But the insured puts it this way, "We never seem to have the right kind of insurance for the loss we sustain."

Such incidents are easily avoided by you. Continue to be apprised, by reading or through information from your insurance advisor, of the changes in types of coverage available. And, as has been suggested above, keep up-to-date records of changes in your exposures, including both hazards and amounts at risk.

If you are considering dropping a policy before maturity, give thought to the premium which will be returned to you. Generally, when you cancel a policy you will receive a return premium based upon a short-rate computation, in contrast with a prorata computation.

The prorata return is based upon the actual number of days remaining unexpired under the policy, in comparison with the entire period of insurance coverage under the policy. Short-rate computation yields a lower return premium.

The latter method of computation gives consideration to the expenses incurred by the company in writing and administering the insurance; obviously these must be paid for out of the premium earned. When the insured cancels a policy, he is penalized by being charged a higher proportion of the total premium (short-rate method) than when the company cancels, or—under some circumstances—when cancellation is effected for the purpose of rewriting the insurance with the same company.

Illustrative of the difference in cost on a 1-year policy, employing the uniform short-rate table used in many areas, is this comparison, applicable where a policy is canceled after being in effect for thirty days:

	Short-rate method	*Prorata method*
Proportion of 1-year premium charged by insurance company, per cent.....	19	Approx. 8.2

It may develop that cancellation is undesirable because the return premium available under the short-rate method is so small as to be more than balanced or offset by the risk of loss remaining after cancellation.

Select your broker or agent on the basis of his knowledge, experience, and skill. Whenever possible avoid picking such representative because a lending agency, a customer, or a creditor makes the designation of a specific broker or agent a prerequisite for doing business with you.

It is usually unwise to have more than one broker or agent. A single

organization or individual will make itself familiar with your problems; it is not feasible to deal with several insurance advisors once you have found a reliable specialist, one who is competent and well informed on insurance matters.

A good broker or agent will study your business and will often anticipate the problems you bring to him. He will know what your exposures are, since he will have learned how you conduct your business, where you get your products, how you process them, what outside manufacturing is performed for you, and what industrial or occupational hazards your business presents.

But you will have to tell him such things as what liabilities you have assumed under your contracts with customers or suppliers, what new ventures you plan to undertake, and similar matters. And you should supply him with all the data he needs to effect proper coverage for you, including valuations of property, volume of business, and changes or developments in your business. Also, you should report your losses to him promptly.

You may properly expect your broker to provide you with the right coverage, in the right amount, in financially sound companies whose claim departments are experienced and efficient as well as fair and prompt in settling claims.

Some risks may be covered in substantially similar fashion under different types of policies, for example, those issued by casualty companies and those by fire companies. But, generally, there will be differences in coverage, one policy being broader than the other. And the underwriting practices of the two types of insurers will also differ. Likewise, the rates will vary. Therefore, a wide knowledge of coverages is required.

Concerning some of the less common types of insurance coverage, it is difficult to make the general observation that a particular method of coverage of a risk, form of policy, or type of endorsement is always best. Each situation must be considered independently. The risks and the costs of coverage under the various proposed methods must be weighed carefully before you decide.

The following reminders are arranged alphabetically by subject.

Some policies are obtainable by you only on the basis of submission of a preliminary *application,* which is also known as a questionnaire, or proposal, or series of declarations. Generally, if the insurance is issued, the application constitutes part of the insurance contract. And you are held to the responses supplied, where they are material to the contract. The statements you make help the company decide the desirability of the risk you offer for coverage and also aid in the computation of the premium. The declarations are therefore important.

Many policies provide for the *automatic reduction of the face amount of the insurance* when a claim is paid. On the payment of an additional premium, computed on a prorata basis, the amount of the policy may be restored to that in effect before the reduction.

However, other policies provide for *automatic reinstatement* of the full amount of the policy without additional premium.

Where a *bailee,* for example, a warehouseman, holds your goods for storage or processing, and is required to insure for your benefit, make sure that you know the name of the insurer and the amount of coverage.

It is generally convenient to insure under one *blanket policy,* issued on a reporting basis, stocks of goods at many locations, sometimes widely separated from one another. Similarly, it may be convenient to arrange for fire insurance and extended coverage upon all of a company's buildings and equipment in one blanket policy, with limitations as to the amount of insurance on the building and equipment at each plant.

Do not consider yourself adequately covered if you have a few individual *bonds* for small amounts, when what is needed is a blanket bond covering all your employees. Remember that the embezzling or defaulting employee is always one who was a trusted worker. His very excellence as an employee militates against the probability of early discovery of his fraudulent acts; if he had not been a trusted worker he would have had little opportunity to make off with the firm's money or property.

And be sure that the limits of coverage under your bonds are adequate. Consider the case of a company which had fidelity coverage, on a named individual basis, of $5,000, although the firm's annual business was a thousand times that sum.

It has been suggested that a skilful defaulter can make away annually with 10 per cent of the total of cash, receivables, and inventory of the company. Tripling this sum for safety, it is suggested that coverage be acquired in the amount of 30 per cent of the total of these assets.

A factor which you must consider in connection with your desire to place insurance is the *capacity problem* which has faced insurance companies, and which, it is reported, is now beginning to ease. In recent years many of the companies found themselves unable to provide the coverage sought by applicants.

The causes of inadequate underwriting capacity were the inflated dollar value of the properties submitted for coverage, without corresponding increase in insurance company capital; the comparatively fixed limits of risk which a single company may take on a particular piece of property; the additional premium reserve requirements which accompany increases in the total risks assumed and which consume surplus; the inability to distribute

insurance risk internationally, through the medium of reinsurance, as widely as formerly.

So, in recent years, insurance buyers have noted difficulty in obtaining coverage of large values subject to a single large risk or catastrophe. This was particularly true of property insurance.

Insurers became—and still are—unwilling to write large amounts on substandard risks. Therefore it has been difficult to obtain coverage of large amounts where the risk of loss is increased because the property is maintained in substandard fashion.

Because of the capacity problem, on occasion a broker, expert in insurance matters and possessed of excellent understanding of the insurance placement market, may nevertheless have difficulty in placing your line. If your problem is unusual, and offers uncommon risk, it may be difficult to find an underwriter who will manifest interest.

Naturally, you should select the best insurance company available. The criteria to employ are financial soundness and stability, and reputation for fairness in loss settlements, rather than merely the amount of premium charged. But inability to find well-known insurers which will accept your risk may force you to seek coverage with companies not widely known. The result may be an increase in your supplementary work—checking a larger number of policies as to propriety of coverage, making appropriate record for the more numerous policies, and making the acquaintance of new brokers and agents.

Concerning policy limits in *holdup* insurance, it is desirable to take coverage for the maximum possible risk, not the average or usual amount.

In times of rising prices, insurance surveys generally indicate the need for *increase in the amount of insurance.* Queried on this point, most businessmen respond that they are not carrying enough insurance. Many are concerned lest a serious loss render them insolvent because they are underinsured.

High limits should be obtained on *liability* policies. The additional premium cost for coverage above that for low limits is relatively small. Offsetting this is the noticeable tendency for courts and juries to award judgments which take into consideration the rise in commodity prices.

Where more than one form of public liability insurance is carried, it is desirable to place all the insurance with one company. This will reduce the possibility of controversy among the insurance companies concerning the allocation of liability where the degree of responsibility of each insurer is in dispute.

Under certain liability policies, nonmotorized vehicles, such as hand trucks, bicycles, and carts, are excluded from coverage unless special endorsements

are added and additional premiums paid. Under other policies, these vehicles are included in coverage without charge. Be sure, therefore, if you use such equipment, that it is covered.

All liability policies contain lists of exclusions. Be certain to obtain coverage, so far as is possible, on such of the items excluded as you consider necessary.

Minimum premiums are often set for specific classes of insurance policies. The minimum premium is the lowest amount which the company will charge to provide insurance of the type sought, for the period agreed upon. It is payable where the premiums computed on the sum at risk, at the regular rate, reach a lower figure. This requirement exists because the insurance company's expense in writing the policy, and the provision for loss claims, render impractical, businesswise, undertaking to cover the risk for less than the stated minimum amount.

As noted above, increase your coverage to consume the minimum premium, if the value of the assets at risk warrants such increase.

If you *operate in other states* than that where your principal place of business is located, or in foreign countries, be sure that you comply with the laws of these jurisdictions concerning insurance coverage. All states make compensation insurance compulsory. And many have passed financial responsibility laws relating to personal injury and property damage claims against operators of automobiles, insurance coverage being accepted as evidence of responsibility.

In setting up a *pension plan* for your employees, approval of its provisions should be obtained from the Bureau of Internal Revenue so that the pension contributions made by you will be allowed as income-tax deductions.

If you plan to offer *personal surety bonds,* consider the disadvantages of such practice. Fiduciaries have defaulted and the personal sureties, who took on the obligation gratuitously, have found themselves inconvenienced financially.

Be sure to check the *policy limitations on the amounts of insurance* which will apply at specific locations against the values of your property at risk there.

Inside narrow geographic areas, fire insurance *rates* are commonly the same within groups, types, or classes of properties, considered to present substantially the same degree of risk. But exceptional circumstances will affect the rate; for example, additional hazard may be contributed by reason of the nature of the work performed in surrounding buildings, or within the building itself. Or the nature of the materials kept or used at these places, or the unusual construction or fire-resistant devices available, will exercise an influence on the rate.

Self-insurance presents a number of pitfalls. You may be unprepared to withstand the financial impact of a large loss; your reserves may be inadequate to permit prompt resumption of business activities.

The *written portions* of all policies covering the same property against the same risks should read alike. If this is not the case, bring them into conformance with one another.

FIRST PAGE OF STANDARD FIRE POLICY

No. . . . . . .

[Space for insertion of name of company or companies issuing the policy and other matter permitted to be stated at the head of the policy]

[Space for listing amounts of insurance, rates and premiums for the basic coverages insured under the standard form of policy and for additional coverages or perils insured under endorsements attached]

In Consideration of the Provisions and Stipulations herein or added hereto and of . . . . . Dollars Premium

this Company, for the term { from the day of , 19. { at noon, Standard Time, at
of { to the day of , 19... { location of property involved,

to an amount not exceeding . . Dollars,

does insure . . . .

and legal representatives, to the extent of the actual cash value of the property at the time of loss, but not exceeding the amount which it would cost to repair or replace the property with material of like kind and quality within a reasonable time after such loss, without allowance for any increased cost of repair or reconstruction by reason of any ordinance or law regulating construction or repair, and without compensation for loss resulting from interruption of business or manufacture, nor in any event for more than the interest of the insured, against all DIRECT LOSS BY FIRE, LIGHTNING AND BY REMOVAL FROM PREMISES ENDANGERED BY THE PERILS INSURED AGAINST IN THIS POLICY, EXCEPT AS HEREINAFTER PROVIDED to the property described hereinafter while located or contained as described in this policy, or pro rata for five days at each proper place to which any of the property shall necessarily be removed for preservation from the perils insured against in this policy, but not elsewhere.

Assignment of this policy shall not be valid except with the written consent of this Company

This policy is made and accepted subject to the foregoing provisions and stipulations and those hereinafter stated, which are hereby made a part of this policy, together with such other provisions, stipulations and agreements as may be added hereto, as provided in this policy,

In Witness Whereof, this Company has executed and attested these presents, but this policy shall not be valid unless countersigned by the duly authorized Agent of this Company at

. . . . . .

Secretary. *President*

Countersigned this day of , 19 . . . . . .

AGENT

Fig. 1. New York Standard Fire Insurance Policy.

SECOND PAGE OF STANDARD FIRE POLICY

Concealment, fraud. This entire policy shall be void if, whether before or after a loss, the insured has wilfully concealed or misrepresented any material fact or circumstance concerning this insurance or the subject thereof, or the interest of the insured therein, or in case of any fraud or false swearing by the insured relating thereto

Uninsurable and excepted property This policy shall not cover accounts, bills, currency, deeds, evidences of debt, money or securities, nor, unless specifically named hereon in writing, bullion or manuscripts

Perils not included. This Company shall not be liable for loss by fire or other perils insured against in this policy caused, directly or indirectly, by (a) enemy attack by armed forces, including action taken by military, naval or air forces in resisting an actual or an immediately impending enemy attack, (b) invasion, (c) insurrection, (d) rebellion, (e) revolution, (f) civil war, (g) usurped power, (h) order of any civil authority except acts of destruction at the time of and for the purpose of preventing the spread of fire, provided that such fire did not originate from any of the perils excluded by this policy, (i) neglect of the insured to use all reasonable means to save and preserve the property at and after a loss, or when the property is endangered by fire in neighboring premises, (j) nor shall this Company be liable for loss by theft.

Other insurance. Other insurance may be prohibited or the amount of insurance may be limited by endorsement attached hereto

Conditions suspending or restricting insurance Unless otherwise provided in writing added hereto this Company shall not be liable for loss occurring

(a) while the hazard is increased by any means within the control or knowledge of the insured, or

(b) while a described building, whether intended for occupancy by owner or tenant, is vacant or unoccupied beyond a period of sixty consecutive days, or

(c) as a result of explosion or riot, unless fire ensue, and in that event for loss by fire only

Other perils or subjects. Any other peril to be insured against or subject of insurance to be covered in this policy shall be by endorsement in writing hereon or added hereto

Added provisions. The extent of the application of insurance under this policy and of the contribution to be made by this Company in case of loss, and any other provision or agreement not inconsistent with the provisions of this policy, may be provided for in writing added hereto, but no provision may be waived except such as by the terms of this policy is subject to change

Waiver provisions. No permission affecting this insurance shall exist, or waiver of any provision be valid, unless granted herein or expressed in writing added hereto No provision, stipulation or forfeiture shall be held to be waived by any requirement or proceeding on the part of this Company relating to appraisal or to any examination provided for herein

Cancellation of policy This policy shall be cancelled at any time at the request of the insured, in which case this Company shall, upon demand and surrender of this policy, refund the excess of paid premium above the customary short rates for the expired time This policy may be cancelled at any time by this Company by giving to the insured a five days' written notice of cancellation with or without tender of the excess of paid premium above the pro rata premium for the expired time, which excess, if not tendered, shall be refunded on demand Notice of cancellation shall state that said excess premium (if not tendered) will be refunded on demand

Mortgagee interests and obligations. If loss hereunder is made payable, in whole or in part, to a designated mortgagee not named herein as the insured, such interest in this policy may be cancelled by giving to such mortgagee a ten days' written notice of cancellation.

If the insured fails to render proof of loss such mortgagee, upon notice, shall render proof of loss in the form herein specified within sixty (60) days thereafter and shall be subject to the provisions hereof relating to appraisal and time of payment and of bringing suit. If this Company shall claim that no liability existed as to the mortgagor or owner, it shall, to the extent of payment of loss to the mortgagee, be subrogated to all the mortgagee's rights of recovery, but without impairing mortgagee's right to sue, or it may pay off the mortgage debt and require an assignment thereof and of the mortgage Other provisions relating to the interests and obligations of such mortgagee may be added hereto by agreement in writing.

Pro rata liability. This Company shall not be liable for a greater proportion of any loss than the amount hereby insured shall bear to the whole insurance covering the property against the peril involved, whether collectible or not

Requirements in case loss occurs. The insured shall give immediate written notice to this Company of any loss, protect the property from further damage, forthwith separate the damaged and undamaged personal property, put it in the best possible order, furnish a complete inventory of the destroyed, damaged and undamaged property, showing in detail quantities, costs, actual cash value and amount of loss claimed, and within sixty days after the loss, unless such time is extended in writing by this Company, the insured shall render to this Company a proof of loss, signed and sworn to by the insured, stating the knowledge and belief of the insured as to the following the time and origin of the loss, the interest of the insured and of all others in the property, the actual cash value of each item thereof and the amount of loss thereto, all encumbrances thereon, all other contracts of insurance, whether valid or not, covering any of said property, any changes in the title, use, occupation, location, possession or exposures of said property since the issuing of this policy, by whom and for what purpose any building herein described and the several parts thereof were occupied at the time of loss and whether or not it then stood on leased ground, and shall furnish a copy of all the descriptions and schedules in all policies and, if required, verified plans and specifications of any building, fixtures or machinery destroyed or damaged The insured, as often as may be reasonably required, shall exhibit to any person designated by this Company all that remains of any property herein described, and submit to examinations under oath by any person named by this Company, and subscribe the same, and, as often as may be reasonably required, shall produce for examination all books of account, bills, invoices and other vouchers, or certified copies thereof if originals be lost, at such reasonable time and place as may be designated by this Company or its representative, and shall permit extracts and copies thereof to be made.

Appraisal. In case the insured and this Company shall fail to agree as to the actual cash value or the amount of loss, then, on the written demand of either, each shall select a competent and disinterested appraiser and notify the other of the appraiser selected within twenty days of such demand The appraisers shall first select a competent and disinterested umpire, and failing for fifteen days to agree upon such umpire, then, on request of the insured or this Company, such umpire shall be selected by a judge of a court of record in the state in which the property covered is located The appraisers shall then appraise the loss, stating separately actual cash value and loss to each item, and, failing to agree, shall submit their differences, only, to the umpire An award in writing, so itemized, of any two when filed with this Company shall determine the amount of actual cash value and loss Each appraiser shall be paid by the party selecting him and the expenses of appraisal and umpire shall be paid by the parties equally

Company's options. It shall be optional with this Company to take all, or any part, of the property at the agreed or appraised value and also to repair, rebuild or replace the property destroyed or damaged with other of like kind and quality within a reasonable time, on giving notice of its intention so to do within thirty days after the receipt of the proof of loss herein required

Abandonment There can be no abandonment to this Company of any property

When loss payable. The amount of loss for which this Company may be liable shall be payable sixty days after proof of loss, as herein provided, is received by this Company and ascertainment of the loss is made either by agreement between the insured and this Company expressed in writing or by the filing with this Company of an award as herein provided

Suit. No suit or action on this policy for the recovery of any claim shall be sustainable in any court of law or equity unless all the requirements of this policy shall have been complied with, and unless commenced within twelve months next after inception of the loss

Subrogation. This Company may require from the insured an assignment of all right of recovery against any party for loss to the extent that payment therefor is made by this Company

Fig. 1 (continued).

Section 20

HOW TO DO BUSINESS ABROAD

BY

JOHN H. WATSON, III

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HOW TO DO BUSINESS ABROAD

It is traditional for American industry to extend its markets overseas. This practice has been followed notwithstanding the fact that, by comparison with domestic operations, trading abroad is at times exceedingly difficult and these markets are relatively small. While the export history for many companies antedates the Civil War, it wasn't until that era that manufacturers began to make investments in foreign installations in order to service their overseas markets better.

For some companies, foreign markets absorb as much as a third of their output. On the average, however, these markets account for about 10 per cent of sales. Although small in these terms, foreign outlets are regarded as not only extremely profitable but strategically important. Many manufacturers have testified that export operations have acted as a stabilizer to their business and in many instances have enabled them to report a profit where a loss might otherwise have been incurred.

Not only has industry shown a disposition for foreign trading, but the government has placed its stamp of approval upon this activity by providing special legislation designed to encourage foreign ventures. Special tax concessions and exemptions from our antitrust legislation are typical of these inducements. Since our foreign policy is predicated upon the belief that this country must take the lead in bringing about world recovery, industry can continue to expect further assistance on this score.

1. Trading channels

American manufacturers have two broad alternatives from which to choose when selling in foreign markets. They may either "farm out" their export business to a professional specialist in the field or sell directly through their own foreign outlets.

The use of professional export specialists in this country relieves the manufacturer of the problems of foreign selling to such an extent that it is generally unnecessary for him to hire an export manager. The domestic export house contracts to market through its own foreign outlets the products of several manufacturers of related but noncompetitive goods.

Under direct selling the manufacturer establishes his own foreign outlets. This may involve some investment abroad if he establishes his own foreign

branches or manufacturing plants. In more typical cases, an agency agreement defines the relationship between the manufacturer and his foreign representative. A resident foreign agent canvasses a prescribed territory and receives orders, which are submitted to the manufacturer for shipment to the buyer. A foreign distributor, on the other hand, buys outright for his own account. Since under this method of selling it is the manufacturer's responsibility to handle foreign shipments and maintain liaison with his foreign representative, personnel familiar with the techniques of foreign trading become an essential part of the manufacturer's staff.

In response to the diverse needs of exporters, several types of professional export traders are available to serve him, as will be noted in the list below. They reduce broadly into three groups: (1) buyer and seller for own account, (2) buyer for foreign customer, and (3) seller on behalf of American manufacturer.

Channels for Trading Abroad

I. Domestic trading channels
   1. Buyer and seller for own account
      a. Export merchant
   2. Buyer for foreign customer
      a. Export commission house
      b. United States branch of foreign import concern
      c. Foreign-government purchasing commissions
      d. Other: Purchasing missions for foreign utilities, railroads, etc.
   3. Seller on behalf of American manufacturer
      a. Export agent
      b. Combination export manager
      c. Export facilities of another large company
      d. Webb-Pomerene associations

II. Foreign trading channels
   1. Buyer and seller for own account
      a. Distributor or wholesaler
      b. Jobber or retailer
   2. Seller on behalf of American manufacturer
      a. Agent or representative
      b. Traveling representative

Export merchant. Sales to an export merchant are handled in much the same way as domestic sales. The product does, however, eventually reach the foreign consumer. Furthermore, the volume of orders received on this basis provides the manufacturer with an approximate measure of the foreign

demand for his product. But the manufacturer may have no idea of the ultimate destination of his sales, since shipment is made by the export merchant. In fact, the absence of any contact between producer and foreign consumer is a leading criticism of this particular marketing channel. The share of our export trade handled by export merchants operating in this way has been decreasing as manufacturers have become familiar with the technique of exporting.

Export agent. If the American manufacturer is at all interested in expanding his foreign sales, he must have someone to represent him. This is not to say that a good volume of foreign sales has not been obtained in dealing with the export merchant or buyers for export. The export agent, however, is primarily interested in selling rather than purchasing for foreign accounts. He has been most successful in handling advertised specialties for which there would be no demand unless it were created by salesmanship. He channels his shipments through overseas resident agents or sends his own salesmen abroad after orders. Ordinarily he represents several American manufacturers of related but noncompetitive products.

Under this arrangement it is up to the manufacturer to fill orders and finance their shipment. When sales volume has been small, the facilities of the domestic sales department have frequently been utilized. The job of following through all shipments going outside the country has been assigned to one or more members of the department. Experience has shown, however, that there is a limit to the volume of shipments which can be handled without a separate department for export.

Webb-Pomerene association. Cooperative selling in foreign markets is provided for in the Webb-Pomerene Act, passed in 1917 to enable American manufacturers to compete with foreign manufacturers organized into cartels. Price fixing and agreements on selling terms, which are practices prohibited in domestic marketing, assist exporters in obtaining better prices, particularly against foreign buying monopolies. It was also believed that our competitive position on foreign markets would be improved if marketing costs were reduced by eliminating duplicate sales organizations.

There are three general types of Webb-Pomerene associations operating under the law: (1) those in which the association serves as a central selling agency for all the members, taking orders, negotiating sales, and handling the shipment of goods; (2) those in which the association directs the exports for its members and retains certain functions in export trade, but where orders are placed by agents already established by the members abroad; and (3) those in which an export company is formed for the purpose of buying the members' products and reselling them abroad.

Functions Performed by Webb-Pomerene Associations [1]

Acting as export sales agent
Employing agents or directing the agents of the members of the association
Establishing terms and policies for export sales
Allocating export business
Fixing prices for sales by individual members
Purchasing products for resale
Standardizing export product
Exploiting members' products in foreign countries
Arranging for insurance, freight rates, cargo space, etc.
Collecting and disseminating trade information about foreign markets
Promoting conferences and agreements in export trades

2. *Direct foreign representation*

In spite of the convenience offered by professional traders in this country, manufacturers are inclined to favor direct representation abroad.[2] The foreign distributor and the manufacturer's foreign agent are the two major types of foreign outlets. The distributor can be distinguished from the agent in that he carries an inventory. He is sometimes called a wholesaler and receives deliveries from the manufacturer on either a consignment, a credit, or a cash basis. The exporter is obligated to assume all of the risks and responsibilities of foreign trading, since he must ordinarily land his product in the foreign country before receiving payment.

It is felt that the manufacturer is out of touch with foreign buyers when he does not have his own foreign sales outlets. Another criticism sometimes advanced is that the product is too technical to be sold successfully by anyone other than the members of the manufacturer's own selling staff. Particularly is this true of manufacturers of machine tools. Since there may be no contact between the manufacturer and the foreign account, there is little opportunity for efficient servicing of the product and continued business.

More important, however, in influencing the type of channels to be selected, are the positive advantages to be gained from direct selling. Through closer contact with the foreign market, producers are able to tailor their products to the ever-changing needs and desires of the foreign buyers. In addition,

[1] Source: report of the Foreign Trade Subcommittee on Small Business and the Webb-Pomerene Act, U.S. Senate, August, 1946.

[2] A study made by the National Industrial Conference Board entitled "Organization for Exporting" showed that 74 of 105 representative American manufacturers were selling abroad through their own foreign agents or distributors, as against 31 who looked to domestic export houses for assistance.

they are in an excellent position to study and learn about the practices of their competitors.

The exporter engaged in direct selling is also able to exercise a great deal more control over the sale of his product than the manufacturer selling through domestic export channels. For example, if the manufacturer wishes to restrict his sales to a selected clientele or particular level of outlets, he is able to do so. He is also better able to promote many of his products.

Financing Export Shipments

Cash
  Payment with order
Bank letter of credit
  Revocable credit
  Irrevocable credit
  Confirmed irrevocable credit
Export draft on buyer
  Sight draft with payment upon presentation of documents to buyer
  Time draft with documents upon acceptance and payments some time hereafter
Open account
  Periodical remittance by importer ordinarily by sight draft on American bank
Sales on consignment
  Ordinarily limited to shipments to branches and subsidiaries

Dual channels. It is worth noting, however, that the direct and indirect methods are not necessarily exclusive of one another. The Conference Board survey showed that manufacturers frequently use both channels simultaneously. Of course, they are careful to make certain that the professional trader is not competing with their own foreign agents. Usually the less technical lines sold by the manufacturer will be turned over to the export trader. It is primarily because of the opportunity to obtain a coverage in those areas where sales volume is relatively small, or where new products are being introduced, that manufacturers with elaborate export organizations employ indirect channels.

3. Selecting a representative

Obviously the selection of the representative is an important decision. The manufacturer frequently finds himself deluged with requests from foreign outlets for permission to handle his sales. It is necessary for him to be highly selective in making a decision, using many of the same criteria which he

would employ in setting up a sales representative in another part of his own country.

Knowledge of the product, number of related lines handled, and the contacts and organization of the representative are the basic features which American exporters take under consideration when selecting a foreign outlet. Knowledge of the product is particularly important when sales are dependent upon assisting the prospective buyer in solving technical problems. It is also to the foreign agent's advantage if he represents other outstanding but noncompeting companies in the same general field, for then the American manufacturer will presume that he will make a good representative.

Sources of information. The Office of International Trade of the U.S. Department of Commerce is prepared to assist the manufacturer in selecting foreign representatives. Extensive trade lists which they publish are broken down by major industries and countries. While these lists provide but a thumbnail sketch of each dealer, the Department is prepared to provide more complete information in its world trade directory reports. It is a common practice for the manufacturer then to make an appointment for a trial period, after which the agent's activities are evaluated. Should relationships with him prove successful, the American manufacturer then ordinarily attempts to meet him by either paying him a call or having him visit this country.

4. Agency contract

Agreements defining the responsibilities of the manufacturer and his foreign outlet are usually in writing, although oral arrangements have often proved satisfactory. Generally, after naming the territory, the contract then stipulates the services which the manufacturer agrees to provide. The remainder of the contract deals with obligations of the foreign agent. The points covered vary widely; no one contract includes all those in the adjoining check list, which has been compiled from numerous agreements. All agreements, however, include the duration of the agency, the products to be sold, sales terms, and commissions to be paid. Clauses govern the number and type of other lines handled by the distributor and make provision for canceling the agreement. Obviously, the writing of the contract depends upon the nature of the product.

Foreign agreements do not differ substantially from those with domestic agents. Of course, it is not necessary for a domestic contract to stipulate the country under whose laws the contract is binding. Again, the foreign agent may not be equipped to provide the same degree of service as the domestic jobber, and his responsibility may be less. Since he is farther removed from the home office, the need is apparent that all provisions be

AGREEMENT made this .... day of .... , 195.. , between XYZ CORPORATION, of Wilmington, Delaware, U.S.A., hereinafter called the "Company," and ..... of ...., hereinafter called the "Agent."

In consideration of the mutual covenants herein contained, it is agreed as follows:

1. The Company appoints ..... Agent for the sale of its products in .....

2. All quotations made by the Agent will be made on the basis of the Company's current export price list and all orders will be subject to written acceptance and approval by the Company at its principal office at Wilmington, Delaware, U.S.A.

3. The Agent shall be entitled to a commission of . % of the net current export price on all sales made through him and such commission shall become due and payable only when payment for the respective sales made by the Agent has been received by the Company. Commissions due will be reviewed on the 15th of each month and paid direct to the Agent. The Agent shall not be entitled to any commission on any sale by the Company to domestic customers for direct or indirect export shipment.

4. All expenses in connection with the handling of the agency and the securing of business, including, but without limitation, cable expenses incurred by the Agent, will be for the account of the Agent.

5. The Agent agrees not to sell or offer for sale any product competitive with the Company and the Company agrees not to sell its products in .....through any other agent.

6. This Agreement shall go into effect on the..... day of ....., 195..., for a period of one year, after which it will remain in effect indefinitely until either party gives two months' written notice of termination by Registered Mail to the other party, and this Agreement shall be terminated two months after the date of mailing of such notice.

7. This Agreement does not become binding until accepted by the Company at its principal office at Wilmington, Delaware, U.S.A.

8. This Agreement constitutes the entire understanding of the parties and there are no promises, terms, conditions or obligations, oral or written, express or implied, other than those contained herein. No agreement or other understanding in any way modifying the conditions of this contract shall be binding unless approved in writing by the Company.

XYZ CORPORATION

..... *By* .....

Fig. 1. Form of agency agreement.

clearly set forth and understood by both parties. Usually, the foreign distributor and agent are allowed more latitude than domestic dealers.

Territory. The agent is usually given an exclusive territory, and he ordinarily draws a commission on all sales made in this area either by himself or by his manufacturer. Sometimes a reduced commission is paid for sales consummated by the manufacturer, and it is not a practice to reimburse the agent for purchases made by government buying missions.

The manufacturer will not permit his foreign sales representatives to carry competing lines. He frequently insists that the agent devote a specified amount of time to selling his product and requires that one or more salesmen be assigned to his line exclusively. These provisions usually are embodied in the agency agreement.

Points to Cover in Your Agency Contract

Duration of contract	Return of parts, equipment
Cancellation of contract	Reports required of agents
Nation whose laws govern contract agreement	Commissions
Agency rights	Collection risks
Use of names, trade marks, patents etc.	Sales promotion
Territory	"Follow-up" of sale
Acceptance of orders	Distributor's place of business
Shipments	Price regulations
Manufacturer's warranty	Other products handled
	Allocation of expenses
	Sales quotas

5. The export department

Since with direct representation abroad all problems fall upon the exporter, it is necessary for him to assign responsibility within his organization. Either a member of the domestic sales department is charged with handling foreign orders, or a separate export department is set up. The manufacturer's choice is largely influenced by his foreign sales volume.

The "built-in" department. Under this method, a member of the general sales department may be designated as the export sales manager. He is responsible for all export sales activities: he conducts correspondence, selects foreign representation, keeps all informed on specifications and prices, determines conditions of sale, submits all quotations, and follows orders received for completion and shipment. In short, he must be active in all phases of export business and, to do so, must keep informed of existing regulations and restrictions and market conditions. As the domestic divisions, such as the credit and traffic departments, usually handle export mat-

ters in their provinces, it is the function of the export sales manager to keep the several interested department managers informed and to coordinate their activities relating to any individual export transaction. Of course under this arrangement the export sales manager reports to the general sales manager.

As shipments grow, more personnel are assigned to export, first on a part-time basis and then for full-time work. Clerks in the domestic sales department assist with correspondence and routine matters. In a word, the variations are unlimited.

The export department. A separate export department does not always differ significantly from the "built-in" type, for instances are reported of export departments consisting of but one man. However, when manufacturers refer to an export department, they usually imply that the export manager has a staff to assist him—even though it is small—so that as far as the actual handling of exports is concerned, the department is independent of the sales department.[3]

The department head most frequently reports to a vice-president in charge of sales, since he is on the same level as the sales manager. In two out of three instances this is true with organizations with assets between 1 and 20 million dollars. As the corporation grows, about half the directors of exports frequently report to the president. When direct investments have been made abroad and include manufacturing affiliates, he frequently holds an office in each of the subsidiaries.

The department may be organized either on a product basis or according to geographical sales areas. Some large companies break down sales areas into important sales regions, while others have divisions of the department specializing in certain of the company's products. In any event, all orders are eventually channeled through the order-writing, credit, and traffic sections.

Sales correspondents in the department answer all inquiries and keep distributors informed regarding the company's products and its selling policies. Some members of the department make periodic visits to each outlet.

Separate Company. The export department is sometimes incorporated as a separate company. It frequently carries the same name as the parent except for the addition of the word "international." The international company buys its product outright from the parent, and its report of operations is frequently consolidated with the manufacturing company, as in the case of operating subsidiaries.

Incorporation is sometimes resorted to in order to conform to the over-all

[3] The breakeven point for carrying an export organization is in the neighborhood of $200,000 of annual sales.

organization of the home office. For example, a parent company acting as a holding company may incorporate its export department and place it on a level with its other subsidiary companies which the export company is designed to service. The alternative of providing each subsidiary with an export department would not be regarded as efficient.

It is worth noting that a separate company calls for a complete roster of officers, which is an important consideration in dealing with foreign nationals. Joint war operations proved that it is necessary that Americans working with foreigners be given rank comparable to that of those with whom they deal.

Location. The export department is frequently located near a port. Since it is almost mandatory that a company be represented at the port, particularly in times of emergencies, companies often place their entire department in this area regardless of the distance which their home office may be inland.

Foreign selling not classified as exports. It is worth noting that manufacturers do not ordinarily include Canadian business under exports. This is because of the similarity between American and Canadian practices in the fields of merchandising. It is also worthy of note that some companies channel their orders from purchasing missions of foreign governments through their domestic sales department.

6. Foreign investments

When there is a wide demand for their products, manufacturers utilize the channels previously discussed, frequently making investments abroad. In 1948, when the Department of Commerce last estimated our direct investments abroad, they stood at approximately 11 billion dollars.

The underlying motive behind the establishment of foreign installations is, of course, the belief that a greater return will thereby accrue to the manufacturer. However, his decision may be influenced by factors beyond his control. For example, because of high tariffs, quotas, exchange regulations, and a wide variety of trade restrictions, the manufacturer may have no alternative if he wishes to continue to service a particular market. It is also recognized that the spirit of nationalism which prompts foreign nationals to buy products manufactured locally has forced some American producers to manufacture abroad.

On the other hand the initiative frequently lies with the American exporter to service his foreign customers better. He sometimes spots his own warehouses in strategic points in order to keep his markets well supplied. To meet prices of his competitors, he attempts to reduce his transportation and freight charges to a bare minimum. Probably the outstanding example in this instance is that of some companies in the automobile industry who found

that the heavy freight and duty charges incident to the shipment of completed automobiles to foreign countries so greatly inflated the cost to the foreign buyers as to impose severe restrictions upon the volume of sales. They therefore adopted the practice of shipping cars completely knocked down and then assembling them at their foreign plants. This practice had the combined benefit of effecting a saving in the foreign duty as well, since lower duty classifications applied to automobile parts. Further savings have resulted from the purchase locally of as much material and supplies as possible, thus reducing the amount of dollar exchange necessary to provide the importing country with a given number of units.

Combining the advantages of both preceding techniques is the practice of establishing a plant abroad which is prepared to manufacture and merchandise a particular product.

Servicing other foreign markets. A foreign plant strategically located need not restrict its output to the country in which it is located, but may export to other markets. There will be a borderline, of course, where it may be more profitable to export from the United States. However, in many instances there is no room for doubt, since shipments from the American plant may not be feasible. For example, the system of Empire preferences, whereby products manufactured in British countries are exported to other Empire countries and receive tariff reductions, can result in a substantial saving to the company. Again, following the war the sterling shortage made it impossible for the same volume of trade to flow between sterling and nonsterling areas. Companies with plants in England and Australia were able to hold on to certain of their British markets which they would have lost had they been dependent upon shipments from this country.

Shipments from the United States. It should not be presumed that once a company has made an investment abroad it will cease exporting from the United States. On the contrary, corporate history in some instances shows that demand for a product may be so stimulated that exports from America actually increase. For example, one company, which manufactured abroad a line of heating and plumbing supplies for a lower income group than in the United States, found that its products were well received by many of the Europeans who preferred to splurge and purchase equipment of a higher quality which was manufactured only in the American plant. Of course, there will always be those markets which can be serviced more economically from the United States plant.

7. Tax considerations

Taxes are an important consideration in determining the area in which the investment is to be made and the type of investment. While generally

What United States Taxes You Pay When You Organize to Do Business Abroad *

If you have this type of company	Doing business—	Then you are taxed by U.S. this way
Company organized in the United States doing business in foreign countries (Sec. 13-1)	Outside the United States (all or part)	Just like any other domestic corporation. You pay full normal and surtaxes on all your income.
Company organized in a foreign country doing business in foreign countries (Sec. 119-1)	Outside the United States (all or part)	You pay no tax on income from the foreign business. You pay a tax only if engaged in trade or business in the United States, and then only on income from sources within the United States If no manufacturing or like activities in the United States and sales conducted abroad, then no gross income is from the United States. Investment income from United States sources is taxed in any event, except profits from sales of stock if corporation is not engaged in business in the United States.
Company organized in the United States doing business in the United States possessions (Secs. 251-1 to 251-6)	Only in Puerto Rico, Canal Zone, Guam, American Samoa, Wake Island, and Midway Island	Treated just like a company organized in a foreign country (see above). Pays a tax only on income from sources within the United States and amounts received in the United States, if 80% or more of gross income for 3 years before close of year (or for period during which business has been transacted within a possession, if less than 3 years) comes from sources within United States possession; and if 50% or more of gross income is from active conduct of a trade or business within a United States possession.
Corporation organized in the United States to do business in the Western Hemisphere (Sec. 109-1)	All in the Western Hemisphere: North, Central, or South America, or in the West Indies or Newfoundland. But incidental economic contact with other countries outside this geographical sphere will not place corporations outside the exempt classification.	You pay the normal tax on corporations But you are not subject to the surtax if 95% or more of the gross income for the 3-year period immediately preceding the close of the year (or for the part of the period of existence) was derived from sources outside the United States; and if 90% or more of the gross income for that period was derived from the active conduct of a trade or business.
Corporation organized in the United States under China Trade Act to do business in China (Secs. 261-1 and 262-1 to 262-4)	In China, including Manchuria, Tibet, Mongolia, Hong Kong, Macao, and territories leased to foreign countries	You get a credit against net income for normal and surtax. That is based on ratio of par value of the stock owned by United States or China citizens and United States, China, and possession residents to total par value of all stock outstanding. Credit is limited by "special dividend" distributed to stockholders and certified to the Commissioner by the Secretary of Commerce. Full normal and surtaxes are paid on amount over credit.

* Source: *Lasser's Business Tax Handbook*, by J. K. Lasser, Simon and Schuster, New York, 1949, p. 222.

speaking it may be said that our tax laws are neutral on the allocation of investment between this country and abroad, there are some important exceptions to the statement. As should be noted in the accompanying table, there are five choices available to United States companies attempting to do business abroad. Broadly, however, the choice lies between organizing a company in this country and organizing it in a foreign country.

Foreign subsidiary vs. branch. The Federal income tax does not apply to income derived abroad by corporations organized under the laws of a foreign country. Earnings of such subsidiaries are taxable only when dividends are paid in this country. On the other hand, foreign branches are taxed on their profits at the end of each year, with an allowance of a foreign tax credit for taxes imposed by foreign governments on the foreign income.

It is worth noting that in order to encourage capital investment some foreign countries offer special tax inducements to businesses who build up their investment. These incentives are generally ineffective as regards branches of American companies, since their current tax burden is determined under United States law. They are unable to reinvest their foreign profits without being subject to United States taxes. As indicated above, this is the privilege from which the foreign subsidiaries can benefit.

Choice not always possible. It is not always possible to exercise a choice as to the legal form of operating abroad. Sometimes subsidiaries are subjected to restrictions which the American parent does not care to accept. A common requirement is that a certain percentage of the ownership be maintained by foreign nationals.

Experience shows that few companies prefer to organize their foreign operations under the United States law. A postwar study conducted by Management Planning of Washington, Inc., shows that of 99 ventures only eight were organized under United States law. The ability to reinvest earnings free from taxes is undoubtedly a factor. However, nationalistic considerations cannot be overlooked.

Domestic corporations. Domestic corporations doing business in foreign countries may qualify as Western Hemisphere trading corporations, as doing business in United States possessions, or under the China Trade Act.

Western Hemisphere trading corporations. Some manufacturers selling to Latin-American markets have set up "Western Hemisphere trading corporations" to handle these sales. Through these corporations, appreciable savings in United States taxes are made possible. Provisions for relief are contained in the Revenue Act of 1942. Under Sec. 727(*g*), a domestic corporation may obtain tax benefits if 95 per cent of its income is derived from sources outside the United States and if 90 per cent is received from the active

conduct of the business. In addition, business must be conducted in North, Central, or South America, in the West Indies, or in Newfoundland.

In practice, however, the surtax exemption seems to have had little influence as an incentive for corporations to trade through this type of corporation. It is probably because of the restrictions surrounding the operations of such a corporation that it has not gained greater popularity. The meaning of "gross income . . . from sources other than sources within the United States" has never been clearly defined by the courts nor by the Commissioner of Internal Revenue. This question resolves itself into one of the place where the title of a sale occurs. Since this has never been completely clear, there is a continued problem of allocating the income between foreign countries and the United States. The other factor of uncertainty has to do with the "active conduct of trade or business," which likewise is clouded with doubt.

Operations in United States possessions. In addition to offering special inducements of political and tariff protection, United States possessions provide certain tax adjustments to American firms. For tax purposes, the possessions of the United States include Puerto Rico, the Canal Zone, Guam, American Samoa. Wake and Midway islands.

Hawaii and Alaska are territories and not possessions.

China Trade Act. In September, 1922, Congress enacted the China Trade Act to foster business between the United States and China, particularly so that American business might fare better in its competition with the subsidized British, French, and German firms. To qualify for its tax benefits, a corporation must comply with the following: a majority of its directors and the president and treasurer of such a corporation must be China-residing American citizens; it must be organized in the District of Columbia; it must bear the words "Federal, Inc., U.S.A." in its corporate name; and its books must be open for public inspection. It is forbidden to engage in banking, insurance, or, under certain conditions, the shipping business.

Its primary tax advantage is that it is allowed as a credit against net income an amount equal to the proportion of the net income derived from sources within China which the par value of the stock of the corporation owned by residents of China, the United States, and the latter's possessions and by any citizens of the United States and China bears to the aggregate par value of all the corporate shares. This tax advantage is restricted by the fact that the reduction of the tax resulting from this credit may not exceed the amount of the special dividend certified to the Commissioner by the Secretary of Commerce. Unlike the general dividend, the special dividend is an extra dividend awarded in proportion to their holdings to those stockholders who on the last day of the taxable year were residents in China, in the

United States, or in the latter's possessions, or were citizens of the United States or of China.

8. License agreements

American manufacturers frequently seek license agreements with foreign producers when organizing for export selling. When barred from certain markets because of high tariffs, for example, exporters have found in these agreements an alternative to direct investment with its many risks. As such, the income from this operation can be regarded as "plus income." The licensor turns over his blueprints to the foreign firm in return for a fixed sum or fixed percentage of the selling price of each unit produced. Sometimes the foreign manufacturer has agreed to market the product as well. One manufacturer points out that the trend in license arrangements in England is toward manufacturing and selling by a British firm on a fee basis. Other arrangements call for the sale of the product to the American firm that handles the marketing of the product. Since these arrangements are subject to renewal periodically, there is always the danger that the licensee will become a competitor.

American "know-how." Exporters have discovered that foreign producers have a great respect for American "know-how." Experience has taught American manufacturers that it is frequently not enough to turn over a set of blueprints to a foreign licensee, because he often lacks the technical and engineering knowledge to gear his plant for production according to the American standards. Rather than abandon the market, some manufacturers have contracted to provide foreign firms with American "know-how," which in some instances has begun with directing the establishment of the plant and has followed through each process of production and marketing until the product reaches the ultimate consumer. Sometimes installation and servicing of the product are included.

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