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INTRODUCTION TO BUSINESS

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PREFACE

INTRODUCTION TO BUSINESS has been designed to meet the needs of college students who are taking their first course in business.

The last two decades have witnessed several important economic and social changes in this country. College students, particularly those planning a career in business, should be familiar with the basic factors involved in these changes.

The American system of conducting business has evolved naturally in a country where there has been reasonable freedom of action on the part of its citizens. Recent years have witnessed a number of modifications to this freedom, presumably in the public interest. Some persons believe that additional curbs to free enterprise will be necessary if our business system is to yield the greatest good for the greatest number. Others, who are opposed to the imposition of additional restraints, point to the relatively high standard of living of large segments of our population as evidence of the ability of free enterprise to provide the good things of life in greater abundance than any other known system. No more pressing problem faces the people of this nation than that of discerning the truth in these conflicting claims.

The first step in the solution of this problem is that of understanding our present business setup, because only by such an understanding can we proceed intelligently to fashion the type of economic system that will best serve our needs. Our economic system is complex; that fact poses a real problem for those who seek to understand it. Consequently, it is important that there be available to college students a course that consists of clear-cut descriptions and analyses of our business system as a whole and of its various divisions. The relation of these parts to each other, as well as to the whole, must be made clear at the outset of a study of business at the collegiate level. Throughout the course the social and economic implications of the topics treated must be emphasized in order that the student may gain an understanding of the relation of each topic to the broader aspects of our national life.

An introductory business course also serves many other purposes. It presents a survey of business principles, problems, practices, and procedures that is valuable to all students, whether or not they are majoring in this field. For the business student, this type of course also affords assistance in choosing an area for specialization. Furthermore, it provides a background for the more specialized business courses that follow—accounting, economics, marketing, finance, and law, to name only a few. Finally, such a course furnishes the student with a vocabulary of business terms that will prove of value in his subsequent study and reading in the field of business.

It is with these thoughts in mind that the authors have undertaken the task of setting forth the material contained in this volume. The choice of subject matter and the method of presentation have been based on many years of experience in teaching Introduction to Business. During this time the authors have naturally reached certain conclusions concerning topics and procedures that make such a course of maximum value. An attempt has been made to incorporate these ideas into this text.

In the belief that many students will wish to go into business for themselves, the attempt has been made, wherever possible, to point out the relation of the various topics to the small business as well as to the large enterprise.

Considerable space has been devoted to the relations of government and business because of the current importance of these relationships and the ultimate effects of government regulation and supervision on our economic system.

Assistance to the authors has come from numerous sources. For this aid they are very grateful.

R. E. G.
H. A. B.

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CHAPTER 1

THE NATURE OF BUSINESS PROBLEMS

Starting a Business Career The central figure in the story told in this chapter is John Jones, who might be almost any average American young man with a desire to "go into business." Although this story relates the problems that confront Mr. Jones as he plans, establishes, and expands his own business, the same *types* of problems are the concern of every business employee, every buyer of business products and services, and every citizen who wishes to conduct his relationships with the business world in an intelligent manner.

There are a number of lines of business into which Mr. Jones might go, and under many circumstances his choice of field might be quite difficult. It so happens, however, that our Mr. Jones, who is of an inventive as well as a mechanical turn of mind, has largely solved this problem because he has developed and perfected a device which, when attached to the carburetor of a gasoline engine, greatly reduces its fuel consumption. The most important effect that this contrivance produces is that of increasing markedly the number of miles that an automobile can travel on a gallon of gasoline. The device has been patented and thoroughly tested and holds out the promise of being one of the most notable developments in the motor industry.

As might have been expected, several of the automobile and carburetor manufacturers have tried to buy the rights to the device from Mr. Jones. But he has decided to make it himself and to set up a business for this purpose.

In addressing himself to the task of starting his business, Mr. Jones must face and answer a number of questions, all of vital importance to the success of his enterprise. Without dealing with these problems in detail or indicating what their solutions may be, it is the purpose of the remainder of this chapter to present the issues that confront Mr. Jones at this time and that would have to be met to some extent by anyone who is about to start a business.

Ownership One of the first questions that Mr. Jones must answer relates to the form of organization that he will adopt. He can choose between the sole proprietorship, the partnership, and the corporation. If he selects the first of these alternatives, he will literally be "in business for himself"—the sole owner and boss—with the exclusive right to any profits that the venture may earn, but he will also have the entire liability if the business incurs losses.

If he decides on the partnership form, he must find one or more persons who will associate themselves with him in this undertaking. In this type of organization, Mr. Jones will find that his authority is not absolute, and he will not receive all of the profits of the business. He will, however, still retain the unlimited liability that is characteristic of the sole proprietorship, even though his partners will be equally liable under most circumstances.

If Mr. Jones chooses the corporate form, he must act in accordance with the laws of some state in this regard. He will have to secure other persons as incorporators and obtain a charter from the state before he can open his business. In a corporation Mr. Jones will find that others share with him the authority and responsibility for the enterprise as well as the right to participate in the division of the profits. Here, though, his liability for the losses of the concern will be limited, a situation that is in rather sharp contrast to the other two possible forms of organization.

Mr. Jones's conclusion in this matter will be reached not only after a consideration of the factors of control, profits, and liability, but also after taking into account several other major problems that he will meet.

Physical Factors The next major problem to be encountered by Mr. Jones includes the physical factors of production. First, however, he must decide on the way in which his carburetor attachment is to be made. As the device is somewhat complex in nature, requiring the assembly of several different parts, Mr. Jones must consider the desirability of his company's making all of these parts and assembling them, or having other companies manufacture the parts so that his own organization could assemble them.

The physical factors relate to the matters of location and a suitable building; whether to construct a factory or try to buy or rent one already erected; the type of layout to be used; the possible use of conveyor systems, assembly lines; and so on. If Mr. Jones's invention were of a different type, involving the manufacture of such materials as rayon, glass, or steel, he might have to plan for continuous-flow production, in which his plant would operate day and night with shutdowns only at infrequent intervals.

Among the operating problems, he will have to consider such matters as purchasing, storage, inspection, and production control. He must also arrange for a reliable and steady source of supply for all goods that are necessary for the manufacture of his product.

Personnel Unless Mr. Jones plans to do all of the work himself, he will need to hire people to perform the various functions in his venture. This fact brings a host of questions for Mr. Jones to answer, some of which are among the most difficult that he will encounter in his career as a businessman. How he answers these questions may determine the success or failure of his business.

He must decide whether to employ union or nonunion help, or both. In recent years, with the unions bringing great pressure on employers for the so-called closed shop (one in which only union members are employed), this matter has become a very serious one for many businessmen. Mr. Jones must determine whether his company will employ unskilled labor and undertake the job of training them for their respective jobs, or try to secure workers who have already learned their skills somewhere else. An employment office will have to be provided. Routines of hiring and discharge must be established.

Another phase of the personnel question relates to the scale of pay and the methods of payment. Should the company pay relatively high or low wages, and at what intervals—daily, weekly, semimonthly, or monthly? Should wages be paid on a time or a piece-work basis?

Mr. Jones will have to set up certain personnel policies, such as the hours of work, vacation practices, retirement, group insurance, and lines of promotion.

Many of these questions do not have to be answered in their entirety until the company has attained considerable size; in fact, it might be said that many of them become really troublesome only as the company grows. But if Mr. Jones is wise and farseeing, he will approach these problems from the standpoint of their long-range solution.

Marketing With Mr. Jones's contrivance fabricated, there remains the necessity of distributing or marketing it. It so happens that Mr. Jones's invention is such that it has a dual market. It can be sold to motor and automobile manufacturers for installation on their products, and it can be sold to automobile owners, to be attached to the carburetors of their cars. This condition means that Mr. Jones has two sets of problems, which must be considered separately, because the methods of marketing to manufacturers are vastly different from those used in the distribution of goods that are destined for consumer purchase.

Problems of Distribution. In considering the first of these issues—the marketing of his product to automobile manufacturers, Mr. Jones will seek the answers to questions such as these. Should the product be sold directly to the motor car manufacturers through the company's own sales force or through some sort of middlemen? If the former, should the sales organization be centralized or decentralized? If the latter, what types should be employed?

When he turns to a consideration of the marketing of his device to consumers, he must face the question of the choice of channels of distribution. Will he sell direct to consumers, as do the Fuller Brush or Real Silk companies; or should he set up his own stores, like Goodrich or Goodyear? Should he sell directly to retailers or through wholesalers? Should he combine two or more possible channels? Should he sell to chain stores or only to independents, or to both?

Mr. Jones must face the problem of physically getting his goods to his customers. He should investigate freight rates, railroad routes, motor truck facilities, and the other methods of transportation that are available. He must decide whether or not to employ a traffic manager to handle his transportation problems, either at the start or as the business grows.

In connection with marketing his product, Mr. Jones must decide whether or not to advertise it. If he feels that advertising is necessary, he will encounter another set of problems that must be solved. How much should he spend? What media should be used—radio, billboards, magazines, newspapers? Should an advertising agency be employed, or should the company prepare its own advertising? Should the advertising be addressed to both classes of customers—automobile manufacturers and car owners—or only one?

Many manufacturers employ market research to determine their customers' likes and dislikes. If Mr. Jones wishes to do likewise, he must decide whether to employ a professional research agency or have the work done within his own organization. The consideration of the objectives of such a research and the amount of money to be spent is bound to come up at this time. Should the research be carried on continuously or at infrequent intervals?

Perhaps not at the start, but certainly if his business attains any considerable size, Mr. Jones must decide whether or not his product is to be sold in foreign countries. Should he answer this question affirmatively, there are a host of problems with which he will be confronted. In what countries will he sell? Will he employ professional exporters or develop his own export organization? What proportion of his total production will he endeavor to ship overseas? The matter of securing patents for his product in foreign countries will become important if he engages in foreign trade. Tariffs, cartels, embargoes, and the complicated topic of foreign exchange will also come to Mr. Jones's attention at this time.

Pricing. After Mr. Jones's carburetor attachment has been made and before it can go on its way to prospective users, it must be priced. This is one of the most important marketing factors that Mr. Jones will have to consider. Unless the price is low enough to attract potential buyers, it may fail to sell and the whole venture may collapse. On the other hand, if the price is not high enough to cover all of the costs of making and distributing it and to provide a reasonable profit, Mr. Jones may find that his enterprise is less profitable than he had anticipated. It may even lose money and eventually be forced to close its doors. Therefore, Mr. Jones must exercise his

very best judgment and use every available aid in planning for the price that his product is to bear.

The initial price is particularly important as it will determine to a considerable degree the reception that the device will receive when it first appears on the market.

In connection with the problem of pricing, there are several points of policy that Mr. Jones must determine upon, as they will have a strong bearing on the successful sale of the item. He must decide, along with the selection of marketing channels, whether he is going to sell to all buyers at the same price, regardless of whether they are wholesalers, retailers, manufacturers, or consumers. If he chooses to quote different prices to different types of customers, he must determine these price differentials or scales of discounts.

Should he fix the price at which the product is to be sold to the final consumer and take steps to see that this price is not cut by any retailers? Should he have any regard for possible competing products? These are a few of the questions that will have to be answered by Mr. Jones.

As a part of his price deliberations, Mr. Jones must formulate his profit philosophy and adjust his price accordingly. Does he want to make a large profit per unit, with the probability that the price will be relatively high and the sale somewhat restricted? Or should he be satisfied with a smaller unit profit, with a consequently lower price and presumably greater sale? This is a very real problem, which will tax all of Mr. Jones's business wisdom.

Finance Money is necessary to start a business, as Mr. Jones will soon discover. The amount necessary will depend upon a number of things, such as the size of the business, the number of employees, the length of the production process, the extent of the marketing activities, the value of the product, and many other considerations. But, large or small in total, funds must be provided and, before going much further with his plans, Mr. Jones must produce them or know where and how he can secure them.

It is at this point that the consideration of financing bears on the question of the form of organization as each type has its own financial possibilities and limitations. If Mr. Jones has all of the money he needs to start his business, he may

decide to set up a sole proprietorship. However, if he needs more capital than he possesses or can borrow, he will probably have to abandon the idea of owning the business outright and contemplate establishing a partnership or a corporation, for one of the advantages of these two forms of organization is that they offer the possibility of greater amounts of capital than are usually available to the sole proprietor.

If Mr. Jones chooses the partnership, he must find one or more persons who possess capital and are willing to invest it, who are interested in the business of making and distributing a mechanical carburetor attachment, and who are willing to assume liability for any losses that may ensue. If Mr. Jones decides on a corporation, he will be faced with the task of finding other persons who would be interested in becoming co-owners with him and who would have sufficient money to invest in stock.

Closely allied to the subject of finance is the dual one of risk and insurance. Mr. Jones, in going into business, must assume a number of different risks among which are those of fire or windstorms, which might destroy or damage his property, theft or loss of money or goods, and liability arising from accidents to employees. Some of these risks may be transferred to insurance companies, others can not be insured. Mr. Jones will want to consult a reliable insurance broker to learn the extent to which these risks may be shifted and the cost of doing so.

The subject of financing is one that Mr. Jones must solve before he can proceed further with his venture into business.

Managerial Controls Mr. Jones will have occasion to utilize a number of business papers and records. While there may have been a time when a business could be started and operated without benefit of records, that period is over, at least for those concerns that desire to remain in business for any length of time.

Mr. Jones must set up accounting records, which will tell him whether or not his company is being operated profitably and why. This will also be necessary in order that he may know that part of its income which is subject to taxation.

Statistical records of various kinds may be employed to reveal many types of information that accounting does not

supply. Another sort of record that Mr. Jones will find exceedingly helpful will be the budget, by which he may plan the operations of his business and then compare the actual results with his plans as time passes. Business papers, budgets, accounting records, and statistical data are the tools that Mr. Jones will find it necessary or desirable to use in his efforts to exercise control over the operations of his business.

Even more important than these tools, however, are the relationships of the human beings who are employed to do the work of the business. Each person in the business must know exactly what his responsibilities are, to whom he is responsible for his actions, and to what extent he is responsible for the actions of others. In solving this problem for his business, Mr. Jones should determine upon the number and kinds of departments that will be required and set up an organization chart. This preliminary step is necessary to avoid the confusion that takes place when a business comes into being and expands without the aid of a careful plan for departmental interrelationships.

Relations with Government As Mr. Jones formulates his plans for his business and then proceeds to put them into practice, he will come into constant contact with government in one form or another. There are taxes of various kinds, licenses to be secured, a charter to be obtained if he forms a corporation, and regulatory laws to be observed that touch on a great many of the activities of the company. The privilege of enjoying the exclusive property rights of his invention for a stated period of years, which is the basis for his starting his business, arises through the action of the Federal Patent Office. At every turn he is apt to find that some governmental agency or law—local, county, state, or national—is concerned with what he is thinking of doing and either prohibits, permits, limits, or regulates it.

Summary This chapter has stated briefly the problems that must be met and solved by anyone wishing to start a business as well as to identify other problems that develop as a business expands. There are, of course, a great many fields, other than the one indicated here, into which ambitious persons, both men and women, may wish

to go. Among these are grocery stores, book stores, gift shops, automobile dealerships, appliance stores, and apparel shops.

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One out of five full-time workers in the United States is self-employed as a businessman, farmer, professional man, retail merchant, or independent craftsman.

The issues that have been raised in connection with starting a business are intended merely to indicate their presence and not to solve them or to answer the questions raised. Rather the object of this narrative has been to point out that starting and operating a business is not usually a simple process but rather one of considerable complexity. It has also been intended that the student should become conscious of the need for a knowledge of the practices and institutions concerned in order that he may decide wisely whether or not he should start a business of his own.

It is recognized, however, that a considerable number of the students who will use this book may never wish to go into business for themselves but will prefer to enter businesses that are already well established and endeavor to work up to positions of authority and importance. Such students have a similar need for an understanding of business problems.

For the student who plans to major in business, this textbook will provide the basic information for an introductory or orientation course in that field. The study of the major types of problems that confront those who are responsible for the production and distribution of goods and services should help those students who are undecided about the particular area of business in which they shall specialize to make an intelligent choice.

This introductory course in business should prove of value also to students who are not majoring in business. Students who are specializing in the field of medicine, law, engineering, or home economics, for example, may be unable to take more than one course in business. For those students, this course

will provide an overview of business organization, principles, practices, and procedures. This overview constitutes the minimum amount of information that every individual must have if he is to avoid the classification of a "business illiterate."

The chapters that follow are designed to meet the needs of these types of students, in giving them a broad, but somewhat detailed, introduction to the various aspects of the American system of business.

QUESTIONS

1. Mr. Jones can make all the parts that go into his product or have some or all of them made by other companies and then merely assemble them in his plant. What factors should Mr. Jones consider before making a decision on this matter?

2. Assume that there is relatively little unemployment in Mr. Jones's community at the time he starts his business. In what ways might Mr. Jones make employment in his business attractive to new employees so that he will not need to spend a great deal of time and effort in organizing his staff of workers?

3. If Mr. Jones's new device is the best in the world, he will not have to worry about selling it as "the world will beat a path to his door." Is this statement valid today?

4. Some manufacturers refuse to sell to chain stores, while others sell to all comers. Which policy should Mr. Jones adopt?

5. Should Mr. Jones start his business in a small way and rely on future profits for expansion, or should he try to secure sufficient capital to begin operations on a large scale? Discuss.

6. During the first year of the life of the business that Mr. Jones plans to organize it will not be possible for him to compare results with those of the preceding year. Is this fact sufficient reason for Mr. Jones to ignore such control devices as budgets, accounting records, and statistical reports during that first year?

7. If Mr. Jones were starting his business in your community with what governmental regulations would he need to be concerned?

PROBLEMS

1. Assume that you are interested in starting a business of your own and that you have $2,000 in cash for this purpose. In a written report: (a) identify the type of business in which you are interested, (b) state the reasons for your choice, and (c) enumerate the most important specific problems that you would need to consider and solve in order that the immediate and future success of your business would be assured.

2. For each of three of the following businesses, list the problems discussed in this chapter—ownership, physical factors, personnel, marketing, finance, managerial controls, and relationships with government—in the order of their importance. (Assume that the individual interested in starting each of these businesses has $5,000 in cash for this purpose and lives in a community that has a population of 10,000 and that is located eighteen miles from a large city.)

(a) Men's clothing store
(b) Chicken farm
(c) Beauty shop
(d) Electrical appliance store—sales and repairs
(e) Manufacturer of television sets

State the reasons for your selection of the first, second, and last problems in your list for each of the businesses.

3. An individual who is thinking of going into business must consider the possibilities of failure as well as of success. According to one study of bankrupt businesses, the following were the most important causes of their failure:

OWNERS' OPINIONS	CREDITORS' OPINIONS
Business depression	Inefficient management
Insufficient capital	Dishonesty and fraud
Competition	Insufficient capital
Adverse domestic and personal factors	Business depression
Bad debt losses	Adverse domestic and personal factors
Inefficient management	

How many of these causes of failure might be classified as personal causes, that is, causes over which the owners have control?

From a local source of information—such as a banker, the chamber of commerce office, or the bankruptcy court records—determine what seem to be the most important reasons for local business failures. Compare these reasons with those listed above. To what extent do the two lists of reasons agree or disagree? Write a brief report of your findings.

4. From the files of local newspapers or from other available sources of information, compile a list of new businesses that have been started in your community in the last year or two. Make a study of three of these businesses from the standpoint of appearance, location, character of neighborhood, competition, and apparent chances of success. Write a report of your conclusions, stating your reasons for arriving at them.

SUGGESTED READINGS

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New York State Department of Commerce, Small Business Series of Pamphlets. Albany, New York, 1945.

SHOSTECK, ROBERT. *Careers in Retail Business Ownership.* Washington, D. C.: B'nai B'rith Vocational Service Bureau, 1946.

United States Department of Commerce, Washington, D. C., 1945:

Establishing and Operating Your Own Business. Industrial Series No. 19.

Manuals on establishing and operating small businesses. (The following are only a few of the many types of businesses for which the manuals in this series have been prepared.)

A Year-Round Motor Court. Industrial Series No. 50.

Air Conditioning and Refrigeration Business. Industrial Series No. 59

An Apparel Store. Industrial Series No. 32.

Automobile Repair Shop. Industrial Series No. 24.

Automatic Merchandising Business. Industrial Series No. 58.

Real Estate and Insurance Brokerage Business. Industrial Series No. 26.

Restaurant. Industrial Series No. 39.

Retail Bakery. Industrial Series No. 29.

Service Station. Industrial Series No. 22.

Sporting Goods Store. Industrial Series No. 54.

An Outline for Making Surveys. Economic Series No. 34.

One Hundred Questions to Be Considered in Establishing a Small Manufacturing Business. Bureau of Foreign and Domestic Commerce.

Small Business Manual.

Small Retail Store Mortality. Economic Series No. 22.

Veterans and Small Business.

WESSELS, O. R. *Small Business as a Career.* Syracuse, New York: Syracuse University Press, 1946.

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CHAPTER 2

OUR ECONOMIC SYSTEM

What Is Capitalism? Before undertaking the detailed study of business in the United States, it will be helpful to examine the economic setting in which our business system operates. The term customarily applied to the American method of doing business is "capitalism." The purpose of this chapter is to present the outstanding characteristics of capitalism as it is to be found in the United States.

All business is a human activity, regardless of how impersonal it may appear at times. The aim of all economic activity, whatever form it may take, is the satisfaction of human wants. It would be impossible to conceive of an economic system on the moon or any other unpopulated area. We must therefore define capitalism in terms of the efforts of individuals to satisfy their wants.

Capitalism is an economic system in which individuals, with comparative freedom from external restraint, produce goods and services for public consumption, under conditions of competition and with private gain or profit as the motivating force. These goods or services are distributed through an exchange procedure in which the common medium for such purposes is usually money or some acceptable substitute therefor, such as credit.

This is a rather sketchy definition, but it will serve as a framework for the examination of the principal elements in the system. These factors, not necessarily in the order of their importance, are the entrepreneur, private enterprise, capital, profits, production, distribution, price, and competition. The characteristics of each factor will be briefly described. Then an attempt will be made to combine them into a whole, by indicating their relationship one to another.

The Entrepreneur. The term applied to the individual, or group, who engages in business under the capitalistic system is "entrepreneur," a French word for which no completely accurate or satisfactory counterpart exists in the English

language. The word "enterpriser," a fairly literal translation, is not at all in common usage. But the idea of the entrepreneur is widespread in the American business system and basic to an understanding of its operation.

An *entrepreneur* may be regarded as the one who, having the necessary capital or being able to secure it, enters business in some form in which he believes that there is an opportunity for profit to himself. Subject to certain outside influences, such as competition, laws, governmental action, and chance, he manages the business in accordance with the dictates of his own judgment, always with the view to securing the greatest possible profit from his venture. He recognizes the possibility that circumstances may so shape themselves that he will suffer a loss instead of gaining a profit; by implication, at least, he accepts this risk when he goes into business.

The entrepreneurial functions may be performed by a single individual in the form of a sole proprietorship, or by several individuals, either as a partnership or a corporation. Very frequently, in the case of a corporation, there is a separation between the ownership or risk-taking functions and those of management. The risk-taking functions consist of the willingness of the entrepreneur to assume the risk of loss of the money that he has invested in the business if the venture should fail. He may also become liable for certain legal actions that may be brought against him or his company for a number of reasons, such as injury to employees or failure to pay debts. But this does not destroy the fundamental concept of the entrepreneur as the prime initiator of all economic activity in a capitalistic system.

Private Enterprise. Another basic characteristic of capitalism is private enterprise, with the emphasis placed on *private.* The vast majority of business ventures in this country are private enterprises, however vast or small may be the extent of their operations. Such commercial giants as the Ford Motor Company, the Great Atlantic and Pacific Tea Company, and R. H. Macy and Company, and such one-man businesses as the corner newsstand or a shoe-shining shop, are all private enterprises. The important point in this connection is that these businesses were started and are operated by individuals using their own capital for the purpose of earning a profit.

In no sense are they public or governmental projects, such as the Federal Post Office, police and fire departments, county poorhouses, and the Tennessee Valley Authority.

Even though a corporation must go through certain routine formalities to secure a charter to conduct its business, it is still a private enterprise. The state, in granting a charter, does not enter into partnership with the corporation, supply any of the capital, or agree to share in any of the losses that may be suffered. Nor may the state ordinarily require that the concern applying for a charter show that there is any need for its being brought into existence, or refuse a charter if such proof is not forthcoming.

Thus the second characteristic of capitalism pertains to form and indicates that business is private rather than public in character. Private sources of capital are used to secure the wherewithal to start and operate a business. The dealings between businesses are private transactions and, if they are not illegal in nature, are customarily not of public concern. The efforts put into the management of business are those of private individuals whose judgments and decisions determine the paths that it follows.

Capital. Few words have had more diversified definitions and interpretations by economists than has the term "capital." For the purposes of this discussion, it might be said that the entrepreneur, in his venture into private enterprise, invests (or puts up) capital, upon which he expects to earn a return or profit. This capital may consist of cash, credit, tools, patents, copyrights, buildings, fixtures, and/or land, in any desirable combination.

Some capital, usually in the form of cash, may come from bondholders, who loan their money to the entrepreneur. This type of investor is motivated by the expectation of receiving interest on his money and has no direct concern in the profit phase of the business.

One of the distinguishing marks of the entrepreneur is his possession of, or access to, stores of capital, which may be available for investment in some form of private enterprise. This capital is normally forthcoming only if the owners thereof believe that they see an opportunity for a satisfactory return on their investment. If such return does not appear

to be in prospect, the investment will not be made and the business project in question will not be initiated. It is probable that the term "capitalism" owes its origin and meaning to its dependence upon the decisions and actions of the owners of capital.

The owners of capital, who are sometimes known as capitalists, are the principal agents of control in capitalism. They decide whether or not capital is to be invested in new enterprises, which they believe to be potentially profitable, or is to be withdrawn from those that are demonstrably unprofitable. In addition, they exercise control over the operation of those businesses in which their capital is invested, always with the view to securing the maximum possible profitable return on their investments. It thus becomes apparent that the underlying stimulus in a capitalistic system, the thing that makes it go, or, in some instances, causes it to slow up, is the attitude on the part of the owners of capital toward the actual or probable profitability of private enterprise. If they expect to receive or are receiving profits from their business ventures, they will make the investments from which come the sinews of business, or they will continue the active prosecution of the enterprises in which they are already interested. Under circumstances such as these, the economic system accelerates its speed of operation, and a so-called "boom period" takes place.

On the other hand, if profits are declining or becoming nonexistent in any large number of enterprises, or if the future profitability of business appears doubtful, the owners of capital curtail the extent of their operations and refrain from making further investments until the prospects, or actual results, undergo a change. In such periods as these, the economic system slows down, and depression or recession sets in.

This is not intended to be a vest-pocket explanation of the ups and downs of a capitalistic system, nor can these fluctuations be laid entirely at the doors of the owners of capital. Actually the interplay of the factors responsible for these movements is exceedingly complex, and there is no general agreement among students of economics as to either the causes or their relative importance. But it does appear as a

defensible proposition that, unless conditions are such as to hold out reasonable promise of profits to the owners of capital, no recovery from a depression can be long-lived or on a sound basis.

Profits. For all practical purposes, business profits may be considered to be the difference between the income of an enterprise and the costs of its operation. As previously pointed out, profits constitute the inducement to the owners of capital to invest in private enterprises. It is not necessary at this point to enter into an analysis of what may be properly considered as the costs of operating a business. The significance of profits in the present discussion lies in their role as determinants of action on the parts of the owners of capital.

The question might well be raised as to the amount of profits, in any given instance, that would be required in order to induce capitalists to invest in the enterprise in question. No absolute quantitative answer can be given, and there are wide variations among different lines of business. The question, however, is not unanswerable if attention is directed to the term that signifies the opposite of profits, namely, losses.

Losses arise when the income of a business is insufficient to cover its costs; they are an ever-present possibility or risk in any private enterprise under capitalism. The entrepreneur, as already indicated, accepts the risk of loss when he enters business in the quest for profits. Some writers in the field of economics have claimed that profits are justified as inducements to the entrepreneur to assume the risks of loss in any private enterprise. Whether or not there is any justification, moral or social, for profits is not of any moment in this discussion, but it is here that the clue may be found to the answer to the question presented above. Speaking broadly, it may be said that in order to induce entrepreneurs to enter any given business, they must be convinced that the prospective profits are potentially greater than the possible losses that experience or reliable estimates have shown as inherent in this business.

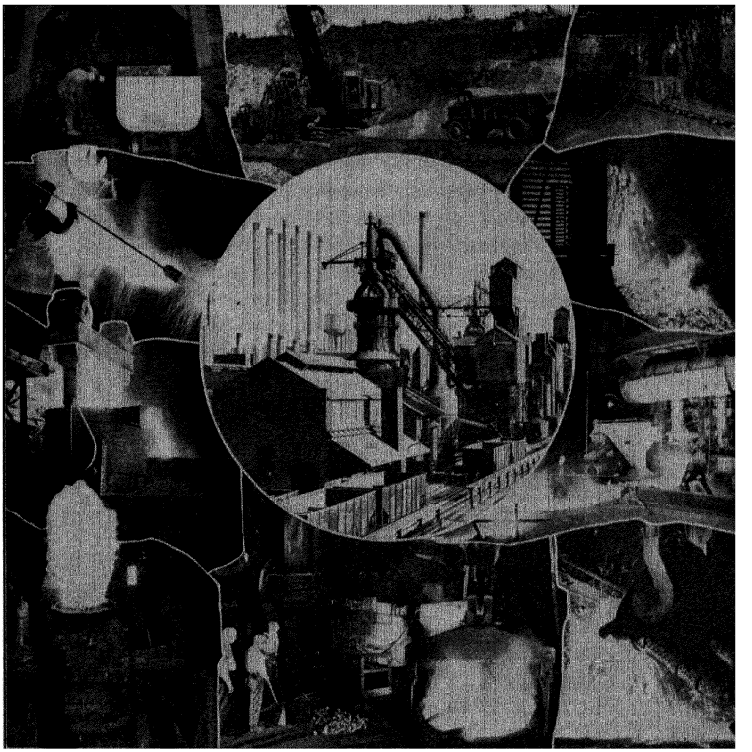
This very general statement, which indicates a basic characteristic of capitalism, might be difficult to prove in any given situation, if for no other reasons than the absence of

supporting data and the difficulty of knowing exactly what might be in the minds of prospective investors. An example, however, will testify to its general validity. Investors in mining enterprises, where the risk of loss is great, are offered chances of much higher profits than in food enterprises, where the risks are much smaller. And this same situation would be discovered in similar contrasting situations. The rule would be, then, the greater the risk, the larger the profit.

Production. The term "production," as used in its broadest economic sense, means the furnishing, by the entrepreneur, of some economically valuable goods or services that may be sold to others. Production includes not only the manufacture of things, such as automobiles, food, radios, and so on, but also their transportation and their distribution at wholesale and retail. In its narrower and more common usage, the term refers merely to the physical manufacture of goods, whether this be a simple extractive process, such as fishing, farming, lumbering, or mining, or the highly complex types necessary to bring forth rubber tires, washing machines, and electrical appliances. It is in this latter sense that production will be discussed here.

The elements of production as seen by the businessman are land, labor, and capital. These are presumed to be manipulated and combined by the entrepreneur in such a manner as to produce the greatest possible profit in any given business situation. A detailed discussion of land and labor is not essential at this point, as these terms, as they are usually understood, are sufficiently accurate for this presentation. It should be noted, however, that, according to this statement, the wages paid to labor are secondary to the securing of profits and interest for capital. This contention, and some of the practices that have followed in its trail, are responsible for some of the labor difficulties that this country has seen.

The entrepreneur in production can experiment with materials, processes, and scales of operations in his efforts to produce those commodities that will yield him the largest profit. He will concentrate most of his energies on the production of those products that yield him the greatest return and will give the smallest part of his energies to those products of the lowest profitability.



Ford Motor Company

Production

Production of iron and steel from coal, iron ore, and limestone involves many steps, only a few of which are illustrated here.

Distribution of Goods. In line with the narrow definition of production just given, distribution may be regarded as the ways by which the output of production is made available to its users, the consumers. From the standpoint of the capitalistic system, the entrepreneur in distribution is one who seeks profit by providing the facilities whereby products may reach their destination. He, like the entrepreneur in production, will use land, labor, and capital in those combinations that appear to him to be the best from the standpoint of profits. He will deal only in those goods whose movement through his hands is profitable. He will place his major efforts behind those articles from which he receives the largest measure of profit.

The production entrepreneur usually has to undertake some of the duties of the distribution entrepreneur in order to dispose of his product; whereas the latter only occasionally enters the field of production. Chain stores and others who have undertaken the manufacture of some of their own branded goods both produce and distribute. This latter development, noticeable in the past few years, is the result of the seeking of greater profits by distribution entrepreneurs.

Price. In a capitalistic system, the movement of goods from the producer to the consumer takes place on an exchange basis; or, to use the customary phrase, a "sale" takes place. The buyer gives something of value to the seller in exchange for the goods of which the seller wishes to dispose. In our economy this "something of value" is money, our medium of exchange; and the amount of money that is involved is determined by the price.

The price at which a commodity is bought and sold is normally determined by demand and supply. As prices increase, the supply tends to increase and the demand, to decrease. Contrariwise, as prices decrease, the demand tends to increase and the supply, to decrease. According to one school of economic thought, the price at which a commodity is bought and sold is the one for which the quantities supplied for sale and demanded for purchase are equal.

Presumably over a period of time the prices that sellers receive will be high enough to cover their costs of doing business and yield them their desired profits. If prices are too low, the sellers will supposedly withdraw from their present business and enter more profitable fields. On the other hand, it is presumed that the prices that the buyers will pay over a period of time must at least equal the satisfaction or usefulness that they will receive from the purchase of the goods. If prices are too high, buyers will withhold their purchases or transfer them to other, lower-priced goods.

While the above-mentioned supply and demand situation unquestionably has a certain amount of validity, it would be an oversimplification to presume that it was the only explanation of this phenomenon of capitalism. Actually the price-making and determining situation is amazingly complex, involving a vast number of factors, psychological as well as economic.

Competition. Under capitalism, the entrepreneurs in each line of business compete with each other in the sale of their products or services.[1] This is basic to the capitalistic system. The institution of free, private enterprise implies freedom on the part of any entrepreneur to enter any field of business and to compete with those already established therein for the favor of the buyers in the market.

There are several bases of competition, such as service, convenience, prestige, and reputation, but the principal one is price. An entrepreneur endeavors to gain a competitive advantage by lowering his prices. This action causes his competitors to try to meet the new lowered prices and, in some instances, to go below them. The extent to which this price-cutting activity will go is determined largely by two things, the demand and the operating costs of the entrepreneurs concerned. If the demand is great enough to take all of the products of the producers in a given field, the competitive price will tend to be that at which all producers are making at least a satisfactory profit. If the demand is not great enough for this purpose and can be increased by lowering the price, then the operating costs of the entrepreneurs enter the picture. Obviously the producers with the lowest costs can go farther in the direction of lowering prices than can their less efficient competitors. It should be equally apparent that, when the price goes below the production and distribution costs of any producer, he cannot long remain in business, unless he can reduce his costs and thereby become more efficient.

This provides the clue to the presumably beneficent social character of competition. Through its operation, people are supposed to secure their goods and services at the lowest possible prices based on the highest attainable efficiency of the producers. Those who are unable to achieve this standard of efficiency are assumed to retire from business; thus the public is rid of the high-cost or inefficient producers. There is also, according to this presumption, a never-ending effort on the part of all producers to lower their costs, both to

[1] There are certain exceptions to this rule, as in the case of such public utilities as electric power, telephone, and transportation companies, which enjoy a more or less monopolistic situation, subject to regulation by some governmental agency.

increase their profits and to give them a possible competitive advantage thereby.

This is obviously a simplification of this part of our economic system, as there are many factors operating to offset and supplement this more or less purifying competitive movement. But it is still basically true in a large segment of our economic life, and the student's attention is directed to it at this point in order that he may understand something of the stronger trends that characterize capitalistic economics.

Capitalism thus emerges as an economic situation in which entrepreneurs, engaged in private enterprise, seek profits on the capital that they have invested, by producing and distributing competitively the goods and services that they believe are needed by the people of the country. This competition is expressed largely in terms of price and is based on the relative degree of efficiency obtainable by each producer.

Types of Businesses Although most of this chapter, thus far, has been devoted to a discussion of the production of goods, this does not mean, of course, that there are no other worthwhile types of business. The goods that are produced must be distributed to the final users, and they must be serviced and kept in repair. Our business economy needs wholesalers and retailers of all kinds and a myriad of service establishments. A wide variety of businesses exists to give personal service to consumers. Among these are barber shops, beauty parlors, laundries, and dry cleaners.

The construction industry comprises all companies that contribute to the building of homes, industrial and commercial structures, bridges, and roads. A professional group comprises physicians, dentists, lawyers, engineers, teachers, and others. All of these types of businesses are a part of our economic system and involve many of the basic economic factors mentioned above, such as entrepreneurship, capital, profits, and private enterprise. While the professional group contains some who might demur at being included in this category, they do qualify to a greater or less extent.

Some Significant Trends Before this brief account of our economic system is closed, mention should be made of some significant recent trends in business.

Movement Away from Competition. In spite of all of the lip-service that is paid to competition by businessmen, the fact of the matter is that many of them do not like it as far as their being exposed to it is concerned. They want the sellers from whom they buy to compete, in order that the prices that they have to pay may be as low as possible; and they likewise desire competition among their buyers, in order that they may sell at the highest possible prices. But they do not care for a competitive situation into which they themselves must fit.

Accordingly, they have tried in a number of ways either to avoid the competition to which they would normally be subjected or to restrain it in some way. An example of the former procedure is to be seen in the growth of the practice of using brand names for goods in order to differentiate such goods from others serving the same purpose. Examples of the latter procedure are to be found in the rise of trade associations, mergers of competitors, codes of fair competition, and regulations outlawing so-called "unfair" competition.

These trends, carried far enough, would have the effect of nullifying the supposed beneficence of competition and of the fundamental characteristics of capitalism.

Role of the Consumer. Thus far in this discussion, little has been said about the consumer. He appears to have a minor place in a capitalistic economy, which seems to be set up to feature the entrepreneur and to operate to his advantage and, to some extent, at his whim. Actually the role of the consumer is a dual one concerning which considerable confusion exists in the thinking of many people. In the first place, every individual is a consumer. Everyone must consume a minimum of food and drink in order to sustain life. Upward from this lowest point, we find various gradations of consumption levels.

However, the picture is not quite so simple as that just portrayed. In order that a person may consume goods in our economic system, it is necessary that he possess purchasing power so that he may buy those things which he needs and wants. In most instances this purchasing power comes into being when its possessor is paid for doing (producing, in the broad sense of the term) something, whether the payment is in the form of profits, wages, rent, or other types of income.

The consumer thus emerges in a second role, that of a producer.

Any economic system arises because of the needs and wants of the people living under it. This seems to put the consumer first in the system and the producer second, an order that is probably historically correct. However, a number of factors have arisen to obscure this relationship. Chief among these was the inability of producers, for many years, to make enough goods to satisfy the wants of the people. This situation caused the major emphasis to be placed on production to the neglect of consumption.

At some time, probably shortly after the first World War, the production facilities of this country in many lines of goods increased to the point where it was physically possible to produce not only all the goods that could be sold profitably, but also goods much in excess of this amount. While this situation did not obtain in all lines, it was present in enough of them to bring about the conditions that followed.

This circumstance, in an economy peopled with independent entrepreneurs, could only lead to a more rigorous competitive situation, with the consumer becoming much more important than in the years preceding it. An era of so-called "high-pressure selling" failed to solve the problem and was succeeded by a rather widespread movement whose main objective was to study the needs and wants of consumers and to try to produce only those things that they would surely buy. This has served to put the consumers back into an important place in the economic picture. In many parts of the land, consumers have become conscious of their newly-recognized importance and have banded themselves together into various consumer groups and organizations. It is just possible that some of these groups, in the exhilaration of their new-found prominence, have lost sight of their interests as producers and that some of their ideas and policies may have to be modified in accord with the dual role which they must always play in a capitalistic system.

Specialization. The trend toward specialization in industry has been most noteworthy at all levels. Workers have tended to specialize, and the jack-of-all-trades, so common a few

years ago, has been largely replaced by the specialist, the worker who is trained to excel at one, relatively small, task. Thus the all-round machinist, who could operate all types of machine tools, has given way to the individual who is equipped to run only a lathe or a drill press. The machines are adjusted and made ready for operation, not by the general machinist, but by a set-up man, a specialist in grinding and setting the cutting tools by which the work is shaped into the finished product.

Companies have also developed along specialized lines. There are many firms that produce items which have no separate utility in themselves, but which must be combined with other goods to form some sort of a whole that is useful to man. For example, an automobile is made up of a great many parts which, apart from the car, have little usefulness. Sparkplugs, tires, upholstery fabric, cotter pins, piston rings, and valve caps are a few parts that are the products of specialized industries. While it is true that the great motor car manufacturers, such as Ford and General Motors, have tended, in the past few years, to produce more and more of the items that go into their cars, there are still a large number of parts that are made by firms that produce nothing else. This tendency is an outstanding characteristic of the development of capitalism in this country.

Mass Production. This is a phenomenon of our industry that is responsible, to no small degree, for the availability, at low cost and in large numbers, of such goods as automobiles, telephones, radios, washing machines, and many other commodities that help to give us the highest standard of living known to man.

Mass production does not merely mean the producing of a large number of any given item. It involves a manufacturing technique that not only results in the creation of a great quantity of goods but also brings about a reduction in unit costs, which, in turn, permit lower prices and greater sales. This technique consists mainly of a standardization and interchangeability of parts; the use of the assembly line, whereby the item to be produced moves slowly along a belt or chain and undergoes a series of additions of component parts until

it emerges at the end completely assembled; and the subdivision of the labor element into a series of simple, repetitive operations. This process probably originated in the automobile industry but has spread to many other fields.

Large-Scale Industry. Most businesses start on a relatively small scale, and many never experience more than a moderate growth. There are some, however, that have grown to great proportions and more or less dominate their fields. Among the outstanding examples of large-scale industry are United States Steel Corporation, Great Atlantic and Pacific Tea Company, Ford Motor Company, General Motors Corporation, American Telephone and Telegraph Company, F. W. Woolworth Company, General Foods, and R. H. Macy and Company. Their capital, sales, properties, and number of employees are all on a Gargantuan scale. Some are mass production companies; while others, the non-manufacturing group, are not. Their great size is one of their outstanding characteristics and is a development of the last fifty years or more.

Government and Capitalism. The relations of business and government have become of such importance that a later section of this book is devoted to an exposition of this situation. It should be noted at this time, however, that early capitalism called for a minimum of governmental interference and regulation. Entrepreneurs were granted the maximum of freedom in their quest for profits. This picture has been gradually changing for many years. The present situation is one in which the entrepreneur finds his traditional freedom greatly restricted through laws, commissions, administrations, regulations, ordinances, taxes, and, in a few cases, actual competition from governmental enterprises.

One of the apparent effects of this trend is that the entrepreneur is less free to pursue his profit. Some persons claim that the participation of government in economic activity has reached the point where the power of the old profit-seeking motive has been so greatly weakened that it is no longer capable of providing the necessary force for the continued favorable operation of the economic system. Regardless of the validity of this claim, which cannot be argued at this juncture, it should be readily apparent that the capitalism

of today is quite different from that which existed in the years when its first complete outlines became discernible to the students of economics. Whether or not this is a desirable development is a point that is somewhat aside from the scope of this book. But the student should constantly be aware of these changes and keep them in mind as a background to his reading and study of the pages to come.

QUESTIONS

1. It has been said that one of the worst features of capitalism is that it puts "profits before persons." Do you think that capitalism does put "profits before persons"?

2. Higher profits to entrepreneurs mean a higher level of prosperity for everyone. Do you agree?

3. "Private enterprise, operating under capitalism, has brought to this country the highest standard of living the world has ever known." Is this statement true? In your judgment, could the same standard of living have been achieved under some other form of economic organization?

4. Why does the government find it necessary to undertake slum clearance and public-housing projects? Why are these things not done by private enterprise?

5. Does the growth of governmental contact with, and regulation of, private enterprise indicate that private enterprise is incapable of governing itself?

6. "It is the prospect of profits, rather than the actual achievement of them, that impels capitalists to invest in business enterprises." Discuss the validity of this statement.

7. Does the term "production" include the marketing of goods and services?

8. Is price control compatible with capitalism? Why?

9. It has been suggested occasionally that persons wishing to enter a business field should be required to show that there is a need for them in that field and that they are qualified by experience and capital to succeed. Is this proposal in line with the basic principles of capitalism?

10. Much has been heard about the so-called "wastes of competition." What are these wastes? What can be done about them?

11. What are the basic characteristics of mass production?

12. Is large-scale production synonymous with mass production?

13. What examples of specialization can you give, other than those mentioned in the text?

PROBLEMS

1. For each of five different businesses in your community or in a neighboring city list the specific kinds of capital that are necessary in its operation.

2. Our system of free, private enterprise does not mean absolute freedom for each entrepreneur. Using different types of businesses, show the extent to which each does not have complete freedom. In each case do you think that this curtailed freedom is desirable from the standpoint of public welfare?

3. From the records that are available in your library, prepare a list of business enterprises that are owned and operated by the Federal Government. For each, state why the Federal Government has engaged in the venture rather than leaving it to private enterprise.

4. The economic system of the United States is capitalistic; that in Russia is characterized as communistic-socialistic; and that in Great Britain, as the beginning of a socialistic order. For each of the following prepare a list of the advantages and disadvantages of the economic systems in those three countries: (a) a worker and (b) the owner of a business.

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CHAPTER 3

SOLE PROPRIETORSHIPS AND PARTNERSHIPS

Form of Ownership Once a decision is reached to "go into business," one of the first problems that confront the individual or group of individuals is that of choosing the form of organization in relation to ownership—sole proprietorship, partnership, corporation, or one of the less common forms. Each form presents certain advantages and disadvantages, and these should be weighed carefully. The ultimate choice may be based on an appraisal of the relative merits of each form, or one factor may dictate the decision. In 1945, when the Kaiser-Frazer Corporation was formed to manufacture and distribute automobiles, the amount of capital required seemed to call for organizing a corporation because it would have been extremely difficult to secure the necessary millions of dollars under any other form of business ownership.

In this chapter consideration will be given to the sole proprietorship, the partnership, and several modified partnership forms, including the limited partnership association, the joint-stock company, and the Massachusetts trust. Although the last three classifications have some of the characteristics of partnerships, they also possess corporate features. In the next chapter the corporation is discussed.

SOLE PROPRIETORSHIPS

What Is a Sole Proprietorship? A *sole proprietorship* is a type of business organization in which one person owns and operates a business for profit. Other people may be employed by the owner to work for him, and the owner may use other people's money in financing his business; but he is solely in charge of all the business functions, unless he chooses to delegate some of them to subordinates. It should also be pointed out that the term "sole proprietorship" is interchange-

able with several others, such as "individual proprietorship," "sole ownership," "individual enterprise," and "single proprietorship."

Although overshadowed by corporations in terms of total capital, the sole proprietorship is by far the most common type of business form. There are more than 2,500,000 sole proprietorships operating in the United States in all types of business operations. Retail stores of all types, restaurants, barber and beauty shops, amusement centers, insurance and real estate agencies, and many other businesses and businessmen dealing with the consumer operate most frequently as sole proprietorships. The following table shows a classified distribution of the estimated number of operating business firms by type of ownership in a pre-war year.

Estimated Number of Operating Business Firms by Type of Ownership and Industrial Classification

CLASSIFICATION	TOTAL 1	SOLE PROPRIETORSHIPS	PERCENTAGE PROPRIETORSHIPS	PARTNERSHIPS 2	CORPORATIONS 2
Retail Trade	1,530,700	1,356,881	88.6	87,540	86,279
Transportation-Communications-Public Utilities.	192,700	166,529	86.4	4,107	22,064
Service Industries	601,600	517,166	86.0	43,404	41,030
Contract Construction ..	192,400	165,436	86.0	10,903	16,061
Wholesale Trade..	138,800	85,839	61.8	16,940	36,021
Manufacturing ..	213,600	105,154	49.2	22,263	86,183
Finance, Insurance, Real Estate ...	281,000	107,097	38.1	31,571	142,332
Mining and Quarrying	21,100	4,033	19.1	6,247	10,820
Total, All Industries .	3,171,900	2,508,135	79.1	222,975	440,790

1 March 30, 1939. Source: *Survey of Current Business*, Dept. of Commerce.
2 March 15, 1939. Source: Bureau of Internal Revenue.

Frequently the name of the establishment, such as "Ben's Restaurant" or "John Graves, Photographer," denotes a single proprietorship. However, a name such as "Ye Village Shoppe" does not indicate whether this establishment is operated by

one or more persons. Furthermore, a sole proprietor may use a name such as "Dayton Paint Company," which would be legal in most states even though the implication is that the organization is a corporation. Registration of a name of this type is customarily required by the states that permit the use of the word "company" for a business owned by one person. In brief, the name of a firm should not be considered as proof that the business is a sole proprietorship.

Advantages of a Sole Proprietorship

Why do so many organizations use the sole proprietorship form of business ownership? Some of the reasons are to be found in the following list of advantages.

Ease of Organization. With one or two exceptions, anyone can go into business for himself without any "red tape" or special legal procedures. For example, a farm hand who finishes painting a barn in the evening may decide that he likes painting better than other farm chores, and the next morning he may quit the farm to become a house painter. He may work by himself or, if his services are much in demand, he may hire others to work for him. In the latter case he may dignify his occupation by calling himself a painting contractor.

Restrictions on becoming a businessman are not numerous or serious. Of course, the type of business chosen must be legal. In some instances a license is required by the state, city, or county. For example, in most states barbers must be licensed, and no one may practice medicine without state authority. Some cities issue licenses to operate pool halls, restaurants, or retail stores. In most states banks may not be organized by a single proprietor.

Freedom of Action. A sole proprietor has the maximum of freedom in his actions. From a personal standpoint, he is the "boss," and all of his decisions are final. He may expand his business at will; he may add new products or discontinue old ones at his discretion; he may sell or close his business as he wishes; and he may change from one kind of business to another as he pleases. For the individual who does not work well with or for others, the sole proprietorship is the ideal form of business organization.

A sole proprietor is also free from government control to a greater extent than is any other form of business ownership. He is usually allowed to do business in states other than the one in which he resides without special permission; he can work as many hours a day or week as he chooses; and he may pay himself a large or a small salary. However, this freedom is not complete. He must abide by state and Federal labor laws as they apply to his employees; he must file reports if they are requested by authorized governmental agencies; and he cannot ship certain merchandise into states that prohibit such shipments, for example, shrubs and trees into states with quarantine laws. These are merely illustrations of governmental restrictions on the freedom of action. Such restrictions vary with the type of business, but for many firms they do not play an important part.

Retention of All Profits. No other form of organization permits one person to retain one hundred per cent of the profits the business may earn. In a partnership or corporation the amount shared with others may be limited if one person has a substantial ownership percentage; but some portion of the profits will be distributed to other individuals. A man going into business may debate whether to borrow funds needed beyond his own resources or to find a partner with sufficient cash to provide the necessary amount. If he adopts the first course of action, all of the profits will be his. However, if he enters into a partnership agreement, there will be some division of the profits as long as the business continues in its original form.

Low Taxes. There are no laws, either state or Federal, that levy taxes on an individual in his role as the sole proprietor of a business. Although he is subject to the payment of taxes, special taxes are not levied on his business because it is a special type of organization. He must pay income taxes, but these he would have to pay if his net receipts came from a salary, from rents, or from interest, rather than from profits of his own business.

Secrecy. In some business organizations the success of the firm is based on the ownership of a secret process or secret

formula. The sole proprietorship offers the safest way to keep this secret from becoming the property of others who could gain financially from such knowledge. The fact that only one person knows the process or formula is the best guarantee that the secret will be kept, particularly when the individual concerned is also the owner of the business.

Low Organization Cost. Of the three major forms of businesses the sole proprietorship offers the lowest cost of organization. Frequently no cost whatsoever is involved. Corporations must pay the state a charter fee, and partnerships normally incur legal fees in drawing up a partnership agreement.

Minimum Legal Restrictions on Form. The sole proprietor does not deal with other people as far as ownership is concerned. This is not true of other forms of business organization, which means that the legal rights and duties among owners may give rise to serious problems. All states have laws governing corporations and partnerships, but there are none on sole proprietorships as such. The man who owns his own business must obey the law in all of its phases, but no special legislation is directed at him in his capacity of sole proprietor.

High Credit Standing. Anyone extending credit to a business owned by one person may look beyond the value of the firm to the private resources of the owner. In contrast, an extension of credit to a corporation must be based entirely on the ability of the business to repay the debt. Assuming that a sole proprietorship and a corporation are identical in size and in the nature of the wealth owned, the credit standing of the sole proprietor usually will be better than that of the corporation unless the individual involved has no resources beyond those invested in his business.

Personal Incentive. A great deal has been written about individual initiative and its value to the prosperity of this country. A man in business for himself has everything to lose if his efforts are not successful; this makes him willing to devote a maximum amount of time, thought, and energy to the successful prosecution of the activity for which his firm was organized. The entire responsibility is his.

Disadvantages of a Sole Proprietorship

After examining the numerous advantages of a sole proprietorship, it might seem logical to conclude that this form should be used by most or all firms. However, there are also some disadvantages inherent in this type of business ownership. Although the list that follows is not so long as the preceding list of advantages, each disadvantage may present such a serious problem as to preclude choosing a sole proprietorship as the best form of business organization in a given situation.

Unlimited Liability. Each year approximately one out of every one hundred operating business firms fails. Thousands of others discontinue operations. In either case, there are usually creditors who seek to collect the amounts owed to them. If the business is a sole proprietorship, practically all the property, both real and personal, owned by the proprietor is subject to liquidation in order to raise funds to pay the business debts. Unlimited liability refers to the availability of a person's wealth beyond the amount invested in the business to satisfy the claims of creditors.

At the age of twenty-two Mr. Roy Sanders opened a machine shop, and from the outset it proved profitable. For thirty years the business grew steadily, and at the age of fifty-two Mr. Sanders owned a firm employing fifty men and worth $80,000. He also owned a fine home, two cars, and had $50,000 invested in stocks and bonds of other companies and in securities of the United States. During the next three years a succession of misfortunes forced Mr. Sanders out of the machine-shop business. After everything of value in the business was sold, only $20,000 was available to pay the creditors, whose claims totaled $60,000. This meant that $40,000 of his personal wealth had to be liquidated in order to pay the business debts in full.

Limitation on Size. The investment in a sole proprietorship is limited to the amount one person can raise by investing his own estate, by borrowing, or by a combination of the two. If the business to be organized requires a substantial amount of capital, it may well be that the individual will find it necessary to choose another form of organization unless he is an unusually wealthy man. It has been estimated that the amount

of capital required to build and equip a plant to produce steel efficiently is not less than $20,000,000. Obviously, few individuals could form a sole proprietorship in the iron and steel industry.

The problem may be just as acute for a much smaller business. A World War II veteran who desires to open a job-printing shop discovers that he needs at least $12,000, but he can raise only $7,000 of this amount. Or, assuming that he is already in business on a modest scale, he finds that he would earn two or three times as much as his present profits if he could buy $5,000 worth of additional equipment. If the amount of capital needed to start or to expand a business is much beyond the resources of an individual and his ability to borrow, the sole proprietorship form of ownership cannot be used.

Lack of Continuity. The death of the proprietor terminates the life of his firm, as does his insanity, imprisonment, or bankruptcy. Furthermore, the physical inability of the owner to continue work often forces the enterprise to close its doors. One man may build up a fine business, but it is valuable only so long as he is able to run it. At his death his widow or other heirs may try to continue the business, but they frequently lack the knowledge or the ability to operate it successfully.

Difficulties of Management. Ordinarily a sole proprietorship is a small business. The owner assumes the responsibility for such diverse tasks as purchasing, merchandising, extending credit, financing, employing personnel, and so on. He may be unusually capable of handling some of these functions but unable to perform others. For example, a retail store with a large volume of business went into bankruptcy because the owner was so generous with extension of credit and was so poorly qualified to collect accounts that finally there was not sufficient money left to pay current bills.

Summary The foregoing advantages and disadvantages indicate rather clearly that there is a place for the sole proprietorship but that it is not always the most desirable form of business ownership. For the man who wants to be his own boss and is willing to enter into a

field that does not require a large amount of capital, it is frequently ideal. For large-scale operations involving a heavy investment and complex problems of management, it is rarely a suitable form.

PARTNERSHIPS

What Is a Partnership? The Uniform Partnership Act, which has been adopted by a large number of states, defines a *partnership* as "an association of two or more persons to carry on as co-owners a business for profit." Frequently a sole proprietor may sell someone an interest in his business and thus a partnership is formed, or two individuals decide to start a firm with each contributing part of the original capital. Even corporations sometimes change to the partnership form. The number of partners may be two, three, ten, or even more. Usually the number is less than ten.

Articles of Copartnership Since partnerships include two or more owners of the business, it is most desirable, although usually not necessary, that the agreement between the parties be reduced to writing and signed. Such a contract, known as *articles of copartnership* or *articles of partnership*, may prevent misunderstanding and ill will among the partners at a future date. Furthermore, if the partners desire to share profits on any basis other than equal shares, a written contract providing for this is a legal necessity. An illustration of such an agreement, covering some of the common provisions, is shown on pages 37 and 38. Note that the following items are covered:

1. The name of the firm.
2. The location and type of business.
3. The length of life of the partnership agreement.
4. The names of the partners and the investment made by each.
5. The distribution of profits and losses.
6. A provision for salaries of partners.
7. An agreement on the amount of interest to be allowed on capital and drawing account balances.
8. A limitation on withdrawals.
9. A provision for an accounting system and a fiscal year.
10. A statement of procedure on the admission of a new partner.
11. The method that will be followed in case of the withdrawal of a partner and other causes of dissolution.

ARTICLES OF PARTNERSHIP

THIS CONTRACT, Made and entered into on the first day of August, 1947, by and between Harold Thomas, Robert Thomas, and Lester Bowen, each of Springfield, Illinois,

WITNESSETH: That the said parties have this day formed a partnership for the purpose of engaging in and conducting a radio sales and service business, and the doing of all things necessary and incident thereto, under the following stipulations which are made a part of this contract:

FIRST: The said partnership shall commence on the first day of August, 1947, and continue from and after said date for a period of twenty years at the pleasure of said partners; and shall be otherwise terminated by the death, bankruptcy, insolvency, or disability of any one of the said parties thereto, or under the provisions for such act hereinafter set forth.

SECOND: The business shall be conducted under the firm name of Thomas Bros. & Bowen at 1865 Lincoln Avenue, Springfield, Illinois.

THIRD: Each of said partners shall contribute to the capital of said partnership the sum of $4,800.00, which shall be paid on the date of the execution of this agreement, and by the execution thereof by said partners the receipt of same is hereby acknowledged.

FOURTH: All profits and losses arising from said business are to be shared as follows: Harold Thomas, 40 per cent; Robert Thomas, 30 per cent; Lester Bowen, 30 per cent.

FIFTH: Each of said partners shall devote his entire time, skill, labor, and experience to advancing and rendering profitable the interests and business of said partnership, and no partner shall engage in any other business or occupation whatever on his individual account during the existence of said partnership without the written consent of the other partners.

SIXTH: A systematic record of all transactions is to be kept in a double entry set of books in which shall be promptly and properly entered an account and record of all the transactions and business of the partnership. All books of account and all contracts, letters, papers, documents, and memoranda belonging to the partnership shall be open, at all times, to the examination of any one of the partners. On December 31 hereafter a statement of the business is to be made, the books closed, and each partner credited with the amount of the gain or charged with his share of the loss. A statement may be made at such other times as the partners agree upon.

SEVENTH: Each partner shall furnish to the other, on request, full information and account of any and all transactions and matters relating to the business of the partnership, within his knowledge.

EIGHTH: All moneys received by, or paid to, said partnership shall be daily deposited in the Sixth National Bank, Springfield, Illinois, except a small change account used in the operations of said business not to exceed $25.00, or in such other bank as said partners may mutually agree upon. All disbursements of partnership moneys in excess of $5.00 shall be made by check on said partnership bank account. Checks for amounts drawn on partnership accounts may be drawn by any one of said partners.

NINTH: No partner shall at any time sign the firm name, or his own name, or pledge the firm's credit, or his own individual credit, in any manner as surety or guarantor on any paper, bill, bond, note, or draft or other obligation whatsoever. Neither shall he assign, pledge, or mortgage any of the partnership property, or his interest therein, or do anything or permit any act whereby the firm's money, interest, or property, or his interest therein, may be liable to seizure, attachment, or execution.

TENTH: Each partner shall promptly pay his individual debts and liabilities and shall at all times indemnify and save harmless the partnership property therefrom.

ELEVENTH: Salaries of $200.00 per month to Harold Thomas and $150.00 per month to Robert Thomas and Lester Bowen are to be allowed, these amounts to be withdrawn at such time or times as each may elect.

None of the partners is to withdraw from the business an amount in excess of his salary without the written consent of the others. Interest at the rate of 6 per cent per annum shall be allowed on the amount of investment each partner shall have in the business in excess of his original contribution as determined at the close of each month. Salaries and interest shall be considered an expense of doing business before arriving at net profit or net loss.

TWELFTH: The duties of each partner are defined as follows: Harold Thomas is to have general supervision of the business and have charge of credit and collections, all correspondence, and the accounting records. Robert Thomas is to have supervision of incoming and outgoing new and used radios and parts, and the stock of this merchandise. Lester Bowen is to have charge of the repair and service department. Each partner is to attend to such other duties as are deemed necessary for the successful operation of the business.

THIRTEENTH: One partner may, at any time, dissolve said partnership by written notice of his intention to do so, delivered or mailed to the other partners, and said partnership shall be dissolved at the expiration of sixty days after the giving of such notice.

FOURTEENTH: At the time of giving notice of dissolution of said partnership, or any other termination thereof as set out in the first stipulation above, an inventory and appraisement of all assets and property of said partnership shall be made, by three disinterested parties engaged in the same or similar business in this vicinity, one each to be chosen by the partners to this agreement or their legal representative, at the true value to the business thereof; and an account shall be taken of all assets and liabilities. After payment of all debts and liabilities of said partnership, the assets and property so remaining shall be divided between the partners, their heirs and assigns, in the proportion in which the capital of said partnership has been contributed by each. Provided, however, that if any of the original partners to this agreement desire to carry on the said business he or they shall have the first option to take over said business at the net value as calculated from the account so made and assume all operations thereunder in their own right and relieve the other partner, his heirs and assigns from all liabilities. Said option to be enforceable shall be exercised within ten days after the accounting of the partnership has been made. Each partner for himself, his heirs and assigns hereby agrees to execute all instruments necessary or proper to invest the other with the property, real, personal or mixed, so taken over by him or them.

FIFTEENTH: No changes, alterations, additions, modifications, or qualifications shall be made or had in the terms of this contract unless made in writing and signed by each of the partners.

IN WITNESS WHEREOF, the parties have hereunto set their hands to triplicate copies hereof, the day and year first above written.

Signed in the presence of:

O. A. Krachen

L. W. Morgan

Harold Thomas

Robert Thomas

Lester Bowen

STATE OF ILLINOIS, COUNTY OF SANGAMON, SS:

Personally appeared before me, a Notary Public within and for said State and County, the above named Harold Thomas, Robert Thomas, and Lester Bowen, the parties to the foregoing contract, who each acknowledged the signing thereof to be his voluntary act and deed, for the uses and purposes therein mentioned.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this first day of August, 1947.

Esther Lyons

Notary Public, Sangamon County, Illinois

Number of Partnerships Partnerships are the least common of the three major forms of business organization. They are particularly prevalent in the service fields such as brokers, lawyers, and public accountants. Law firms operate as partnerships in many cities. Also, many small business firms that include father and son, two or more brothers, or merely two or more close friends who go into business together are partnerships.

All partnerships must file an annual information return with the Bureau of Internal Revenue of the United States in order to show the amount of income allocated to each member. A tabulation of these returns shows the following totals for the years indicated. Business firms comprise a large percentage of these figures, but the totals include farmers, fishermen, professional groups, and partnerships in other fields not usually included in the broad coverage of business and industry.

Number of Partnership Returns Filed with Bureau of Internal Revenue

YEAR	NUMBER OF RETURNS
1942	490,320
1941	453,911
1940	372,796
1939	290,876
1938	273,361
1937	261,470
1936	237,367
1935	222,293
1934	221,740
1933	214,881
1932	216,712
1931	230,407
1930	244,670
1925	309,414
1920	240,767

Source: Bureau of Internal Revenue, *Statistics of Income.*

In every city, town, and village there are usually a number of partnerships engaged in many types of business activity. Some can be identified by name; others cannot. The name Smith and Son indicates a partnership, although a business

with such a name might be an individual proprietorship or a partnership with several members in the firm. If a fictitious firm name is used, such as Wright and Wrong, some states require that a record showing the names of all partners be filed in a country office.

Advantages of a Partnership Many of the advantages of a sole proprietorship are also present in the partnership form of organization. It, too, is easy to organize, although a lawyer should be consulted when the articles of partnership are drawn up. There are no special taxes levied on partnerships, and this form is relatively free from governmental regulation. There are, however, some other advantages that may make this form of business enterprise preferable to a sole proprietorship.

Larger Amount of Capital. In a sole proprietorship the amount of capital is limited to the personal fortune and credit of one individual. In a partnership the capital can easily be doubled, trebled, or otherwise increased by bringing in additional owners. An inventor with little capital, for example, may locate a rich man who is willing to contribute a major portion of the total capital needed to produce and market the inventor's product.

Combined Judgment and Managerial Skills. The old adage that two heads are better than one is true in the case of many partnerships. Two or more owners can consult each other about proposed actions, and a wiser course of procedure may result. Sometimes two or three men complement each other in securing maximum operating efficiency. Adams is a genius at producing precision tools, but he loses all interest in them as soon as they pass final inspection. Brown, on the other hand, is an outstanding salesman but has no interest in the problems of manufacturing. As partners, the two men are very effective, but neither would be a success as a sole proprietor.

Personal Interest in Business. Since each general partner is responsible not only for his own acts but also for the acts of his partners, he is vitally concerned in every move made

by the business. As a result he will devote his personal attention and interest to the firm. Most individuals are willing to spend long hours of hard work when they have their entire financial security at stake. Also, every act of each partner affects his associates, and most men feel a strong sense of responsibility toward others who are sharing profits and losses.

Credit Standing. A partnership has little difficulty in obtaining credit, especially if the partners have some personal wealth. If there are several partners and one or more have extensive private means, creditors have little reason to doubt that the debts of the partnership will be paid in full.

Disadvantages of a Partnership

Although the partnership form has many advantages that attract businessmen, it does, unfortunately, have some disadvantages that weigh heavily against it.

Unlimited Liability of the Partners. The greatest disadvantage is that of unlimited liability of the partners. All general partners are liable personally for the partnership debts. If one partner makes an unwise commitment, even against the wishes of his partners, all the partners may be liable for the loss that results. If partnership A, B, and C fails and has losses totaling $50,000, and if A and B are without outside resources, C must pay the entire debt up to the limit of his ability.

Possibility of Disagreement among the Partners. Two or more men may start out together as close friends or bound by the ties of relationship. However, a group that is congenial at the start may develop differences over the years that will make for unpleasantness and inability to work together for the best interests of the firm. If the number of partners is even, such as two or four, the written agreement sometimes provides that disputes will be referred to a disinterested party in case the partners are equally divided on a question. If the number of partners is odd, the minority will be outvoted on some issues and may resent the action taken by the majority.

Dissolution upon the Death or Withdrawal of a Partner. If any one of the partners dies or wants to withdraw from the

business, it becomes necessary to dissolve the existing partnership. Also, if a partner becomes insane or takes out bankruptcy papers, it is necessary to dissolve the firm. The more persons there are in a partnership, the more often this is liable to occur. Sometimes the remaining partners find it possible to buy out the interest of the individual who withdraws or dies, and they can reorganize with little outward change. However, if it is necessary to admit a new partner to assume the interest of the old one, it may not be easy to find an individual who is satisfactory to all of the old partners and who will work in harmony with them.

Divided Control. In contrast to a sole proprietorship more than one person is involved in every decision reached. Unless all of the partners are active in the operation of the firm, it may be necessary to delay the making of an important decision until all of the partners can be contacted. Furthermore, unless the agreement specifically allocates certain duties and responsibilities to each partner, a condition is created in which each member may be reluctant to act without consulting the others even though he can legally bind the partnership.

Frozen Investment. For an individual who wishes to invest some money in a business, the partnership form may prove to be a poor investment from the viewpoint of liquidity and transferability. It is almost axiomatic that it is easy to invest in a partnership and difficult to withdraw these funds. If a partner withdraws or dies, the existing firm is dissolved, and most firms are worth more as going concerns than they are at a forced sale.

Summary From the foregoing list of advantages and disadvantages of the partnership, it may be understood why service organizations, such as professional men, find the partnership form of organization satisfactory. If the business consists of selling a service, no extensive amount of money is tied up in such things as inventory or equipment. Usually there are few or no liabilities. For this reason, the main disadvantage of a partnership, unlimited liability, becomes negligible, and the advantages outweigh the objections.

Classification of Partnerships The term *partnership* usually refers to a *general partnership*, that is, one in which each partner assumes complete responsibility for the affairs of the business, including the liabilities. In several states it is possible for one or more partners to secure limited liability by filing a copy of the special agreement in the public records. A firm with one or more such partners is known as a *limited partnership*. There are no restrictions on the number of partners who may secure such legal protection provided there is at least one general partner.

In addition to this classification of partnerships into general and limited categories, there are special types of partnerships. These are described later in this chapter.

Classification of Partners The individuals who comprise a partnership are subject to several classifications. Members of a general or limited partnership who have unlimited liability for the debts of the firm are known as *general partners*. Others in a limited partnership are called *limited partners*.

A *secret partner* is one whose identity or existence is not known to the general public. A *silent partner* is an individual who is known as a partner to the general public but who takes no active part in the management of the business. If a partner is both secret and silent, he is sometimes known as a *dormant* or *sleeping partner*. Those who appear to be partners, whether they actually are or are not, are known as *ostensible partners*.

Many general partnerships classify their members as *senior* and *junior partners*, making this distinction on extent of participation in the profits, investment, age, years of association with the firm, and rights in management.

The reason for the various classifications of partners is usually connected with their rights, duties, and obligations. Secret and dormant partners are not liable for the debts of the enterprise unless they are discovered. Silent partners cannot participate in management, but they do share profits and losses and have unlimited liability. If an ostensible partner is not a member of the firm, he may obligate the members by certain acts and be liable for debts of the partnership without sharing in the profits and losses.

The Story of Garson's Garage An illustration of the practical operation of a sole proprietorship and a partnership may help to emphasize some of the foregoing points.

In 1926 Mr. Harry Garson opened a car repair business. Before this time he had graduated from an auto mechanics school and had worked in a large garage. He invested his savings, approximately $2,000, in necessary equipment—tools, machinery, and parts. He rented an old building, which was conveniently located, and announced in the newspapers that Garson's Garage was in operation.

From 1926 to 1931 Harry Garson prospered. After taking a modest living out of his profits, he invested the remainder in several large pieces of equipment that would enable him to render a more complete service. These items, costing approximately $10,000, were purchased with down payments totaling $3,000; for the balance of $7,000, Mr. Garson gave notes running over a ten-year period. In 1932 Mr. Garson found himself unable to continue the payments on the equipment because of the general depression, which reduced the volume of his business considerably.

Mr. Garson went to his bank and attempted to borrow the needed funds. Mr. Richman, president of the bank, explained that his institution was in no position to make such a loan, in view of the business outlook and the inability of Mr. Garson to repay such a debt from any personal wealth should his business continue to operate at a low level. However, Mr. Richman suggested that Mr. Garson contact M. W. Johnson who had talked to him about investing some idle capital in a local business. This Mr. Garson did, and Mr. Johnson agreed to advance the necessary funds if Mr. Garson was willing to form a partnership in which Mr. Johnson would be a secret partner. Mr. Garson accepted. The two men agreed to divide the profits on an equal basis in return for an investment of $7,000 on the part of Mr. Johnson. The agreement also provided that Mr. Garson was to draw a weekly salary of $50. Mr. Garson was to be the manager of the partnership on all matters concerned with operation, and Mr. Johnson was to be consulted on all financial problems. The name was to remain the same, and no one was to be informed of Mr. Johnson's connection with the garage.

In 1933 a new piece of equipment proved to be of faulty construction. Mr. Johnson advised against continuing payments on notes, which had been signed by Mr. Garson, until a satisfactory settlement was made. The concern making the equipment sued Garson's Garage and, during the course of the trial, it was disclosed that Mr. Johnson was financially interested in the firm. As soon as this news became public property, Mr. Johnson assumed the role of a general partner. He could have availed himself of the state law that would have made it possible for him to become a limited partner, but he preferred to become a general partner.

A year later the owner of another garage in the community retired. An opportunity was presented to buy his property and, at the same time, to secure an agency for a well-known car manufacturer. Mr. Johnson was willing to invest additional funds, and Mr. Garson was in a position to do likewise. A good salesman was needed to handle the car agency, and the most logical person for the position was the salesman for the agency that was being discontinued. This man, Howard Jameson, was not interested in being employed on a salary or a commission basis only but wished to buy out his former employer and go into business for himself. Unfortunately for him, his total capital was insufficient.

After several conferences, it was agreed by Mr. Garson and Mr. Johnson to allow Mr. Jameson to buy an interest in the partnership. The articles of partnership were drawn up as follows: (1) The name of the firm was to be changed to Garson and Jameson. (2) The business would thereafter include car sales, parts, and service. (3) The investments of the partners were to be Garson $5,000, Johnson $10,000, and Jameson $4,000. (4) Mr. Garson would continue to draw $50 a week in salary. Mr. Jameson was to be given a commission of five per cent on each car sold. After these charges and all other expenses, net profits were to be shared equally by the three men. (5) Mr. Garson was to continue as manager of all repair and service activity, Mr. Jameson was to have exclusive charge of sales of new and used cars, and Mr. Johnson was to continue in his capacity as financial adviser. (6) Other provisions were included to cover accounting, dissolution, signing of contracts, etc.

The years from 1934 to 1941 were quite prosperous. But from 1942 through 1945 the rationing of gasoline and tires, as well as the lack of new cars to sell, caused the partnership to lose money. Fortunately, early profits had not all been withdrawn from the business, and the firm survived. In 1946 Mr. Johnson died. At that time it became necessary to dissolve the existing arrangement and to liquidate the interest of Mr. Johnson. This was fixed at $15,000; it consisted of his original investments plus profits that had not been withdrawn. Mr. Garson and Mr. Jameson were now faced with the problem of paying this amount to the heirs of Mr. Johnson's estate or of admitting a new partner who could do so. As the business was again in a favorable position, both men were able to borrow some money which, together with their own accumulated capital, proved sufficient to make the necessary payment.

Special Types of Partnerships Other partnership forms include the limited partnership association, the joint-stock company, the joint adventure, and the mining partnership. The *joint adventure*, or *joint venture* as it is frequently called, differs from a general partnership in that it is formed to carry out a single purpose that can be accomplished in a relatively short time. A *mining partnership*, because of the need for continuous operation of the business, allows for the sale of an individual interest to another without the approval of other partners and without dissolving the partnership.

Limited Partnership Associations. A limited partnership association is a special type of partnership that must be organized in strict accordance with legal requirements. The essential difference between this form and a limited partnership is that all members secure limited liability. At present there are only five states—Michigan, New Jersey, Ohio, Pennsylvania, and Virginia—that have enacted legislation permitting partnership associations, as they are usually called, to be organized. This geographical restriction, plus some disadvantages, has limited the number of such partnerships despite the fact that they have many of the advantages of corporations without some of the objections of the corporate form.

A limited partnership association can be formed by following the provisions of the state statute, which include filing a copy of the articles of association in a public office, usually that of the county recorder. In Ohio the length of life cannot exceed twenty years, the number of partners cannot be less than three or more than twenty-five, and the management of the firm is placed in the hands of a small group of not less than three or more than five. In all states the name must contain the word "Limited" or the abbreviation "Ltd.": Horton and Stone, Ltd., for example, would be an acceptable name. This does not mean that all firms that include the word "Limited" in the firm name are partnership associations. English and Canadian corporations, as well as some corporations organized under the laws of certain states, are frequently designated in this manner.

The chief advantage of the limited partnership association is that of securing limited liability for all partners. This may not hold true if business is conducted in another state because that state would have a right in its courts to look upon the organization as a general partnership. Also, if strict compliance with the special law is not maintained, the state that authorized the business may consider it as a general partnership. A disadvantage is that the partnership association is usually taxed as though it were a corporation. Evidences of ownership are frequently in the form of stock certificates, but the limitations on the withdrawal and admission of partners are the same as for a general partnership.

Joint-Stock Companies. The joint-stock company is a type of partnership formed under the laws of states that provide for such organizations or by contract among its members in other states. It resembles a limited partnership association but differs from it in two important details. One of these is that all members have unlimited liability for the debts of the company, and the other is that shares are freely transferable without regard for the wishes of other partners. This latter feature, plus those of operation by a board of managers and the possibility of a large number of members, gives this modified form of a general partnership some of the features of a corporation. The term *quasi corporation* is sometimes ap-

plied to a joint-stock company and, less frequently, to a limited partnership association.

The joint-stock company is of more importance historically than it is in the business world of today. During the period from the beginning of the seventeenth to the middle of the nineteenth centuries, it occupied a position in commerce and industry comparable to that of the large modern corporation. For this reason, if for no other, students of business should know something about this form of business ownership. Everyone familiar with American history has heard of the Hudson's Bay Company, the Virginia Company, the Plymouth Company, and the Mississippi Company. All of these were joint-stock companies, which received their charters from the King of England. They played an important part in the development of North America as did other joint-stock companies that were organized in this country during colonial days to build roads, canals, and ships.

In the United States there are only a few thousand joint-stock companies operating today. In England the form is more common, but in both countries the corporation has all but supplanted the joint-stock company. Both are designed to secure a large amount of capital from many members and to delegate the authority to manage the business to a small group. The joint-stock company possesses some of the advantages of a general partnership, such as lower taxes and less governmental regulation, and at the same time shares can be transferred easily. However, the unlimited liability feature looms large as an objection. Furthermore, some states tax the joint-stock company in the same manner as a corporation.

Massachusetts Trust. Strictly speaking, the Massachusetts trust cannot be classed as a special type of partnership even though at least one state so regards it. Nor is it a corporation. Unlike the limited partnership association and the joint-stock company, which might be termed "hybrids," this quasi-corporation form uses a somewhat different approach to the problem of organizing a business. It is classified here as a modified type of partnership as a matter of convenience.

A Massachusetts trust is sometimes called a *common-law trust*, a *business trust*, or a *voluntary association.* It is formed

by a number of investors who turn their funds over to a small group of trustees, who issue trust certificates to the owners. The board of trustees manage the business of the organization in the interest of the certificate holders, and profits are distributed on the basis of the value of the trust shares held by each individual. These shares are freely transferable, and there is no additional liability attached to such ownership. The original trust agreement describes the powers of the trustees, who cannot be removed by the certificate holders except under unusual circumstances. Usually a trust is dissolved within a stipulated number of years after the death of one or more trustees.

The name "Massachusetts trust" was given to this type of organization because the form originated in Massachusetts. At one time that state had laws that prohibited the formation of corporations for the purpose of buying and selling real estate. In order to secure the advantages of limited liability, the trustee device, which had been and is available for other uses, was adopted for the purpose of business ownership. This form of organization is legal throughout the United States, and many states have enacted statutes prescribing the methods of organization and operation, which usually include filing a copy of the trust agreement in one or more public offices.

Several large firms, notably some investment trusts, operate today as Massachusetts trusts, but this form of business organization has not been widely used. Most of the advantages of partnerships are present, and the disadvantages of unlimited liability, divided control, and transferability of ownership have been eliminated. However, its legal status is somewhat uncertain and a court or state might rule the trust to be a partnership, which would automatically raise the question of unlimited liability. Also, the Federal Government and many states have applied the corporation tax rates against Massachusetts trusts.

QUESTIONS

1. What is the fundamental difference between a sole proprietorship and a partnership?
2. Which form of business organization would be best suited for starting a small tourist camp out in the country? Why?

3. Is a formal document necessary to establish a business (a) as a sole proprietorship? (b) as a partnership?

4. What motives might lead a man or a woman already engaged in business as a sole proprietor to seek a business partner?

5. A well-established partnership offers an opportunity to a man with idle funds to join the group as a partner. What factors would influence his decision?

6. What are the disadvantages of becoming (a) a secret partner? (b) a silent partner? (c) a dormant partner?

7. Why are partnerships more prevalent among lawyers than in the field of manufacturing?

8. What determines the basis on which partnership profits are divided among the members of the firm?

9. What are some of the provisions that are usually contained in the articles of partnership? Why are such articles desirable?

10. What is the difference between a limited partnership and a limited partnership association?

11. How does a joint-stock company differ from (a) a limited partnership association? (b) a general partnership?

12. What are the advantages of a Massachusetts trust over (a) a joint-stock company? (b) a limited partnership association? (c) a general partnership?

13. What are the reasons why so little use has been made of the modified type of partnerships that may be classed as quasi corporations?

PROBLEMS

1. Using the data in the table on page 30, compute for each classification of business firms (a) the ratio of sole proprietorships to partnerships and (b) the ratio of sole proprietorships to corporations. For example, if there were 15,000 sole proprietorships, 5,000 partnerships, and 6,000 corporations in a particular classification, the answer for (a) would be 3.0 to 1 and for (b) 2.5 to 1. Your calculations should be accurate to one decimal place.

After completing your calculations, list each set of answers in order of decreasing size of the ratios.

2. According to the story of Garson's garage on pages 44 to 46, Messrs. Garson, Johnson, and Jameson formed a partnership in 1934. Write the articles of partnership for this partnership. In addition to the information about this business that is given in the chapter, you will need the following information: date, October 1; address of business, 18 West Hickory Street, Waring, Pennsylvania; and firm's depository, First State Bank of Waring. The illustration on pages 37 and 38 may be used as a guide.

3. One of the columns in the table on page 30 shows for each classification the percentage of total businesses that is represented by sole proprietorships. Calculate similar percentages, accurate to one decimal place, for the partnerships in each classification.

(a) Arrange the classes of business in order of decreasing percentages.

(b) Why should the partnership form be more popular in the business classifications that appear in the first half of your list?

4. The last year for which the Bureau of Internal Revenue issued a classified report of information returns by *business partnerships* was 1939. The figures for that year are shown in the table on page 30. Since 1939, the Bureau has reported only the number of returns for *all kinds of partnerships.* The table on page 39 is based upon such figures.

Using the figures in the tables on pages 30 and 39: (a) determine for 1939 the percentage of all partnerships that were business partnerships; (b) calculate the number of business partnerships for 1940, 1941, and 1942 (assume that the 1939 percentage of business partnerships remained constant for the next three years); (c) compute the percentage increase in business partnerships between 1939 and 1942.

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CHAPTER 4

CORPORATIONS

What Is a Corporation? The most famous definition of a corporation was contained in a decision of the United States Supreme Court written by Chief Justice John Marshall in 1819. In the case of Dartmouth College v. Woodward, the following phraseology was used:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and, if the expression may be allowed, individuality; properties, by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity, of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men in succession with these qualities and capacities that corporations were invented and are in use.

This definition emphasizes the fact that the *corporation* is a legal entity endowed with the rights, duties, and powers of a person. It is interesting to note that most state and Federal laws that pertain to persons have been applied to corporations. The Supreme Court definition also includes the concept of many people united into one body which does not change its identity even when there are changes in ownership.

Importance of Corporations The dominant type of business ownership in the United States today is the corporation. Although corporations are not so numerous as sole proprietorships and are only slightly more so than partnerships, the amount of wealth controlled by corporations is vastly greater. Various estimates have been made of the

percentage of the national wealth controlled by corporations and, although the statisticians are not in agreement, estimates have run as high as 80 per cent. There are approximately 40 corporations with assets totaling over a billion dollars; these would equal in size many thousands of sole proprietorships of the average size. Furthermore, there are thousands of smaller corporations, many of which are no larger than the average partnership or proprietorship.

Among the largest corporations in this country are the Metropolitan Life Insurance Company of New York and the American Telephone and Telegraph Company. In the banking field the Chase National Bank of the City of New York and the Bank of America National Trust and Savings Association have led in the race for size leadership. In the transportation business the Pennsylvania Railroad; the New York Central; the Southern Pacific; the Atchison, Topeka, and Santa Fe; the Union Pacific; and the Baltimore and Ohio are all in the billion-dollar class. Industrial corporations with assets of over one billion dollars include the Standard Oil Company of New Jersey, the United States Steel Corporation, the General Motors Corporation, the Socony-Vacuum Oil Company, Incorporated, and E. I. duPont de Nemours.

Types of Corporations Corporations may be classified in several ways. An examination of all types will make clearer the exact nature of the profit-making or business corporation.

Public versus Private Corporations. A *public corporation* is a corporation that is established and supported by a city, a state, or the Federal Government. It is operated for governmental purposes or for the administration of public affairs. Examples of public corporations are incorporated cities, state hospitals for the insane, and state universities.

A *private corporation,* on the other hand, is one established and operated entirely by private individuals (1) for social, charitable, or educational purposes or (2) for the financial profit of its owners.

Profit versus Nonprofit Corporations. Business corporations are organized for the purpose of making profits for their owners; most public corporations are not organized for this

purpose and do not distribute such profits when they are made. Likewise, social, charitable, educational, and other similar private corporations may or may not make profits, but those that make profits do not distribute them to their members.

Stock versus Nonstock Corporations. Business corporations issue *stock certificates*, representing shares of ownership, which provide a means of distributing the profits to the owners, called *stockholders*. In general, public corporations, and also private corporations that are not organized to make profits for their members, do not issue stock. Examples of such private corporations are churches, hospitals, and schools. There are a few public corporations, such as the Reconstruction Finance Corporation, that do issue stock, but these are exceptions to the usual operations of a public corporation.

Domestic, Foreign, and Alien Corporations. A corporation is usually organized under the laws of one state. In that state the business is regarded as a *domestic corporation*; but in every other state in which it may operate, it is considered a *foreign corporation*. For example, the United States Steel Corporation, which is organized under the laws of the state of New Jersey, is considered a domestic corporation in that state; but in Pennsylvania, where it has numerous offices and factories, it is a foreign corporation.

A company doing business within the United States that has been organized in another country, such as Canada, Mexico, England, or Holland, is known in the United States as an *alien corporation*.

Open versus Close Corporations. If the stock of a corporation is widely held and can be purchased by almost anyone, the organization is known as an *open corporation*. However, if the stock is closely held and there is no opportunity for the general public to purchase shares, the organization is known as a *close corporation*. The General Motors Corporation, organized under the laws of the state of Delaware with 6,000,000 shares of preferred stock and 75,000,000 shares of common stock authorized, had outstanding at one time 1,835,644 shares of the preferred stock and 44,104,340 shares of the common stock held by 435,657 stockholders. In contrast, the Ford

Motor Company, also organized under the laws of the state of Delaware and with 20,000,000 shares of stock authorized, had outstanding at one time 3,452,900 shares of stock, all of which were held by members of the Ford family and the Ford Foundation.

In general, the large corporations are open in type because ownership in them can be purchased through the agency of stock brokers. It is also true that most of the smaller corporations are of the close variety. The only way in which stock in these can be acquired is by direct contact with an owner who is willing to sell all or a part of his holdings. Family corporations and corporations that have been formed by converting sole proprietorships or partnerships into a corporate form are typical of the close classification.

Industrial Classifications. Private, profit-making, industrial corporations may be classified in several ways. Moody's Manuals, which include a description of almost every corporation in the United States, as well as those in foreign countries, are issued in four volumes. These are headed Industrials; Railroads; Public Utilities; and Banks, Insurance, Real Estate, and Investment Trusts.

The Bureau of Internal Revenue of the United States Treasury Department classifies corporations into several major industrial groups. The table on pages 56 and 57 shows these groups and also the number of returns received and the net income reported. Inasmuch as every industrial corporation must file a return, the totals indicate the number of corporations operating in the different areas.

How a Corporation Is Organized An examination of the method of forming a private corporation organized for profit will give further insight into its nature. Although the Federal Government charters national banks, Federal credit unions, a few Government corporations, and some scientific and educational organizations, other business enterprises operating as corporations must receive their authorization, called a *charter,* from one of the forty-eight states.

Incorporation laws in the several states vary in detail, but they follow a general pattern. The first step necessary in

Corporation Income Tax Returns
Number and Net Income by Major Industrial Groups

INDUSTRIAL GROUPS	NUMBER OF RETURNS	NET INCOME
All industrial groups	455 753	$27,790 651,000
Mining and quarrying	10 123	337,916,000
Metal mining	1,888	116,185,000
Anthracite mining	145	7,497,000
Bituminous coal, lignite, peat, etc	1,783	96,157,000
Crude petroleum and natural gas production	4,060	74,670,000
Nonmetallic mining and quarrying	1,553	42,905,000
Mining and quarrying not allocable	694	502 000
Manufacturing	81 443	16 556 001,000
Food and kindred products	9,327	1 116,978,000
Beverages	2,832	364,207,000
Tobacco manufactures	221	184,115,000
Cotton manufactures	819	326,322,000
Textile mill products except cotton	3,661	506,401,000
Apparel and products made from fabrics	8,193	251,581,000
Leather and products	2,064	149,822,000
Rubber products	463	364,589,000
Lumber and timber basic products	2,542	168,653,000
Furniture and finished lumber products	3,992	140,310,000
Paper and allied products	2,149	394,511,000
Printing and publishing industries	10,423	439,842,000
Chemicals and allied products	6,544	1,260,823,000
Petroleum and coal products	526	759,233,000
Stone, clay, and glass products	2,942	301,729,000
Iron, steel, and products	6,506	2,695,153,000
Nonferrous metals and their products	2,418	527,961,000
Electrical machinery and equipment	1,730	1,077,413,000
Machinery, except transportation equipment and electrical	6,201	2,190,473,000
Automobiles and equipment, except electrical	598	413,696,000
Transportation equipment, except automobiles	1,224	2,318,503,000
Other manufacturing	3,792	389,812,000
Manufacturing not allocable	2 276	213,873,000
Public utilities	20 680	4 494,510,000
Transportation	13,760	2,794,022,000
Communication	3,629	680,013,000
Other public utilities	3,291	1,020,475,000
Trade	124 120	3,091,535,000
Wholesale	35,347	1,189,198,000
Commission merchants	5,555	92,006,000
Other wholesalers	29,792	1,097,192,000

INDUSTRIAL GROUPS	NUMBER OF RETURNS	NET INCOME
Retail	74,263	$ 1,652,802,000
General merchandise	5,792	787,134,000
Food stores, including market milk dealers	5,881	131,460,000
Package liquor stores	1,797	7,322,000
Drug stores	4,600	56,265,000
Apparel and accessories	10,440	216,752,000
Furniture and house furnishings	4,718	94,369,000
Eating and drinking places	9,787	64,413,000
Automotive dealers	8,229	62,257,000
Filling stations	1,934	9,981,000
Hardware	2,335	14,179,000
Building materials, fuel, and ice	7,490	65,780,000
Other retail trade	7,325	94,768,000
Retail trade not allocable	3,935	42,122,000
Trade not allocable	14,510	255,535,000
Service	38,660	546,443,000
Hotels and other lodging places	4,521	82,299,000
Personal service	8,536	48,758,000
Business service	7,061	66,561,000
Automotive repair services and garages	3,398	6,407,000
Miscellaneous repair services, hand trades	1,501	14,020,000
Motion pictures	4,067	257,551,000
Amusement, except motion pictures	4,766	32,513,000
Other service, including schools	4,698	37,242,000
Service not allocable	112	1,091,000
Finance, insurance, real estate, and lessors of real property	142,191	2,375,449,000
Finance	35,109	935,109,000
Banks and trust companies	15,822	420,198,000
Long-term credit agencies, mortgage companies, except banks	3,252	(4,230,000)
Short-term credit agencies, except banks	3,950	49,814,000
Investment trusts and investment companies	3,376	157,868,000
Other investment companies, including holding companies	1,895	274,995,000
Security and commodity-exchange brokers and dealers	1,448	28,349,000
Other finance companies	1,692	7,227,000
Finance not allocable	3,674	889,000
Insurance carriers, agents, etc.	7,909	1,290,415,000
Insurance carriers	1,923	1,263,775,000
Insurance agents, brokers, etc.	5,986	26,640,000
Real estate, including lessors of buildings	91,789	64,693,000
Lessors of real property, except buildings	7,384	85,232,000
Construction	13,324	267,284,000
Agriculture, forestry, and fishery	7,295	113,845,000
Agriculture and services	6,593	108,194,000
Forestry	433	2,863,000
Fishery	269	2,788,000
Nature of business not allocable	17,917	7,668,000

Source: Bureau of Internal Revenue, Statistics of Income for 1943.

organizing a corporation is to secure an application form, usually from the secretary of state in the state in which the corporation is to be formed. This paper provides spaces for the name of the corporation, the names of the principal stockholders, the number and the types of shares of capital stock, the place of business, the type of business, and so forth. A sample of such a form, from the state of Delaware, is shown on pages 59 and 60.

When the application form is available, it is filled out, with special care given to fulfilling all specific requirements. All states require at least three stockholders; in some states the minimum number is five. Also, the minimum amount of capital is at least $500; frequently, the smallest permitted amount is $1,000.

After the requirements have been met, the completed papers with the requisite charter fee are forwarded to the state capitol. The fee varies with the number of shares of stock that the proposed corporation wishes to be permitted to issue, although a minimum fee of from $10 to $25 is customary. The charges in Ohio, for example, are as follows:

First 1,000 shares	10 cents a share
1,001 to 10,000 shares	5 cents a share
10,001 to 50,000 shares	2 cents a share
50,001 to 100,000 shares	1 cent a share
100,001 to 500,000 shares	½ cent a share
Over 500,000 shares	¼ cent a share

In the early days of corporate history it was necessary for the state legislature to grant charters. This procedure did not prove satisfactory and led to the adoption of general incorporating laws. Under these codes the power to authorize the formation of corporations has been delegated to an official or a department of the state government. If an application is complete in every detail and no attempt is made to exceed the customary powers granted to corporations, approval is virtually automatic.

The selection of the state in which incorporation papers are to be filed depends upon a number of factors. If most of the business is to be done in one state and if the corporation is small, it will probably be advantageous to organize the cor-

Certificate of Incorporation
OF
THE WHITESIDE CORPORATION

FIRST.—The name of this Corporation is ....The Whiteside Corporation....

SECOND.—Its principal office and place of business in the State of Delaware is to be located at 10 Main Street, in the .....City of Wilmington .....,

County of .....Newcastle..... .....

The agent in charge thereof is .....The Corporate Management Company .....

at ....10 Main Street, Wilmington, Delaware .....

THIRD.—The nature of the business and the objects and purposes proposed to be transacted, promoted and carried on, are to do any or all the things herein mentioned, as fully and to the same extent as natural persons might or could do, and in any part of the world, viz:

To buy, manufacture, assemble, or otherwise acquire, and to sell, exchange, rent, and repair office machines of every kind and description, and to deal in all supplies and other merchandise relating to or useful in connection with office machines.

IN FURTHERANCE AND NOT IN LIMITATION of the general powers conferred by the laws of the State of Delaware, and the objects and purposes herein set forth, it is expressly provided that this corporation shall also have the following powers, viz

To take, own, hold, deal in, mortgage or otherwise lien and to lease, sell, exchange, transfer, or in any manner whatever dispose of real property, within or without the State of Delaware, wherever situated

To manufacture, purchase or acquire in any lawful manner and to hold, own, mortgage, pledge, sell, transfer, or in any manner dispose of, and to deal and trade in goods, wares, merchandise, and property of any and every class and description, and in any part of the world.

To acquire the good will, rights and property, and to undertake the whole or any part of the assets or liabilities of any person, firm, association or corporation, to pay for the same in cash, the stock of this company, bonds or otherwise, to hold or in any manner to dispose of the whole or any part of the property so purchased, to conduct in any lawful manner the whole or any part of any business so acquired, and to exercise all the powers necessary or convenient in and about the conduct and management of such business

To apply for, purchase or in any manner to acquire, and to hold, own, use and operate, and to sell or in any manner dispose of, and to grant license or other rights in respect of, and in any manner deal with, any and all rights, inventions, improvements and processes used in connection with or secured under letters patent or copyrights of the United States or other countries, or otherwise, and to work, operate or develop the same and to carry on any business, manufacturing or otherwise, which may directly or indirectly effectuate these objects or any of them

To guarantee, purchase, hold, sell, assign, transfer, mortgage, pledge, or otherwise dispose of the shares of the capital stock of, or any bonds, securities or evidences of indebtedness created by any other corporation or corporations of this State or any other State, country, nation or government, and while owner of said stock may exercise all the rights, powers and privileges of ownership, including the right to vote thereon, to the same extent as natural persons might or could do

To enter into, make and perform contracts of every kind with any person, firm, association or corporation, municipality, body politic, county, territory, State, government or colony or dependency thereof, and without limit as to amount to draw, make, accept, endorse, discount, execute and issue promissory notes, drafts, bills of exchange, warrants, bonds, debentures, and other negotiable or transferable instruments and evidences of indebtedness whether secured by mortgage or otherwise, as well as to secure the same by mortgage or otherwise, so far as may be permitted by the laws of the State of Delaware

To have offices, conduct its business and promote its objects within and without the State of Delaware, in other States, the District of Columbia, the territories and colonies of the United States, and in foreign countries, without restriction as to place or amount

To do any or all of the things herein set forth to the same extent as natural persons might or could do and in any part of the world, as principals, agents, contractors, trustees, or otherwise, and either alone or in company with others

IN GENERAL to carry on any other business in connection therewith, whether manufacturing or otherwise, not forbidden by the laws of the State of Delaware, and with all the powers conferred upon corporations by the laws of the State of Delaware

FOURTH.—The amount of the total authorized capital stock of this corporation is Ten Thousand Dollars ($10,000.00) divided into One Hundred shares, of One Hundred Dollars ($100.00) each.

The amount of capital stock with which it will commence business is Five Thousand Dollars ($5,000.00).

FIFTH —The names and places of residence of each of the incorporators are as follows:

NAME	RESIDENCE
George W. Whiteside	36 Clark St., Reading, Pa.
Esther R. Whiteside	36 Clark St., Reading, Pa.
Richard L. Roe	401 Lisle Ave., Eugene, Oregon

SIXTH —The existence of this Corporation is to be perpetual.

SEVENTH —The private property of the stockholders shall not be subject to the payment of corporate debts to any extent whatever.

EIGHTH —The Directors shall have power to make and to alter or amend the By-laws; to fix the amount to be reserved as working capital, and to authorize and cause to be executed, mortgages and liens without limit as to the amount, upon the property and franchise of this Corporation.

With the consent in writing, and pursuant to a vote of the holders of a majority of the capital stock issued and outstanding, the Directors shall have authority to dispose, in any manner, of the whole property of this corporation.

The By-laws shall determine whether and to what extent the accounts and books of this corporation, or any of them, shall be open to the inspection of the stockholders, and no stockholder shall have any right of inspecting any account, or book, or document of this Corporation, except as conferred by law or the By-laws, or by resolution of the stockholders.

The stockholders and directors shall have power to hold their meetings and keep the books, documents and papers of the corporation outside of the State of Delaware, at such places as may be from time to time designated by the By-laws or by resolution of the stockholders or directors, except as otherwise required by the laws of Delaware.

It is the intention that the objects, purposes and powers specified in the third paragraph hereof shall, except where otherwise specified in said paragraph, be nowise limited or restricted by reference to or inference from the terms of any other clause or paragraph in this certificate of incorporation, but that the objects, purposes and powers specified in the third paragraph and in each of the clauses or paragraphs of this charter shall be regarded as independent objects, purposes and powers.

WE, THE UNDERSIGNED, for the purpose of forming a Corporation under the laws of the State of Delaware, do make, file and record this Certificate, and do certify that the facts herein stated are true; and we have accordingly hereunto set our respective hands and seals.

Dated at Reading, Pennsylvania
July 28, 1947

George W. Whiteside [SEAL]
Esther R. Whiteside [SEAL]
Richard L. Roe [SEAL]

In the presence of Mary Borden

STATE OF Pennsylvania }
COUNTY OF Berks } SS.

BE IT REMEMBERED, That on this 28th day of July A. D. 1947 personally appeared before me, Andrew Vorhees a Notary Public, George W. Whiteside, Esther R. Whiteside, and Richard L. Roe parties to the foregoing Certificate of Incorporation, known to me personally to be such, and I having first made known to them and each of them the contents of said certificate, they did each severally acknowledge that they signed, sealed and delivered the same as their voluntary act and deed, and each deposed that the facts therein stated were truly set forth.

GIVEN under my hand and seal of office the day and year aforesaid.

Andrew Vorhees
Notary Public.

(SEAL)

poration in that state. The chances are that the minimum amount of taxes and fees will be incurred under this plan. However, if a large corporation plans to extend its business operations to every state in the Union, the choice will probably depend upon the state that is most generous in its provisions for a charter and the least expensive from the standpoint of organization cost. Another factor of importance is the amount of the annual franchise fee charged by the various states. This fee is assessed in addition to the incorporation fee and is a charge for permission to continue as a corporation.

Delaware, Maryland, and New Jersey are the most popular states for securing a charter although Nevada, South Dakota, Maine, and Florida also do a thriving corporation business. The roster of nationally-known firms that have been incorporated under the laws of Delaware is particularly impressive and includes, somewhat surprisingly, the Standard Oil Company of California, the Denver and Rio Grande Western Railroad Company, and the Middle West Corporation, a one-half billion dollar utility company. Low fees and liberal provisions in the corporation code are the chief attractions offered by these states. The result is a high volume of incorporations, which produce substantial amounts of annual revenue to support the state government.

Advantages of a Corporation

Considering the legal complications of forming a corporation and the fees involved, it may well be asked: "Why organize a business as a corporation?" In many instances there is a real question as to the merits of this form of business ownership, while in others the corporation seems to be the best solution.

The corporate form of business ownership has several important advantages. The order in which the advantages are listed in the following paragraphs is not necessarily indicative of their importance because, under any given set of circumstances, any one of the factors might prove to be of maximum importance.

Limited Liability of Stockholders. Frequently the most important factor in favor of the corporate form of business organization is that of limited liability. Each stockholder risks only the amount he has invested in the corporation. If

the company proves unprofitable and fails, creditors cannot look beyond the assets of the corporation for funds to settle their claims. If Mr. James Brandt decides to invest $1,000 in the Ajax Manufacturing Corporation, he knows that his risk is limited to that amount, no matter what happens to this company in the years ahead. If he owns a home, government bonds, or other forms of wealth, these items are not available to creditors of the Ajax Manufacturing Company, even though that organization goes into bankruptcy owing many thousands of dollars.

Several years ago, most bank stocks carried a double-liability provision; that is, an assessment on each stockholder equal to his investment could have been made in case of failure of the bank. Legislation passed by the Federal Government and by most states between 1933 and 1938 eliminated this special liability feature of bank stocks. However, if stock is purchased at less than its face value, the stockholder is liable in some states for the difference. A few states have other variations from the general rule, but these exceptions are not important.

Ease of Securing Capital. By dividing its ownership into shares of small denominations, the corporation can attract capital from thousands of individuals. Only in this way could some of the giant corporations of today have been organized. The American Telephone and Telegraph Company has assets of approximately seven billion dollars, which have been acquired for the most part from funds secured from over six hundred thousand stockholders. At least ten other corporations have over one hundred thousand stockholders each.

It is true that some corporations do not make a very successful appeal to a wide selection of potential investors. It is also true that, if a handful of extremely wealthy men could be grouped together, a large amount of capital could be secured under a partnership form of organization. Nevertheless, the opportunity to secure funds from thousands of individuals scattered all over the country is a very definite advantage of the corporation and one that makes possible the existence of most of the larger enterprises. A notable exception to this general rule is the Ford Motor Company.

Length of Life. The corporation has potentialities of a permanent existence. The death or incapacity of stockholders, officers, and employees usually has little bearing on the continued existence of the business. If the business can thrive and prosper, it can remain in business indefinitely. Corporations with over fifty years of continuous life are not uncommon. Many well-known firms, such as the Procter and Gamble Company, are included in this group.

Some states restrict the number of years of life in the granting of a charter, although formerly perpetual charters were common and can still be obtained in many states. Even in those states that limit the life of a corporation, the renewing of the charter for another term is usually a routine procedure.

Transfer of Ownership. Ownership evidenced by stock certificates gives maximum ease of transfer. If Mr. Adams sells his interest in a corporation to Mr. Bass, he merely endorses his stock certificate, and this change of ownership is recorded in the books of the corporation. All open corporations and many close corporations allow their stockholders to transfer ownership to anyone at any time; some close corporations attempt to control the ownership group by restricting transfers to the corporation itself or other remaining stockholders. Through the medium of stockbrokers and organized stock exchanges, millions of shares of stock change hands daily.

Although a corporation usually has no voice in the matter of who buys its shares of stock, it is responsible for keeping an accurate record of the stockholders. Because large corporations are subject to numerous changes in owners, some find it advantageous to hire a separate organization, usually a bank, designated as a *transfer agent,* to handle this task.

Efficiency of Management. This advantage is really a result of the larger size of the organizations formed under the corporate structure. In larger organizations, it is possible to delegate duties to specialists in various lines. On the pay roll of a large corporation may be found a purchasing agent, a sales manager, an advertising manager, a production superintendent, accountants, lawyers, and other specialists. Each man or department has certain responsibilities, which can and should be performed with efficiency.

The separation of ownership and management may also contribute to the efficiency of a corporation. The holders of shares of voting stock elect a board of directors who, in turn, elect a president and other officers. The president is the chief official of the company, and the final authority for day-by-day decisions rests with him.

Legal Entity. A corporation can sue and be sued, make contracts, and secure title to property in its own name. In this respect, the corporation is in sharp contrast to the sole proprietorship and partnership, which must use individual names in legal matters even though operating under firm names not unlike those of corporations. The artificial person concept separates the owners from the corporation. This relieves the stockholders from personal responsibility for many acts that the corporation might commit.

As an illustration of this latter point, assume that the president of a corporation directs the production department to turn out a nonbreakable glass ash tray. The problem is turned over to the engineering department, and it devises a process and a product that prove satisfactory. After considerable production and sales have resulted, a suit is brought against the corporation for a patent infringement. Despite the fact that the responsible employees should have checked this detail, only the corporation is liable for any damages that a court might award to the original inventor.

Disadvantages of a Corporation The corporate form of business ownership has its disadvantages as well as its advantages. The more important disadvantages follow.

Taxation. Without much question, the chief disadvantage of a corporation is the imposition of special taxes. The states and the Federal Government have singled out corporations as a source of revenue. The impersonal nature of this form of organization means that few votes will be lost by politicians if levies are assessed against corporations, whereas heavy taxes imposed on other sources might bring about a storm of protest.

Most states require any corporation doing business within its boundaries to pay an annual franchise tax. If the state

levies an income tax, the corporation is responsible for a tax on the volume of business secured in that state. Real estate and property taxes are assessed against the corporation in the same manner as against individuals. In some states special taxes have been levied against certain types of corporations, such as public utilities, railroads, and insurance companies.

The Federal Government also looks to corporations for a major source of its revenues. In addition to the income tax, the Federal Government has, within recent years, levied a capital stock tax, a declared-value excess profits tax, an excess profits tax, and an undistributed profits tax. The tendency is to relieve corporations of these multiple taxes and to levy only a tax on income.

Expenses of Organization. Of all of the various forms of business enterprise, corporations are the most expensive to organize. A fee must be paid to the state in order to receive a charter. Furthermore, stock certificates and record books must be purchased. Because of the legal nature of a corporation, it is usually advisable to engage a lawyer to assist in the organization procedures. For both large and small businesses, these costs may prove to be a real drawback.

The General Motors Corporation is organized under the laws of Delaware with an authorized capitalization of 6,000,000 shares of no-par preferred stock and 75,000,000 shares of common stock with a $10 par value. Rates charged by Delaware for a certificate of incorporation are as follows:

For each share of authorized capital stock up to 20,000 shares without par value	$.005
For each share in excess of 20,000 shares and up to 2,000,000 shares without par value	.0025
For each share in excess of 2,000,000 shares without par value	.002
For each share up to 20,000 shares having par value	.01
For each share in excess of 20,000 shares and up to and including 200,000 shares having par value	.005
For each share in excess of 200,000 shares having par value	.002
In no case less than $10. Each one hundred dollar unit of par value stock shall be counted as one taxable share.	

The application of these rates to the par and no-par shares of the General Motors Corporation produces the following computation:

Preferred Stock (6,000,000 shares no-par)		
20,000 shares at one-half cent each	$ 100	
1,980,000 shares at one-quarter cent each	4,950	
4,000,000 shares at one-fifth cent each	8,000	$13,050
Common Stock ($750,000,000)		
$ 2,000,000 par value at ten cents per $1,000.	200	
18,000,000 par value at five cents per $1,000.	900	
730,000,000 par value at two cents per $1,000.	14,600	15,700
Total Cost—Preferred and Common Stocks.....		$28,750

Governmental Control and Reports. Because the corporation is a creature of the government, various departments of the state and Federal governments have the right to exercise certain controls and to require certain reports. By way of illustration, a corporation cannot sell securities outside of a state without securing permission from the Federal Securities and Exchange Commission, and it cannot sell them within the state without securing permission from a similar state agency.

All types of annual and special reports, which frequently become burdensome and costly to the corporation, must be prepared. Some corporations, particularly public utilities, find it necessary to maintain report departments for the sole purpose of providing governmental bureaus and agencies with figures that must be furnished.

Charter Restrictions. In the preceding chapter it was pointed out that a sole proprietor could change his business almost at will. A corporation, on the other hand, must state the business it intends to pursue at the time of applying for a charter. Unless the charter is amended, the company may not engage in any type of business not covered by the original permit.

In order to avoid this disadvantage, some corporations have secured charters with the widest possible latitude in the activities in which they may engage. Some states are more generous than others in allowing numerous activities to be written into a charter. For example, the specific purpose clause of a cor-

poration organized for operating a bathing beach and amusement center might read as follows:

To carry on the trade or business of owning and operating all types of amusement enterprises including bathing beaches, dance halls, motion picture theaters, opera houses, roof gardens, restaurants, and other places of public amusement, entertainment, and refreshment; to produce and give athletic, dramatic, musical, variety, and all other types of public performances; to operate transportation facilities to and from the place of business; to build, lease, sell, and otherwise deal in all kinds of real estate, land and buildings, and machinery and equipment necessary or incident to the conduct of this business; to own, hold, lease, and otherwise acquire or dispose of patents and inventions useful in the amusement business; to borrow and loan money; and to engage in all activities necessary for the promotion of the company's business not inconsistent with the laws of the state.

Lack of Secrecy. A corporation must publish its annual statements for the benefit of the many stockholders, and these statements become public property. Sales volume, gross profit margins, net profit, asset values, and other financial matters are accessible to all. Furthermore, salaries of officers receiving in excess of $25,000 a year must be published, as well as the stock dealings of these same men in the company for which they work. Rival corporations have an excellent chance to discover the financial details of their competitors.

Lack of Personal Interest. A corporation has an identity of its own. Therefore, all who work for a corporation assume the role of employees, even though they may own stock in the organization. This fact sometimes results in a lack of personal interest in the success or failure of the organization. The managers draw a salary paid by the corporation; and they assume that, as long as they handle their assigned tasks efficiently, they will continue to be paid. Mistakes involving loss of profit are detrimental to the corporation but not necessarily to them individually. They do not feel that the loss affects them personally as they would in the case of a sole proprietorship or a partnership.

Relative Lack of Credit. While it is true that many corporations enjoy a very high credit rating, others are not so

fortunate. Creditors of a corporation can look only to the assets of the organization for payment of debts incurred. Consequently, a $10,000 corporation would not have the same credit standing as a sole proprietorship or a partnership of the same size if the sole proprietor or the partners had some private resources.

The Corporate Structure The structure of a corporation sheds further light on this form of organization. The owners are the stockholders. The holders of voting stock elect a board of directors to represent them in the general management and in the determination of policies that the corporation is to follow. The directors elect the necessary officers, such as president, vice-president or vice-presidents, secretary, and treasurer. These men are responsible for the actual direction of the corporation and report periodically to the board of directors. The full board may meet as seldom as once a year, although normally it convenes oftener than this. The chairman of the board can call extra meetings. Usually the board divides itself into committees, which may meet much oftener than the entire board.

The accompanying chart pictures in a simple manner the organization of the corporate form.

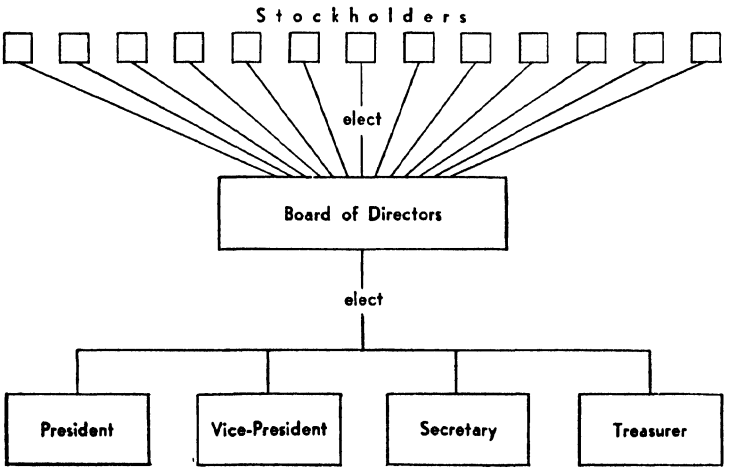

Chart of Corporate Structure

Stockholders. Voting by the stockholders is usually done once each year. If a stockholder can be present at the meeting, he may cast his vote in person, one vote for each share of voting stock owned. If, as is more likely, he cannot attend the meeting, he may send his *proxy*, which is a written authorization for someone else to cast his votes for him. Usually a majority of the voting stock outstanding must be represented at each annual meeting.

The solicitation of proxies is undertaken by the existing management at the expense of the corporation. This usually means the existing group perpetuate themselves in office. If a rival group attempt to secure control, they must finance the effort to secure proxies for themselves. If a corporation has 250,000 stockholders, the mailing cost alone would approximate $15,000 and the printing and handling costs would easily double this figure. Because of this, there have been but few rival solicitations of proxies among the larger corporations. The proxy battles of the Standard Oil Company of Indiana and the Youngstown Sheet and Tube Company of a few years ago are notable exceptions.

Some corporations permit *cumulative voting*, which is a method of allowing minority interests to secure representations on the board. Under this plan, if there are twelve directors to be elected, the owner of a single share of voting stock can cast one vote for each of twelve men or twelve votes for one man. The owner or owners of a small fraction of the entire stock issue can elect one man if they concentrate their voting on this individual.

A notice of annual meeting and proxy form is shown on pages 70 and 71.

In addition to the right to vote, a stockholder has the right to receive dividends in proportion to his holdings of stock. Only the board of directors has the right to declare a dividend. A stockholder also has the rights to hold or sell stock certificates, to share pro rata in the assets that remain after the debts have been paid when the corporation is dissolved, to subscribe to additional stock offerings before such stock is made available to the general public, to vote on specific matters that might vitally affect the welfare of the corporation, to inspect the books and records when good cause is shown,

P. W. WOODRUFF CORPORATION

Annual Meeting of Stockholders, March 28, 1947

Proxy Statement

Accompanying this Statement is a form of proxy for use at the Annual Meeting of Stockholders of P W Woodruff Corporation, to be held on March 28, 1947, which proxy you are requested to sign and return without delay in the enclosed envelope, so as to assure the presence of a quorum at the meeting The By Laws provide that the presence in person or by proxy, of the holders of 40 per cent of the outstanding shares are necessary to constitute a quorum The giving of a proxy does not preclude the right to vote in person, should the person giving the proxy so desire, and the person giving the proxy has the power to revoke the same at any time before it has been exercised

It is intended that the enclosed proxy will be voted (I) for the election of seven directors, (II) for the appointment of a General Auditor, and (III) in the transaction of such other business as may properly come before the meeting, or any adjournment thereof

I The persons for whom it is intended that a vote will be cast for their election as directors pursuant to the enclosed proxy, and the respective number of shares of stock of the Corporation of which they are directly or indirectly the beneficial owners, as of February 28, 1947, as advised by them to the Corporation, are as follows

NAME	NUMBER OF SHARES
P W Woodruff	1 000
R F Woodruff	500
James Reagan	250
J S Stoddard	200
Charles Tolley	100
Josephine McClain	50
A B Johnson	50

During the fiscal year 1946, P W Woodruff received $35 000, and R F Woodruff received $30,000, as the aggregate amount of remuneration received by them, respectively, in all their capacities, either from the Corporation or from its subsidiaries, directly or indirectly, during such fiscal year

The aggregate amount of remuneration paid by the Corporation and its subsidiaries during the fiscal year 1946 to the directors and officers of the Corporation, considered as a group, was $146,500

II It is intended that the proxy will be voted for the appointment of Price, Waterhouse & Co, certified public accountants, as General Auditor, unless another certified public accountant or firm of certified public accountants be specified by you in the space provided therefor in the proxy

III It is expected that, in addition to the election of directors and the appointment of a General Auditor, only routine matters will be transacted at the Annual Meeting, and the Management is not informed that any other person intends to present any matter for action at such meeting, but it is intended that, as to any other matters or as to any other business which may properly come before the meeting, a vote may be cast pursuant to the enclosed proxy in accordance with the judgment of the persons voting the same The Management does not intend to request the stockholders to take any action with

respect to the Annual Report or with respect to any minutes of meetings of the Board of Directors or of the Executive Committee thereof that will constitute approval or disapproval of any of the matters referred to in such report or minutes.

The enclosed proxy is being solicited on behalf of the Corporation by its Management. The expenses of solicitation, consisting chiefly of the cost of printing and mailing, will be paid by the Corporation, and are estimated to amount to approximately $3,000. In addition, the Corporation may reimburse stockholders' nominees or agents for their out-of-pocket expenses in obtaining from their principals authorizations to execute proxies.

By authority of the Board of Directors,

JAMES REAGAN,
Secretary

Milwaukee, Wisconsin
February 28, 1947

P. W. WOODRUFF CORPORATION—PROXY

KNOW ALL MEN BY THESE PRESENTS, that the undersigned stockholder of P. W. Woodruff Corporation hereby constitutes and appoints P. W. Woodruff, R. F. Woodruff and Josephine McClain, and each of them, the true and lawful attorneys, agents and proxies of the undersigned, with full power of substitution to each of them, for and in the name of the undersigned to vote all the shares of Common Stock of the said Corporation which the undersigned may be entitled to vote at the Annual Meeting of Stockholders thereof, to be held on March 28, 1947, or at any adjournment of the said meeting, with all powers which the undersigned would possess if personally present, for the election of directors and the appointment of a General Auditor, and upon all questions which may arise at such meeting with reference to any or all matters set forth in the notice of said meeting, dated February 28, 1947, copies of which notice and of the Proxy Statement accompanying the same have been received and read by the undersigned; *HEREBY RATIFYING AND CONFIRMING* all that the said attorneys, agents and proxies, or their substitute or substitutes, or a majority of such of them as shall be present and act at the said meeting, may do in or about the premises by virtue hereof.

The undersigned hereby directs that this proxy be voted as follows:

For the appointment of the following-named accountant or firm of accountants as General Auditor:

(To be filled in by stockholder only if proxy is to be voted for a General Auditor other than Price, Waterhouse & Co.)

IN WITNESS WHEREOF, the undersigned has executed this instrument under seal, this day of March, 1947.

_____ (L. S.)

Signature should correspond with the name appearing on stock certificate. No witness required.

and to sue the corporation if he believes the board or even a majority of the stockholders have taken actions detrimental to his best interests.

Board of Directors. One of the first acts of a board of directors of a newly-created corporation is to adopt a set of by-laws, which form a framework of rules under which the board operates. These by-laws must fit in with the charter; they supplement this document, which is general in scope. Some of the important provisions in a set of by-laws cover the time and place of the stockholders' regular meetings, methods of calling special meetings of stockholders, the number of directors and their organization and remuneration, the names of the officers to be chosen by the board of directors, the duties of these officers, provisions for filling vacancies on the board, rules for the issuance and the transfer of stock, provisions for publishing an annual statement and other accounting matters, and the method by which the by-laws can be amended. By-laws are very important, so much so that in the absence of any express provision the courts have held that only the stockholders have the right of adopting them. However, this power is almost universally delegated to the board of directors.

In addition to the duties outlined in the by-laws, the directors have certain responsibilities that are imposed by common law or state law. Since management is divorced from ownership, the board of directors must operate the corporation in the interests of the stockholders. If it commits certain acts, such as paying a dividend illegally (when no profits of current or past years are available for distribution), the individual members of the board may be personally liable. However, if the members of the board act in good faith and discharge their relationship as agents or trustees of the stockholders with reasonable care, they cannot be held personally liable even though the corporation may go into bankruptcy.

Officers. As noted above, the by-laws usually specify the officers of the corporation to be elected by the board of directors. The president is normally the chief executive of the company although some corporations delegate more power to the chairman of the board. The vice-president or vice-presidents are usually vested with specific powers. It is not uncommon

to have a vice-president in charge of sales, a vice-president in charge of production, and so on.

The secretary is in possession of the corporate seal, and this results in his signing or countersigning many corporation documents. He also attends all meetings of the stockholders and directors and keeps the minutes of these meetings. The finances of a corporation are under the supervision of a treasurer, although in recent years much of the responsibility for the detail has been transferred, in some corporations, to an elected officer called the comptroller. The division of duties between these two officers varies according to individual companies, but the treasurer retains the power to sign the checks of the corporation.

QUESTIONS

1. What are the main characteristics of the ordinary industrial corporation?

2. May a corporation be both a domestic and a foreign corporation at the same time?

3. Can an investor buy shares of stock in any corporation in which he is interested?

4. Is it possible for one man to incorporate a business by himself and thus be the sole proprietor?

5. Can a charter be secured from a state other than the one in which a corporation plans to operate?

6. If several wealthy men planned to start a business with a high degree of risk, why might they choose the corporate form of organization?

7. Which form of organization—a sole proprietorship, a partnership, or a corporation—would best suit the needs of a firm that planned to manufacture automobiles? Why?

8. If a college graduate wished to open a small shop to sell clothing, would he or she form a corporation? Why?

9. Corporations are usually thought of as having excellent credit ratings. Why is the factor of credit rating listed as a disadvantage?

10. What is the chief responsibility of stockholders of a corporation to the organization in which ownership is held?

11. What are the main responsibilities of the board of directors of a corporation?

12. If the board operates a corporation in a manner displeasing to the stockholders, what can the stockholders do?

PROBLEMS

1. (a) Using the data in the table on pages 56 and 57, compute for each of the major industrial groups (in bold-faced type) the percentage of the number of corporation income tax returns for all industrial groups that is represented by the number of returns for the particular group. Arrange the industrial groups with their percentages in order of rank according to the percentages.

(b) Following the same procedure, compute the percentage of net income for each of the industrial groups in relationship to the total income for all the groups, and arrange the groups in order of rank. For these calculations disregard the last six figures in the amounts.

(c) Compare the two lists that you prepared for parts (a) and (b). What conclusions do you draw?

2. (a) Using the Ohio rates for determining the charter fee as given on page 58, calculate what would have been the cost of securing a charter for the General Motors Corporation (see page 65) if it had been incorporated in Ohio. (Ohio makes no distinction between either par and no-par stocks or preferred and common stocks in the determination of charter fee costs.)

(b) How much greater or smaller would the charter fee of the General Motors Corporation have been if the company had been incorporated in Ohio?

SUGGESTED READINGS

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CHAPTER 5

LOCATION AND LAYOUT

General Nature of the Problem All new businesses have problems of location and layout, and some "going" businesses face these problems when growth or other factors force them to move or to expand their quarters. The importance of proper location and layout can hardly be overemphasized, for the eventual success or failure of a business may be determined by these factors. The sections that follow consider these two topics for several different types of enterprise.

LOCATION

Importance of Proper Location One of the first problems that come up for consideration when a company is organized is that of determining a location for the business. A businessman must take location into account in estimating the probable cost of launching a business, although there are doubtless many instances in which the originators of small businesses give little or no scientific consideration to this factor. It is probable, however, that if these companies experience any appreciable measure of growth, sooner or later they will outgrow their early locations, and the problem of more carefully determined situations must be met and solved.

It is a matter of considerable consequence to the executives of any company that their business be located satisfactorily. In these days of intense competition, the difference between a favorable and an unfavorable competitive position may well turn on the factor of proper location. Competition frequently manifests itself through the instrumentality of prices, which in turn are based on costs. A good location may contribute heavily toward a favorable cost position, whereas a poor location may have just the opposite effect. The relative permanence of any location and the difficulties attendant upon any attempt to move make it imperative that every possible step be taken to ensure the selection of the best available place.

Location, a Two-fold Problem The location problem has two phases. The management must determine, first, the section of the country in which it wishes to place the business and, second, the particular city, town, or village in which the company is to be located. A possible third division of the problem exists in the question of the actual site to be chosen within the community. However, this is so frequently determined by the matter of available vacancies that its consideration will not be taken up here except incidentally. The other two parts of this question will not be separated in the discussion that follows because the applicability of either will be readily apparent.

Factors Involved in Plant Location A number of factors that must be borne in mind when the matter of plant location for a manufacturing business is being considered are listed below without regard to their relative importance. These factors rarely operate alone, but rather in conjunction with one or more of the others. To avoid confusion, however, the pertinent elements in the question of plant location are presented separately.

Nearness to Markets. In many lines of business it is vital to the success of the enterprise that the factory be located close to the markets for the products. Examples include producers of oil-well equipment, who are usually located near the oil fields; makers of automotive parts, who are to be found in lower Michigan near the manufacturers of automobiles; and producers of folding boxes, who are ordinarily located in the same cities as their customers. Nearness of factory to appropriate markets is vital where rapid delivery to customers is essential, where the product is relatively perishable, and where frequent factory service is necessary. In any of these instances it is highly desirable that the factory or, in some instances, branch plants be situated comparatively close to the markets for the goods produced.

Sources of Raw Materials. The raw materials for any given industry may consist of either or both of the following types: (1) unprocessed substances fresh from the earth, such as agricultural products and petroleum; and (2) semifinished

goods, such as chemicals, bearings, and tanned leather, which are the end products of other industries but must be either further processed or assembled with other articles before they are ready for sale to their final consumers. The cost of transporting these items as raw materials as compared to that of transporting the finished products into which they go is frequently a determining factor in the placing of factories that must use them.

There are times when the sources of the necessary raw materials are so varied and widespread and the cost situation is so complicated that no clear-cut advantage appears to attach to locating the plant near any one of them. In such instances some other factor, such as nearness to markets or to labor, will probably be decisive.

If the raw materials are perishable, such as fresh fruits and vegetables, the plants that utilize these types of goods are usually located in the agricultural districts where the raw materials are grown.

The raw materials question, like the others in the problem of plant location, is often one of relative costs, which need to be kept at the lowest possible level in the formidable competition that characterizes many lines of business today.

Transportation. The transportation factor is a complex one, for it involves costs, speed, and the selection of a particular carrier from among those that are available in a given locality. If the products concerned, such as lumber and cement, can be moved by water, the problem may take on quite a different aspect than if that form of transportation were not available. The expansion of the country's network of highways, which has greatly facilitated the development of truck transportation, has served to widen the markets for companies that are able to ship their products in this manner. The important point is that a factory should avoid locations where it would be at a disadvantage as compared with its competitors in regard to transportation.

Labor. In determining the location for a factory, the management must study the question of the available labor supply in each community under consideration. If the company requires skilled workers, it would be unwise for it to establish

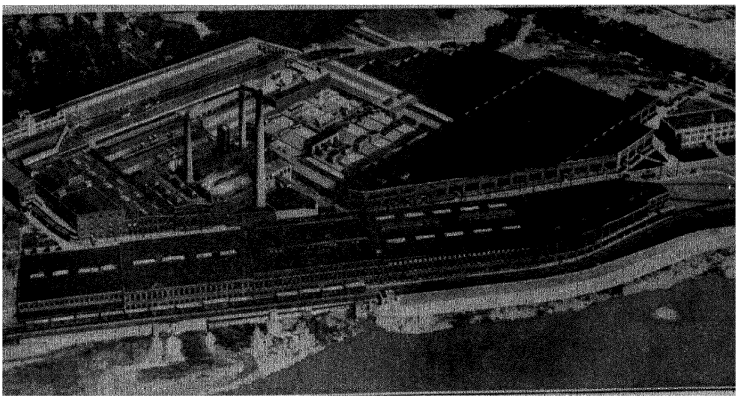
its plant in a place where there is a shortage of this type of operative. If its processes are such as to require special skills to be found only where there are plants of a similar character, then the decision is a comparatively simple and obvious one. On the other hand, if unskilled labor can perform satisfactorily the production tasks, the company will have a broader field from which to choose and can contemplate the setting up of its plant in those neighborhoods where unskilled workers abound.

During World War II the War Manpower Commission designated certain parts of the country as "labor-shortage areas," which pointed out those regions where critical labor shortages prevailed. This condition was usually due to the concentration of war industries in these areas and to the inroads into the local labor supply made by the draft.

The subject of wage rates is one of consequence. Other things being equal, there is a discernible tendency for firms in many lines of business to gravitate away from districts where high wage rates prevail to those where labor costs are lower. The classic example of this point is to be found in the migration of large portions of the textile industry from New England to the South, although there were other considerations, such as the proximity of raw materials. It is possible, however, that the working out of the provisions of the Wages and Hours Act may serve to equalize some of the wage differences that have existed between different parts of the country.

Another factor that has been of considerable moment is that of the presence or absence of labor organizations. This is closely related to the subject of wage rates, which may be rendered somewhat less vital by the growth of unionization. The matter of restrictive state labor laws, such as strong workmen's compensation acts or laws restricting the hours of labor of women or minors, is another factor that might influence the decision in favor of states that are lenient in this respect.

Climate. In certain industries the nature of the climate—temperature and humidity—in different localities is a factor that assumes considerable importance. The manufacturer of



Champion Paper and Fibre Company

Plant Location

Water is an important factor in the location of a paper mill. It is used for transportation, for power, and in the production processes.

shoes, for example, prefers a moist climate because he does not wish the leather that he uses to dry out rapidly. The manufacturer of airplanes seeks a climate that makes possible the year-round testing of his finished product.

Recent developments in the field of air conditioning have tended to lessen the importance of the climate factor. At one time New England was considered the most desirable section of the nation in which to locate a textile industry. Now that it is possible to control the humidity of the air in a factory by mechanical means, New England does not have this same advantage over certain other sections of the country.

Power. Relatively cheap sources of power are necessities to those lines of business that utilize large quantities of this service in their productive processes. Within this category are many plants manufacturing chemicals and abrasives. The cheap power may be the result of a natural phenomenon, such as Niagara Falls, or it may come from large central stations that are found in many parts of the country. The T.V.A. (Tennessee Valley Authority) is a good example of a man-made power source. The Norris dam and the various other dams in this project produce large quantities of power.

An alternative to the purchase of power is for a company to produce its own. This involves the construction and operation of a power house, which entails not only a heavy investment in plant and equipment but also rather high fixed charges that continue even if the factory is idle for an extended period

of time. For this reason many concerns prefer to purchase their power rather than to produce it themselves. Therefore they are interested in those communities that can offer them cheap power.

Location of Competitors. Some lines of business have centered around certain localities. Examples are the automobile industry, the vast majority of whose members have their plants in or near Detroit, Michigan; the steel industry around Pittsburgh, Birmingham, and Gary; and cotton textiles in the Southeast. Originally there may or may not have been some logical reason, such as nearness to raw materials or power, that accounted for the selection of their localities by the industries concerned. Regardless of these factors, however, it is sometimes greatly to the advantage of a concern contemplating the establishing of a new factory, or the removal of an old one, to be situated in or close to the center of the industry. Frequently there are accessory businesses nearby; the offices of the trade associations may be located there; or the labor supply may be peculiarly well suited to the type of business. In any event, when a recognized center for manufacturers of a given type has been established, there is a tendency for this to attract newcomers to the same locality.

Special Characteristics of the Business. The manufacture of some few lines of goods takes place under conditions that involve special problems of location. Plants where explosives are made are customarily placed far from other factories or places of human habitation. Chemical plants sometimes emit unpleasant or harmful odors that cause them likewise to be placed in more or less isolated spots. The same may be true of industries where large quantities of refuse are inescapable results of the manufacturing processes.

Trade Barriers. To executives with plant location problems to solve, a factor that has been of increasing importance in the past few years is that of so-called interstate trade barriers. These impediments to free interstate trade, which have taken on many forms, have been designed to "protect" home industry by setting up what have amounted to protective tariffs, the presumed effect of which has been to exclude to

some extent the competing products of companies located in other states. The legality of many of these measures is open to some question, and there has been a concerted movement among some state officials to bring about their repeal or nullification. This topic becomes of interest in the plant location picture in that it may influence a company to locate its factory within, rather than without, the boundaries of any given state where its main markets may be found.

Local Inducements. There are times when the foregoing factors are of no particular consequence and when the choice between two or more acceptable communities may be determined by certain local considerations. Some of these are low taxes, even postponement of taxes for a period of time in some instances, free or cheap land, available sites, low rentals, favorable banking connections, and good living conditions. The chambers of commerce of most cities are very active in endeavoring to attract factories to their own localities, and competition between these places sometimes produces some exceedingly enticing offers to interested industrialists.

Chance. A realistic view of the factors affecting the choice of a plant location must recognize that many communities are selected to some extent on the basis of chance. This does not mean that a coin is tossed or that dice are thrown, but rather that the irrationality of human conduct in many instances brings about decisions in this matter that have little, if any, foundation in reasoned conclusions based on a careful evaluation of all of the factors concerned. In a great many instances a company is located where it is merely because the founders or owners happened to live there. Likewise, when a move is contemplated or a branch plant is projected, the selection may be based on the personal prejudices of certain of the officers or on some wholly illogical grounds. This sort of thing is not recommended as a scientific procedure, but it would be useless to deny its existence.

Location of Other Types of Businesses The factors that make up the location problems of nonmanufacturing businesses are fairly simple and largely local in character. For these concerns the question of location usually re-

solves itself into that of determining upon the section of a city where they wish to go. There are exceptions, of course, as in the case of a wholesaler who wishes to extend his market into other parts of the country or of the chain store organization that desires to broaden its scope along the same lines.

For the purpose of clarity and simplicity, the nonmanufacturing companies are divided into wholesalers, retailers, and service establishments, and their location problems are considered separately.

Location of Wholesalers. Wholesalers who are contemplating establishing warehouses or moving from their present quarters must consider the following points.

Nearness to the Wholesale District. It is important for firms engaged in some lines, such as wholesale fresh fruits and vegetables, to be situated in or close to the wholesale district specializing in their wares. In other lines this proximity is not a matter of any consequence. There is, however, a noticeable tendency for drug, hardware, clothing, and paper wholesalers to be grouped together in many cities.

Nearness to a Railroad Siding. It is frequently desirable for a wholesaler to be located on a railroad siding, as this reduces the handling and transportation costs on incoming goods.

Nearness to Retail Stores. In large cities, where there may be several neighborhood retail centers, wholesalers may desire to be located fairly close to those where the majority of their customers are to be found.

Available Sites. In any case the number and location of available sites are limiting factors in the determination of a wholesaler's business address.

Location of Retailers. Although manufacturers and wholesalers go to their customers through representatives or salesmen, the customers of retailers come to them. Because of this, retail stores must be readily available to their patrons. A store that is unfavorably situated in this regard may lose out competitively even though its merchandise is excellent, its prices are attractive, and the management is entirely capable.

Of paramount importance to a retailer seeking a location for his store is the matter of available sites. If he wishes to enter a certain community in which there are no vacant stores, he is prevented from achieving his objective until more store buildings are constructed or until one of the present stores moves or leaves the field. The available store locations must be evaluated on one or more of the bases that follow in order to determine the most promising one.

Nearness to a Trading Center. Stores tend to be grouped together into what are known as *trading centers.* To these centers the customers come to make their purchases. A store located near the heart of a trading center will thus have a certain advantage over one that is situated on the outskirts of the center. Hence it is advisable for a retailer to note the position of any available vacancies with respect to the trading centers of which they may be parts.

Delicatessen stores, which are open evenings and on Sundays, may be able to disregard this factor under certain circumstances. In some parts of the country, supermarkets have been located at considerable distances from trading centers. This has been done for the purpose of securing adequate parking space for their customers, and also to remove themselves from the proximity of their competitors. It is yet too early in the development of the supermarket to tell whether or not this represents a permanent trend.

Nearness to Competitors. Progressive retailers, particularly those handling shopping goods,[1] try to secure locations as close to their competitors as possible. They do so on the assumption that this proximity will bring into their stores also the consumers who visit their competitors. This factor is closely related to the trading center idea.

Nature of Customer Traffic. A retailer who is appraising the merits of a prospective location should give some thought to the character and amount of the pedestrian traffic that passes the store because it is from these passersby that many of the store's customers will come. This is a factor that has

[1] Shopping goods may be defined as those goods that a customer wishes to examine and to compare in a number of stores before buying.

assumed considerable importance in recent years. Chain store executives conduct qualitative and quantitative traffic counts near the places where they contemplate establishing stores. A retailer who expected to stock his store with women's wear would hardly choose a location where the traffic consisted chiefly of men.

Rental or Sale Price. Usually a fairly close relationship exists between the rental or sale price of a location and its relative desirability as a site for a store. Competition between retailers who wish to rent or to buy and between landlords who wish to lease or to sell their properties tends to bring about a parity in rentals or selling prices for locations of equal desirability. There are, however, occasional instances where some outside influences may enter the picture and disrupt this condition. The need for settling an estate, new store building projects, or other things of this nature may enable a retailer to make unusually favorable arrangements concerning the rental or purchase price of his new location. Alert retailers are always on the lookout for situations such as these.

Character of Neighborhood. A retailer who is contemplating a new location should study carefully the characteristics of the neighborhood that he is considering. This applies with particular emphasis to the matter of any changes for better or for worse that may be noticeable or in prospect. Instances are to be found in various parts of the country of trading centers that have declined because the character of the neighborhood has changed. This is frequently the result of the advance of slum areas in cities, because a factory has been closed, or sometimes because a change in city zoning laws has permitted factories to enter an area, with a consequent lowering of the economic level of the surrounding residential district. Retailers who are so unfortunate as to be caught in such circumstances may experience the failure of their enterprises.

Location of Service Establishments and Offices. Service establishments, such as garages and service stations, restaurants, laundries and dry cleaning shops, beauty parlors, and barber shops, also have location problems. To a very considerable extent the factors that affect the choice of the location of retail stores apply to this category of enterprises. There may

be this difference, however. The customers of service businesses tend to become quite attached to them and are frequently willing to disregard the inconvenience of somewhat out-of-the-way locations. In this the service stores differ from most retail stores, which must endeavor to be placed as conveniently for their customers as possible.

The problems of office location are rather simple. Downtown business offices are dependent for their locations on the availability of vacant space in office buildings and its adequacy for their needs. Factory offices are usually located on the factory sites.

LAYOUT

Plant Layout When the problems of location have been solved by a manufacturing business, there arise those of the layout of the factory. The purpose of plant layout is to bring about the best obtainable combination of plant and equipment from the standpoint of the highest standards of production and the lowest unit cost.

Some of the more important factors that must be taken into account by plant executives at the time the matter of plant layout comes up for consideration are discussed below. These are given with only incidental reference to the effect that they might have on the layout of a plant in any given instance.

Types of Product, Fabricated or Assembled. The manufacturing policies of some companies call for the fabricating of products almost in their entirety, while others call for the purchase of nearly all of the component parts from outside makers and the performance of only the assembly operations. A good example of the former policy is the Ford Motor Company, which has always made a very large portion of the parts entering into the Ford products. Contrasted to this, a few years ago, was the Jordan Motor Company, which purchased practically all of the necessary parts in finished form and contented itself with assembling them under the Jordan name. Companies embracing the first of these policies have problems of layout that are quite different from those to be met by concerns following the second course of action.

Types of Manufacturing Process. There exist, generally speaking, two types of manufacturing processes, the intermittent and the continuous. The difference between the two is to be found mainly in the length of the periods of time during which labor and equipment are applied continuously to the materials being processed. In the case of the intermittent process these periods are relatively brief. With the continuous process they are much longer, often being of several months' duration. In the rayon industry, for example, it is customary for certain of the chemical operations to be continued day and night, Sundays and holidays, without stopping until the operations have been completed. The chemical substance from which the thread is spun must be a specified number of days and hours old at the time it reaches the spinning room. If delay occurs, the chemical compound may become useless. In other words, the processes cannot be interrupted without incurring sizeable losses. In a few other industries, such as steel and glass, the same conditions prevail.

On the other hand, there are many lines of production where it is both possible and feasible to interrupt the flow of production at regular or irregular intervals. The character of the manufacturing processes in this regard will bear strongly on the solution of layout problems.

Volume of Work. The amount of work that will be normally progressing through a plant will have an important bearing on the number of machines and men required to handle it and the consequent physical setup of the plant.

Manufacturing Policy. Closely allied to the foregoing factor is that of manufacturing policy, as it determines whether the company is to produce only to order or for stock. Manufacturing policy is determined to some extent by the nature of the products; for example, road-building machinery, which is usually designed especially for the job, is rarely made up for stock. Shirt makers, however, may keep a sizeable inventory of finished goods on hand for rapid delivery to their customers upon the receipt of their orders.

Amount of Labor Required. The quantity of labor that the manufacturing operation requires, in relation to machines,

tools, benches, etc., is likewise pertinent to the question of layout. Concerns that require considerable hand labor, such as tool makers, will seek the solution of their layout problems along lines different from those of firms with a low ratio of labor to machinery, such as in machine shops.

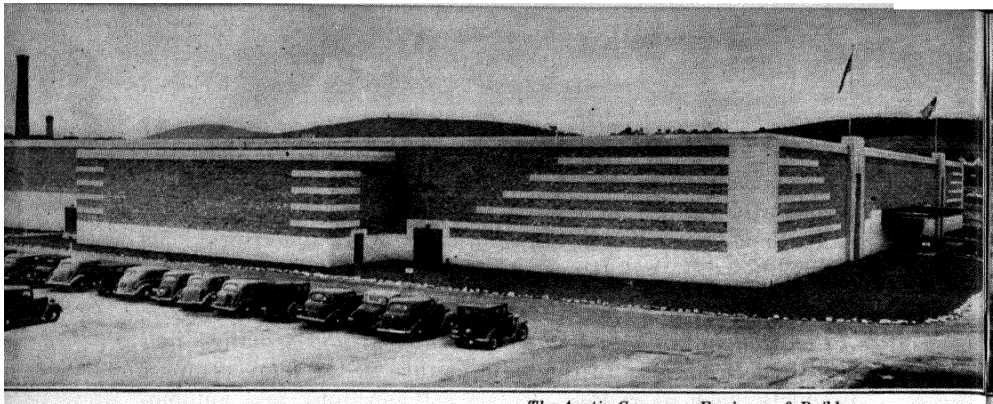
Relationship among Component Parts, Subassemblies, and Finished Products. In the manufacture of the more complex products, such as radios, electric refrigerators, and automobiles, there is the problem of the time and space relationships between the basic parts of the products, the subassemblies (in the case of automobiles, motors, bodies, and rear ends), and the finished articles ready for the market. This means that a certain amount of space must be allotted to the manufacture of the parts, to their assembly into subgroups, and to their final assembly into the end products of the process. These must be located so that each step in the procedure is completed at the point when it will be needed for the next stage. In the case of many commodities this is a problem of major proportions.

Internal Transportation. Intrafactory transportation of parts and materials is costly. A well-planned layout, having due regard for the materials-handling equipment on hand or available, will reduce this cost to a minimum.

Need for Flexibility and Changeability. Underlying all other considerations in the matter of layout is the basic need for flexibility and changeability in any plan that might be adopted. The attempt should be made to foresee any possible future circumstances that may call for changes in the layout. While this obviously cannot be done with a very great degree of exactitude, any effort expended in this direction will probably result in time- and trouble-saving in the future.

The adaptability of the accepted setup to such minor changes as experience may suggest is a desirable attribute of any layout plan.

Types of Factory Buildings There are many types of factory buildings, but most of them may be classified as single-story buildings with a flat or saw-tooth roof, the monitor type, multi-story buildings, and special types.



The Austin Company, Engineers & Builders

Single-Story Factory Building

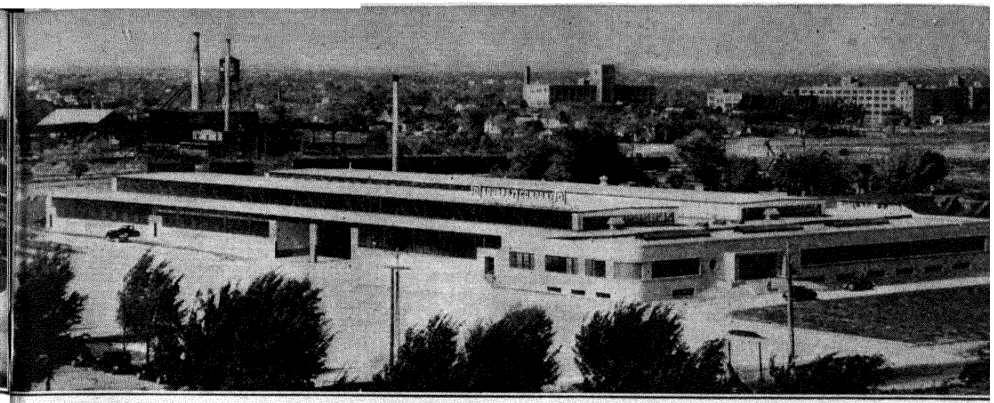
This is a part of a 5½-acre, single-story, windowless, controlled-conditions building, which accommodates the activities previously conducted in 17½ acres of floor space distributed among three multi-story buildings.

The *single-story type* is used in such industries as the electrical precision instrument and aircraft production. The chief advantage of this type is that there is relatively little unproductive floor space because there is no need for elevator shafts, stairways, or other similar space-consuming fixtures. When the *saw-tooth roof* is utilized, natural light is made available to those productive processes and operations that may be located some distance from the side walls of the structure. The relative lightness enables the building to be of almost any width and allows for future expansion.

Single-Story Building with Saw-Tooth Roof

The saw-tooth roof makes natural light available for all operations regardless of their location.

The Austin Company, Engineers & Builders



The Austin Company, Engineers & Builders

Monitor Building—Exterior

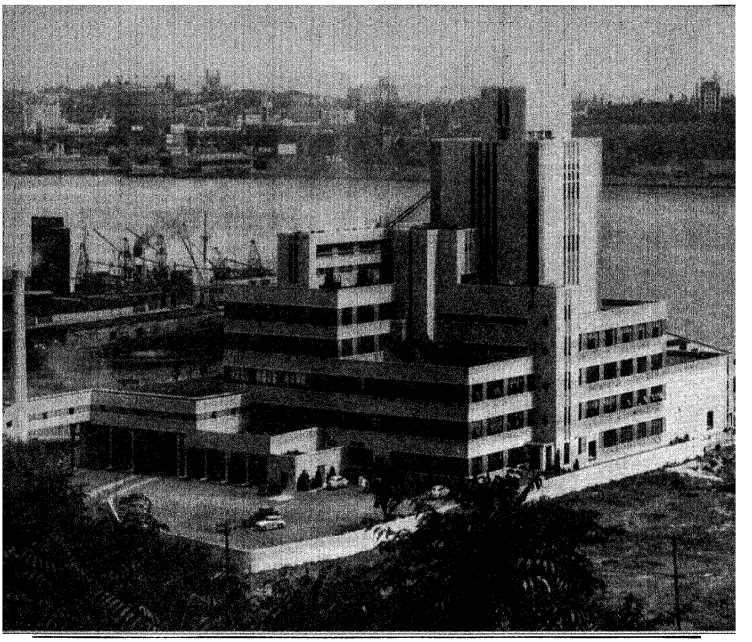
This single-story building has two monitor sections extending almost the full length of the roof. Note the large percentage of window space.

The *monitor type* of single-story building, of which exterior and interior views are shown on this page, is quite common in the automobile industry where traveling cranes for the handling and moving of heavy materials are required. This type has many of the advantages of the single-story building with saw-tooth type of roof insofar as illumination and ventilation are concerned. The side walls of a monitor building can be devoted almost entirely to illumination purposes be cause very little of the weight of the roof rests upon them

Monitor Building—Interior

This typical monitor aisle shows two 20-ton cranes, supplemented by jib cranes, mounted on the side columns. Here Diesel engine frames and cylinder blocks are prepared for assembly.

The Austin Company, Engineers & Builders



The Austin Company, Engineers & Builders

Multi-Story Factory Building

The 14-story section of this coffee plant is used as a mixing tower. The roasting ovens are located in the two-story penthouse to the left of the mixing tower. From the ovens the coffee beans are fed directly to the grinding, packaging, and shipping departments below.

The *multi-story type* is useful where the ground space available is limited and when materials may be moved through gravity conveyor systems. It is used in the rayon and coffee-roasting fields, for example. The first disadvantage of this type is lack of flexibility. Natural illumination is possible only when the floor space is greatly restricted in size. The development of the fluorescent lamp, however, may serve to offset this disadvantage.

Many buildings involve *combinations of the three foregoing types.* Since they are especially designed for a particular type of production, they have the disadvantage of not easily lending themselves to changes in productive processes.

Mercantile Layout Layout problems arise in fields other than that of factory production. One of the most important of these fields is retailing. The current trend toward the modernization of retail stores together with the

increase in the factor of self-service makes this of intense interest to the student of business.

As in the case of plant layout, there are several factors that must be taken into consideration when the store owners or executives are contemplating the establishing of a new store or the remodeling of an old one.

Type of Merchandise. The nature of the merchandise carried is basic in the consideration of mercantile layout. The handling and sale of groceries, drugs, hardware, wearing apparel, dry goods, and furniture, to mention only a very few of the many different types of goods sold at retail, give rise to problems of layout peculiar to the particular goods concerned. Furniture, for example, requires a large amount of space for the proper display of the various pieces and suites. Wearing apparel, on the other hand, can be hung on racks but requires mirrors and individual dressing rooms.

Another phase of this same topic, which has a definite bearing on the layout problem, concerns the frequency with which customers purchase the various sorts of goods carried in the store and the ease with which they are sold. For example, eggs, butter, bread, and such articles are being constantly purchased by the customers of grocery stores and require relatively little sales effort on the part of the sales clerks. Certain other types of goods, such as fancy cheese, cakes, and crackers, sell much more slowly and often require sales effort by the clerks to move them satisfactorily. While there is no complete agreement among grocers as to the placement of these goods in planning the store layout, many instances can be found in which the wanted, fast-moving goods are placed at the back of the store so that, in order to reach them, the customers will have to pass the other, slower-moving goods, which are placed nearer to the front of the store. The presumption is that this arrangement will help to bring about more rapid sale of the second type of merchandise. These considerations obviously will determine the placement of the fixtures that these goods require.

Type of Service. In recent years there has been a discernible trend in certain types of stores, notably those handling groceries and meats, toward the self-service type of establish-

ment. In stores of this kind the customers are afforded ready access to the merchandise and are permitted to serve themselves to a great extent. For this purpose wide aisles, display stands, and easily accessible shelving are required.

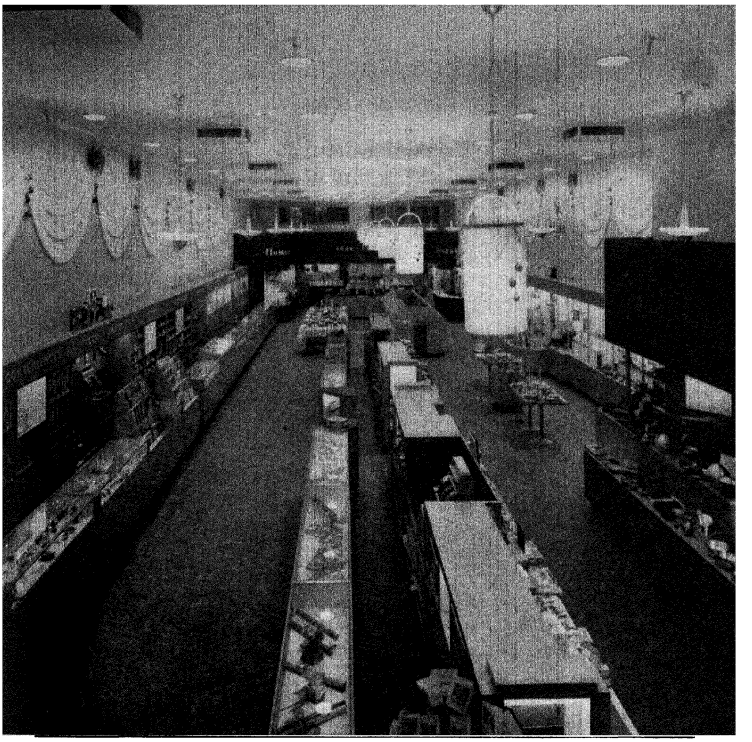
Opposed to this type of store is the older, service kind, in which clerks "wait on" the customers and procure for them the desired goods. Here counters of various lengths are required, and the layout is quite different from that of the self-service store.

Characteristics of Customer Traffic. In many types of stores the usual flow of customer traffic has an important bearing upon the location of the goods. The fact that customers tend to turn to the right upon entering the store is of importance in the placing of certain goods, such as impulse merchandise, on the right side of the store where they will be exposed to the greatest amount of traffic. Impulse merchandise is frequently bought as the result of customers' spur-of-the-moment decisions, which are stimulated by attractive displays that call merchandise to the customers' attention. Examples include such varied types of products as candies, men's neckwear, tobacco products, jewelry, novelties, toilet goods, and ladies' purses.

Methods of Moving Customers. If goods are offered for sale on more than one floor, as in department and specialty stores, there arises the question of the means of affording customers access to the upper levels. Stairs, elevators, and escalators are commonly used for this purpose. The selection of the types to be used and their location provide one of the major layout problems that store executives must solve.

Lighting. The sources of illumination, either natural or artificial, are important elements in determining where goods and fixtures shall be placed. It is essential that displays be adequately lighted so that customers may be attracted to the merchandise and be able to inspect it. In this, as in many of the other items in mercantile layout, the comfort and convenience of customers are given paramount consideration.

Ventilation and Heating. Provision must be made, in planning the layout of a store, for the placing of the heating and



Dennison Manufacturing Company

Retail Store Layout

The interior of this modern retail store is viewed from the front entrance. Note the arrangement of the display fixtures, the wide main aisles, and the equipment for lighting, heating, and ventilation.

ventilating apparatus. In recent years, with the great increase in the use of air conditioning in stores of many kinds, the locating of the required ducts and vents has become a problem calling for careful consideration.

Store Service Requirements. In addition to the foregoing factors, which are principally concerned with those phases of store operation that have to do with customers, there are several others which might be termed "store service requirements." Some of these concern the provision of adequate and correct space and facilities for receiving, marking, and storing merchandise, and for wrapping and packing it for delivery after it is sold. Added to these are the requirements for office space and rest rooms.

Office or Commercial Layout The third major type of layout to be considered is that of office layout, or commercial layout as it is sometimes called. The items to be considered in this connection are quite different from those discussed in plant or mercantile layout. Goods are not fabricated in an office, and the convenience of customers need not be considered in the same way. The problems of office layout are related primarily to the efficient performance of clerical work. They include the following factors.

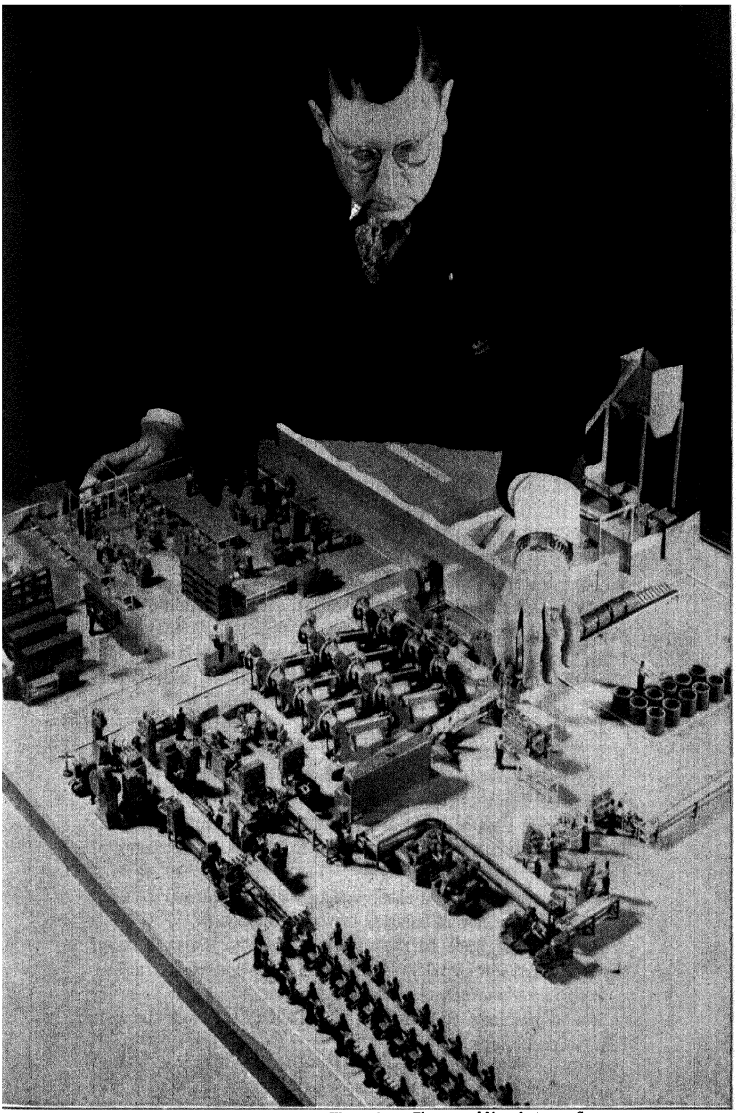
Flow of Work. The course of the flow of paper work through the office governs, to a considerable extent, the layout of the place. Insofar as possible, it is highly desirable to have the work move uninterruptedly through the various departments, following as straight a line as conditions will permit. This will affect not only the placing of departments, but also the locating of desks, files, and other equipment within the departments.

Private Office Requirements. The need for private offices for executives and department heads will have an important bearing on the office layout.

Machines Used. The number of business machines used and the amount of disturbance that they make will determine whether they are to be placed in the general office or given an enclosure of their own. Certain types of tabulating and accounting machinery produce a din so that it is necessary to place them in a separate, more or less soundproof room.

Light, Heat, and Ventilation. These factors must be kept in mind in planning the office layout, as they will weigh heavily among the items that affect the efficiency of the office employees.

Layout Procedures Before actually proceeding to arrange the machinery, fixtures, or furniture in any layout situation—plant, mercantile, or commercial—it is customary for those in charge of the job to set forth their ideas in miniature. They utilize for this purpose a large sheet of paper and small paper, cardboard, or even metal pieces that



Westinghouse Electric and Manufacturing Company

Planning a Factory Layout

By the use of miniature men and machines that are accurately scaled, engineers can plan a satisfactory plant layout.

represent the essential furniture or fixtures. On the paper the outlines of the available rooms with all doors, windows, heating and lighting outlets, and other permanent parts of the building are drawn to scale. On this are placed the pieces, likewise carefully made to scale, in the locations that the real fixtures will probably occupy. In this manner it is possible, to some extent, to foresee the finished layout and to judge its probable effectiveness. Any adjustments to the layout plan that may appear to be needed can be made in miniature, and the results of these changes may be noted before the actual placing of the fixtures is begun. Thus there emerges from this process a much more satisfactory final layout scheme than would probably be the case if this step were to be omitted.

QUESTIONS

1. Why is the selection of the proper location for a plant of major importance to the future success of the business?
2. We associate certain products with certain localities. For example: automobiles, Detroit; tires, Akron; glass, Moundsville, West Virginia; silverware, Oneida, New York; flour, Minneapolis; beer, Milwaukee; and shoes, Boston. Why are these products concentrated in these places?
3. Why are rail rates so important in considering the location of a manufacturing plant?
4. Why are the steel mills not located in Minnesota, near the source of the iron ore?
5. In what lines of business might the development of air-borne freight and express be a factor tending to lessen the importance of plant location?
6. If Southern labor is cheaper than that in other parts of the country, why has not all industry moved to the South?
7. "Interstate trade barriers serve to promote the business of the states that have established them." Is this statement true?
8. Should the owner of a chain of gas stations plan to place his outlets on prominent corners or in the middle of the blocks between busy thoroughfares? Why?
9. Chain stores tend to locate close to one another. Should an independent store seek to locate in a neighborhood already full of chain stores?
10. What is the chief objective of plant layout?
11. In what respects does transportation as a factor in location differ from internal transportation as a factor in layout?

12. In what way is the type of building that is considered best for a factory a location factor? Give an example.

13. Customers tend to turn to the right upon entering a store. What is the reason for this tendency? How may a storekeeper capitalize on it?

14. Why are toilet goods, jewelry, and notions customarily placed on the main floor of department stores, while furniture and floor coverings are to be found on the upper floors?

15. Should an office be laid out with a central stenographic department or with stenographers located in each section where they are required?

PROBLEMS

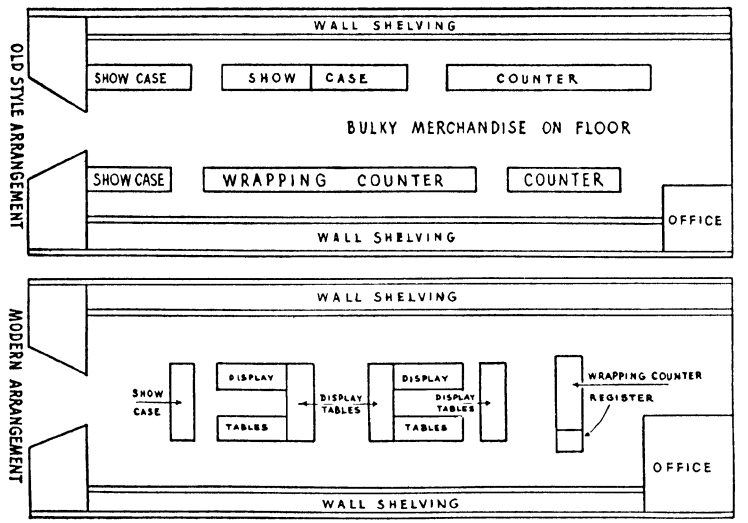
1. Assume that you have the responsibility for determining the location of a grocery supermarket in your community. (a) What location would you select? State fully the reasons for your choice. (b) Draw a map of the area immediately surrounding the location that you have selected. Indicate the location of the store and the nature of the neighborhood from the standpoint of such factors as competing stores, residential areas, public transportation, and parking facilities.

2. Assume that you have been employed by the chamber of commerce of your community or of a neighboring city for the purpose of preparing information that will attract new businesses to the locality. Select a type of manufacturing business, such as a shoe, tire, or airplane manufacturer. Make a survey of the community and prepare a report of its advantages designed to persuade the owners of the business to choose this location.

3. What type of business would you be interested in if you were starting your own business upon the completion of your education? Where would you locate the business? List the reasons for your decision.

4. The diagrams at the top of page 98 show the old and new layouts of a retail store. List the specific advantages of the new layout. What are the disadvantages, if any, of the new layout?

5. Visit one of the following local businesses: bakery, department store, drugstore, garage, grocery store, or laundry. Note the location of the different departments, including the office and store room, and such items of equipment as counters, machines, and display facilities. (a) Draw a chart showing the layout of the business. (b) List the advantages and disadvantages of the present layout. If you think that you can improve the layout, draw a second chart incorporating the changes that you would make.



National Cash Register Company

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CHAPTER 6

PURCHASING AND STOCK CONTROL

The Problem of Purchasing and Stock Control

In the businesses that are engaged in the manufacture and distribution of commodities, there exists the twofold problem of buying and controlling the goods concerned. Factories buy materials of various sorts and fabricate them into the many kinds of goods that are needed in our economy. Wholesalers buy the finished consumer products and pass them on to retailers, who in turn sell them to the final consumers. In the case of industrial goods, such as machine tools and equipment, which are consumed by industry, the problem of the purchase and control of materials customarily ends with the producers because comparatively little of these goods is handled by intermediate sellers between the makers and the users. Not only must materials be purchased, but they must also be subjected to control procedures while they are on hand, in order to make sure that they go to their proper destinations along the production line or within the warehouse or store, and to prevent their being lost. The acquiring of goods is called *purchasing*, and *stock control* is the term used to describe the procedures and methods involved in handling them.

The purpose of this chapter is to discuss the problems of purchasing and stock control as they affect producers of all goods and the distributors of consumer goods. In the fields of manufacturing, goods are customarily called *materials*; in wholesaling and retailing, the term most commonly used is *merchandise*.

PURCHASE OF MATERIALS

Place of Purchasing in Production

Before production of goods can proceed in a plant, the materials that go to make up the product must be purchased and brought into the factory. It is, of course, necessary that the requisite machinery, tools, transportation equipment, and other manufacturing facilities be present. These, however, are more a part of the

construction and layout picture than of production. For the discussion presented here, it is assumed that these facilities have been provided and that what is needed is to acquire the materials of which the finished products will be made. It is the function of the purchasing division to assume the responsibility for seeing that this need is taken care of. Chronologically speaking, purchasing might be regarded as the first step in production. Materials must be purchased before they can be processed.

Purchasing Department That part of the organization of a manufacturing firm that has the task of procuring the required materials for production is known as the *purchasing department.* The head of the purchasing department is usually called the *purchasing agent.* In small plants the purchasing agent and a clerk or two may comprise the purchasing department, while in larger establishments there may be a specialized group of buyers working under the supervision of a purchasing agent, who may bear the title of General Purchasing Agent or, occasionally, Vice President in Charge of Purchases.

Organization and Status of the Department The division of the purchasing work is customarily on the basis of classes of materials rather than according to the use of the materials within the plant. Thus one man might be given authority for the buying of textiles only, rather than all the material needs of a certain part of the shop. He would thus become thoroughly acquainted with all of the factors affecting the textile market.

In some companies the receiving and material stores departments are placed under the purchasing agent as a part of the purchasing department, while in other companies these units are placed under the production manager. When they are part of the purchasing department, control routines can be established to effectuate the naturally close connection between purchasing, receiving, and storage. When they are under the production manager, interdepartmental liaison must be established so that they can work closely with purchasing.

There is some variation in the status of the purchasing departments within the companies where they operate. In

recent years there has been a discernible trend toward giving them equal standing with sales, production, and finance. This has come about through a growing recognition of the importance of the purchasing function and the need for divorcing it from the other divisions.

In companies in which purchasing is not a separate entity, it may be placed under the production manager or in the treasurer's department. In very small firms the job of purchasing agent may be a part-time activity, handled by one of the executives or members of the firm in addition to his other duties.

Purchasing Department Procedures

For the purpose of securing the materials needed by the company, the purchasing department places orders with vendors who are in a position to supply these goods. The act of placing these orders, important as it is, is merely the final step in a long series of carefully planned and executed procedures.

As a means of simplifying the examination of these practices, the steps leading up to the purchase and receipt of certain materials will be traced.

(1) The Need for Material Is Recognized. In the case of those plants where products do not vary greatly over long production runs and where the process involves repetitive manufacturing processes, the need for materials makes itself known in the stock room. Records are established there that will call for the issuance of a purchase requisition when the stock of any item gets down to or below the predetermined minimum. The *purchase requisition* serves two purposes: (a) it sets forth the necessary details and specifications to guide the purchasing department in buying; and (b) it serves as a warning that the stock of the item in question has reached a point where a reorder is required at once to prevent the company from being out of it with a possible consequent production delay.

Another type of producer, known as a *job shop*, has certain manufacturing facilities, such as machine tools or foundry equipment, that are available to make almost anything that his customers want. What is being produced in a plant of this type at any given time is what the current customers have

REQUISITION TO PURCHASING DEPT

DATE April 3, 1947 P O #

FOR Production Department ASSEMBLY ORDER No. --

DATE REQ RED April 24, 1947 DEPT No 2-C SHOP ORDER No --

QUANTITY	DESCRIPTION	RESERVE FOR PURCHASING DEPT
2	M-13-640 Motors	
3	M-79-640 Motors	

CHARGE Dept. No. 2-C

Make separate requisition for different character of items
One item only per
If poor quality, unsatisfactory give particulars
Specify date item when wanted
Do not speed by at once when time can be allowed

Req By C. A. Pritchard

Counter Signature Charles Miller

Purchase Requisition

ordered; and it may differ radically from what will be made six months hence. In factories of this kind the request for the purchase of something probably comes from the plant superintendent or works manager, who determines what is needed for a particular job, rather than from a stock clerk who notices that the stock of an item is low.

(2) The Supply Market Is Investigated. Before the purchasing agent is ready to place orders for requisitioned items, he must have an exhaustive investigation made of the supply market for all commodities that his firm might need. He must know all the suppliers, whether producers or industrial distributors, their products, their prices, the quality of their wares, their terms and discounts, their reputations in the trade, and anything else that will enable him to perform his buying function more intelligently and to the advantage of his firm.

To keep a permanent record of the essential and pertinent information that is required for satisfactory purchasing, the agent must set up a special file for all suppliers. Then, when a requisition comes to the purchasing agent, he can turn to this file and ascertain the names of suppliers of the wanted item as well as complete information about them.

(3) Specifications Are Established. Industrial purchasing conforms almost entirely to specifications, which are established by the purchasers. These specifications originate, usually not with the purchasing department, but customarily with the engineering staff. In setting up specifications, scientific accuracy is desirable in order that the purchasing department may be enabled to purchase materials that will do the job required of them but that are not too good for the task at hand. It is uneconomical to buy a certain grade of material when a lower and cheaper grade will give satisfactory service.

Many industrial goods have industry-wide standards that are commonly recognized and accepted by all users. Nuts, bolts, screws, washers, steel bars, raw cotton, lumber, and many other finished or semifinished goods come into this category. In specifying these items, the engineering department merely indicates to the purchasing department the industry grades desired.

(4) Purchasing Negotiations Are Started. In the case of certain standardized products that are bought frequently, or in those instances in which the wanted items have been purchased before on a satisfactory basis, the order may be placed as soon as the requisition is received. This is particularly true if the price tends to remain stable over long periods of time. This procedure, known as *routine purchasing*, comprises no small part of the work of the average purchasing department.

In the case of goods for which the price is not stabilized, or when the company has never made a similar purchase before, or when no industry standards are available, the purchasing agent may send *letters of inquiry* to several suppliers, stating the company's needs and inviting them to submit bids or to call and demonstrate their products. Following this, there may be a series of conferences between the suppliers' representatives and the purchasing agent, who may call in the engineer or the plant superintendent to aid him in deciding on the best source of supply for the needed item.

Sometimes the selection of a source of supply is made on the basis of *sealed bids*. When this method is used, the pur-

chasing agent provides to prospective suppliers complete information in the way of specifications and quantities needed. The suppliers who are interested submit secret, written offers on or before a certain date, at which time the bids are opened and the order is given presumably to the lowest bidder.

(5) The Order Is Placed. It is the practice of most companies to execute a formal *purchase order*, specifying carefully all the facts pertaining to the transaction, such as an exact description of the goods wanted, the unit prices, the quantities desired, the delivery dates, the discount terms if any, shipping instructions, billing instructions, and an identifying order number. Any other details that may have been

ORIGINAL

PURCHASE ORDER

ANCO COMPANY

10501 Haggerty Ave

DEARBORN, MICHIGAN

No. B 5156

F O B	TERMS	DELIVERY REQUIRED	VIA	DATE
Chicago	n/30	4/19/47	Motor Truck	4/5/47

B. A. Hanson Company
6402 South Michigan Avenue
Chicago, Illinois

JOB NO --

ACCOUNT NO 22-78

QUANTITY	UNIT	DESCRIPTION	PRICE
2		M-13-640 Motors	$115.00
3		M-79-640 Motors	92.50

Order Number must be plainly shown on each Package Invoice and Packing List Mail Invoice at time shipment is made

ANCO COMPANY

By N B Benson

PURCHASING AGENT

Purchase Order

agreed upon in the course of the negotiations should be set forth clearly. The order should be so drawn that there is no chance for misunderstanding on either the buyer's or the seller's part. In some companies the signature of the purchasing agent is sufficient to validate the order, while in others the signature of a financial officer, such as the controller or treasurer of the company, also is required.

The original signed copy of the order is sent to the vendor; a carbon copy is kept in the purchasing department; and additional copies may be sent to any or all of the following departments: the receiving room, the accounting department, the inspection department, the department initiating the order, and the stock room.

(6) The Order Is Followed Up. In many concerns it is standard practice for the purchasing department to install and operate an order follow-up system that is designed to keep the purchasing agent informed about the status of all outstanding orders. Inasmuch as the delivery dates are calculated so as to bring the goods into the plant the shortest possible time before they are to be used, it is extremely important that the buying company know whether or not its order is progressing according to schedule and if it will be shipped on time. The follow-up man contacts the seller some time before the shipping date to discover if all is well with the order. He checks with him shortly before the goods should be shipped and on the day of shipment. After they are *en route*, he keeps in touch with the transportation company to make certain that there are no delays from that angle. If a delay develops somewhere along the line between the time the order is placed and the time the goods are received, he moves quickly to see that the trouble is remedied and that the progress of the goods is resumed.

(7) The Goods Are Received. When the goods arrive, they should be checked against the copy of the order by the receiving clerk to make certain that all of the provisions of the purchase order have been met. With certain types of goods it may be desirable to institute an inspection routine in order to check on the quality of the shipment. If the shipment is correct in both quantity and quality, the goods can be sent to

stock, and the vendor's invoice may be certified for payment. If there are any discrepancies between the order and the shipment, the purchasing department should be notified in order that the shipper can be contacted and the error remedied.

Purchasing Department Records The records that an efficient and well-managed purchasing department should keep are very important to its continued satisfactory operation. Even the smallest department must maintain most of those listed below, as its problems differ from those of large companies mainly in extent and complexity rather than in kind. These records should provide the answers to the following questions: Who makes the item? From whom have we bought it before? What has our experience been with our suppliers? What are the prices? With whom have we placed outstanding orders? What is the present status of these orders?

List or File of Vendors. Perhaps foremost in the records of the purchasing department is the list of vendors, manufacturers, jobbers, and distributors who carry the types of goods that the company needs for its production processes. This list should include not only the names and pertinent data concerning the actual suppliers from whom purchases have been made in the past, but also all obtainable information about other vendors in these fields. The necessary data would consist of the names and addresses of the companies, the names of the officers to be contacted, the transportation situation, the time required for delivery, order sizes, and minute descriptions of the items handled. The more complete the information on each supplier, the more valuable the record will be to the purchasing department. Of particular value are the records of past performances of the various vendors, of their promptness of delivery, of the accuracy with which they filled their orders, of their adjustment policies, and of their adherence to their promises.

Catalog File. It is desirable that a catalog file of all suppliers be established and kept on an up-to-date basis. This may be maintained as a part of the list of vendors, or it may be kept separately.

Quotations File. A file should be maintained that gives the history of past quotations that the company has received, whether or not they were followed by the placing of orders. This amounts to a price file, by vendors and commodities, that has both historical and present data, which are always valuable when purchases are being contemplated.

Specifications File. If the manufacturing processes of a company involve the use of materials for which specifications have been established by it, these details should be embodied in a specifications file. This record is a timesaver to the purchasing personnel.

Records of Purchases. Purchase records should be kept by commodities, by suppliers, and by purchase order numbers. This three-way classification expedites the task of referring to these records at some future date. If the reference is for the purpose of checking on commodities, the first classification serves the purpose. If it is desired to check on the sources, the second classification fits into the picture. The arrangement of the purchases by purchase order numbers provides a check on the completeness of the records because of their numerical arrangement.

File of Outstanding Orders. This is sometimes called the *order tickler* or *follow-up file.* It serves as a record of all purchase orders that have been placed for which shipments have not been received. This record furnishes the information upon which is based the necessary follow-up of outstanding orders, so as to assure their being received on time.

Purchasing Policies

In addition to the purely procedural aspects of purchasing, which have just been discussed, there is the matter of purchasing policies. Some of the policies that govern the purchasing department may originate in that department and be decided by the purchasing agent, while others may arise in other parts of the plant and require that the executive heads of the company confer and establish the policies to be followed.

Decision to Purchase or to Manufacture. The decision as to whether to purchase a certain part required in fabricating

a firm's product or to manufacture it, is obviously one that transcends the scope of the purchasing department and becomes a matter of company policy. The part that the purchasing department plays in the formulating of a rule in this regard is to furnish the company executives with sufficient information concerning the supply market for the item in question so that they may be enabled to make a wise decision. The purchasing department should be constantly alert to any changes in the supply market that might influence the company heads to change their minds.

Hand-to-Mouth Buying versus Forward Buying. The basic difference between hand-to-mouth and forward buying lies in the size and frequency of purchase of any given item. There is no exact line of demarcation between the two, but purchasing departments are frequently knowingly committed to one or the other. The condition of the price aspect of the market customarily determines which of these policies will be followed. If prices tend to fluctuate rather unpredictably at frequent intervals, hand-to-mouth buying will probably govern the purchasing in order to minimize the risk of loss through inventory depreciation. On the other hand, if prices tend to be relatively stable over long periods of time, the company may be willing to commit itself to larger purchases at each ordering period, with longer intervals between orders.

Another factor that warrants consideration by many companies is that of the amount of capital that is tied up in their inventories of materials and parts. In recent years the concept of frequent turnover of inventories, with consequent savings in storage space required, minimizing of risk of spoilage and damage, and the release of capital for other uses, has gained a number of adherents. Theirs is the philosophy of hand-to-mouth buying, the making of more frequent purchases of smaller amounts of materials. These firms have found, in many instances, that the savings they are able to effect through this policy more than offset the added expense of purchasing, transportation, and receiving.

There is doubtless a point beyond which this policy cannot profitably be carried, when order sizes become so small and orders so frequent that the added costs more than offset the

savings. Each company must determine this point for itself in the light of its own experience.

An additional determinant, which may have an important bearing on the action of any company in this matter, is the condition of the supply market. This will consist of a number of factors, such as the attitude of suppliers toward hand-to-mouth buying, the effect of transferring a part of the storage burden back to the vendors, the continuous or intermittent nature of the suppliers' productive processes, and the year-round availability of the goods.

Market or Speculative Purchasing. In contrast to the buying that arises directly from the current need for certain items, there is what is known as *market* or *speculative purchasing.* This means that the purchasing department, believing that prices of certain items are going to rise appreciably in the near future, places orders for them in quantities far in excess of their usual amounts. This is done to take advantage of the anticipated price rise. If the amount ordered or the terms of buying bear little relationship to the current needs of the company, the speculative nature of the transaction is even more marked.

The principal danger in market purchasing, apart from the amount of capital it ties up, lies in the possibility of an unforeseen price drop, which may not only wipe out the anticipated advantage that inspires this policy, but also entail a severe loss if the price decline is sufficiently far-reaching. Many businessmen believe that the proper function of a purchasing department is to buy materials to the best advantage *at the time they are needed,* and not to engage in extraordinary purchasing except where necessary to protect the company's supply against possible future shortages. An alert purchasing agent, however, constantly studies price trends and, if he thinks he discerns price increases in the immediate future, the temptation to try to take advantage of the situation may be overwhelming. If he guesses correctly, his company may benefit and his own prestige may be greatly enhanced.

Many or Few Suppliers. A purchasing agent must usually decide whether to make his purchases from a large number of suppliers or to concentrate on relatively few of them. If

he adheres to the first policy, he may avoid having too few suppliers and hence always be able to find alternate sources if anything should happen to remove some of them from the market. On the other hand, the policy of spreading his business among many vendors will result in his being the favored customer of none of them. This is one of the dilemma-like situations that businessmen constantly face and which require them to weigh carefully the factors on both sides of the question before coming to a decision.

Splitting Large Orders. Closely related to the point just mentioned is the question of whether large orders should be split among several suppliers or given to one vendor. The idea here is that by giving the business to many suppliers, contacts are maintained with all segments of the market, avoiding the "eggs in one basket" situation. Also, it is sometimes possible to secure more rapid delivery of many small orders than a single large one. On the other hand, the concentrating of a large purchase in a single resource may result in favorable price concessions and in the supplier's giving priority to the large order in his plant.

Reciprocal Buying. *Reciprocal buying* means buying from customers or, stated somewhat more explicitly, favoring customers over prospective vendors who are not customers when purchase orders are being placed. For example, a producer of motor trucks might buy coal only from a coal company that uses its trucks for delivery. While this practice has been universally condemned as uneconomic and wasteful, it still persists in many lines of trade. The arguments against it are that it narrows the field of suppliers and that it may result in the buyer's paying higher prices and possibly in his failing to procure exactly the sort of goods that he requires. The main argument in favor of reciprocal buying is that it helps to hold customers, a rather powerful persuasive factor.

Contract Purchasing. *Contract purchasing* is the policy of a company entering into contracts with its suppliers covering the purchase of certain materials, the delivery of which will be effected over long periods of time. There are two reasons for this practice—to protect the supply and to take advantage of low prices prevailing at the time the contracts are executed.

Buying Ethics. Unfortunately the field of purchasing has not always been entirely free from some rather sharp practices on the parts of the buyers. These have ranged from indiscriminate and pointless cancellations to the use of falsehoods in playing off one vendor against another. Needless to say, these practices do not redound either to the credit or the long-time advantage of the perpetrators. Most firms recognize the value of ethical dealing with their suppliers as well as with their customers.

Calculation of Purchase Quantities

One of the problems that confronts a purchasing agent is that of determining how many units of the various needed items he should order at one time. In the case of certain items such as factory equipment, machine tools, desks, files, and similar articles, this question usually is not raised as he knows exactly how many are needed and he orders accordingly. With a large number of other items, such as nuts, bolts, washers, semi-finished parts, and small castings and forgings that are used in the manufacturing process, it is necessary to decide upon the most economical purchase quantities and to adhere to these amounts in ordering.

In view of the wide diversity of materials that enter the industrial channels of trade, it is not feasible to indicate at this point the complicated mathematical formulas that have been developed to arrive at the proper purchase quantities for any single commodity. It will suffice to call attention to some of the factors involved.

Manufacturers' Shipping Package. Most manufacturers of small items have their own predetermined shipping packages —single units, pounds, dozens, gross—from which they are somewhat loath to depart. Purchasing agents tend to order these items in multiples of the manufacturers' shipping packages.

Time Required from Order to Delivery. The number of days that ordinarily elapse from the time that the order is placed until the goods are received is an important factor. Past experience with each vendor or the word of the vendors' representative will provide this information.

Rate of Consumption within the Factory. The number of pieces used per day has an obvious bearing on the calculation of purchase quantities.

Transportation Rates. The rates charged by each type of carrier for the transportation of various quantities of the commodities in question must be taken into consideration by the purchasing agent. For example, he may find it advisable to order in carload quantities and thus take advantage of the lower shipping costs as compared with those involved when less than carload lots must be handled.

Safety Factor. To the quantities that result from the blending of the preceding items are added safety factors to allow for such things as transportation delays, production breakdowns, and other unforeseeable but possible mishaps that might postpone the delivery dates of the ordered goods.

Once established, these purchase quantities tend to remain constant over long periods of time or until one of the determining factors undergoes a significant change.

Policy on Order Cancellations The determination of a policy in regard to order cancellations requires careful consideration of all factors involved. Situations are bound to arise in the conduct of any business when it seems to be the part of wisdom to cancel certain outstanding purchase orders. The reasons for this action may be unfavorable price changes since the orders were placed; cancellations of orders by the firm's customers, thereby eliminating the need for the ordered goods; the presentation of more attractive purchase propositions by the vendors' competitors; sudden model changes instituted by the buying company; and others.

Some concerns have a policy of never canceling orders, regardless of the circumstances that might indicate the wisdom of such action. They hope to achieve reputations as reliable customers and to enjoy the benefits that flow from this policy. Others have no compunction about sending in cancellations on almost any pretext, regardless of the reactions among their suppliers. The ideal policy would be somewhere between these two extremes and would depend to a large extent upon the nature of the business and of the goods re-

quired by it. There are instances in which the solvency of a small concern might be seriously threatened by its not canceling an order for goods that it could no longer use because of changes in its situation since the order was placed. On the other hand, it sometimes happens that the temporary advantage that might be gained through canceling certain orders would be more than offset by the ill will engendered among the affected suppliers by such action. In a sellers' market [1] the firms with the reputations for frequent cancellations do not usually fare as well as those which are less prone to such practices.

Ordinarily the manufacturer or seller who receives an order cancellation accepts it without objection. If the amount involved is large, however, and particularly if the product is made to order or to the buyer's specifications, he may protect himself by resorting to court procedure to force the buyer to live up to his agreement.

HANDLING AND CONTROL OF MATERIALS

Methods Used in Handling Materials

From the moment that industrial materials arrive at the receiving platform or yards until they emerge as the completed product and are loaded for shipment to customers, they must be handled and moved from place to place in accordance with the nature of the finished product and of the materials themselves. The movement from the receiving room is frequently to stock rooms, where the materials are stored until they are needed in production. Then they must be taken to the point of the first application of the production process and thence through the manufacturing routine until the finished product is ready to be shipped or sent to storage to await future shipment.

The methods used are many and varied and are determined by the nature of the materials and by the layout of the factory buildings as well as by the type of product being made.

[1] A *sellers' market* is a situation in which the demand exceeds the supply and in which vendors are in the position of choosing the customers to whom they will sell their goods. In other words, the market advantage is on the sellers' side. A *buyers' market* is one in which these conditions are reversed, and the buyers enjoy the more advantageous position.

No small part of the cost reduction in manufacturing that has taken place in the past few years has been achieved through improvements in the handling and moving of materials. Whereas in the early days of manufacture most of the moving of materials was done by hand with trucks and skids, recent years have seen a definite swing toward mechanical conveyors. Gravity has been harnessed, whenever possible, for this purpose and in many industries supplies almost the entire motive power for materials handling. Because of the multiplicity of devices in common usage and the specialized nature of the handling problems in each industry, the various conveying methods will be merely named here, and no attempt will be made to describe them or to suggest the ways in which they might be employed. Chief among these devices are overhead cranes, conveyor belts, roller conveyors, pipe lines, trucks, and overhead conveyors.

Handling Materials

In this warehouse overhead conveyors are used for handling and moving bags of sugar.

Cleveland Tramrail

Storage of Materials As with handling, the storage of materials is to a large extent a problem the solution to which is dependent upon the nature of the goods and the manufacturing processes to which they are subjected. Coal and iron ore are usually stored on the ground; liquids such as chemicals, paints, and oils are kept in tanks; small metal parts are stored in bins in stock rooms; and so on.

Stock rooms may be centralized or decentralized, depending upon the area covered by the production division and the rapidity with which the stored materials are consumed in manufacture. The basic idea back of the stock room operating policy should be that of having the materials available for production at the times they are wanted, in such quantities as to ensure unbroken operation of the production facilities and yet not to impede free movement of the operating personnel in performing their duties.

Storage of Materials

In this modern storeroom steel shelving provides visible, accessible storage of manufactured parts.

Lyon Metal Products, Inc.

Types of Storage There are three possible types of materials for which the management, in any but the most simple kinds of manufacturing processes, must provide storage.

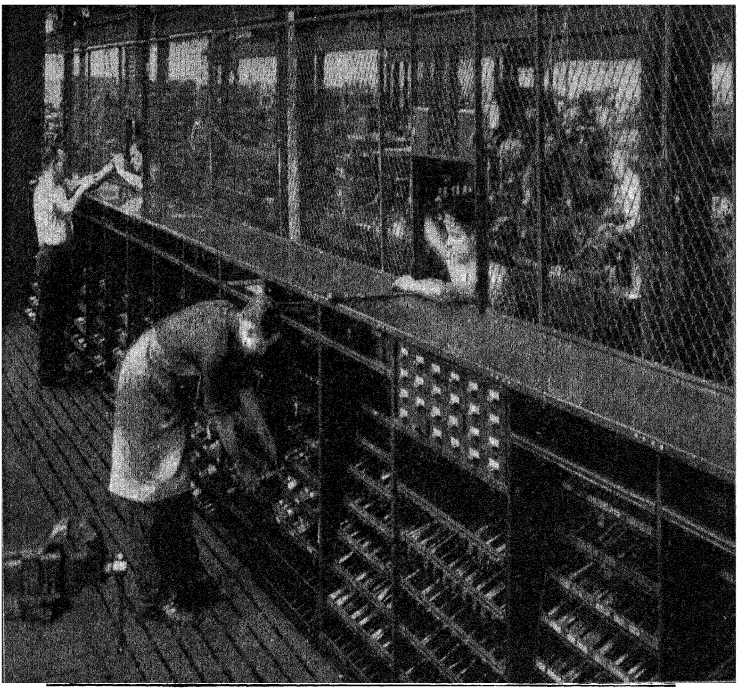
Raw Materials Storage. These materials, which have been received from other manufacturers, are scheduled for processing, which will result in radical changes in their form, their appearance, and in the case of chemicals their composition. Among them are ores, chemicals, paper pulp, castings, forgings, and supplies, such as cutting and lubricating oils and greases.

Semifinished or "Worked-Materials" Storage. Many goods are subjected to certain manufacturing processes and are then returned to the store room where they are held until they are needed for assembly into the finished products. Included in this category would be articles purchased in completed form from other producers that will not be further processed but merely included in the final assembly. Small motors, lenses, carburetors, and oil filters are examples of this latter group.

Finished Goods Storage. After manufacture is completed, many items are placed in stock to await shipment to customers.

Storage for each of these three types of materials presents its own problems and requires appropriate fixtures, storage facilities, and control records. The equipment includes all sorts of bins, racks, hooks, tanks, and handling devices in which flexibility, ease of access, and removal are of paramount importance.

Materials Control Industrial materials are placed under a system of strict control as soon as they reach the receiving department; and they remain under it, in one form or another, until the finished product is delivered to the shipping department for shipment to a customer. This control, which takes the form of records and procedures, is designed to keep the management constantly informed of what materials and how many units of each are in the plant, and in what departments they are located. It provides a written record of the transfer of materials from one department to



Lyon Metal Products, Inc.

Materials Control

Tools that are needed in the manufacturing processes of this plant must be secured from this stock room. Note the card-file drawers.

another, and it serves as the authority for such movement. It is likewise important as a source of cost data for the cost accounting department.

Control Procedure While there is some diversity of detail in the control of materials in different industries, the basic procedure is about as follows. As indicated on page 105, when goods arrive at the receiving department, they are carefully checked against that department's copy of the purchase order to make certain that all details of the order have been faithfully complied with by the vendor. The receiving department fills out a *record of materials received* that states the date received, the number of packages, the weight, the purchase order number, the transportation information, description of the material, and other pertinent data.

When the material is delivered to the storekeeper, another record, a *material-received report*, is made out to indicate its receipt in the storeroom. If the goods are to be held in stock, *bin tags* are made out. These give the date of receipt, the amount, the purchase order number, the location within the stock room, and a short description of the items.

Copies of the material-received report may be sent to the purchasing and accounting departments and to the balance-of-stores clerk in the stock room office. The *balance-of-stores record* is a perpetual inventory of material in the stock room. All incoming goods are checked in, and all outgoing materials are checked out. The balance on hand on the record and in the bins should always be the same. There may be an allowed variation between these two amounts in the case of certain items that are counted by weight rather than by number. Nuts, bolts, washers, and cotter pins are examples of materials that are counted by weight.

When material is needed in the factory, a requisition is made out, requesting the storekeeper to issue a stated number of pieces of the needed items to the production department and stating the production order number to which the transaction is to be charged. This requisition goes first to the balance-of-stores clerk so that the proper entry can be made on his record. It then goes to the issuing clerk who fills the requisition, prepares an *issue ticket*, and sends the material on its way. A clerk in the department that requested the materials usually signs the issue ticket to acknowledge receipt of the needed materials. Copies of the requisitions or issue tickets are sent to the accounting department for the purpose of cost keeping.

When the material reaches the production department that ordered it, *work tags* are made out and attached to it. These work tags identify the material and the production order to which it is to be charged. Spaces are provided for periodic counts as the material moves from one operation to another. These tags remain with the material until it is either returned to the stock room for further storage or loses its separate identity through assembly into some larger unit. This process is repeated until the finished product emerges at the end of the production process.

When material is returned to stock, the balance-of-stores clerk is notified, a record of material received is made out, bin tags are written, and the material is placed in the proper receptacle.

As has already been indicated, when the stock of an item reaches a predetermined minimum, the purchasing department is informed so that a purchase can be made and the stock replenished before it is completely exhausted. The balance-of-stores record is the usual source of this action, and part of the duties of the clerk in charge is to watch his inventory figures carefully and to notify the purchasing department as soon as any item needs to be reordered.

PURCHASE AND CONTROL OF MERCHANDISE

Purchasing in Nonmanufacturing Enterprises

The problem of purchasing in wholesale and retail businesses differs from that in manufacturing enterprises. In the former the goods are purchased for resale without change in form, whereas in production they are subjected to some kind of processing before being sold again. Thus wholesalers and retailers buy only finished goods, and the major factor that determines which items shall be purchased is the probable salability of the goods to their customers.

Buying Personnel—Wholesalers. In wholesale establishments, the persons who do the purchasing are known as *buyers*, except in those cases where the smallness of the firms forbids the employment of buying specialists, in which cases the buying function is assumed by one of the company heads. Larger concerns quite commonly employ a number of buyers, each concentrating on a group of related items. For example, in a grocery wholesale house there might be a buyer for the fresh fruits and vegetables, one for canned goods, one for fancy groceries, and one for cereals, flour, and other staples.

Buying Procedures—Wholesalers. Wholesale buying procedures are relatively simple and divide themselves into two kinds: original buying and repeat buying. In the case of original purchase, the buying of goods that have not been handled before, it is customary for the salesmen to contact

the buyers and to demonstrate their wares, either in the manufacturers' showrooms or at the wholesalers' places of business, If the sale is consummated, a purchase order is made out, indicating the goods involved and such other data as prices, terms, delivery dates, and transportation methods. The purchase order forms are not essentially different from those used by industrial purchasing agents, except that the specifications cover finished goods rather than industrial materials. The original incentive to make the purchase may come from several sources, such as advertising matter put out by the makers, visits by salesmen, or requests from customers.

Where repeat purchases are made, and in many lines these comprise the bulk of such operations, they are usually handled by mail on a purely routine basis. The incentive to make the purchase comes, usually, from the fact that the stock records indicate that the supply of the items to be purchased has fallen below the prescribed minimum requirements. The purchase order procedure is identical with that described above.

Buying in Retail Stores. While retail buying in both large and small stores follows the same general pattern, there is a notable difference between the carefully determined practices of the department stores, the chain stores, and the specialty stores on the one hand, and the unorganized buying procedures of small stores on the other.

Retail Buying Personnel. In the larger stores the purchasing personnel are called *buyers* and customarily are in complete charge of the departments for which they buy, including in their duties responsibility for sales, stocks, and personnel. Each buyer specializes in a relatively few, closely related items and becomes quite expert in these fields. For example, in a typical department store there will be a furniture buyer, a toiletries buyer, a housefurnishings buyer, and others.

In the chain stores the personnel are likewise known as buyers, but they are usually located at some central buying office, which may or may not be located at a merchandise warehouse. They customarily confine their activities to buying and have no other responsibilities.

In small stores the proprietors usually do the buying along with their other managerial and entrepreneurial duties.

Retail Buying Procedures. In the larger stores and the chains, the buyers frequently take the initiative in seeking out new goods and make regular trips to the market centers for this purpose. They customarily buy the bulk of their merchandise direct from the manufacturers and employ wholesalers only rarely.

Their buying practices for original purchases are simple and involve viewing of available lines of merchandise, selecting of the desired items, and making out the order. The order forms are much like those already described. Repeat buying is a routine procedure, usually handled by mail. The incentive to make original purchases arises from goods seen on previous market trips, magazine advertisements, competitors' offerings, and occasionally from customers' requests. The incentive for repeat buying comes from the stock cards when the on-hand figures show that the stock is below the established minimum.

The chain stores follow the same general procedure, except that in the grocery field the salesmen come to the buyers, as a general rule.

Buying in small stores may take place in the stores with the wholesalers' salesmen in attendance or in some instances at the wholesalers' warehouses. Retailers' purchase order forms for these stores are practically unknown, and the orders are taken on the wholesalers' blanks. Frequently the wholesalers' salesmen enter the stores, count the retailers' stocks of the goods concerned, and make out the orders for the quantities that they believe should be purchased. This procedure, of course, applies only to repeat purchases. For original purchases the salesmen display the goods and endeavor to persuade the retailers to purchase.

In the large stores careful preparations are made by the buyers well in advance of their trips to the market. *Buying plans*, which set forth in some detail the types, sizes, and prices of goods to be bought, are prepared and followed quite closely during the market experience. Dollar limits to the amount of money to be spent are established, as well as the approximate retail prices at which the goods will be offered.

In the small stores this sort of buying preparation is almost completely lacking, and buying is done more or less on the spur of the moment when the wholesalers' salesmen appear.

Stock Control in Wholesaling and Retailing Because of the essential similarity between the stock control methods of wholesalers and those of retailers who keep such records, they will be discussed together. The department and specialty stores and the chains maintain fairly elaborate stock control records as a guide to purchasing and to account for the merchandise that they handle. In the smaller stores such records are almost unknown and stock control is practically nonexistent.

A typical stock control record would consist of a file of cards, one for each different type of goods, which provide for complete descriptions of the items and their sources, together with spaces to record the arrival of merchandise, its outward movement as the result of sales to customers, and the current balance of stock on hand. Minima are computed for those items subject to repeat purchase for the purpose of notifying the buyers when the stock of these items is getting low.

Wholesalers customarily maintain these records for all of their merchandise, as do the chains. Department and specialty stores do likewise for goods for which repeat purchases are made and for some types of merchandise that move slowly and of which a reserve stock is kept in stock rooms. Many kinds of goods, however, such as women's apparel, toiletries, and accessories, sell so rapidly that the entire stock is carried in the selling departments (forward stock), and only the most rudimentary stock records are kept, if indeed any are kept, on many fast-moving items.

QUESTIONS

1. Under what circumstances and for what kind of business might it be advantageous to have the purchasing department under the supervision of the production division? When is it better for the purchasing department to be a separate unit of equal status with sales, production, and finance?

2. In department stores a buyer (or department manager) frequently has charge of both buying and selling. This situation is practically never duplicated in manufacturing. Why?

3. Under what circumstances should the receiving and stores department be a part of the purchasing department? Of the production department?

4. Under what circumstances should the inspection department be a part of the purchasing department? Of the production department?

5. Give several examples of a job shop.

6. Should a company adopt rigid policies with regard to hand-to-mouth and forward buying?

7. Is speculative purchasing a permissible activity for the purchasing agent?

8. Describe some unethical buying practices, other than those mentioned in the chapter. Why are they unethical?

9. Some companies permit vendors' salesmen to talk to the engineer, the production manager, and even to the foreman and workmen, while others insist that all contacts be made only with the purchasing agent. Which policy is better?

10. Is there too much "red tape" in requiring that all material needed from the stock room be formally requisitioned and receipt acknowledged?

11. The owners of small stores rarely prepare buying plans, such as department store buyers do. Should they be criticized for this omission?

12. Elaborate stock records are kept in furniture stores, but grocery stores rarely keep any. What is the reason for the difference of practice in these two types of stores?

13. What purpose is served by each of the following: purchase requisition, specifications, letter of inquiry, sealed bid, purchase order, file of vendors, order tickler, balance-of-stores record, issue ticket, work tag?

PROBLEMS

1. In the Neilson Company, purchase requisitions are prepared in duplicate, the original for the purchasing department and the other copy for the department that issues the requisition. Five copies of each purchase order are prepared as follows: copies 1 and 2, for the vendor (the second of these copies is returned by the supplier as an acknowledgment of receipt of the order); copy 3, for the purchasing department; copy 4, for the receiving department; and copy 5, for the department that issued the requisition.

Show by diagram the purchasing procedure of the Neilson Company from the time the purchase requisition is made out until the goods are received. Indicate in the diagram the disposition of each copy of both forms.

2. The purchase price of item XC-437 is as follows: not exceeding 500, $1.66 per item; more than 500 but not exceeding 1,000,

$1.62 per item; more than 1,000 but not exceeding 2,000, $1.60 per item.

For each of the following purchases determine the cost per item, taking into consideration the purchase price and the cost of transportation: No. 1, 2,000 items, freight charges (carload rate), $120; No. 2, 1,000 items, freight charges (less than carload rate), $80; and No. 3, 400 units, express charges. $40.

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CHAPTER 7

PRODUCTION PROCESSES

Meaning of Term "Production" As the term is used here, *production* includes those economic activities that are concerned with producing or making things. This is a somewhat narrower concept than that employed by some economists, who include the marketing part of the economic picture under the general heading of production. It is, nevertheless, in accord with the common usage of the term as found in business.

Meaning of Production Processes *Production processes* are the methods by which industrial materials are produced or manufactured into the things that consumers or industry want. The discussion in this chapter does not attempt to include all of the many different types of businesses that engage in production, nor should the student presume that the production control methods outlined here are used by all producers. Many kinds of businesses operate on such a small scale that the use of modern methods of production control would appear to be an absurdity. Plumbers, custom tailors, earth movers and excavators, small machine shops, greenhouses, and a host of other similar small businesses with few employees and relatively simple processes have no particular need for the complicated control mechanisms that are imperative in large-scale productive enterprises. The methods described here are employed by producers who range in size from operators of moderate proportions up to the industrial giants of the automobile and steel industries.

Types of Production Processes According to one classification, production processes are identified as extractive, analytic, synthetic, and fabricating. A second classification includes two types of processes: continuous and intermittent. Each of these six processes is discussed briefly in the sections that follow.

Extractive Process. In some industries the basic productive process is one of extracting substances from the earth or the sea. Examples of this process are the mining of coal, iron ore, lead, gold, and silver; drilling for petroleum; and the extraction of magnesium and other chemicals from the ocean. Farming and fishing may be called extractive industries, but they are on a different ownership and operating basis from the above illustrations.

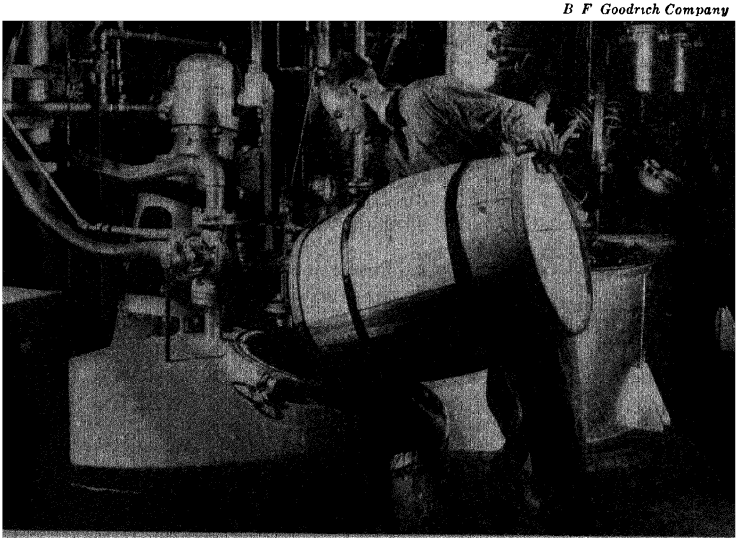
Analytic Process. This is a process in which a basic substance is broken down into a number of other materials, which may or may not bear any resemblance to the parent substance. In this category come petroleum refining, meat packing, and lumber milling.

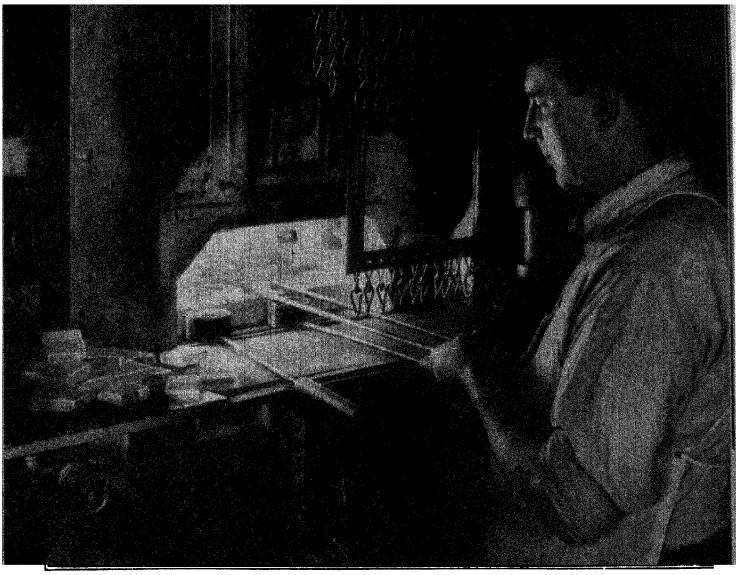
Synthetic Process. This term is applied to those industries in which a number of different materials are combined or assembled to form a single product. The manufacture of rayon, automobiles, steel, radios, and many other commodities is included in this classification. The terms "analytic" and "synthetic" represent processes that are the opposite of each other.

Synthetic Process

This step in the manufacture of synthetic rubber shows a worker adding soap to a solution that is mixed in a nickel-lined tank.

B F Goodrich Company





Eastman Kodak Company

Fabricating Process

Optical glass is softened in a furnace at a temperature of 1600 degrees before it is molded into lens discs.

Fabricating Process. This term, while used mainly in the structural steel industry, describes a rather widespread process wherein a material has its form changed somewhat through being machined, finished, or otherwise treated. In the textile field the term "converter" describes the manufacturer who utilizes this process. Examples of this process are to be found in the manufacture of clothing, shoes, certain types of furniture, nuts, and bolts.

Continuous Process. Unfortunately the term "continuous process" has a dual meaning that is sometimes confusing. It is sometimes used to describe a manufacturing situation in which the productive facilities must be kept continuously in operation, without interruption, for relatively long periods of time, necessitating day and night shifts and Sunday work. In the steel industry, for example, the furnaces must be kept hot, once they have been lit, until a shutdown is caused by a mechanical failure or a lack of orders. If the furnaces are allowed to cool, they must usually be rebuilt before they can be used again.

The term "continuous process" is also applied to certain manufacturing situations in which there is a sufficient volume of production so that most or all of the machines will perform the same operations for long periods of time. It is usually employed in connection with industries that use assembly line production. The production of automobiles, or other products that change their models only once a year, is frequently mentioned as an example of the continuous process. In this aspect of the term, the fact that the plants may shut down every night and over the week end has no bearing on the definition.

Intermittent Process. Here again, as with its counterpart, there is a double meaning to "intermittent." In its first sense the term refers to any manufacturing process that can be stopped at will—for example, at the end of each day—and that can be started up again the next morning with no difficulty. Under this concept of the term, almost any industry that operates on a purely one-shift-a-day basis would qualify.

The other meaning involves manufacturing conditions in which the duration of each run is sufficiently short so that the machines are shut down rather frequently and retooled to produce something different. Most so-called "job shops" come under this category.

Because of the rather widespread use of these two meanings for both continuous and intermittent processes, the student should always probe further into the matter in order to discover which meaning holds in a given situation.

Standard versus Custom Manufacture All manufacturing is divided into two basic groups—those companies that manufacture standard articles, which are frequently originated, developed, and branded by the manufacturers; and those that are produced to their customers' specifications. Occasionally both of these types are found in the same company. The principal product is one that bears the maker's brand name but, because it does not require all of the producer's manufacturing facilities, the company keeps the factory fully employed by taking on a certain amount of custom business in addition to its own standard product.

Standard manufacture frequently involves producing for stock, as well as for shipment to customers and to dealers.

This may be occasioned by a seasonal selling period even though production continues the year round, because of the need for a reserve stock from which deliveries can be made to customers who are unable or unwilling to wait for goods to be manufactured, and for the purpose of stabilizing production when the demand is irregular. This condition raises questions of securing sufficient capital to carry the inventories, of the risk of loss through market price declines, fire, or theft, and of providing adequate storage space and custodial personnel. To firms engaging in custom manufacture, these problems are not usually present, as the customers specify the quantities to be made and the producers limit their runs to these amounts.

Production Management The management of production involves the utilization of certain techniques and methods that have become fairly well standardized during the last fifty years or so. Included in these is a procedure that is known as scientific management, the development of which brought about a change in managerial practices that can be described only as revolutionary. Unlike many of the changes that have come about in our economic system, this one can be traced directly to the work of one man, who, observing things as they then were, was dissatisfied with what he found and set out to do something about it. The activity of this man, Frederick W. Taylor, has had a profound influence upon production and production management.

Development of Scientific Management Frederick W. Taylor, who has been called the father of scientific management, was an engineer who in 1882 was in the employ of the Midvale Steel Company in Philadelphia. During a period of duty in the company's machine shop, he was impressed by two facts that disturbed him. One fact was that no one, workers or management, seemed to know what constituted a day's work at any of the tasks in the plant; the other was that the details of the performance of any given job were left entirely to the individual workers concerned. The workers were presumably skilled at their various trades and, when they were assigned to a task, it was their responsibility to work out the techniques and procedures in the light

of their own training and ability. Furthermore, management was generally in complete ignorance of these procedures and relied on the workers to use their best judgment and skill.

Under circumstances such as these, management obviously had little means of knowing whether the workers were using the best possible methods of production practice and whether they were working at their own best speeds. Furthermore, management did not possess sufficient knowledge of the workers' trades to permit it to offer constructive suggestions or corrective criticism of those whose personal output appeared to be faulty. In short, management did not truly manage in the complete sense of the word.

Taylor's Philosophy of Management. Taylor set out to remedy this situation and to place in the hands of management sufficient information regarding the details of the workers' jobs so that (1) management would know just what a worker was supposed to do on any given job; (2) management could instruct each worker in the best way to perform each task and then make certain that these instructions were followed; (3) management could establish standards for the rate of output for every job and thus be able to determine which of the workers were turning out satisfactory work from the standpoint of quantity and quality; and (4) management could establish a wage-incentive system that would reward the diligent, ambitious workers and spur on the poorer workers to greater effort and production.

Taylor's Attitude toward the Workers. Although it is not strictly within the purview of the aspect of production under discussion in this chapter, it should be noted that Taylor's attitude in this matter was not entirely that of management. He was thinking also of the worker, particularly from the standpoint of the reward he received for his labor. Taylor felt that the ignorance on the part of management of how a worker should do his job and of what constituted a good day's work served to penalize the better workers and failed to spur the poorer workers on to the effort of which they were capable and the enhanced earnings that would follow from this increased productivity.

Taylor's method in bringing about this change was to select the best worker he could find at any given task and to observe what that worker did when he was working at his best sustained speed. As the result of this observation, Taylor broke down each task into its component elements, timed each element separately with a stop watch, and recorded each timing carefully. When this process had been completed several times, the observations were studied and compared; and finally the one best method of performing each task was evolved. This method was committed to writing as a permanent guide to both management and labor. In the development of these studies, the co-operation of the workers involved was sought, and they were informed of the purposes of the project, one of which was to enable them to earn more money.

The next step was to select a good, intelligent worker and require him to follow the instructions covering the best evolved method of doing his task, even to the point of resting at certain intervals in the procedure. Over a considerable period of time there emerged from Taylor's researches a collection of standard job instructions, which, if followed faithfully by the workers after they had been given adequate instruction and coaching, almost invariably resulted in increased earnings for the workers and greater production for the company. Furthermore, the management now was in possession of the detailed information about all of the tasks under its control as well as a technique for a continuing appraisal of them and for the establishing of a work routine for any new ones.

Scientific Management This new tool of management Taylor named *scientific management.* The implication of that term was that scientific methods would now replace the rule-of-thumb procedure which had so long characterized the presumed control of production exercised by the executives of manufacturing companies. Throughout the years since Taylor's work, alert management has followed along the path that he pointed out, refining his methods and developing new ones, as the occasion has required. The term "scientific management" is no longer in common usage, but the techniques and practices that it was coined to describe, modernized in keeping with present-day production problems, are

now accepted as essential, integral parts of the implements of progressive production management.

It is only fair to state that there are still a large number of manufacturers who, for one reason or another, have not as yet adopted the principles and practices of modern scientific production management. Some of them are about where industry generally was in this respect when Taylor began his studies. Others have embraced one phase or another of the methods of modern management, but still fall far short of those who are the leaders of such things. As the competition of the future grows more intense and the pressure for lower manufacturing costs and more efficient production methods becomes more severe, it may be expected that an increasing number of these backward companies will turn toward the practices of scientific management as a means of improving their positions in their respective industries.

Purposes of Time and Motion Study Taylor's method of studying the motions of workers as they go about their tasks and of checking the time that these motions require, has been continued under the name of *time and motion study.* In this manner management seeks to establish time standards for the performance of all productive work, which are of value in the exercise of production control. The principal purposes of time and motion study are as follows:

To determine the best methods of doing each task. Through breaking each job into its component elements and observing the time required to perform each element, management is enabled to determine the most efficient methods to be used.

To aid in planning production. When management is confronted with the task of planning production, the knowledge of the standard time required to perform each operation is of value in setting up the production schedule. This has an additional importance when the planned operations include some that have not yet been time studied. Through the study of the elements involved, for which time standards may have been previously recorded on other jobs, it is possible to arrive at approximate time standards for the new jobs that are useful in estimating the probable production time. Later time studies may serve to verify or correct the estimated time.

To control operating costs. Through the use of time standards established through time study, comparisons can be made between the standards and the actual performances by the workers. Differences can be noted, and remedial measures can be applied to bring the actual performance into line with the standard performance. Thus control of labor costs can be achieved.

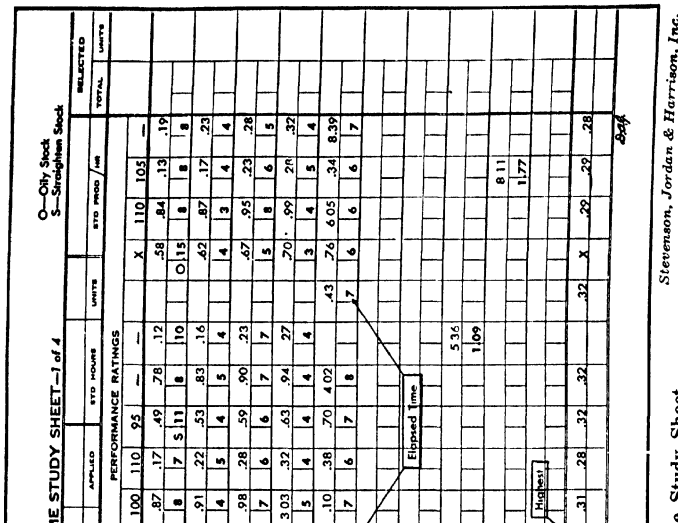
Time and Motion Study Procedures The term "time and motion study" should be broken into its component parts, and the order of those parts should be reversed in order that the basic procedures may be understood. In order of precedence, motion study comes first and time study second. These will be briefly described in turn.

Motion Study. This is the first step in the analyzing of a job. It consists of a careful scrutiny of all of the motions that go to make up a task. Examination is made not only of the actual motions that the observed worker makes, but also of the physical conditions surrounding the job site, such as the distance from the machine to the boxes holding the incoming and outgoing work, the lighting, and anything else that may affect the job.

The principal purpose of motion study is to establish the most effective way of doing a job from the standpoint of the motions involved. A skilled observer can quickly detect waste movements that can be corrected in the interest of better performance. From this study will come a series of elemental motions, which, when added together in the proper sequence, will produce the best method of doing the job. Each of these elemental motions can then be timed.

Time Study. The actual mechanics of time study is a rather technical process that requires a considerable measure of experience and training on the part of the observer. It is not desirable in this discussion to go beyond a brief description of the time-study procedure. The details are more properly given in specialized texts dealing with time and motion study or production management.

Equipped with a special stop watch, an observation sheet for recording data, and a special board to hold both the watch



Time Study Sheet

This is a record of a simple manufacturing operation involving the five elements listed at the left of the form. The bold-faced figures in each of the vertical columns show the time required for the

and the sheet, the observer stations himself where he can see everything that the worker does during a job cycle.[1] He then

[1] The term "job cycle" refers to all of the motions necessary to the complete processing of one unit of work, for example, the drilling of a certain number of holes in a piece of steel or iron. The job cycle includes everything the operator does from the moment he turns to pick up the undrilled iron piece until he lays down the finished piece.

times each elemental motion and records on the observation sheet the findings in each instance. This goes on until a considerable number of job cycles have been completed, sometimes as many as fifty. During this time the observer notes everything that happens, all delays—from whatever cause, and all of the worker's actions, whether cyclically recurrent or not. When the observations have been completed, a time-study clerk calculates the time allowance for a unit of work by adding the periods of time required for the elemental motions that make up that unit. The standard thus determined can be used as a measure of efficiency in production as well as a base for determining the worker's compensation.

Micromotion Study. A refinement of the time-study method just described is micromotion study, which involves the use of a motion-picture camera. Instead of an observer who watches the worker and records the times of the elemental motions, a camera captures the actions as well as the times, which are taken from a clock with a large dial that is placed in focus with the operator. The analysis of the film is made later by trained engineers. This method is of value where the operation to be studied involves a great many motions that are too rapid or complicated for the human eye to follow. The extent to which micromotion study is used in scientific management is not known. It is probably used on a limited scale because of the cost involved, as compared with the gains achieved, and the relative shortage of competent observers and analysts.

Mention should be made of the attitude of labor, and particularly organized labor, toward time and motion study. Because of the tactics of the managements of some of the companies that undertook time and motion study in the early days, which included cutting the pay rates after the workers had increased their productivity so that they were earning only about as much after the study as before, labor has become suspicious of all time studies. This has been partially overcome through the action of the more enlightened managements, which have invited the unions to elect time-study stewards, who work closely with the time-study engineers and observers and whose approval must be secured

before a new time standard is established or an old one changed.

Production Control In its highest state of development, the control of production consists of a well-defined set of procedures that has as its objective the coordination of all of the elements of the productive process —men, machines, tools, and materials—into a smoothly flowing whole, which results in the fabrication of products with a minimum of interruption, in the fastest possible time, and at the lowest obtainable cost. The details of the various systems of production control differ according to the characteristics of the industries in which they are used, but the basic principles are the same under all circumstances. Therefore the present discussion will be limited to an examination of those fundamentals.

Depending upon the nature of their products and their demand characteristics, some manufacturing concerns operate their plants only when they have received orders from their customers; while others produce for stock and are prepared to make immediate deliveries from their finished goods inventories as soon as customer orders are received. In either case it is the function of production control to make certain that the flow of materials through the factory is such that the promised delivery dates are fulfilled, or that the delivery to stock is so timed that a proper balance of stocks to sales may be attained.

Steps in Production Control The basic steps in production control, in the order in which they occur, are (1) planning, (2) routing, which is sometimes regarded as a part of the planning process, (3) scheduling, and (4) performance follow-up and control.

(1) Planning. When a customer's order or a company stock order is received by the production planning department, it is broken down into its component parts. This involves a *bill of material,* which lists all of the finished parts, subassemblies, and assemblies that are called for by the order. This list, in turn, is broken down into those parts that are purchased in finished form from other manufacturers and the materials

that are bought for fabricating and processing in the company's own factory.

After reference is made to the parts and materials inventories, purchase requisitions for the parts and materials needed are issued to the purchasing department, which issues purchase orders to the proper vendors.

From the engineering and production departments information is secured that indicates the number and types of machines that are required, the processing time for each part, and the tools that will be needed. From this the production control department can determine the starting dates for processing all parts and materials so that they will arrive at the assembly at the proper time. If any tools are not available, the purchasing department is notified so that it may place orders in time to assure their being on hand when needed.

*(2) **Routing.*** This is the stage of the production control where the determination is made of the route that the work will take through the shop and where and by whom the processing shall be done. It specifies the sequence of operations pertaining to a single part and also in regard to its relationship to other parts being made.

Route sheets are made up to show the sequence of operations for all parts and materials and for all assemblies. *Route charts* are constructed to indicate the production processes necessary to make the subassemblies and the finished product.

A *route file,* which consists of all of the necessary job tickets required to move the material out of stock to the various machine positions and on to the assembly stations, is set up. This step causes the creation of all of the identification and authorization tickets that will be needed to establish a flow of work through the shop.

*(3) **Scheduling.*** This step involves the setting up of the timetables that will govern the movement of the work as it is subjected to the various fabricating processes. A *master schedule,* which indicates the number of finished products that will come off the assembly each month or week until the order is completed, is created.

Weekly departmental schedules are drawn up to set forth the expected production of all parts in each department for

Careful planning, routing, scheduling, and performance follow-up make possible the rapid assembly of modern automobiles. A bare chassis frame, which enters the production line at the upper left, emerges eighty minutes later as a completed car at the lower right. In between a number of sub-assembly operations begin-ning at different times as indicated on the chart.

each week of the production cycle. Care is taken not to schedule work for a department in excess of that department's capacity to deliver, taking into consideration the normal contingencies that must be met, such as machine breakdown, set-up time, length of shift, number of shifts, and so on. By set-up time is meant the time required to prepare the machine for a particular job. This includes adjusting the cutting tools and the machine speeds.

Load ahead schedules are made up for each department. These indicate the amount of work that lies ahead of it until the present run is completed. The load is altered from week to week as the actual production results are achieved. It is very important from the standpoint of scheduling subsequent jobs as orders are received. It prevents scheduling more work for a department than it can handle.

Another part of the scheduling operation is that of scheduling purchase requisitions so that purchase orders may be placed with a view to achieving well-balanced inventories, and of scheduling tools so that the toolroom will have the proper tools on hand when needed, in correct condition for the work to be done by them.

(4) Performance Follow-up and Control. After the preparatory steps have been taken along the lines indicated above, the work orders are released and production starts. The putting into effect of the work orders and the transmission to the shop of the routing papers are called *dispatching* and are a purely clerical activity. Elaborate *control boards* are sometimes set up, utilizing various printed forms that show the progress of the work in the shop and serve as indicators of production irregularities which call for supervisory corrective action. The function of production control then becomes that of following up on all of its performance schedules to detect any significant variations from the plans, to discover and correct the causes of these variances, and to compensate for any irregularities resulting therefrom.

Various follow-up routines are established, particularly for purchases, tools, and production. *Schedule performance reports* are issued by the production control department on the basis of parts and schedule follow-up reports received from

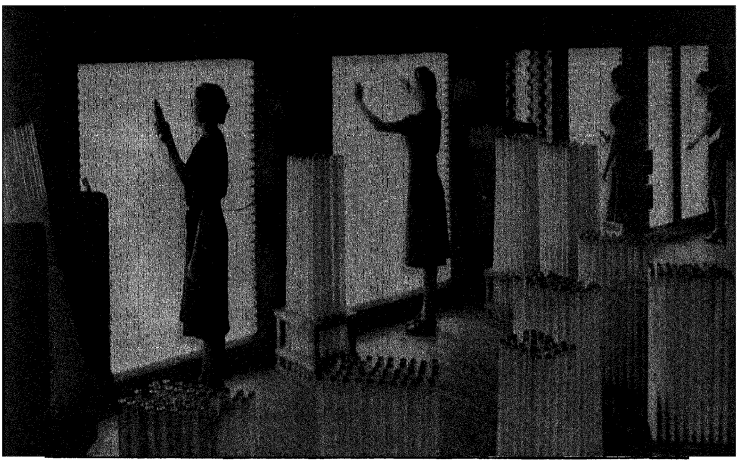
the operating departments. These reports set forth the performance of all departments as compared to the schedules. In this way the top management is kept advised of the flow of work through the shop, and it can note any deviations from the plans and fix accountability for them. *Scrap reports*, received from the inspection department, relate the number of pieces rejected and the reasons. These reports permit the production control department to notify the production department of an unusually large number of pieces scrapped so that arrangements can be made for additional production to take their places, in order to prevent shortages from occurring at some later stage.

As the flow of production progresses and the processed parts move to the subassemblies and to the final assembly and finally emerge as finished units, the paper work routine indicates this to the production control department and the records are marked accordingly. When the entire order is completed, the schedules are terminated, the whole project is wound up, and the records are filed for future use.

The foregoing description has been presented as if a single order were all that occupied the attention of the production control department at any one time. This is probably an oversimplification in many instances, as it is more likely that a large number of orders, in varying stages of completion, are running coincidentally. The principles of operation, however, are as outlined and, if followed through on each order, regardless of how many other orders the department may be processing at the same time, will result in an intelligently controlled production situation, with a minimum of cost and a maximum utilization of productive facilities.

Inspection In all manufacturing operations the work is produced to certain standards that are set forth in writing for the guidance of all production personnel. The function of inspection is to measure the extent to which these standards have been observed and to detect and reject any part of the product that is not up to the standard.

Inspection is performed by a department that is set up for that purpose and that is frequently under the supervision of



General Electric Company

Inspection

This is the final test and inspection in the manufacture of fluorescent lamps.

the works manager; but only rarely are the inspectors under the control of production department foremen. The reason for this is that the duty of the inspectors is to "call them as they see them"; and as the rejecting of material is something of a reflection on the foreman in charge, a more objective determination of quality can be obtained if the foreman is not the inspector's immediate superior.

When Does Inspection Take Place? The problem of when inspection takes place is one that is dependent upon the complexity of the manufacturing processes concerned and the wishes of the management. Most incoming parts and materials are inspected as they arrive from the vendors. After this point the minimum inspection requirement would be one made of the finished article before it is shipped to the customer. The maximum conceivable number of inspections would be after every separate operation with a 100 per cent final inspection.

In most cases the prevailing practice is somewhere in between these two extremes, depending upon the nature of the manufacturing processes, the tolerances permitted, and the past history of defective material and workmanship. The term "tolerances" refers to the practice of permitting a certain leeway in the measurements of manufactured parts.

Where Should Inspection Take Place? The inspection operation may take place at one or more centralized locations to which the work to be inspected is transported and where the inspection personnel is more or less specialized and completely removed from contact with the workers whose product they are examining; or it may be done at every work station. The latter method has the advantage of saving material transportation costs, but also the disadvantage of the proximity of the workers and the inspectors.

In certain complicated machining operations, the worker does his own preliminary inspection as the work progresses, but the work is checked by an inspector when the job is done. An inspection is quite common immediately after a machine has been set up for a new operation and before the production run has started.

How Much Should Be Inspected? There are three methods of meeting this problem—100 per cent inspection, single-sample inspection, or multiple-sample inspection. The 100 per cent method is required only in those instances where the products are of exceptionally high quality or where the accuracy of the manufacturing processes is dependent more on the skill of the operators than on that of machines. The choice between the other two methods depends on how close the tolerances are and the extent to which the productive processes are mechanized.

Inspection Devices Used. A wide variety of tools and devices are used in inspection. Gauges, chemical processes, X-ray equipment, and electrical apparatus are among those commonly found. Some plug gauges are quite simple in their construction and application, while others are exceedingly complicated. Micrometer gauges are a part of the tool equipment of most machinists and are widely used in inspection work. Electrical devices are valuable in inspecting electrical apparatus, and the X-ray has recently been employed to detect flaws in castings or other materials where visual inspection methods are inadequate.

Inspection can aid in exposing weak points in the production process so that management can apply remedial measures.

It can also help to build good will for the company by preventing the shipment of finished products that vary from the prescribed standards.

Inspection must be conducted objectively according to a set of standards that should be sufficiently rigid to assure the satisfactory operation of the parts concerned, but flexible enough to allow for the permissible variations and tolerances within whose limits the materials are acceptable. Inspection standards should be as high as necessary, but should not be needlessly strict. The determination of these limits is the concern of the engineering department.

QUESTIONS

1. Give examples other than those mentioned in this chapter of each of the following types of production processes: extractive, analytic, synthetic, and fabricating.
2. Give examples to distinguish between the two meanings for each of the following production processes: continuous, intermittent.
3. Would the adoption of modern production control methods be useful in a small dairy? in a dry cleaning shop? in a monument works?
4. Under what circumstances should a firm produce for stock?
5. Should a worker know when he is being subjected to time and motion study, or should the procedure be kept secret?
6. In what types of industries would micromotion studies be useful?
7. Many plant executives attempted to justify the cutting of wage rates that followed the adoption of scientific management in their plants by saying that at last the workers were doing a good day's work, for which they had always been paid but had never before earned. Evaluate this argument.
8. Should union stewards be trained to take time studies or to pass judgment on their adequacy?
9. What part should the engineering department play in production control?
10. With which step in production control is each of the following associated and what purpose does each serve: bill of material, route file, master schedule, control boards, scrap reports, route sheets, load ahead schedule, and schedule performance reports?
11. Should workers be permitted to make the final inspection of their own work?

PROBLEMS

1. For each of the six production processes described in this chapter, list examples from the manufacturing businesses in your community or in the nearest industrial section. List the six production processes in a column at the left, the names and locations of the businesses in a center column, and brief descriptions of the particular manufacturing operations that are examples of the processes in a column at the right.

2. Following the same general instructions as those given for Problem 1, give examples of standard manufacture, custom manufacture, and a combination of the two kinds.

3. Make a time and motion study of a simple operation. Report briefly (a) the nature and purpose of the study, (b) your procedure, (c) your findings, including your recommendations regarding the best manner in which to perform the operation and a reasonable time standard.

Examples of simple operations that might be studied for this problem are: (1) alphabetic sorting of a hundred 5 x 3 cards containing the names of individuals (every letter of the alphabet should be represented, except possibly x and z); (2) inserting a single sheet of paper into a typewriter and placing it in position; and (3) answering the telephone at a desk with pencil in hand and note pad in position for recording a message.

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CHAPTER 8

PROCUREMENT AND TRAINING OF PERSONNEL

Hiring, Past and Present In the days gone by, when most business was on a relatively small scale, the routine of hiring new employees was rather simple. If a job was to be filled, the employment officer, who was not infrequently the head of the company, let it be known that a vacancy existed. When an applicant appeared, he was probably hired and put to work if he seemed to have the necessary qualifications. In small enterprises with but few employees, this method of hiring is still quite characteristic and is probably fairly satisfactory. This situation involves rather close contact between the employer and his employees; the jobs themselves are frequently rather simple; and even when the jobs require certain skills, the boss can ask some rather pertinent questions that will indicate quite clearly whether or not an applicant has the requisite ability or experience.

In recent years there has been such a notable growth in the size and scope of operations of many firms that the free and easy contact between the heads of the companies and their prospective employees, which was so prevalent in earlier times, has largely disappeared. This condition has resulted in the need for improvements in the techniques of hiring new employees and in the whole field of employer-employee relationships. Previously the boss and the workers met on a rather informal basis; there was a sense of mutual loyalty and responsibility; and differences could be ironed out easily through direct man-to-man discussions. Now all this has changed, at least as far as moderate-sized and big businesses are concerned. In place of the contact with the boss, the prospective employee meets a professional personnel manager or one of his assistants; the worker feels no great sense of loyalty to the company; and in many instances the officers of the company feel no great sense of responsibility to him. There

is an impersonality about the whole situation that is in marked contrast to that which preceded it by a number of years.

No small part of the industrial labor unrest that has characterized the last seventy-five or more years can be traced to the gap that has grown between employers and employees. In an attempt to bridge this gap and to meet some of the problems that have arisen, the personnel department has come into being and has developed to a position of considerable importance in most large firms.

Personnel Department Starting many years ago as an employment office, the personnel department has gradually expanded and added to its duties until now it embraces a rather wide range of personnel matters. The people who work in this department are often skilled at the job of administering this newest of company functions. The director of personnel, as the executive in charge of this work is frequently called, is one of the key men in the firm, sometimes with vice-presidential rank. The other employees in the department are chosen for their demonstrated interest in and ability to meet the personnel problems of present-day industry.

The manifold duties of the personnel department group themselves naturally into five divisions, which will be briefly indicated here and then enlarged upon throughout the remainder of this chapter.

Employment Division. This division is concerned with the hiring of new employees, the maintenance of personnel records, and sometimes with the transfer, promotion, and dismissal of the workers.

Training Division. The training programs for the entire plant are frequently placed under this division. These include apprentice training, foremanship training, courses for executives, and co-operation with private or public schools, colleges, and universities for training purposes.

Welfare Division. A wide variety of activities come under this division, among which are the promotion of social functions; administration of sickness, benefit, and savings funds; athletic programs; and legal advice.

Safety and Health Division. As its title indicates, this division looks after the safety of workers and provides the medical assistance and facilities that are so necessary to employee good health.

Employee Representation Division. This segment of the personnel department is concerned with the relationships between the employees as a group and the company. When a union exists in the plant or office, this division serves as the point of contact between it and the company. Shop councils or committees, grievance-hearing procedures, and other matters of this sort would come within its purview.

Techniques of Hiring In the discussion that follows, the hiring techniques described are those in force in many companies which are alert to the advantages of modern employment methods and whose hiring volume is great enough to justify the expense that such methods entail. Unfortunately, a considerable number of firms follow procedures that are somewhat less up to date, although recent years have seen a distinct trend toward the revamping of obsolete techniques in this important phase of business practices.

Job Analysis and Specification The principal purpose of modern hiring procedures is to fill all jobs that become vacant with the best equipped and trained workers that can be found. The so-called round pegs should be fitted into the round holes, and the square pegs into the square holes. This results in a more effective labor force and a lower labor turnover. The United States Department of Labor has defined *labor turnover* as "the replacements in a working force made necessary by employees leaving the service." It is generally regarded as an index of the stability of the employee group in any business concern. Where labor turnover is high, the presumption is that all is not well personnel-wise within the plant. Conversely, where labor turnover is low, good personnel conditions are supposed to exist.

The first step in an intelligent approach to the problem of securing the best people for a group of jobs is to discover and put in writing everything that pertains to these jobs. This procedure is known as *job analysis* and involves inquiry into

all of the details of every position in the company that the personnel department might be called upon to fill. Nothing that pertains to or affects a job is too small to be noted and set down on the record.

Among the topics that should be covered in analyzing a job are the location of the job; its duties and responsibilities; the equipment, tools, or machines used; the working conditions; the pay; the opportunities for promotion; and whether or not any training for the job is offered. It is furthermore desirable that data be gathered concerning the qualifications that are required of the prospective employee. These data can be secured from department heads, the present workers, or both. Occasionally a firm of management consultants is called in to do this job if its magnitude or complexity warrants this action.

When this information has been gathered, it is reviewed in the personnel department, and from it the *job specification* is established. This consists of a digest of the data obtained in the job analysis and sets forth all of the particulars of the job, such as the duties, responsibilities, pay range, promotional possibilities, line of authority, and the qualifications required of candidates. With this statement on hand for all jobs, the employment division of the personnel department is equipped to proceed intelligently with the task of securing the proper workers for any jobs that are open.

Sources of Workers The sources of supply for prospective employees are many and varied. The extent to which the more common ones can be utilized depends upon the nature of the business, the degree of skill required for the different jobs, and the character of the population in the area in which the plant is located. These sources include past and present employees, their friends and relatives, applications on file in the employment office, state employment agencies, private employment agencies, employment scouts, schools and colleges, trade and technical schools, classified advertising, and union headquarters and hiring halls.

Some concerns have policies requiring them to look within their own organizations for workers to fill all jobs above the beginning or lowest grades. In this regard, the Great Atlantic and Pacific Tea Company has an almost inviolable rule, which

JOB SPECIFICATION

POSITION 0-75.10 CLASSIFICATION 4 A NO. ON JOB 35-50 DATE 6/18/47
Floor Manager
SECTION XI LOCATION Main Bldg. AV. NO IN DEPT. 50-60

MAY BE PROMOTED TO
Division Superintendent
Assistant Buyer or
Assistant Misc. Manager

TIME REQUIRED TO LEARN
3 Years

LINE OF AUTHORITY
Division Superintendent
Superintendent Office

SEX
Either

MINIMUM AGE
22

EDUCATION
High School Required
College Preferred

TECHNICAL TRAINING
None

EXPERIENCE
None

HOURS
Unrestricted

OVERTIME

STORE TRAINING
Executive Training
Leadership
J.R.T.
J.I.T.
J.M.T.
Store Org. & Mgt.

PREPARED BY

PHYSICAL REQUIREMENTS

CHECK (✓) REQUIREMENTS STAR (*) WHERE HANDICAPS WOULD NOT INTERFERE IN PERFORMANCE OF WORK

WALKING	CONSIDERABLE: X	LITTLE	NONE	
HEIGHT	NO REQUIREMENT	TALL	SHORT	AVERAGE: X
LIFTING	UNDER: 10# / 20# / 30# / 40# / 50# / 60# / 70# / 80# / 90# / 100#			
	TIMES PER HOUR: None			
POSTURE	SITTING:	CONTINUOUS	OCCASIONAL	NEVER
	REACHING:	OFTEN	OCCASIONAL: X	NEVER
	STOOPING:	OFTEN	OCCASIONAL: X	NEVER
STATION	INSIDE: X	OUTSIDE	IN & OUT	HOT / COLD	WET	NORMAL: X
NOISE	LOUD	AVERAGE: X	SLIGHT			
EYES *GLASS EYE PERMITTED	APPLICATION: CLOSE CONTINUOUS	CLOSE OCCASIONAL	AVERAGE: X*	LITTLE		
EARS *HEARING AID PERMITTED	KEEN	NORMAL: X*	SUB NORMAL	DEAF		
HANDS *ARTIFICIAL PERMITTED	USE REQUIRED: BOTH	EITHER: X*	LEFT	RIGHT		
FINGER DEXTERITY	HIGH	AVERAGE	LOW			
FEET *ARTIFICIAL PERMITTED	USE REQUIRED: BOTH: X	LEFT	RIGHT	EITHER	NEITHER	
RELATIONSHIP	MEMBER OF GROUP: X	NEAR OTHERS WORKS ALONE	ISOLATED WORKS ALONE			
PHYSICAL EXAMINATION REQUIRED	BEFORE STARTING: X	AFTER STARTING				
EQUIPMENT TO BE USED						

Job Specification

Omitted parts of this form provide space for "Description of Work" under the following headings: (a) Specific Tasks, (b) Factual Information Needed, and (c) Special Qualities Required.

is presumed to result in an enhanced morale among its employees. Other firms are more or less indifferent regarding the sources of their new workers, endeavoring always to obtain the best available candidates no matter what their source.

There are weighty arguments on both sides of the policy of filling jobs from within. The main one in favor of it is that the present employees feel that they are always given first consideration when better jobs are to be filled and that their loyalty to the company will be intensified thereby. On the other side, it is claimed that such a policy leads to a form of inbreeding and prevents the company from taking advantage of workers who have been trained in other concerns and who may be better fitted for the positions that are open than are any of the present employees. Those who hold this view believe that a well-qualified person in the company has just as good a chance of getting the job as an outsider, and that any policy other than that of securing the best available person, regardless of where he may be located, will redound unfavorably to the company in the long run. As with many policies in business, it is probable that a flexible one in this regard is the most advantageous. Hard and fast rules tend to come into conflict with actual conditions, which are in a state of constant change.

Employment Procedures Several separate and distinct procedures feature the employment process. Any or all of them may be used in any given instance, depending upon the policies of the companies concerned.

Application Blanks. Most concerns use some form of application blank, if for no other reason than to secure a permanent record of the applicant's qualifications. Some companies use the application blank as a means of discovering the applicant's ability to follow instructions and to express himself clearly.

While the details of these forms differ somewhat among companies, they customarily request certain biographical information concerning the would-be employee, such as his name, address, age, education, and business experience; as well as the names of references; the position desired; and so on. These data serve to give the employment department an over-

all picture of the applicant and frequently serve as the basis for immediate rejection or for further consideration. A common fault of many such blanks is that they do not allow enough space to permit the applicant to furnish all of the really pertinent information about himself, often to his detriment as well as to the company's.

Interviews. There are frequently two types of employment interviews: the preliminary interview and the main or hiring interview. The *preliminary interview* may come before or after the application blank is filled out. Its principal purpose is to size up the applicants quickly and to dismiss the more obviously unfit. In most companies all applicants are given a short interview, even though there are no jobs open in which they might be interested. This is not only a matter of courtesy, but also a point of value to the employment personnel in that it serves to keep them informed of the current state of the local labor market.

The *main interview* takes place after the preliminary one; it is usually the occasion when the applicant is either definitely hired or rejected. If psychological tests are administered or a physical examination is required, these frequently precede the main interview.

During this conversation the employment official endeavors to make a final evaluation of the applicant and to determine whether or not he should be hired. It is a crucial point in the employment procedure, and one to which personnel experts have given considerable thought and study because of the wide variations in the conclusions that may result from several different people interviewing the same applicant. In some companies the interviewer has a prescribed form to follow, with a fixed series of questions and remarks. Others allow their interviewers a free hand in conducting their conferences, merely holding them responsible for the selection of good workers and for the rejection of poor ones.

Tests. Recent years have seen the growth of the use of tests of various kinds as a means of determining the fitness of applicants for the jobs to which they aspire. These tests are used for the purpose of measuring so-called general intelligence or mental alertness, aptitude or basic talents along

particular lines, and ability or actual proficiency in given trades or skills.

Intelligence tests were first used on a large scale by the army in World War I for the general purpose of classifying the soldiers. Since then these tests have been improved and revised and have come into wide usage in many fields, including that of employment. Many of those who have used them feel that they have been most helpful in aiding personnel officers in their task of separating the mentally alert applicants from the dull ones.

There are many critics of intelligence tests who claim that the tests do not measure intelligence, that success in business comes from spiritual as well as mental qualities, that the tests merely measure acquired knowledge, and that the physical or emotional condition of the applicant at the time the test is given may be such as to prevent his doing his best. These accusations undoubtedly contain a large measure of truth, and the more enlightened of the psychologists who are interested in intelligence tests are doing their utmost to overcome these faults and to devise tests and methods of administering them that will fill in some of the gaps left by this type of test.

The *aptitude tests* are administered to untrained applicants in an attempt to evaluate their response to subsequent training. Sometimes they may be given to those who profess a certain amount of skill in some field in order to determine the probability that they may become experts. The general philosophy behind the use of aptitude tests is that almost anyone will respond to training but that the person without an aptitude for a given field, say mechanics, can never hope to become more than a mediocre craftsman in it. The tests are supposed to detect both the gifted workers and those not so fortunate, with the result that the company can direct its training program toward the educating of those who can best benefit from it.

The *ability or achievement tests* are valuable from the standpoint of checking on the truth of the applicant's statements concerning his trade skills. It is an unfortunate fact that some would-be employees have been known to exaggerate their trade qualifications in their eagerness to secure employment, a circumstance that management has discovered to its dis-

advantage later. It is in the hope of detecting these imposters *before* they are hired that trade tests have been devised.

Use of Letters of Recommendation. One of the time-honored devices of employment procedure is that of requiring a prospective employee to produce letters of recommendation written in his behalf by various people, including former employers, attesting to his abilities, attitudes, accomplishments, and character. It has been presumed that the writers of these letters were in a position to discern the truth about the applicants in these matters, and that they would unhesitatingly reveal their knowledge "to whom it may concern."

In recent years there has arisen a profound skepticism concerning the value of letters of recommendation. This is due in part to a recognition of the general reluctance of most people to put down in writing anything that might be considered unfavorable to a former employee or a friend. Furthermore, an analysis of a great many of these letters reveals that they either extol the virtues of the subjects beyond the power of most men to fulfill, or else they consist of some airy platitudes or polite "double-talk" that reveals but little. For these reasons and others, many firms have done away with requiring letters of recommendation from applicants and have substituted in their places the practice of asking for the names of references and of calling them on the telephone or in person and asking for their oral opinions of the individuals concerned.

Physical Examinations. Many firms require all new employees to undergo a physical examination. This is usually administered by the company doctor; it may be only cursory or, on the other hand, quite thorough. One of the main objectives of this examination is to discover whether the prospective employee has any physical impairment that might hamper his usefulness on his new job. An example of such an impairment is poor eyesight on a job requiring use of a micrometer. A physical examination is also valuable in detecting any existing trouble that might be made the basis of a claim for injury or disability at some later date.

Introduction to the Job. After the new worker has been formally hired, it is necessary that he be properly introduced

The Higbee Company

A Printed Welcome to the New Employee

This is a page from a booklet stating the rules and policies of the employing company.

to all of the details and personnel connected with the job. He must be directed to the department where he will work and be presented to his superiors and, in some instances, to his co-workers. The practice in regard to this introduction varies with different firms. A common procedure is for a representative of the personnel division to accompany the new employee to the locale of the job and arrange for the meeting with the foreman. The latter, in turn, shows the newcomer where he will work and explains the details of the job. Many foresighted companies have found it worth while to make this introduction as friendly and cordial as possible in order to put the new employee in a good frame of mind and to enlist his best abilities and co-operation right from the beginning.

Certain details concerning the company and the job must be imparted to new employees so that they may understand the rules and policies of the company and fit themselves into the picture with the least friction or delay. Among these matters are the following: hours of work, lunchroom facilities, attendance rules, rest periods, safety rules, locker or coatroom facilities, methods and times of wage payment, employees' organizations, recreational facilities, medical services available, and many others. This information is usually printed in booklet form and presented to the new employee with the request that he read it and familiarize himself with its contents.

Follow-ups. Some companies have a policy of periodic follow-up on new workers, the purpose of which is to discover the character of performance that they are putting forth, whether or not they are happy in their jobs, and so on. The first of these follow-ups may occur at any time within the first

few days after employment and the others at more or less regular intervals thereafter, sometimes twice a year.

The original check is useful in revealing the individuals who are not quite suited to the jobs for which they were hired and who may be of greater value to the company in some other types of positions. Many companies hold to the belief that it is a good policy to transfer apparent misfits to other jobs, even to the extent of several moves if necessary, in the attempt to find the work for what they are best fitted and where they will be the most contented. This not only may save the original investment that they have in their workers, but also tends to create a feeling on the employees' parts that their employer is interested in them and wants them to be happy in their jobs.

The later follow-ups are helpful in rewarding employees for continued satisfactory service, and in detecting the laggard workers and in applying remedial measures. If necessary, the unsatisfactory employee is discharged.

Employee Training All new employees require a certain amount of training before they are able to give their best efforts to their jobs. The methods whereby this training is given will be described in the sections that follow.

Training on the Job. Certain types of work lend themselves to training on the job, whereby the employee learns while doing. These are usually fairly simple jobs, where the presence of unskilled workers does not seriously affect the smooth operation of the business.

The training may be given by foremen or supervisors, by experienced operators, or by special instructors employed for this purpose. In department stores the sponsor system is often used, whereby an older employee "sponsors" the new worker for the first few days of employment and teaches her the details of the job. New elevator operators are placed in the care of older ones who demonstrate their skills and instruct the neophytes in handling the controls.

Training for the Job. This refers to the type of training that is given before the new worker starts on the job. It is used where the jobs are rather complex and where completely

inexperienced operators cannot be permitted to function without seriously interfering with the production flow.

Many firms operate so-called *company schools* to which new employees are sent after they are hired but before they are assigned to their jobs. In these schools they are given the requisite instruction for handling their jobs and they are tested for the proficiency that they acquire. These schools are staffed by special instructors who frequently devote their entire time to teaching. Obviously this sort of school is useful only where there is a large number of workers to be trained and where the training period is of more than brief duration. The Ford Motor Company has long maintained a training school of this type.

The *vestibule school* differs from the company school chiefly in the matter of the length of the training period. It is located on the company property, manned by a group of instructors, and designed to provide relatively brief and intensive instruction for specific jobs.

The *apprenticeship system* is one in which inexperienced workers are apprenticed to master craftsmen for a period of years, during which time they are supposed to become thoroughly grounded in their trades. This method of training is still extant in the building trades but has become rather rare in the other branches of industry. One of the reasons for this is that with the gradual change in the character of many factory jobs, whereby merely the ability to operate a specialized type of machine is required rather than the skill of an all-round machinist, the vestibule school is able to provide the requisite training in a matter of days, and the need for the prolonged period of apprenticeship no longer exists. The unwillingness of young men to serve a long apprenticeship is another cause of its decline.

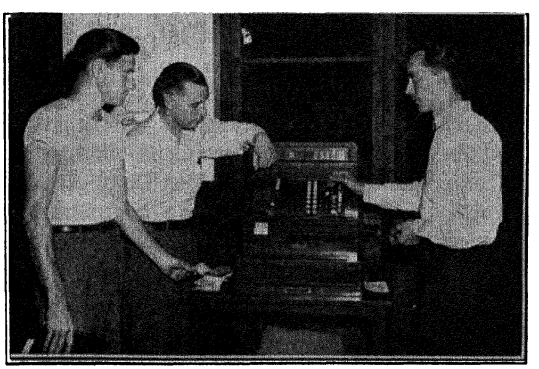
Many firms maintain *training courses for selected college graduates.* These are frequently designed to provide broad schooling in all phases of the business, with the expectation that the trainees will find their own places in the organization as the plans unfold. The Goodyear Flying Squadron and the R. H. Macy executive training group are two examples.

Courses in foremanship are offered by a considerable number of companies. These are designed to enable foremen more

adequately to discharge their duties as the representatives of management in closest contact with the workers. The old concept of the foreman as a rough, domineering boss, whose physique and language kept his workers in a state of constant awe, has long since been discarded. In its place has come the modern idea of the foreman as an executive whose main task is that of securing the greatest amount of production at the lowest cost. Instruction is now available in the many facets of the job, and as a result more intelligent and effective foremen are secured.

Executive training at rather high levels is offered by some firms which believe that the way to be assured of good executives is to select the individuals with great care and give them thorough training, not only in the essentials of their jobs, but also in the broader aspects of economics and business practices and policies. Sometimes these courses are given on the company's premises with instructors drawn from the executives of the firm; in other cases the facilities of local educational institutions are utilized, with the tuition paid by the company.

Training Methods Experience has shown the wisdom of the maxim "train through doing," which involves a minimum of lectures and reading and a maximum of practical instruction either on the job or under circumstances that simulate those surrounding the job. Of course, in some kinds of training a certain amount of oral instruction is inevitable, but most shop training can best be effected by having the trainees operate the machines or tools, either in the shop or in the school.



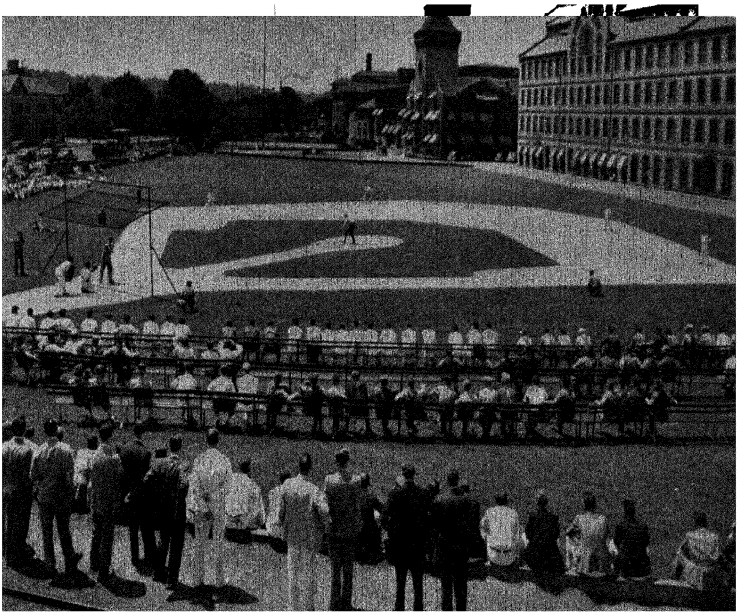
The National Cash Register Company

An Example of Training through Doing
This is an example of group or squad practice.

A careful planning of the training program before it is administered will go far toward increasing its effectiveness and decreasing the time necessary to accomplish its objectives. An excellent example of this is seen in the Training Within Industry program of the War Production Board during World War II. By means of a thorough analysis of the jobs to be taught and an intelligent planning of the program to be given, it was possible for hundreds of thousands of relatively unskilled workers to be trained for war jobs in an amazingly short time. The teaching principles that this program developed are bound to have a profound influence upon industry training practices for a long time.

Welfare Work During the last several years, the concept of employee welfare work as a duty of the employer has made notable headway. It has resulted in the development of a rather wide variety of activities that come under this general heading. In the early days of welfare work, there was a considerable measure of indifference or even opposition by employees to what they regarded, in many cases probably rightly, as paternalism on their employers' parts. Their attitude was to the general effect that, if the employers would add to their pay envelopes the amount of money that was being spent for welfare work, the employees would be much happier. As time passed, however, many of the paternal aspects of welfare work disappeared. The suspicion that it was being offered as a substitute for better wages became less strong, and many of these activities have become part and parcel of the employee contacts in large numbers of companies. The term "welfare" is not in good repute, however, and the term "personnel services" has been substituted for it in many instances. The change in employee attitude has come to reflect the sincerity of the companies that proffer these services, not as a means of keeping their workers reasonably satisfied with low wage scales, but as a friendly gesture that will not only bring about a happier and more contented employee group, but will also lessen labor turnover and increase the productive effectiveness of the plant personnel.

The list of welfare or personnel service activities is a long one. Eating facilities, rest rooms, and locker rooms are found



Procter & Gamble Company

An Employees' Noontime, Interplant Baseball Game

The employees of this firm participate in a schedule of interplant sports and recreation more elaborate than is found on many college campuses.

in many plants and large stores. Recreational opportunities take the form of football, baseball, and bowling teams sponsored by the firms. Some plants provide handball, volley ball, and tennis courts, with the necessary equipment for the workers. Legal advice and assistance is sometimes made available to employees through the company's legal department. Many concerns encourage the establishment of credit unions. These organizations provide the opportunity for the investment of the employees' surplus funds and offer loans at low interest rates and easy repayment terms. Employee savings plans help the workers to put aside a part of their earnings.

In certain communities where adequate living quarters are difficult to find, company housing projects have been undertaken to relieve the local shortages. Company stores have been established in some places, either to provide shopping facilities that would otherwise be lacking or, occasionally, to offer goods to the employees at lower prices than the neighborhood customarily afforded.

Group insurance and hospitalization plans have been common in the last few years. Employee mutual benefit associations are to be found in a great many companies. Retirement and disability plans to which both the employer and the employees contribute are becoming increasingly common. The advent of social security in August, 1935, as a project of the Federal Government has given added emphasis to the problem of taking care of the superannuated workers. A few firms have undertaken to guarantee their employees a certain number of weeks employment each year. A small number of other firms have established unemployment compensation funds, but there had been comparatively little progress along this line until the Social Security Act, with its provisions for compulsory unemployment compensation, became law.

Employee Safety and Health The promotion of employee safety is a cause that has made rapid strides in recent years, not merely as a humanitarian measure, but also because many firms have discovered that the prevention of industrial accidents is desirable as an aid to a continued high rate of production. This movement is manifested through the installation of safety devices of all kinds on dangerous machinery and through the dissemination of safety information to workers. In this latter activity, safety clubs, literature, posters, and contests are all enlisted for the purpose of making employees safety-conscious. An added incentive for employers to stress the safety theme is the presence, in almost all states, of workmen's compensation acts, which, while they vary somewhat from state to state, generally increase the cost to a company that has a bad accident record and, conversely, reward a concern that is able to reduce the number of its accidents by lowering its required contributions.

Industrial consideration of employee health is in a rather sketchy state of development in this country. A few companies have quite adequate medical and dental facilities available to their employees; others have nurses on hand, with physicians available on call; while the majority of businesses, particularly small ones, have nothing along this line.

Where industrial medical attention is provided for the workers, it is intended to supplement rather than to supplant

the outside medical care that they receive from their family physicians. First-aid treatment of injuries is of prime importance, and all other treatment is secondary. However, many companies treat colds, headaches, and other ailments, and are thus able to provide a service that their employees might not otherwise enjoy, in addition to lowering the absentee rate in most instances. The dental services offered by a few concerns are supposed to be used solely for the treatment of emergency cases and probably follow this policy fairly closely.

In recent years there has arisen, with some of the more far-seeing companies, a recognition of a condition among their employees that is known as *industrial fatigue*. It results from too long application to the job by the individual affected. It produces diminished perceptive faculties and a proneness to accidents. Long hours, overtime and Sunday work, with insufficient rest, will sooner or later bring about industrial fatigue. Poor working conditions, faulty lighting, heating, or ventilation, and excessive monotony in the job are all contributing factors to this condition. Occasionally industrial fatigue appears as the result of faulty placement of individuals in jobs for which they are definitely unfitted.

The remedy for this condition is found in its causes. Shorter hours, rest periods, better working conditions, and, for the persons wrongly placed, transfer to more congenial work are the best methods of combating industrial fatigue.

Many companies offer periodic physical examinations to their employees as a means of helping to maintain their health. These are valuable to both employers and workers. In this way employers can detect physical defects of which the individuals are often unaware and suggest remedial measures before the trouble has progressed too far. A common requirement is that all persons who have been absent because of illness or injury report to the medical department for examination before returning to work.

Employee Transfer, Promotion, and Discharge

This section is concerned with three personnel functions that are common to all companies, and which, if not correctly handled, may have very unfortunate results in the employer-employee relations.

Transfer. This action may be defined as the shifting of a worker from one job to another that does not involve the employment of greater skills or the assumption of additional responsibilities. Transfers take place to offset a decrease in the work load in a department; to correct a faulty placement and to give an employee work more suited to his abilities; to take care of older workers who must be assigned to lighter tasks; to transfer promising employees from jobs without opportunity for promotion; to rotate workers in dangerous or unpleasant jobs; to afford employees training in several jobs; and frequently to alleviate unfortunate personal experiences, or incompatibility with supervisors or fellow workers.

It is important that policies and rules governing transfers be established and adhered to, in order that the employees affected may feel certain that they are being fairly treated and not merely being pushed around at someone's whim. It is equally imperative that the personnel department be advised of all prospective transfers in order to guard against the possibility of weakening one department at the expense of another. The reasons for all transfers should be scrutinized carefully and their validity evaluated.

Promotion. This might be defined as the advancement of an employee to a job that requires greater skill and larger responsibilities with, customarily, a commensurate advance in pay. There are many reasons for promotions, among them being to reward good performance; to retain valuable employees; and to maintain the morale of the workers. A company that gets a reputation for very slow promotions, even if the nature of the business is such that no other policy is possible, as is true in many small concerns, will fail to hold its better employees; and those who do remain will frequently be disgruntled and go about their tasks in a half-hearted manner. This condition does no good either to the company or to the workers.

It is very desirable that a carefully thought-out policy be established in regard to promotions. Apart from the ill effects of infrequent promotions, there are few circumstances that will wreak more havoc with the *esprit de corps* of an organization than the practice of ill-advised or undeserved

promotions. It may be assumed that, whenever a promotion takes place, some one of those not thus favored will be unhappy. However, if the advancement has come as a reward for demonstrated merit and if it has been carefully considered before being announced, the effect on the other workers generally will be much more favorable than when the opposite is the case.

Two factors should be considered whenever a promotion is being considered—the ability of the worker concerned, as compared with that of the other employees, and the length of his service with the company. These points must be borne in mind if the management wishes to avoid stirring up resentment among the other workers and crippling their morale. When a company establishes a policy of carefully scrutinizing every proposed promotion in these respects and then follows it consistently, the danger of unfavorable consequences will be greatly diminished.

Discharge. This involves the permanent separation, by the company, of the employee from its service. A layoff differs from discharge in that it is assumed that the separation is merely temporary. Many reasons exist for the discharge of employees. Common ones are incompetence, insubordination, laziness, and incompatibility.

Policies regarding discharge range from the simplest, where the mere word of a superior is sufficient to effect a dismissal, to quite complex procedures that call for the referral of all proposed dismissals to committees, and formal statements of charges, hearings in which the prospective dischargee is given a chance to defend himself, with final review by the personnel manager. In many companies it is the policy to endeavor to effect a transfer of the employee concerned to some other department, unless the charges be those of insubordination or something of that sort.

Regardless of the length of the procedures specified, it is customary for the management to uphold the supervision that initiated the move toward the dismissal, at least as far as the department is concerned. Even if a mistake has been made, most companies will consent to the worker's having to leave the department if his foreman insists.

Discharge is almost always an unpleasant process that leaves some bitterness on the part of the employee affected. But the blow can be softened somewhat through a system of review and appeal, which may result in the prospective dischargee's being shifted elsewhere in the plant.

A *layoff* is quite different and usually results from a diminution of work, either in a particular department or in the company as a whole. It assumes re-employment as soon as conditions have become better. Within certain limits it is customary to effect layoffs in reverse order of seniority, those with the shortest period of service being the first to go.

Personnel Records The records of the personnel department are suggested by the recital of its functions as previously given. Files are kept for all applicants who have not yet been hired, together with all pertinent papers relating to them. These files are reviewed periodically in order to cull out the older applications and keep them up to date.

A file is maintained for job requisitions that have not been filled, as a guide to the hiring activities of the personnel department.

A folder file is kept for all employees currently working for the company. Each folder contains all of the papers relating to the subject employee, including the original application, the results of the physical examination and the psychological tests, and a complete record of the individual's service with the company. Another folder file is kept for all former employees who have left the company for any reason. Included in this file are the records of the termination of their services, with statements by their superiors concerning the reasons for their leaving, the quality of their work, and whether or not they should be rehired at some future date.

QUESTIONS

1. Which of the divisions of the personnel department would it be desirable to combine if the director of personnel has only two assistants to assign to the five divisions? if he has three assistants?

2. What is the difference between a job analysis and a job specification?

3. Many companies have a policy of filling all executive vacancies from within the ranks of their own employees, while others bring in outsiders if they seem to be better fitted for the positions than their own people. Which of these policies is better? Why?

4. Distinguish between the purposes of the preliminary and the main interviews.

5. Of what value to the employment department is the information secured from intelligence tests? aptitude tests? achievement tests?

6. Of what value are letters of recommendation to the applicant? to the company? Do you agree with the current belief that letters of recommendation are of doubtful value in employment procedure?

7. What are the advantages of a carefully worked-out plan of introducing the newly employed worker to his job? Do you think of any disadvantages?

8. Give the factors that would be important in deciding whether or not a company should train its own workers or endeavor to hire workers already trained.

9. Why has the apprenticeship system declined in popularity?

10. Is welfare work the proper province of employers, or should a company content itself with paying the best possible wages and letting its employees look out for their own interests?

11. Why have some employers been slow to install safety devices and to provide instruction in safety methods for their workers?

12. Is it possible for a business to build good will through its procedure for discharging employees?

13. Some companies have a policy of refusing to employ two or more members of the same family. Do you regard this policy as wise? Why?

14. Were you ever interviewed for a job? If so, describe what took place and criticize the proceedings.

PROBLEMS

1. Prepare a job specification for a particular position with which you are familiar or about which you can secure the necessary information. Examples of positions that may be used for this purpose are (a) sales clerk in a particular type of retail store, (b) gasoline station attendant, (c) stenographer, typist, office clerk, or receptionist, (d) cashier, and (e) waitress.

2. Design an employment application blank for use in the preliminary selection of applicants for a particular position, preferably the one selected in Problem 1. Include the questions that you think

would prove helpful in accomplishing the desired purpose. Assume that the most promising applicants will be interviewed before a final selection is made.

3. Assume that you have the responsibility for the final interview of applicants for a particular position, preferably the one you selected in Problem 1. List the most important questions that you would ask during the interview, and state the purpose of each question.

4. Visit the personnel training department of a local business and secure the details of its training procedures. Briefly summarize your findings. Indicate what you consider to be the best features of the program.

5. The personnel records of a manufacturing business reveal the following figures for one year:

	DEPT. A	DEPT. B	DEPT. C
Average number of employees	1,236	180	2,785
Number of replacements	854	27	3,103

Calculate the rate of labor turnover for the business as a whole and for each of the departments. For this purpose, use the formula $R \div E = LT$ when R represents number of replacements; E, average number of employees; and LT, labor turnover.

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CHAPTER 9

EMPLOYEE REMUNERATION

Role of Wages in Our Economy The term "wages," as used in this chapter, is intended to embrace all forms of payments made to individuals for personal services rendered. It includes not only the pay received by workers in factories, mines, offices, wholesale establishments, and stores, but also the salaries of executives and managers, the commissions earned by salesmen, and the fees of professional folk such as lawyers, doctors, dentists, teachers, and clergymen.

Broadly considered, wages may be regarded as the reward paid to workers for the productive work that they perform. Labor together with land, capital, and entrepreneurship make up the factors of production, and here the term "production" is used to embrace all economic activity. (Some writers include a fifth factor—management; others combine management with labor.) Just as rent is paid for the use of land, interest for the use of capital, and profits for the risk of entrepreneurship, so wages are paid for all physical and mental effort that contributes directly or indirectly to the production of goods and services. It is apparent, then, that only those who contribute to the production of goods and services have earned wages. A further conclusion is that the wages received by any individual tend to be in proportion to the value of the productive effort that he puts forth.

In most instances wages provide the recipients with their sole source of purchasing power. It may thus be said, as far as wage earners are concerned, that they acquire their purchasing power through the exercise of their productive capacities. This purchasing power is of paramount importance in our economic system because it brings about the consumption of the output of our productive facilities.

It can be seen, then, that wages play a dual role in our economy. They comprise the price that is paid for the human effort that goes into production and at the same time provide

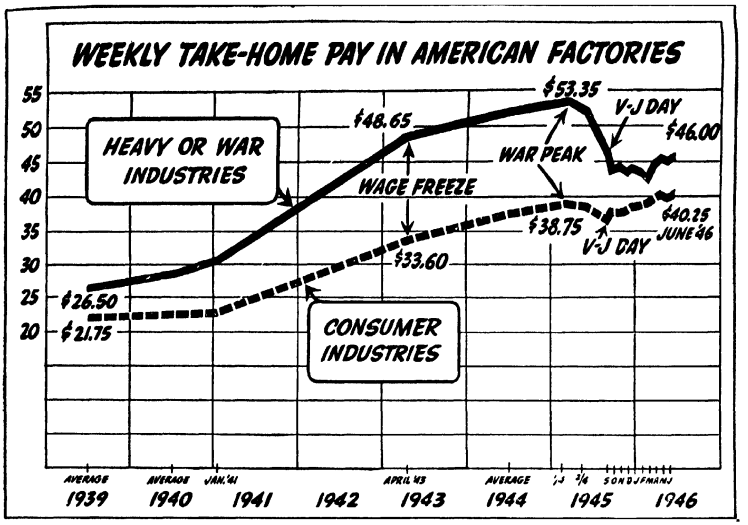
the wherewithal by which the results of production are distributed.

Why Do Wages Vary among Individuals? It is, of course, a commonplace that there is a wide variation among the wages paid to different individuals, or more correctly, to different jobs. An elevator operator receives a small fraction of the pay of a corporation president; a day laborer gets much less than a crack salesman; a filing clerk's wages are less than those of an expert typist; and so on, through a long and diversified category of jobs. Why should this be so?

There are two basic reasons for this divergent wage phenomenon. The first of these is a matter of supply and demand. Many people, whose capacities are limited or who find themselves in situations where the opportunity to develop their latent capacities is limited, are able to do work only approximating that of common laborers. The ratio of these folks to the number of jobs available is almost always high; hence it is not necessary for management to pay high wages in order to secure as many workers of this type as it needs. As the scale of job complexities and as the level of personal skills required to fill them rises, increasingly fewer individuals are qualified to fill them; therefore, they are paid higher and higher wages. For high executive posts, comparatively few persons have the requisite qualifications, hence they are able to command very large salaries.

The second of these reasons is more or less of a corollary of the first and is based on the fact that the instruments of production compete with each other, on a cost basis, for employment in the productive process. There is not only intergroup competition (labor competing with capital, man versus a machine) but also intragroup rivalry (laborers competing against laborers, executives against other executives).

It is of importance in this regard that not only are there a large number of laborers to compete among themselves for the available jobs, but that laborers, as a group, must compete against machines which can do the same things that they can do, and frequently cheaper. This tends to keep laborers' wages at a comparatively low level. By the same token, it should be noted that not only are there comparatively few



Source: U. S. Labor Department *Labor's Monthly Survey*

Differences in Average Weekly Earnings of Factory Workers

The average weekly earnings of workers in consumer industries are less than those of workers in heavy industries. Manufacturers of nondurable goods, such as food and textile products, employ a larger percentage of unskilled workers.

executives to compete among themselves, but that there is practically no competition to them offered by land or capital. Hence the remuneration of executives is relatively high. This same analysis could be carried on through all grades of jobs.

How Are Wages Determined? Economists have long theorized on the manner in which wages and wage levels are determined. It might be interesting to review briefly the various wage theories that have been advanced since man first attempted to reduce our complex economic system to a set of rules.

Subsistence Theory. This theory, which appeared during the seventeenth century, held that the level of wages tended to be set at a point that would just enable the workers to subsist and to reproduce their numbers with little variation over long periods of time. This theory has also been called "The Iron Law of Wages." It probably reflected the condition of many, if not most, of the workers of that time, who were engaged chiefly in agriculture, in a period of relatively low productivity.

This theory is no longer held to be valid because it disregards differences in skill between workers, fails to recognize an increase in the productivity of agriculture, and does not envision a mechanized economy wherein machinery helps to augment man's productive capacity. It also disregards the possibility that employers may bid against each other for workers, or that workers may band themselves together for collective bargaining. Like many other discarded economic theories, it probably was put forward as a description, if not a justification, of conditions which existed at the time that it was propounded.

Wages Fund Theory. After the decline in the acceptance of the subsistence theory of wages, there appeared in the early nineteenth century the wages fund theory. This endeavored to prove that wages were paid out of a capital fund, which was definitely limited in size, being, roughly, the gross value of the products of the economic system minus the necessary payments to landowners and those who had invested their capital in business. It was, of course, assumed that the payments for the use of land and capital would be made before those to labor and that nothing could impair the receipt of their rewards by these factors of production, lest they decide to withdraw and enter some more fruitful field. The theory further held that wages were thus limited by forces outside the workers' control and that, if any individual or group succeeded in getting their wages increased, this meant that a corresponding individual or group must suffer a commensurate decrease in wages in order that the fund be not overdrawn.

This theory, while presumably discarded by most economists, is still held by a number of people, particularly those who would resist the attempts by labor to better its situation. A variant on the theory is to be found in the belief, which is held by certain labor leaders, that there is only a given amount of work to go around and that limitations on the productivity of the workers must be imposed so that there will be enough work for all, or at least all members of the unions concerned. Evidences of this belief are to be found in the restrictive practices of the unions in the building trades.

One of the main reasons why the wages fund theory is no longer regarded as valid is that it fails to allow for the possibility of increased productivity on the part of labor, which may more than offset any concurrent increase in wages. While there may be certain outside limits to the total amount available for wage payments, it is quite probable that these boundaries are extremely elastic and that we have not yet reached the point beyond which they could not be stretched. The wages fund theory assumes a static rather than a dynamic economic system, and ours has been of the latter variety.

Marginal Productivity Theory. This theory is rather widely accepted among economists today as an explanation of wages as they are to be found. It assumes that the price of anything is determined by the amount that will be paid for the last or marginal unit that is offered for sale. It assumes that management, by experimenting in the use of various units of land, labor, and capital, will eventually arrive at the optimum combination of the three that will yield the greatest profits to the company. The amount that has to be paid to the last unit of each that had to be employed determines the price of all units of that element. In the case of labor, the price is, of course, the wage rate.

Thus the value of the product of the marginal unit, its marginal productivity, becomes the price paid for all such units. It is assumed that there are various grades of land, labor, and capital, and this explains why skilled labor receives more than unskilled. A further assumption is to the effect that the price that must be paid to the marginal unit is dependent upon the supply of the units of that class. Since the supply of highly skilled workers is relatively small, the price that must be paid to the marginal unit, and hence to all of the others, will be high compared to a group where the supply is greater as compared with the demand.

The theory has almost endless ramifications and implications. Many economists regard it as the best explanation of wages that has yet been brought forth. Because of its complexity, no further appraisal of this theory will be attempted here, other than to state that it probably is not the last word in wage theory.

Bargaining Theory. Many observers of the economic scene are inclined to favor the bargaining theory of wages. This theory assumes that wages are set in more or less of a labor market place as the result of a bargaining process between labor, as sellers, and management, as buyers, and that the relative bargaining strengths of these two factors determine the wages to be paid in any given situation. This theory has the virtue of describing an actual procedure in that it portrays the collective bargaining process with a fair degree of fidelity. As this practice spreads in industry, as now seems quite probable, the pertinency of the theory will become even greater.

However, to assume that an individual applicant, seeking a job with an employer, particularly a large corporation, engages in a bargaining process, is to take an entirely unrealistic view of what actually takes place. This statement is true, even though one aspect of the bargaining theory assumes that there are lower limits, below which the workers are unwilling to go, and upper limits to the employers' offerings. The fact of the matter is that most jobs carry price tags, so to speak, or at least have a range of wage rates that are set by the employers on a take-it-or-leave-it basis. When there is a range, the employing officials are usually allowed to use their judgment in regard to the rates that they offer applicants, but they are rarely permitted to go above the upper limits.

The bargaining theory is a satisfactory explanation of one segment of the wage-determining process but is inadequate as far as the rest of the picture is concerned. It fails to explain high wages in unorganized industries or fields. It completely overlooks the relative productive value of skilled and unskilled workers, and does not explain the variations in wages between workers of equal skills at identical jobs.

Actual Determination of Wages The inadequacy of the wage theories just discussed results from the attempt that each makes to explain the whole wage-determining process. They all tend to oversimplify a situation that is actually exceedingly complex. A large number of different factors enter the wage-determining picture, and their bearing on any given situation varies with the external conditions present.

Without regard to their relative importance, the wage-determining factors include the following:

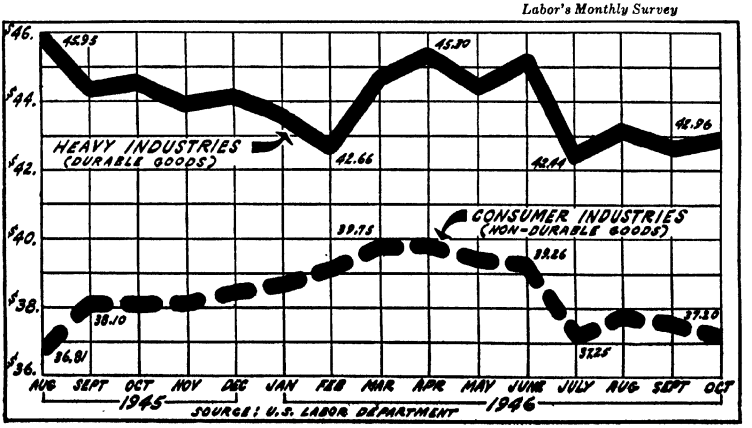
Prevailing wage rates in the community.
Cost of living in the community.
Wage rates paid by other communities.
Supply of the various classes of labor.
Demand for the various classes of labor.
Wage philosophy of the employers.
Relative disagreeableness or attractiveness of the work.
Degree of organization among the workers.
Bargaining skill of the workers' organizations.
Relative mobility of labor.
Stage of the business cycle—prosperity or depression.
Profit situation in the various businesses.
Degree of skill required.
Social desirability of the jobs.

Money Wages versus Real Wages An important distinction should be made between money wages and real wages. *Money wages* are, as the term implies, the actual dollars and cents that workers receive from their employers as payment for services rendered. *Real wages* are the goods and services that the money wages will buy at any given time. This means, therefore, that real wages are dependent on the current price level as well as on the existing wage level. If money wages are high and the price level is relatively low, real wages are higher than if the price level were to be raised several points. In view of the fact that the value of money lies in the goods

Real Wages of Factory Workers

In this chart the real wages of workers in heavy and consumer industries are expressed in terms of the buying power of dollars in January, 1941.

Labor's Monthly Survey



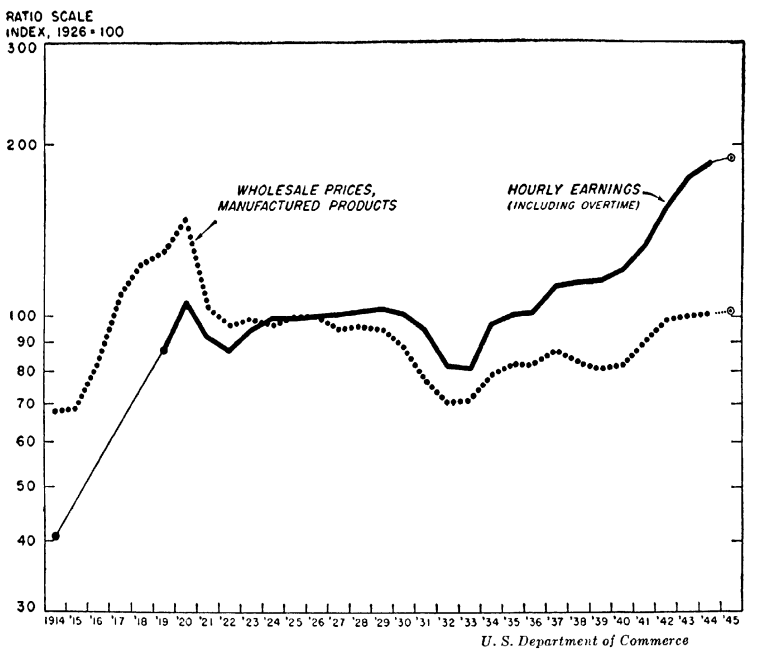
and services that it will buy, the test of the adequacy of any given wage level is in the real wage concept rather than in the purely dollars and cents aspect.

A great many workers and labor leaders appear to be entirely unaware of the importance of the real wages part of the remuneration picture. They struggle to secure higher money wages, quite without regard for the fact that, in many instances, their increased wages may result in higher prices for the things that they buy. Furthermore, they will do practically nothing to bring about a lowering of the price level, even though this might result in their being able to buy more goods and services on their present incomes than they could buy were they to secure the "raises" which they seek. Labor is "money-wage" minded, whereas it needs to turn its attention more to the real wages aspect of its income problem. During World War II there was some evidence that the more enlightened labor leaders were aware of the value, to their followers, of restraining price rises; but it is doubtful if they experienced much success in creating enthusiasm among their members for this point of view. This was due to the workers' failure to grasp the real wages point of view.

Wages as a Cost of Production As indicated above, wages in a capitalistic system are regarded as one of the costs of production. Thus, if the degree of productivity of the workers remains the same, a wage increase is tantamount to a cost increase and, unless the profit margin is to be narrowed, must be followed by a commensurate price increase.

There are many instances, however, where wage increases, if accompanied by increased productivity on the workers' parts, may not result in cost increases, but may even bring about unit cost decreases, which in turn may cause prices to be lowered.

The Philosophy of High Wages The realization by many employers of the truth of the principle set forth in the immediately preceding paragraphs has resulted in the coincidental increasing of their workers' wages and a lowering of the unit costs and the selling prices of their products. The philosophy of high wages may be regarded as the policy of



U. S. Department of Commerce

Average Hourly Earnings of Factory Employees and Wholesale Prices of Manufactured Products

Changes in hourly earnings and wholesale prices are expressed in terms of the 1926 level of earnings and prices. Increased productivity has made possible an increase in hourly earnings greater than that for wholesale prices.

rewarding workers for increasing their productivity, which in turn brings about lowered costs and enables the companies embracing this philosophy to gain competitive advantage through lowering their prices. There are undoubtedly limits beyond which this process cannot go, but there are many industries where steps in this direction would yield advantages to the workers, the companies, and the consumers.

Wages and Prices

Among the fundamentals of economics that many workers have failed to grasp is the fact that increasing the prices of many commodities has the effect of reducing the demand for them if this demand is elastic. If prices are increased too greatly, the commodities are said to be "priced out of the market." This means that the prices are so high that the sale of these items is practically stopped.

This principle has two applications. One refers to the inescapable fact that wages are the prices paid for labor and that, if they are too high relative to the workers' productivity, management may be forced to switch to some other instrument of production, such as capital in the form of machinery that replaces labor. Labor, in this case, will have priced itself out of the market.

The second application of this principle is found in those situations in which increased wages have forced the management to raise its prices to the point where sales have experienced a significant decline. While the product may not be forced off the market, a falling off in sales may result in actually lowered money wages for the workers whose demands for wage increases started the unfortunate chain of events.

Wage Rates versus Earnings The foregoing discussion is not to be interpreted as an argument for keeping wages down. There are probably few industries in which the application of modern scientific management methods or the increased use of machines would not increase the productivity of the workers to such an extent that markedly higher wages could be paid. The adoption by more companies of the philosophy of small unit profits on increased sales brought about through lowered prices would likewise help in the absorption of increased wage costs. The point to be stressed, however, is that wage rates, particularly hourly rates, when not accompanied by increased productivity, may be set so high that the workers' total earnings will be less than they would be at lower rates.

An excellent example of this may be seen in the building trades. The unions, with their eyes on wage rates, have set these rates so high that, when coupled with restrictive rules concerning worker productivity, these rates have for years actually served to impede the building of homes and other structures. This has unquestionably resulted in the workers being employed for fewer hours with lower total earnings than would have been the case had their rates been reduced or their productivity stepped up.

The relationship between wages and prices, and wage rates and earnings needs to be brought to the attention of workers

and their leaders in order that the true economics of the situation may be apparent to them. They should also recognize the competitive situation in regard to the prices for their own labor, as well as those of the products that they make. Until this comes about, the matter of wages will continue to be one concerning which there is much misunderstanding in regard to what can and what cannot be done under our system of competitive capitalism.

Higher Wages, Shorter Hours That which has just been stated applies with equal force to the matter of increasing wages and shortening hours at the same time. This can be accomplished through increasing the productivity of the workers with the result that unit production costs remain constant or are lowered and prices follow unit costs, or it may bring about an increase in unit costs that must be absorbed out of profits, or translated into higher prices, which may reduce sales. There are no other alternatives to these possibilities.

In the past it has been possible in many industries to reduce hours and increase wages through the introduction of modern production methods that increased the workers' productivity. Sometimes the reduction of workers' fatigue through shortening the working hours has had a favorable effect on the rate of production. In other instances time and motion study has so increased worker efficiency that production costs were not increased by curtailing the hours and increasing wages.

Incentive Wages Before taking up an examination of the various methods of wage payment presently in force, mention should be made of the use of incentive wages or, as they are more frequently termed, wage incentives. The purpose of wage incentives is to induce workers at all levels to put forth greater productive efforts, for which an immediate cash reward is paid. The installing of a wage-incentive system in a company is a task that requires a high degree of skill, judgment, tact, and knowledge of the productive processes that are employed. Experience seems to indicate the desirability of "tailoring" each system to the plant in which it is to operate. It is important that the confidence of the workers be gained and that they understand thoroughly

just how the system works. In unionized plants it is desirable that union stewards be brought into the operation and their approval of the procedures be secured.

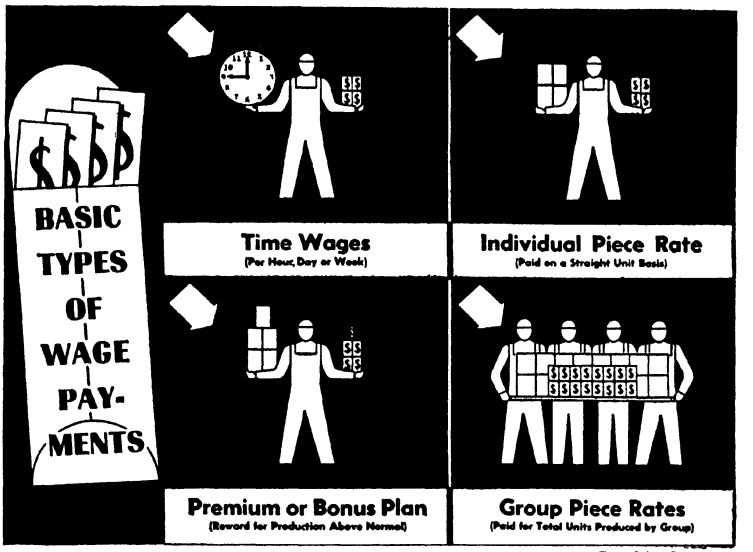
Incentive plans can be used for office workers, salesmen, and even for executives. In each instance they must be fitted with care to the job to be done, and close attention should be paid to equalizing the extra reward to be paid with the additional effort required by the worker to secure it. A good incentive plan can do much to improve the productivity and morale of an organization, whereas a poor one can have a devastating effect on the personnel.

Labor has long been suspicious of incentive plans because in the past certain companies appear to have used them to speed up the tempo of workers' operations, and then have cut the rates of pay so that the workers' earnings returned to their original level, whereas their productivity remained higher. A management that contemplates anything of this sort is storing up trouble for itself in its labor relations and might better abandon the whole project before it is started.

Methods of Wage Payment There are a large number of different methods of making wage payments to workers. In the sections that follow, the more common systems will be mentioned and briefly discussed.

Straight Salary. This is the simplest form of wage payment. It may be expressed in terms of a stated amount per day, week, month, or year. Straight-salary plans may or may not provide for deductions for absence or tardiness according to the policies of the companies using them. There is little in this system other than the possibility of a salary increase to serve as an incentive to an employee to exert extra effort on the job.

Time Wages. In this system payment is made on the basis of stated rates per hour of time worked, without regard to the quantity or quality of output. If a worker's hourly rate is $1 and he works eight hours, he receives a total wage of $8. Under the Wages and Hours Act employers must pay time-and-one-half for overtime. Many contracts negotiated with management by labor unions also provide double time for



Graphics Institute

Four Common Types of Wage Payment Plans

work on Sundays and holidays. It is customary for the regular working hours to be indicated either on a daily or a weekly basis. Except for the overtime feature, there is nothing of the incentive wage in this system.

Shift Premium. A variant of the foregoing type occurs when a higher rate is paid to workers on the afternoon and night (graveyard) shifts. This method appeared during World War II when additional rewards were required to induce employees to work on these two shifts.

Bonus Payments. A mild form of incentive wages is found in the bonus payments that many firms make to their employees. These bonuses, which are frequently paid on a yearly basis, are customarily related to length of service rather than to output. They are found in banks, offices, stores, and other establishments where a record of each individual's production would be difficult, if not pointless, to maintain. They are incentives to employees to stay with the company but have little other value.

Executive bonuses are sometimes related to the profitableness of the company or its component divisions; and, because this may be under the control of the executives, these payments take on the nature of incentives.

Piece-Rate Payment. This type of wage system involves payment at a stated rate per piece produced. For example, if the piece rate for a given item is $.005, and a worker produces 1,000 pieces in a day, he receives $5 for his efforts. In many plants each worker has a day (or hour) rate that becomes effective whenever he is not working on piece work. This allows for time consumed in setting up the machine, sharpening tools, machine breakdown, power failure, waiting for stock, and so on. Usually these plants guarantee their workers their day rate of pay as minimum wages. This is customarily well below what they can earn if they are on piece work.

It is through piece-rate systems that wage incentives are usually established. There have been a large number of such systems in force during the past several years, all of them varying slightly from the others but all designed to induce additional effort on the worker's part and to reward him for it. Most of them establish a standard task that the worker must perform before he can begin to reap the additional remuneration that the systems hold out. Another point of similarity has to do with the problem of whether the worker should receive all of the earnings from the incentive or whether part should go to the worker and part to the management, frequently the foremen.

Standards for Piece-Work Payments

These piece-work systems are based, in the first instance, on time and motion studies, which are designed to establish performance routines that the workers will follow and to determine the standards that form such important parts of the payment patterns. A few of these systems are described below.

Taylor Differential Piece-Rate Plan. This system, established by Federick W. Taylor, sets up two piece rates for each job, one of which, the smaller, applies if the worker produces less than the standard task, and the other, the larger, becomes effective if the worker's production is equal to or greater than

the standard task. It is thus obviously to the worker's interest to produce at least the standard task. By setting the rates sufficiently far apart, the management can provide a strong incentive to workers to produce at their maximum speeds.

Halsey Gain-Sharing Plan. This plan, which was devised by F. A. Halsey, is one in which the worker is paid a stated amount for performing the standard task and is rewarded for finishing the task in a shorter time by receiving a certain percentage of the value of the time saved. This bonus ranges from 30 per cent to 70 per cent according to the difficulty of the task and the value of the time that he has saved. If the worker fails to achieve the standard task, he is usually guaranteed his day rate. The management agrees not to change the standard task unless a reasonable adjustment is made in favor of the worker.

Gantt Task and Bonus System. This plan, which originated with H. L. Gantt, one of the pioneers in the field of scientific management, provides for the establishing of a task time for each operation and an hourly rate for each worker, who is paid this rate plus a bonus of a stated percentage of the task time if he completes the job within the allotted time. This bonus varies in size among different companies, but it generally ranges between 20 per cent and 50 per cent of the task rate. If a worker fails to complete the job in the specified time, he is paid his hourly rate for the time required, whatever it may be, but does not receive a bonus.

An interesting feature of this system is that it provides for a bonus for the foreman, based on the number of workers in his gang that make their bonus. The foremen are thus encouraged to spend their time with the poorer workers, in an attempt to bring their performance up to the point where they can earn a bonus.

The following example illustrates the plan. If the standard time for a task is two hours and if a worker whose hourly rate is 60 cents finishes the job in the allotted time, he is paid 2×60 cents, or \$1.20, plus a 25 per cent bonus, or a total of \$1.50. If he maintains the same speed for an eight-hour working day, his daily wage will be \$6.

If a poorer worker requires three hours to perform the task, he is paid 3 × 60 cents, or $1.80. At this rate he would be paid $4.80 for an eight-hour day.

The foreman's bonus might consist of 10 cents for every worker in his gang who made the bonus, plus an additional 5 cents per worker if all the workers equaled the standard.

Many other wage-incentive systems are in effect; some others have been discarded. They vary as to details, but all are designed to increase worker productivity by offering rewards for the extra effort that the workers put forth.

Commission Payment. This type of wage payment is confined to salesmen and is, in effect, more or less of a piece-rate system. The salesman's remuneration is a commission that is paid for each unit of product that he sells. The commission may be either a certain sum of money per unit, or it may be a percentage of the value of the item sold. Occasionally the commission is based on the profitability of the commodities sold.

Since some companies pay only on a commission basis, a salesman who fails to sell anything during any given period receives no pay for that time. Other companies pay a basic salary plus commissions. A number of firms give their salesmen drawing accounts, which are chargeable against commissions earned. For example, a salesman who has a drawing account of $50 per week might, during a four-week period, earn $300 in commissions. A common method of handling this situation is to pay the salesman his $50 weekly for the first three weeks and then at the end of the fourth week to pay him $50 plus $100 ($300 commissions minus $200 drawings), or a total of $150.

Incentive plans are very common in the field of selling, and they are all built around the commission theme. Quotas are determined, which are similar to standard tasks in factory work, and various types of rewards are established for salesmen who reach or exceed their quotas.

Nonmonetary Rewards Mention should be made of the practice of offering nonmonetary rewards for workers who put forth extra efforts at their tasks. Perhaps the

best known of this type is the "E" award made by the Army and/or the Navy for excellence of production during World War II. There have been many others. Honorary clubs are established, membership in which is attained only through continued superlative performance. The old "72 Car Club" sponsored by the Chevrolet Motor Company was an exclusive organization made up of salesmen who had sold 72 or more Chevrolet automobiles during any one year.

Banners or pennants are sometimes awarded to departments that lead in some phase of their work. Contests are held, and the winners are honored at banquets. Merchandise awards are occasionally given to the leaders in these contests. Recognition is frequently given to employees with long service records through the instituting of so-called service clubs, to qualify for which the workers must have a certain number of years of continuous employment. Those who belong to these groups are privileged to wear buttons indicating their length of service.

Valuable as these nonmonetary rewards may be as morale builders in an organization, they can be effective only if the company has a fair, workable wage-incentive plan as its basic remuneration plan. No system of nonmonetary rewards is worth anything if it is regarded as a substitute for money incentive, as many executives have discovered to their sorrow.

Profit Sharing A form of incentive payment that has had some vogue in this country is the distribution of some fraction of a firm's profits to its employees without requiring them to purchase stock to receive them. This is called profit sharing. It may be accomplished either through cash payments or through distribution of company stock.

The purposes of profit sharing have been many. They include inducements for greater production, lower labor turnover, economy in worker use of materials and supplies, loyalty to the company, and resistance to pressure for unionization.

Profits are distributed according to some predetermined pattern. They frequently recognize length of service, both in the matter of the amounts paid to individuals and in the requirement of a certain minimum period of employment as a prerequisite to participation in the distribution.

Some companies pay the employees' share of the profits into special funds, which may be used for various purposes, including that of purchasing shares of stock for the workers. Others follow the practice of offering their employees the opportunity of purchasing stock in the companies at prices that are sometimes a mere fraction of their quoted market prices. For example, some years ago employees of the Great Atlantic and Pacific Tea Company who had three years of continuous service were permitted to buy nonvoting stock in the company for one third of its price on the New York Curb Exchange.

The results that have been obtained through profit sharing have been varied, according to the reports of some of the companies that have adopted this plan. Some firms feel that the effects have been most beneficial, while others have indicated their sentiments by discontinuing profit sharing. The critics of the idea offer several cogent arguments against it. They say that the whole thing is unsound as it violates the fundamental purpose of profits, that is, to reward the stockholders for the risk that they are willing to take in investing their money in the company; and they point out that the employees have no financial stake in the company's success other than that of continued income if it succeeds or dismissal if it fails. It is claimed, also, that the workers are interested only in sharing in the profits and are not willing to assume the risk of loss, which is just another way of putting the first objection.

A profit-sharing scheme assumes the presence of profits, which may not be realized in times of poor business or depression, or when it seems the part of wisdom to plow a large part of the earnings back into the business. The effect on the workers of the failure of the company to continue to distribute the profit bonuses, regardless of the reasons behind it, is said to be distinctly unfavorable and to more than offset any benefits that previous distributions may have afforded.

For these reasons, plus the hostility of the unions to profit sharing, this practice will probably never become very widespread in this country.

Federal Wages and Hours Act In 1938 the Federal Government enacted the Fair Labor Standards Act, commonly known as the Wages and Hours Act, which applies only to

firms engaged in interstate commerce. Section 6 provided that all affected employers must pay minimum wages of 25 cents an hour during the first year following the effective date of the act, 30 cents an hour during the next six years, and 40 cents thereafter. Section 7 set up a maximum work week of 44 hours for the first year and a decrease to 40 hours during the third year of the act. It also provided that all work in excess of 40 hours, after the third year, shall be paid for on an overtime basis. This law has had the effect of raising wages and shortening hours in many of the more poorly paid segments of our economy.

QUESTIONS

1. Can you envision a capitalistic economy without wages? Discuss.
2. A argues that wages come out of profits; B contends, on the other hand, that profits come out of wages. Do you agree with either A or B, or do you disagree with both, and why?
3. What, in brief, is the marginal productivity theory as it applies to wages?
4. Why is it difficult to formulate a single theory of wages that will explain all of the many phases of wage determination?
5. Is it possible to raise wages without similarly raising prices?
6. What is the theoretical limit for wages in any industry?
7. Is there any justification for the restrictive rules of the building trade unions, such as prohibiting the use of spray-painting equipment, limiting the number of square feet of plaster that a plasterer can apply in a day, and forbidding union members to work on prefabricated houses or parts? Explain.
8. There are certain types of jobs to which incentive wages would not be applicable. Name several.
9. If two men in a factory are doing identical work, should they be paid different wages? Why?
10. Why is organized labor generally opposed to piece-rate systems of wage payment?
11. In what important respects does the Gantt Task and Bonus System differ from the Taylor Differential Piece-Rate Plan? from the Halsey Gain-Sharing Plan?
12. Evaluate profit sharing as an incentive to workers to do better work.
13. If salesmen's commissions vary directly with the profit on the items sold, is this a profit-sharing system of compensation?

PROBLEMS

1. A newly organized manufacturing company adopted the policy of offering prospective employees 15 cents an hour more than the going rate for similar types of work in the community in which the factory was located. The purpose of the policy was to attract the best workers in the community. Appraise this wage policy from the standpoint (a) of the workers in the community, (b) of the other manufacturing businesses, and (c) of the probable effect on the company that established the policy.

2. Which type of employee remuneration is most satisfactory for each of the following occupations? Justify your selection in each instance. (a) Elevator operators, (b) waitresses, (c) automobile salesmen, (d) machinists, (e) truck drivers, (f) insurance adjusters, (g) filing clerks, (h) carpenters.

3. The Acme Manufacturing Company uses a differential piece-rate plan for compensating the operators of drill presses in its machine shop. The daily production standard for a certain part is 75 units. For production below standard the piece rate is 10 cents a unit. For standard or greater-than-standard production the piece rate is 11 cents a unit, and this rate applies to all units produced. Compute the daily earnings of the following operators: Adams, 65 units; Caskey, 74 units; Hill, 75 units; Runge, 85 units.

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CHAPTER 10

LABOR-MANAGEMENT RELATIONSHIPS

Labor Problems The subject of labor-management relationships and all that the term implies is easily the most explosive issue in the economic picture today. Whether the future will see a solution to the many problems that have arisen or the continuance of the threat of industrial warfare in many lines of business is a question to which the answer is not clear now.

The purpose of this chapter is to inquire briefly into the causes of our labor problems and to describe labor organizations and their methods of operation, without attempting to attach any blame to management or labor for things as they are. Like many of our economic problems, that of labor and labor organizations is an exceedingly complex one, which has its roots in the industrial history of capitalism and in the fact that the trait of self-interest is the one most likely to be exhibited in economic situations. This latter factor is mentioned because the labor situation is essentially a human problem in which the self-interests of the parties concerned come readily to the fore. It serves to illustrate the essential difficulty that man seems to experience in his attempts to live with other men.

Relations of Labor and Management The focal point in the labor picture is found in the relations of labor and management,[1] both past and present. Over the years, in many industries and companies, labor and management have arrived at a state of mutual antagonism. In some instances this feeling is not readily apparent, whereas in others it is only too patently present.

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[1] Management, in the sense that it is used here, refers to the policy-making group in any company regardless of its identity with the owners. In large corporations management refers to the officers and executives, who are frequently merely salaried employees rather than stockholders, whereas in smaller businesses the individuals comprising the management are usually also the owners.

The sources of irritation appear to some observers to have come from management, rather than from labor, and labor's reaction to these stimuli is what has, in turn, aroused resentment on the part of management. These sources of trouble will be briefly examined.

Management's Impersonality. The impersonality of management in its dealing with labor is a characteristic more common to large- than to small-scale enterprises. This impersonality has been manifested in a number of ways. Men have been hired, transferred, and discharged in a manner that seemed to them to indicate that the management regarded them as so many productive units completely devoid of feelings, at least as far as their relationships to their jobs were concerned.

Management's Arbitrariness. Along with its impersonality, management has too often manifested an arbitrariness in its handling of labor matters that has antagonized the workers, in many instances needlessly. Some orders from management have been just that, "orders," not subject to discussion or argument. The following statement, which appeared on the bulletin board of a large store a short time ago, is typical of this attitude: "Effective immediately, this store will remain open until 9:30 on Monday and Thursday evenings." No explanation was offered to the employees as to why this action was being taken, although there was a good reason for it. The management had delivered an ultimatum, and that was that. Such things do not help to create a friendly attitude toward management on the part of the workers.

Management's Concept of Labor as a Cost of Production. In a capitalistic economy labor is one of the major costs of production. The principal responsibility of management is to combine labor with capital and land in such a fashion that the highest possible profits are achieved for the owners. Management is paid to keep its costs down; and in most instances this means its labor costs as well as the others. The development of modern cost accounting methods has emphasized the cost phase of the labor picture. Thus, some managers see labor, not as a group of human beings, but as a cost of production.

Management is paid to produce profits, not to provide a high standard of living for the workers. It sometimes happens, as has been indicated in the preceding chapter, that the paying of high wages results in a greater degree of productivity on the workers' parts, with lowered unit costs and, eventually, higher profits for the companies concerned. When management does increase profits, the workers affected are fortunate if the increase has come about through increasing wages. However, if the increase in profit is achieved through cutting wages, the effect on labor is less pleasant.

Management's Preoccupation with Profits. As has just been stated, management's first concern must be the securing of profits. This is distinctly not the case with labor. It feels that it has little, if any, interest in profits. On the contrary, the only monetary aspect of their jobs that workers care about is the wages that they receive. This is, of course, entirely understandable. However, the fact that management in many instances thinks first of profits and tends to regard wages principally in the light of their effect on profits is most irritating to labor when this attitude comes to its attention as it usually does sooner or later.

As a matter of fact, labor does have a very real, if unconscious, interest in profits. Only profitable concerns can continue in business and pay good wages. Those that are unprofitable must either retrench, which frequently involves lowering wages, or go out of business, which, of course, would cost their workers their jobs. Many of the rank and file of labor, and probably some of their leaders, apparently fail to recognize this.

The typical worker seems to have the firm belief that all business is extremely profitable and that higher wages could easily be paid by most companies without seriously impairing their profit positions. In the minds of a great many workers, the purpose of business is to provide them with jobs and not to make profits for the owners. For this reason management's preoccupation with profits serves to infuriate labor and to convince the workers that management thinks first of the interests of the stockholders and only secondarily of the employees' welfare.

Incomprehensibility (to Labor) of Business Methods. It seems to be a human characteristic that man either fears or distrusts that which he does not understand. This is singularly true in the case of workers' lack of comprehension of business methods, particularly accounting and financial practices, and those by which the payment for the various jobs is computed. The failure of management to educate the workers in the meaning and purpose of many managerial procedures has served merely to aggravate labor's suspicion of these methods. The fact that management has never felt obliged to inform labor about those things and that a great many workers would not understand them if they were explained, does not change the situation in the least.

Results of These Frictions Over a long period of time, these management attitudes and actions have served to create a deep-seated resentment and distrust on the part of labor. There have been, of course, notable exceptions, but unfortunately these are comparatively few in number. The evidence at hand appears to indicate that in most companies of any size the feeling of labor toward the management is one of irritation and suspicion. The workers feel that management is against them, is not sympathetic to their desires and aspirations, treats them as if they were merely machines, and sacrifices their interests to the production of profits.

All of this has made a large segment of labor receptive to the proposals of union organizers. Here they have found folks who talk their language and appear to have their interests at heart, who will listen to their troubles and promise to try to do something about them. The workers have long since discovered the futility of trying to accomplish any betterment of their condition single-handedly and now are confronted with the possibility of bringing this about through joint action. It is small wonder that labor organizations have grown in numbers and in power.

There is evidence to indicate that a sympathetic, more understanding attitude on the part of management would have retained the loyalty of the workers and made the task of the union organizers immeasurably more difficult. This statement is made because of the fact that a great many workers feel an

almost instinctive loyalty towards any organization of which they are a part. This is most noticeable in the case of new, young workers, who usually approach their first jobs with an enthusiasm and a desire to excel that would augur well for their employers if they would recognize and encourage it. Instead, management often appears more or less indifferent to this priceless offering and, as a result, it quickly subsides and is replaced by a sullen distrust and resentment. Workers in this frame of mind are quite favorably disposed toward the overtures of union organizers.

Reasons for the Growth of Labor Organizations

In addition to the factors just discussed, which have served to set the stage for the growth of unions, there are a number of other factors that have helped the advance of labor organizations.

Weakness of Individual Action. There are a number of areas where employees have long sought to better themselves through their own individual efforts with rather indifferent success. These involve such matters as wages, hours of work, seniority, and working conditions. The lone worker, arrayed against the might of the large corporation in an attempt to improve his lot, finds himself in the position of a supplicant, almost entirely dependent upon the mercy of management. If his requests are granted, he feels that it happens to please the management to accommodate him. If they are denied, there is not much that he can do about it other than to return to his post, disappointed, or to resign and look for another job. This has been the experience of many workers, who, rightly or wrongly, felt that they were entitled to something better.

The worker has experienced a sense of futility and helplessness in the face of such odds, and he has long recognized his inability to do much about it by himself. To such people the union brings the hope of achieving betterment through collective action and of affording them the chance of making their requests not from a pronouncedly inferior position, but rather on the basis of a discussion between equals. Furthermore, the opportunity is presented of enabling them to do something about it if management declines to accede to their

requests. Their self-respect is restored; they can bring pressure to bear on management to enforce their requests, which may even assume the character of demands. This possibility has had a powerful appeal to many workers.

Securing Representation. There have been a considerable number of firms whose liberal beliefs have been such that they wished to give their employees an opportunity to express themselves. Many of these companies have recognized that their employees have a stake in the business, even if not a financial one in a profit-making sense, and that their active co-operation can be secured by providing the means whereby they can meet with the representatives of management and discuss their problems. In very small companies with relatively few workers, this can be accomplished by calling all of the employees together for meetings from time to time. With larger concerns, however, this is obviously impossible because of the number of people involved. The solution, therefore, is for the workers to select their representatives who will confer with the management.

This may be done by the establishing of shop committees, elected by the workers, whose members will meet with representatives of management to present grievances and to offer suggestions for improving the product, the manufacturing processes, or labor relations. In this way the workers are enabled to transmit their ideas to the management under conditions that are considerably more workable than would be the case were several hundred or thousand of them to attempt to express themselves in the mass meetings that would be required to accommodate them for this purpose.

Sometimes joint committees are formed to effect mutual discussion of pertinent matters. These are usually made up of elected representatives of the workers and appointed delegates from management. In large plants there are often shop committees in various parts of the factory from which representatives are elected to the joint committees where they encounter the agents of management.

This same representation can be accomplished through union organizations. In this case the possibility of company domination, which may be present in the shop or joint commit-

tee plans, can be largely eliminated. In recent years there has been a pronounced tendency away from the committee method and toward entrusting employee representation to union organization. This is in line with the growth and spread of unionism throughout industry. Whether this is a permanent trend, or only a temporary one, only time will tell. There is no question, however, but that employees want to be articulate in their dealings with management and that some form of employee representation is the best method of accomplishing this in all but the smallest companies.

Securing the Services of Able Negotiators. Included in the ranks of union officials and organizers are many able and accomplished negotiators, whose skill in dealing with management has come from years of practice under extremely adverse conditions. While there are many instances in which able spokesmen, who can negotiate satisfactorily and skillfully with management, are found among the workers in the plants concerned, the fact that the unions have special outside negotiators readily available makes a strong appeal to a large number of workers. This is perhaps one of the most cogent reasons why workers join unions.

Aggressiveness and Salesmanship of Organizers. It would be something less than entirely realistic to overlook the fact that no small part of the growth of labor organizations of all kinds has been due to the aggressiveness and persuasiveness of organizers, particularly those from the unions. Choosing their arguments skillfully and finding many of them practically ready-made for them because of some of the attitudes of management, they have been quite successful in bringing about the unionization of many plants.

A considerable number of persons probably join unions in order to secure or retain employment in unionized companies. Where a closed shop prevails or where the union has won maintenance of membership, new workers must join the union in order to secure jobs, and present employees must join and keep up their membership in order to hold their jobs. This situation is true regardless of whether or not the individual worker wishes to be a union member.

In the foregoing sections emphasis has been placed more heavily on the union side of the labor organization picture. This does not mean that other forms of employee representation do not exist or that they are not successful. Many companies have works councils, shop and joint committees, that have operated satisfactorily for long periods of time. Also, there are several areas of economic activity where the unions have made little progress. However, there appears to be little reason to doubt that the future growth of labor organizations will be along the lines of unions. The influence of the Wagner Act,[1] together with the recognition by many workers that only completely independent organizations can be certain of being free from possible domination by management, has been to direct the course of this movement toward the unions.

Types of Unions There are two basic types of unions in this country, the craft union and the industrial union. To state the situation in a slightly different way for purposes of clarity, unions are organized according to crafts or trades, such as painters, plumbers, machinists, teamsters, and such, and also according to industries, such as steel workers, clothing workers, and automobile workers. Historically unionism in this country grew up on the trade or craft basis, and it is only since 1935 that industrial unionism has made much headway. However, the years since then have witnessed a profound trend toward the industrial union; and even the craft unions are now admitting to membership some of the unskilled and semiskilled workers in plants where formerly only the skilled workers could qualify.

This is an understandable trend. It follows a similar tendency in industry, where the movement from small to large business units has been an outstanding phenomenon of the past several decades. Whereas fifty or more years ago industrial power was centered in many relatively small companies and a few large ones, recent years have seen a reversal of this condition and the emergence of such giants as the U. S. Steel Corporation, General Motors Corporation, The Ford Motor Company, General Electric Company, and many others. If

[1] The National Labor Relations Act, known as the Wagner Act, is discussed later in this chapter.

the unions are to follow this trend, it is to be expected that they would move into the industrial field and concentrate their efforts on those spots where the greatest rewards would be theirs, should they be successful in their organizing activities. That is exactly what has taken place. The steel and automobile industries, two of our largest, have been quite thoroughly unionized, at least as far as the production workers are concerned; and a great many other, only slightly smaller, industries have been similarly organized.

Union Groups As a means of assisting in an understanding of the labor movement in this country, a brief discussion will be presented of the major union groups into which organized labor is divided. These are the American Federation of Labor, the Congress of Industrial Organizations, the Standard Railroad Brotherhoods, and the independent unions that are not affiliated with any of the other groups.

American Federation of Labor. This group, known as the A. F. of L., was organized in 1881 by a group of trade unions. As the name implies, it is a federation because the power to act rests in the constituent unions, and the federation possesses only such powers as are specifically delegated to it by the unions. Actually about the only real power that the A. F. of L. has is that of expulsion from membership in the federation.

The organization of the A. F. of L. comprises an executive council consisting of the president, the secretary-treasurer, and fifteen vice-presidents, who are chosen from the officers of the constituent unions. Annual conventions are held at which the business of the federation is transacted. An office is maintained in Washington, D. C., to serve as a headquarters for the officers and their staff of economists, advisers, and those whose duties require them to maintain contacts with the Federal Government.

As a means of more adequately handling its work, the A. F. of L. is subdivided into four departments—the Building and Construction Trades, the Metal Trades, the Railway Employees, and the Union Label Trades. These subdivisions have a certain amount of autonomy and embrace most of the unions

in the federation. The departments work closely with their member unions and derive their financial support from them. They are particularly active in the settling of jurisdictional disputes between unions when they occur.

The A. F. of L. is primarily made up of trade or craft unions although there are a few industrial unions included among its members.

The United Mine Workers, embracing most of the coal miners in the country, was organized in 1890 and early was affiliated with the A. F. of L. It followed a rather precarious path of ups and downs until, around 1932, it was in rather poor condition. With the advent of the N.R.A., however, its fortunes revived, and in 1937 it was in an exceedingly powerful position. Under the leadership of John L. Lewis, the U.M.W. went into the Congress of Industrial Organizations; later it became entirely independent and has remained so except for a short period when it returned to the A. F. of L.

Congress of Industrial Organizations. This organization, commonly known as the C.I.O., came into being in 1935 when the heads of eight A. F. of L. unions formed the Committee for Industrial Organization. This action took place after a bitter fight on the floor of the A. F. of L. convention on the issue of whether the federation would proceed vigorously to organize the unorganized workers in the great industries, such as steel, automobile, and rubber, on an industrial or a craft-union basis. The proponents of the industrial union idea were defeated and shortly thereafter took the action mentioned above.

In addition to the industrial union issue, there were other factors causing dissension. Not among the least of these was a general dissatisfaction with the A. F. of L. leadership, particularly during the N.R.A. days, when, under the aegis of Section 7 (a) of the National Industrial Recovery Act [1] there had been a widespread burst of unionization, which later foundered to a considerable extent because of the lack of

[1] This section stated, in part, that "employees shall have the right to organize and bargain collectively through representatives of their own choosing, and shall be free from the interference, restraint, or coercion of employers of labor, or their agents, in the designation of such representatives or in self-organization or in other concerted activity for the purpose of collective bargaining or other mutual aid or protection."

interest on the parts of the A. F. of L. leaders in the unskilled and semiskilled workers who had been recently recruited. Personal animosities and desires for power were also potent factors in the movement.

The Committee for Industrial Organization incited intense opposition among the other, craft-minded leaders of the A. F. of L., and in 1936 the Executive Committee of the Federation suspended the unions participating in the C.I.O. By 1938 the C.I.O. was completely independent of the A. F. of L., and it changed its name to the Congress of Industrial Organizations.

Since then the C.I.O. has vigorously pushed its organizing campaign and has penetrated into a large number of fields hitherto not unionized. The organizational structure of the C.I.O. is somewhat like that of the A. F. of L., although there are no departments. The annual convention is the supreme authority, and the officers comprise a president, nine vice-presidents, and a secretary-treasurer, who are elected at each convention. The constituent unions comprise several international unions, several state, city, county, and district industrial councils, and local unions.

Standard Railroad Brotherhoods. These groups, which include the Brotherhood of Locomotive Engineers, the Order of Railroad Conductors, the Brotherhood of Locomotive Engineers and Firemen, and the Brotherhood of Railroad Trainmen, have never affiliated with the A. F. of L. or the C.I.O. They were formed shortly after the end of the Civil War and have grown to a position of great importance in the railroad field. They have been termed the "aristocracy of unionism" because of their conservatism, discipline, and importance. Other railway workers are members of a large number of A. F. of L. unions, but the brotherhoods have so far remained aloof from the Federation.

Independent Unions. There exist a considerable number of completely independent unions, other than the Railroad Brotherhoods, which have no affiliation with the A. F. of L. or the C.I.O. These are scattered over a wide variety of fields, such as air line mechanics, brewery workers, federal employees, postal employees, and marine firemen.

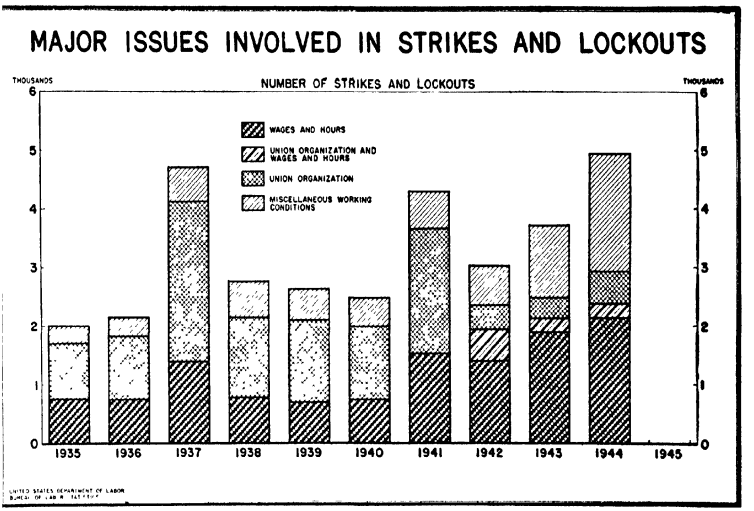
City and State Central Bodies City central labor bodies are made up of delegates from the local unions. They are established for the purpose of protecting and furthering the interests of the union members in the cities concerned. The same thing is true on the state level of the state central bodies. The city and state organizations pay dues to the A. F. of L. or the C.I.O., depending upon which basis they are organized, and send delegates to their conventions.

National and International Unions These are the basic self-governing units of unionism. The two types differ only in that the international unions have local units in Canada, whereas the national unions do not. They are made up of locals which are subject, to a considerable extent, to the decrees and control of the parent organizations. They may or may not be affiliated with the A. F. of L. or the C.I.O., but in either case they retain a high degree of autonomy. The United Meat Cutters and Butcher Workmen of North America is an example of a national union. The International Brotherhood of Foundry Employees is an example of an international union.

Federal Unions Federal unions consist of local unions directly affiliated with and chartered by the A. F. of L. They have no international union connections.

It should be evident, even to a casual observer, that the ramifications of American labor union organizations are exceedingly complex—far too much so for a survey text such as this to attempt to portray in detail.

Union Objectives The aims of organized labor may be divided into two groups, those that are admitted by union representatives and those that must be inferred from the acts of labor leaders. The first group is quite clear-cut and is discussed at some length in the sections that follow. The latter group is somewhat more nebulous and is to be found principally in the assertions of some of the representatives of management who have found occasion to comment on the subject. It is made up of two main items, (1) labor, or at least some of its leaders, is seeking a voice in the management of business; and (2) it is also seeking politi-



In the latter part of the period covered by this chart, miscellaneous working conditions and wages and hours increased in importance as major issues involved in work stoppages.

cal, if not economic, power. In the welter of publicity that invariably attends a period of industrial strife, much is written and said by the spokesmen of both labor and management that needs to be heavily discounted in order to arrive at the truth, if that is possible. However, the demand made by the leader of the U.A.W. strike at General Motors in 1945-46, that the requested wage increase be granted without a price increase, that the company "open its books" to the perusal of the union, and that the amount of the increase be based on the company's "ability to pay," strongly suggests that the accusations made by certain spokesmen for the automobile industry that "a voice in management" was desired by the union leaders was not without a certain amount of substance. Perhaps this was an isolated instance and does not reflect the ambitions of a large segment of organized labor, but it concerned the leadership of one of the largest unions.

The matter of union leaders seeking political power is somewhat more clear cut, with the C.I.O. running candidates for public office and the close association between labor and some of the governmental agencies in Washington. The Political Action Committee, which originated with the C.I.O. and which

was presumed to be later divorced from it, has been little more than a political instrument. The fact that there have been a number of suspected Communists, whose aims are always political, among the labor leaders lends credence to the belief that political power is one of the aims of labor.

Both of these accusations have repeatedly been denied by various representatives of organized labor, but the belief is strongly held by a considerable number of businessmen that these denials are at variance with the ambitions of at least a few of the top labor leaders in the country. The truth with regard to these matters will probably become increasingly clear.

In addition to the objectives suggested above, the unions strive for the attainment of certain, quite concrete objectives, some of which are listed and described briefly below.

Wages and Hours. Foremost among the aims of unions is the raising of wages and the shortening of hours. These are factors affecting workers in which any betterment is immediately recognizable and acceptable; and unfortunately there have been many instances where wages were extremely low and hours very long. The twelve-hour day in many industries was quite common not many years ago, and credit for its disappearance must be given in large part to the unions that fought stubbornly, and often bloodily, against it. Likewise the unions have played a conspicuous part in the slow upward progress of wages from the sustenance levels of the earlier years of the Industrial Revolution.

Closed Shop. An aim of a character quite different from those just mentioned is that of attaining the *closed shop*; that is, the employer agrees to employ no one who is not a member of the union and all employees must continue to be members in good standing during their term of employment with the company. This aim has not been permanently attained in many companies because of the strenuous resistance of employers and because of recent legislation against closed shop contracts.

Union Shop. A *union shop* differs from the closed shop in that the employer may hire nonunion workers, but they must

join the union after a prescribed period, and they must remain in good standing as a requirement of continued employment.

To both the closed and the union shop, most employers have been opposed. In their places employers have preferred the open shop in which, at least theoretically, both union and nonunion workers may be employed.

Maintenance of Membership. This is still another variant on the closed-shop theme. It requires that all workers who voluntarily join the union, in any given plant, must maintain their membership in good standing for the life of the existing contract as a requirement of continued employment.

Preferential Union Shop. In this instance the employer agrees to give preference to union members in hiring and in layoffs. Thus union workers, if available, would be hired before nonunion workers, and they would be retained to the last when layoffs are necessary.

Union Recognition. Under union recognition employers admit the right of the employees to choose their own representatives and agree to recognize the chosen union as the bargaining agent for the workers, or at least that portion of the workers who want the union. The matter of union recognition is another of the points of management-labor conflict that has a stormy career behind it.

Checkoff. This is the term applied to the collection of union dues by the employer through pay-roll deductions. Provisions for this are contained in the agreement executed between the union and management.

Seniority Provisions. Many agreements contain provisions that specify the rights and privileges of employees from the standpoint of length of service. These provisions are concerned mainly with layoffs, rehiring, transfers, and promotions. Obviously this objective more or less disregards the matter of individual ability, loyalty, and ambition.

Effects of These Aims Increasing wages and shortening hours may increase costs and hence prices, if productivity is not increased proportionately; they may

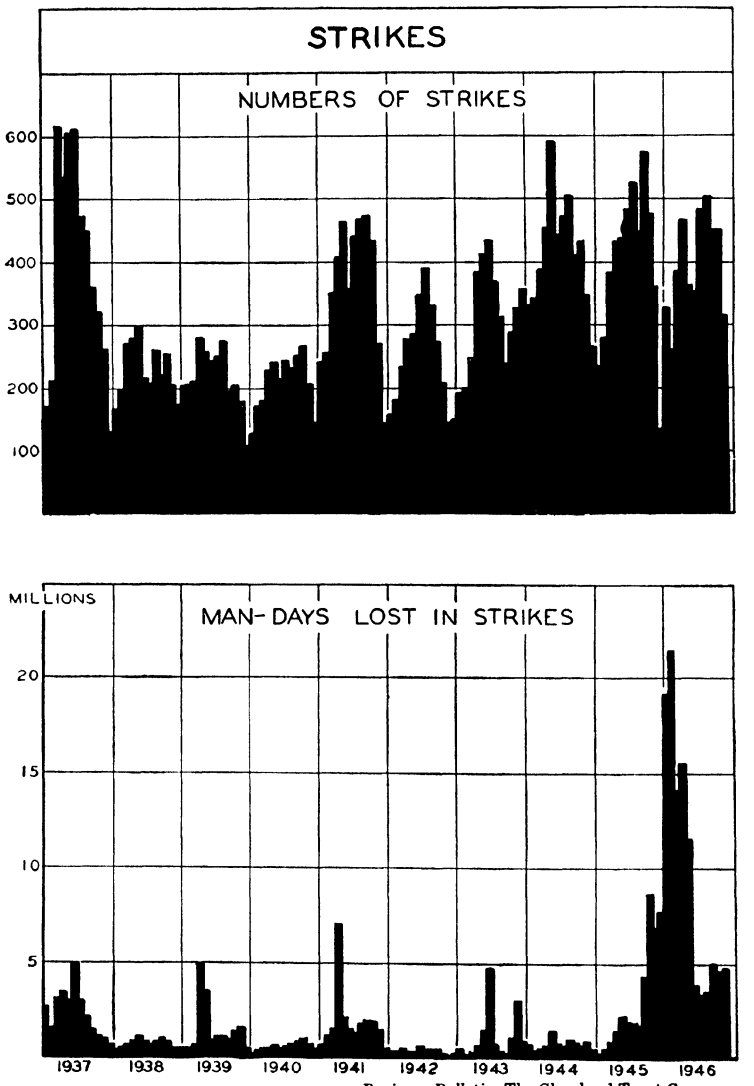
merely increase costs and lessen profits, if prices are not increased; or they may actually lessen costs and result in lowered prices, if productivity is also increased. The matter is a rather complicated one, concerning which it is probably unwise to generalize.

The effect of the other objectives, the closed shop, union shop, and so on, is to move towards a monopoly of labor, wherein it is conceivable that one would have to join a union and remain a member as a prerequisite to getting and holding a job. This condition already exists in many fields of industry and is spreading to others. It tightens the hold of the labor leaders over the rank and file and there is reason to believe that it forces many persons into the unions, who would not choose to join of their own free will.

Furthermore, the attainment of these objectives puts an exceedingly powerful club into the hands of the labor leaders, who have, in some instances, shown little reluctance to use it, without the slightest regard for the effects on the communities where the impact between labor and management takes place. It is greatly to be doubted if the best interests of the people of this country are to be served by permitting such a condition either to develop or to continue.

Industrial Strife The relations between management and organized labor have frequently been on anything but a peaceful basis. This has been due to a militant attitude on the parts of many labor leaders and to the taking of an equally belligerent position by numbers of management representatives. Some of the more common methods employed by both sides are mentioned below.

Labor's Methods. A *strike* is a temporary refusal by employees to continue their work in a plant until certain of their demands have been granted. Usually this is accomplished through the workers' remaining away from the plant, although in recent years the so-called *sit-down strike* has appeared, whereby the workers appear at their posts but refuse to perform their tasks. In some cases they have refused to leave the premises until their demands are met. The sit-down strike has been declared illegal by the courts and has practically disappeared.



Business Bulletin, The Cleveland Trust Company

The chart at the top shows the numbers of strikes by months during the period 1937-1947. The lower chart shows the man-days lost in strikes during the same period.

The *sympathy strike* is found where a group of workers go on strike because of sympathy with another group who are also on strike. The sympathy strikers usually have no grievance against their own employers but strike as a part of the union strategy to help the original striking group.

Picketing consists of posting one or more persons at the entrance to the struck plant for the purpose of dissuading or preventing persons from entering the plant and of informing the public that a strike is in progress.

Mass picketing occurs when a very large number of pickets assemble at the entrances to a struck plant and forcibly prevent persons who may wish to go to work from crossing the picket lines. This is mob rule and has generally been frowned on by the courts.

Soldiering on the job occurs when one or more workers deliberately reduce the pace of their work, for the purpose of impeding production in the plants where they work. If this takes place on an organized basis, it is called a *slow-down strike.* The workers, in this instance, do not stop working, they merely slow down the tempo of their operations.

Sabotage occurs when workers maliciously cripple or destroy the productive equipment of the plants where they work. This is illegal and is not very prevalent at the present.

A *boycott* takes place when union members refuse to purchase products from companies whose employees are on strike or where some condition prevails to which the union is opposed. This type of boycott is called a *primary boycott.* A *secondary boycott* exists when workers apply these tactics against a secondary handler, who offers for sale the goods of a struck or a nonunion plant.

Management's Methods. These have consisted mainly of the lockout, the importation or use of strikebreakers, the blacklist, and the injunction.

A *lockout* consists of the employer's refusal to permit workers to enter the plant to go to work. This usually takes place because of the employer's resentment at some action on the part of the workers.

The importation or use of *strikebreakers* takes place when the employer endeavors to bring in workers to take the place

of strikers while a strike is in progress, thereby getting the plant into operation again and possibly breaking the strike.

A *blacklist* is a secret list of union organizers and members that is compiled by employers' associations and circulated among the members for the purpose of denying employment to the listed persons.

An *injunction* is a court order, secured by the employer, that aims to restrain the unions from interfering with the production of a plant in some manner, usually at the time of a strike. Injunctions used to be issued against almost all forms of strike activity, but in recent years they are restricted to mass picketing, acts of violence, or damage to the employer's property.

National Labor Relations Act In 1935 the National Labor Relations Act was adopted for the purpose of helping workers to organize into independent unions and to secure recognition for them from their employers. A National Labor Relations Board, consisting of three members who were not to be affiliated with either labor or industry, was established to administer its provisions. These provisions set forth a list of five so-called "unfair practices" in which employers were forbidden to engage. These were (a) to interfere with, restrain, or coerce employees in their collective bargaining or self-organizing activities; (b) to dominate or interfere with the formation or administration of any labor organization or to contribute financially to its support; (c) to discriminate in conditions of employment against employees for the purpose of encouraging or discouraging membership in any labor organization; (d) to discharge or otherwise discriminate against an employee because he has filed or given testimony under the Act; and (e) to refuse to bargain collectively with the chosen representatives of his employees.

Employees were given the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in concerted activities for the purpose of collective bargaining or other mutual aid or protection.

The board was empowered to prevent employers from engaging in any of the listed unfair labor practices and also

to conduct elections among employees in order to determine the representatives who shall bargain collectively for them with the employers.

The Act also provided that representatives designated for collective bargaining by the majority of the employees in a plant shall be the exclusive representatives of all the employees in the plant in matters of wages, hours of work, and other conditions of employment.

The Board was given the power to investigate instances where there appeared to be evidence of unfair labor practices by employers, together with the authorization to issue cease and desist orders where necessary.

After the passage of the Act and its validation by the Supreme Court in 1937, the unionization of American industry proceeded rapidly. The so-called company union, insofar as it was company dominated and financed, underwent a change which resulted in the divorcing of it from the control of the company. Many completely independent unions exist, not affiliated with any outside labor groups, whose membership is confined to the employees of the companies where they are to be found. They are actually company unions, but they are no longer under the influence of the employers.

Collective versus Individual Bargaining

The basic difference between collective and individual bargaining is that in the former type representatives of the workers as a whole deal with management in regard to the basic conditions of employment, whereas in the latter type each individual bargains with the management on these matters. The power of collective bargaining lies in the saying "in union there is strength." When labor's representatives sit down around the conference table with management to discuss wages, hours, and so on, they are in a much stronger position to secure their demands if they have all of the workers in the plant behind them than if each man represented only himself. The power behind the threat of a strike of all the workers is vastly greater than the possibility that a few individuals may quit if they are not given what they want.

It is for this reason that collective bargaining is foremost among the aims of the labor unions and most disliked among

employers. It also permits the unions to employ skilled negotiators in their bargaining activities, something that no individual could hope to do. It is through this process that labor is coming to have a voice in the operation of industry.

The main drawback to collective bargaining is that it tends to level out differences in income among workers doing the same tasks. It also acts as a deterrent to ambitious workers who might be able to advance through their own superior efforts or abilities. However, it is probable that the lot of most workers, under collective bargaining, is better than it would be without this process, and an exceptional worker can usually find ways of making his presence felt and of receiving a reward commensurate with his value.

Methods of Settling Labor Disputes

When labor disputes occur, whether or not they are accompanied by strikes or lockouts, certain devices or procedures for settling them may be employed. These are briefly discussed below.

Inasmuch as labor disputes are regarded as such only if management and labor are completely unable to agree on the points in question, the methods for settling them must of necessity involve the intervention of some outside agency or person, who may or may not represent some phase of government.

Mediation. In this method a third party tenders his good offices to both sides in an attempt to bring them to a point of common agreement. This is done without coercion and purely on the basis of helpfulness and the disinterestedness of an impartial third party. The term "conciliation" is frequently used to describe the same process although strictly speaking this refers to the negotiations between labor and management without the assistance of third parties.

Arbitration. Voluntary arbitration involves the submission by the disputants of their differences to some outside party, who takes on something of a judicial role and arrives at a decision concerning what should be done. The voluntary aspect of this method may concern either the submission of the question or the abiding by the decision, a matter which is usually determined in advance.

The procedure in compulsory arbitration is the same as in voluntary arbitration, except that it may involve compulsory submission of the question to the arbitrator and/or compulsory acceptance of the award. There has been very little compulsory arbitration in this country because of the opposition of both management and labor to this method of procedure. The nearest approach to it is where the disputants are required to submit their case to the arbitrator but are not required to abide by the award. This has been called compulsory investigation, which is just about all that it is.

Where either or both sides to a dispute are adamant, no form of intervention is effective and the customary result is a strike with all of the attendant trouble. During World War II the Government seized numerous strike-bound plants in order to avoid a tie-up in the production of needed war materials; but in peace times the only recourse appears to be a resort to industrial strife, with the possibility that public opinion or a recognition of the public interest may bring about a settlement. We still have a long way to go in learning how to solve our labor-relations problems.

QUESTIONS

1. In what ways and to what extent is the labor problem an outgrowth of large-scale business operations?

2. Is labor a cost of production? If it is, how can labor relations be reconciled with this fact?

3. Should labor be given a voice in the determining of managerial policies, for example, whether profits are large enough to permit of a wage increase without a concomitant price increase?

4. Should a worker's first loyalty be to his employer or to a union? Why?

5. What are the advantages of the industrial union as compared with the craft union? What are the disadvantages?

6. How do you account for the existence of several different types of union groups? Is labor's cause strengthened or weakened by having several types instead of one?

7. Do you believe that the charges made by management that labor seeks a voice in management and political power are true or false? Support your stand with items from newspapers or magazines.

8. Is there any justification for such practices as the checkoff, the closed shop, and the maintenance of membership? What are the undesirable effects of these practices on workers, employers, and the public?

9. Of the methods employed by management and labor during periods of industrial strife which are the least desirable from the social point of view?

10. Was it necessary for the Government to come to the aid of labor in its attempts to organize during the 1930's?

11. Should strikes be permitted in industries that directly affect the public welfare, such as transportation, public utilities, the police, and such?

PROBLEMS

1. The major issues involved in work stoppages (strikes and lockouts) ending in 1945 are indicated by the following data:

Total of issues	4,616
Wages and hours	1,956
Union organization, and wages and hours	366
Union organization	580
Miscellaneous working conditions	1,714

From the chart on page 199, determine the approximate number of work stoppages of each kind for 1944, 1940, and 1935, and compare these figures with those for 1945. What are your conclusions regarding the work stoppages in 1945?

Follow this same procedure for the latest data on work stoppages available from the Bureau of Labor Statistics of the United States Department of Labor.

2. Read a report of a company that has had an outstandingly successful labor-management history. Use the *Readers' Guide to Periodical Literature*, the *Industrial Arts Index*, or some similar compilation for locating a report of this type. Write a brief summary of the case, emphasizing the factors from the points of view of both management and labor that have been principally responsible for the situation in this company.

3. The man-days idle as a result of work stoppages beginning in 1945 represented 0.47 per cent of the available work time. The corresponding figure for 1944 was 0.09 per cent.

The workers involved in work stoppages beginning in 1945 represented 12.2 per cent of the total number of employed workers. The corresponding figure for 1944 was 7.0 per cent.

Secure from the nearest Regional Office of the Bureau of Labor Statistics the most recent percentages for man-days idle and num-

ber of workers involved. Compare these figures with those for 1944 and 1945. Write a brief interpretation of these figures.

4. Certain factory workers who are being paid $1.00 an hour for a 40-hour week demand an increase to $1.25 an hour. The management refuses the request and makes a counteroffer of $1.12 an hour. The workers refuse this offer and vote to go out on strike. During the strike, which lasts twelve weeks, the workers receive no pay. The strike is settled at a compromise rate of $1.15 an hour.

How many weeks will it take each worker at the new rate of pay to make up the wages lost during the strike, figuring the wages lost on the basis of the former rate of $1.00 an hour?

From the point of view of labor, what factors might offset the loss of pay during the strike?

5. Secure from the headquarters of a local union and of a local chamber of commerce or similar organization copies of pamphlets, reports, and other types of literature pertaining to labor problems that have been prepared for their members and for the public. Analyze this material, prepare a brief report of the main issues raised, and comment on the validity of the positions taken.

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CHAPTER 11

THE MARKETING PROCESS

Place of Marketing in Business *Marketing* is concerned with all of the business activities involved in the flow of goods and services from production to consumption. Goods that people use go through two basic stages—production and marketing; first they must be made, and then they must be distributed. Production deals with the producing or the making of goods, whether this be through the agency of mining, fishing, farming, lumbering, or manufacturing in some form. The productive process prepares the goods for use by people or business firms. When the goods are finished, they must move toward those who want them. In a capitalistic economy this means that they must be sold and delivered to someone who may use them or, in turn, sell and deliver them to someone else. As long as goods are not being subjected to one of the production processes, all activities that contribute directly or indirectly toward placing them in the hands of the ultimate consumer come within the realm of marketing.

Marketing Functions In the marketing of goods there are certain tasks that must be performed by someone. These tasks are called "marketing functions." They include buying, selling, transportation, storage, standardization, finance, and risk taking.

Buying. Generally, the wholesaler buys from the manufacturer, the retailer from the wholesaler, and the consumer from the retailer. While obviously this is only one half of the picture (the other half is concerned with selling), it is convenient and helpful to consider separately these actually inseparable factors. The performance of the buying function involves certain practices and policies that have been presented in considerable detail in Chapter 6, Purchasing and Stock Control.

Buying involves the selection of the kind of goods to be bought and the determination of the quality desired as well

as the proper quantity for the specified purpose. There is also the necessity for the buyer to select the sources of the goods that he wants. In many business houses routine buying procedures are established to take care of the details of purchasing and to make certain that all purchase orders are executed in a uniform fashion.

Selling. Selling can be conveniently divided into three parts —personal selling; advertising, which has been called impersonal selling; and sales promotion, which includes the planning, directing, and executing of all sales effort.

Personal Selling. In a primitive society there is little need for selling. Man's needs are simple and rather directly satisfied, either through his own efforts or by trading the things he has made for those that he wants and that have been made by his neighbors. In a complex society such as ours, however, the simple directness of this process will not suffice to satisfy our wants economically. An important characteristic of a capitalistic economy is *speculative production,* the manufacture of goods before orders for them are received. Rather than wait for consumers to ask for the goods that they want, manufacturers proceed to produce the things that they think consumers will want and then try to sell them. For example, toy manufacturers produce their entire line of Christmas products months before the holiday selling season opens. They hope that consumers will like and buy the things they have made. While speculative production does not apply to all types of goods, since some goods are made to order, it is characteristic of a great many lines; and it involves the necessity of finding a market for the speculatively produced goods if the manufacturers are to continue to be in business.

It is customary for wholesalers and retailers to maintain stocks of goods from which their customers may make their purchases. They, likewise, usually find it desirable to engage in selling to assure the steady outgo of their wares.[1] Selling

[1] So-called self-service grocery stores in which consumers are free to roam around and make their selections without the assistance of salespeople have experienced a notable growth in the last few years. Here, however, the selling job is merely transferred from personal selling to mass display.

involves a wide variety of tasks, which vary in importance with the nature of the businesses concerned. These include the discovery of potential customers, acquainting them with available goods, and endeavoring to persuade them to purchase the goods. Some selling is educational in its character, having as its principal objective the dissemination of facts concerning certain products, particularly new ones; while other types of sales effort are purely competitive, aiming to accomplish the sale of goods in competition with other similar products.

Retail selling is noteworthy in that it tries to induce customers to come to the stores; whereas most other types of selling involve the practice of actually seeking out customers, wherever they may be located.

Advertising. Advertising, which is considered to be a variety of selling, employs many media, such as newspapers, magazines, direct mail, billboards, radio, and catalogs. For the preparation of certain types of advertising, notably that of manufacturers of nationally known products, specialized groups, known as *advertising agencies,* are employed. They prepare much of the advertising to be found in magazines, such as the *Saturday Evening Post* and *Collier's,* and on the radio. Most other advertising, particularly that of a local character, is created by the advertising staffs of the companies concerned.

Sales Promotion. Sales promotion is a rather all-inclusive term that has come into quite common usage in recent years to describe the activities that are concerned with the planning and assisting in sales work generally. Included in these are the planning and executing of sales campaigns, which involve both personal selling and advertising, the editing of sales manuals, enlisting dealer aid for the display and sale of goods, promoting sampling campaigns, contests, and many other similar activities. In many firms sales-promotion departments have been established to guide these operations, while in others they are divided between the sales and advertising departments.

Transportation. In the overwhelming majority of instances, goods must be transported from the places where they are

produced to the places where they will be consumed. Transportation has a dual duty to perform—goods must be taken to the places *where* they are wanted *when* they are wanted.

The performance of the transportation function involves the use of railroads, waterways, motor trucks, pipe lines, and airplanes. The needs of the market, plus the competition between these various agencies, have resulted in the development of many specialized services, such as fast-freight and motor-truck schedules known to the trade as "hot shot" runs, refrigerated cars and trucks, and store-door delivery. By means of this last service, trucks owned by a railroad pick up goods at the factory and transport them to the railroad terminals, where the goods are loaded into freight cars; then, after the arrival of the goods in the destination city, they are taken by truck to the place of business of the company to which they were consigned.

Storage. Another of the essential marketing functions is that of storage. In many lines of business goods are produced considerably in advance of the time of sale and, consequently, they must be stored for varying periods of time. The manufacturer, the wholesaler, and the retailer all store goods to some extent; hence all of them perform the storage function.

Goods may be stored in warehouses with or without any special equipment for air conditioning. The most common type of air conditioning is temperature control; in this type the temperature may range from that in rooms that are merely "cool" to that in rooms where subfreezing temperatures are maintained. An interesting development along these lines is the individual cold locker, which has made its appearance in various parts of the country, notably the Middle West and the Northwest. These lockers are designed to enable consumers to store frozen foods for such future times as they may need them. Facilities are available not only for storing the foods, but also for freezing them by the "fast-freezing" method, whereby even the most delicate and perishable of fresh fruits, vegetables, and meats may be frozen and stored indefinitely.

At this point mention should be made of the application of "fast-freezing" to produce for sale through grocery stores.

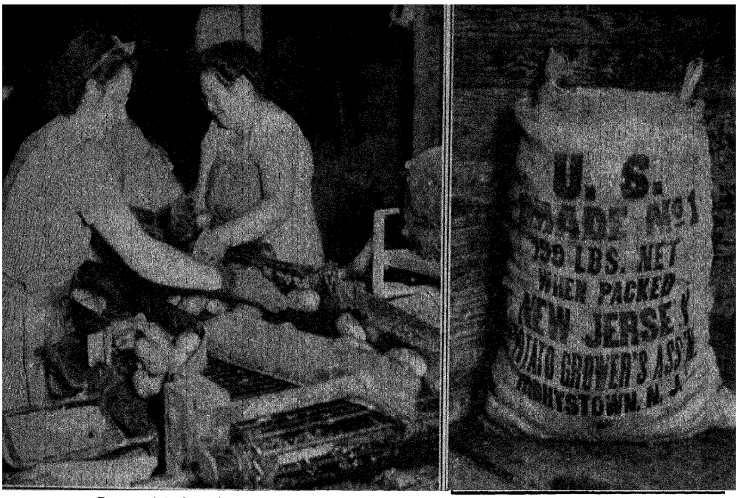
The Birds Eye Company was among the first to develop this process, although there are now several firms engaged in this business. The perfection of this method of preserving foods has had a profound effect upon some of the storage practices in the field of marketing. For example, grocery stores that wish to handle frozen foods must install special cold chests where a temperature of around 10 degrees above zero is maintained. Freight cars and trucks used to transport these foods must likewise keep similarly low temperatures.

The effect of this development upon the availability of many goods is noteworthy. Prior to its introduction, such foods as strawberries, peaches, and raspberries could be obtained only during the relatively short growing and ripening season because of their extreme perishability; but now they are available practically the year round in frozen form.

While many business firms have the facilities for storing their own goods, others employ storage warehouse companies, which are organized for this purpose. Many of these issue warehouse receipts to the storers as evidence of their receipt of and custody over the stored goods. These receipts may be taken to a bank, and a loan may be obtained by the storer, for which the warehouse receipts are deposited as collateral. Then, before the storer or any customer of his can withdraw the goods from storage, the loan must be repaid to the bank in order to obtain the warehouse receipts, as the warehouse company will not release the goods until the receipts are surrendered.

A relatively new variant of this procedure, which is called "field warehousing," consists of the storing of the goods on the premises of the manufacturer or the distributor, with the warehouse company assuming custody. A space is wired or fenced off for storing the goods, and a custodian is employed to look after the goods and to tend to their proper receipt and release. In this instance the warehouse goes to the goods, so to speak, instead of the goods going to the warehouse. Substantial savings in handling, transportation, and storage charges may be effected in this manner.

Standardization. The development and maintenance of standards is of value in helping buyers and sellers to trans-



Bureau of Reclamation *Bureau of Agricultural Economics*

Grading Potatoes

The scene at the left shows the process of grading potatoes. The sack of potatoes shown at the right is properly branded.

act business in an intelligent and helpful manner. There may be standards of quantity, such as weights and measures, and container and can sizes, or standards of quality, which are concerned with such differences in goods as grade, substance, wearability, serviceability, and so on. In fact, one of the more absorbing topics in marketing for some years past has been that of the development and setting forth of acceptable standards of quality, a process sometimes called "grade labeling." This consists principally of determining the acceptable grades for various kinds of goods and then designating these grades in such a manner that buyers may understand them and thus be aided in securing exactly what they need. A controversy has arisen in the field of canned foods between the advocates of the A.B.C. type of labeling and those who favor a more broadly descriptive form of grade designation.

Market Finance. The handling of any economic good in a capitalistic system calls for a method of financing. The buyer must pay for the goods. Sometimes this payment is made at the time that the transaction takes place and sometimes at a later date. If the goods are paid for immediately, the buyer must provide the necessary funds, which may be either his own or those that he has borrowed. If payment is postponed,

the seller extends credit to the buyer for a period of time and thus temporarily assumes the burden of financing the transaction. As a great many sales are made on credit, the performance of this phase of the financing function is of considerable importance. Manufacturers extend credit to wholesalers, wholesalers to retailers, and retailers to consumers.

In many instances the selling institutions are able to perform this function without recourse to outside financing agencies. However, it frequently happens that such assistance is required because of the limited financial resources of the sellers. Banks and finance companies are employed for the purpose of providing the funds. As their methods of operation are explained elsewhere in this volume, no further description will be attempted here.

Market Risk. The mere act of owning goods carries with it the inescapable burden of assuming certain risks in connection with them. These risks arise from the following possibilities:

1. The goods may be damaged or destroyed in some manner.
2. They may deteriorate so as to become unsalable or useless, or their usefulness or salability may be impaired to some extent.
3. They may be stolen.
4. The price may move unfavorably.
5. The goods may be rendered obsolete by new inventions or by style influences.

When goods are sold on credit, the seller assumes a risk even though he no longer owns the goods because the buyer may not pay what he owes.

It is possible to minimize some of these risks through shifting them to insurance companies. Most businesses embrace this method to a greater or less extent. But this is not possible or feasible in all cases, and in these instances the individual businesses must bear the risks.

Channels of Distribution The routes taken by goods in their progress from producer to consumer are called *channels of distribution.* These channels vary according to the nature of the goods, the market, the character of the demand, and so on.

The most direct channel of distribution is found where the producer sells directly to the consumer, as shown in the following simple diagram. This channel is used by many house-to-house selling firms, such as Real Silk Hosiery and Fuller Brush, and by some producers who distribute by mail order, such as the New Process Company of Warren, Pennsylvania.

P ⟶ C

In another channel producers sell to retailers, who in turn sell to consumers, as indicated in the following diagram. This channel represents the paths taken by goods handled by department stores and chain stores.

P ⟶ R ⟶ C

A third channel is utilized where the wholesaler enters the picture between the producers and the retailers. This is the traditionally characteristic method whereby goods have been distributed in this country. It is still the prevalent system for goods that reach the consumer through the small independent retailer, such as a grocer, druggist, hardware dealer, and clothing specialty shop.

P ⟶ W ⟶ R ⟶ C

A producer may adopt any one or more of these channels in his endeavors to have his goods reach the final consumers in as large quantities as possible. Many producers sell direct to the chains and larger independent stores, and at the same time utilize wholesalers to reach the smaller independent retailers. The problems that arise in connection with the choosing of channels of distribution are among the most important that producers are called upon to meet and solve.

Basic Divisions of Economic Goods In order to facilitate the study of our economic system, the goods that are its products have been divided into two classes: (1) industrial goods and (2) consumers' goods.

Industrial Goods. These are goods that are destined for use by industry in the production of consumers' goods or other industrial goods. Examples of industrial goods are machinery, tools, raw materials, fabricated materials, and supplies. The

important point in this connection is the immediate destination of the goods at the time that the characterization is made. In most instances this is relatively simple; iron ore, for example, could hardly be other than in the industrial goods category, as its customary destination is the blast furnace where it is made into pig iron. In some cases, however, this destination is not so obvious. An automobile tire, for instance, as it emerges from the last productive operation in a tire factory, may be a good of either class. If it is slated for shipment to an automobile factory, there to become a part of the assembly of an automobile, it is an industrial good. On the other hand, if it is to be sent to a tire dealer, eventually to be sold to some car owner to replace one of his worn tires, it is a consumers' good.

Consumers' Goods. These are goods destined for use by the individual ultimate consumer and in such form that they can be used by him without further commercial processing.[1] From the standpoint of the typical consumer, consumers' goods may be further classified as convenience goods, shopping goods, and specialty goods.

Convenience Goods. These are goods that consumers like to be able to purchase conveniently, immediately, and with a minimum of effort. They are not bought until needed and, when needed, their purchase is not long deferred. They include such items as cigarettes, popular-priced candies, newspapers, chewing gum, and many grocery products. They are purchased by both men and women.

Shopping Goods. These are goods in the purchase of which the consumer desires to compare the offerings of competing stores on various bases, such as price, quality, and style. In this classification are included many goods of the type usually found in the downtown department stores, such as women's clothing, furniture, dress goods, and millinery. They are bought more by women than by men.

Specialty Goods. These are goods for which a brand preference usually exists and to secure which the consumer is will-

[1] Definitions Committee of the National Association of Marketing Teachers, The National Marketing Review, Vol. I, No. 2.

ing to go to considerable effort. Examples of goods of this class are automobiles, men's clothing and shoes, high-priced watches, and electrical appliances. They are bought more by men than by women. There are, of course, individual differences between consumers regarding the same article, one regarding it as a specialty good and another as a shopping good. The classification given above, however, is made on the basis of the purchasing habits of the average consumer.

Marketing Research This is the scientific study of problems that arise in the field of marketing. It involves inquiry into selling and buying methods, advertising, the location of markets, consumer buying habits and motives, and many other topics. Since marketing research is a comparatively recent development, many questions of techniques, methods, and objectives remain to be fully answered. There have arisen a number of specialists in marketing research, some of whom are independent operators, while others are in the employ of advertising agencies and/or firms with large marketing problems. Much marketing research is also carried on in universities and collegiate schools of business.

The customary attack that market research makes upon questions to which its attention is directed involves three steps: (1) the collection of facts about the subject under inquiry, (2) the analysis of these facts, and (3) the presentation of conclusions or a proposed plan of action based upon an analysis of the facts collected. This is the so-called scientific method that aims at securing the truth concerning the questions brought before it.

Some of the more pressing questions to which market research endeavors to find the answers are: What is the market for a new product? What do users think about the products that they now use? Why do they buy certain merchandise and refuse to buy certain other goods? Where are the users of a given product situated? What is their income status, age, education, and so on? Do they buy goods because they hear them advertised on the radio? Which of two or more proposed advertising campaigns will have the greatest appeal to consumers? At what prices will consumers buy the greatest number of any given item?

The list is practically endless, and the answers that are obtained at any one time may not be valid a few weeks or months later. Techniques of investigation to meet these widely differing problems are equally varied.

The field of market research represents a really pioneering operation in business; and rich rewards await those individuals whose ability, insight, and ingenuity are such as to enable them to solve some of the more urgent questions.

QUESTIONS

1. Give several examples of (a) speculative production and (b) made-to-order production.
2. To what types of goods would field warehousing be applicable?
3. To what commodities can grade labeling be applied? Name several to which it is not applicable.
4. Would the distribution of goods cost consumers less if the extending of credit were eliminated? Why?
5. Name several market risks against which insurance might be secured. Name several uninsurable market risks.
6. Can any of the marketing functions be eliminated in the distribution of goods? If so, which ones? How?
7. Which marketing functions do consumers perform?
8. Name several types of goods that, at the manufacturing stage, might be either industrial or consumers' goods.
9. Name several types of goods other than those mentioned in this chapter that would fall into the categories of convenience, shopping, and specialty goods.
10. State several questions, other than those mentioned in this chapter, that would be suitable for market research.

PROBLEMS

1. Indicate specifically the extent to which each of the following types of businesses performs each of the marketing functions: (a) barber shop, (b) retail bakery, (c) tearoom, (d) fruit farm, (e) manufacturer of electric fans, (f) retail jewelry store.
2. List in parallel columns the marketing functions performed by an independent grocery store and by a chain grocery store in your community. Write a brief explanation of the differences that you find in the two lists.

3. For each of three *different kinds* of commodities in the industrial goods classification that are produced locally or in your state, determine the channels of distribution that are most commonly used. For each commodity draw a diagram of these channels, identifying the institutions involved.

4. Follow the procedure indicated in Problem 3 for three *different kinds* of commodities in the consumer goods classification.

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CHAPTER 12

WHOLESALING

Place of Wholesaling in Marketing *Wholesaling* includes those marketing activities and functions that do not involve the sale of goods to ultimate or individual consumers. This broad segment of marketing embraces all of the following types of transactions:

Sales to retailers.
Sales to wholesalers.
Sales to manufacturers, railroads, mines, and other producers.
Sales to hotels and restaurants.
Sales of building supplies and equipment to building contractors.
All of the operations of functional middlemen, such as brokers, selling agents, and others, who facilitate the movement of goods from sellers to buyers, without taking title to them in the process.
Sales of supplies and equipment to beauty salons and barber shops.
All sales of farm products to other than the final consumers.

CLASSES OF WHOLESALERS

Basis for Classification Wholesalers are frequently classified on the basis of whether or not they take title to the goods that they handle. For the purposes of this study, however, a threefold classification will be used: (1) *full-service wholesalers,* who take title to the goods that they handle and who perform the regular wholesale functions; (2) *limited-function wholesalers,* who also take title to the merchandise but who do not perform all of the usual wholesale functions; and (3) *functional middlemen,*[1] who do not take title to the goods they handle.

[1] The term "middleman," which was at one time in quite common use in this country, is gradually disappearing. This is probably desirable inasmuch as it is essentially a rather loose designation and, in the past at least, has had a rather unfortunate and unpleasant connotation. The Census of Business uses the term "agents and brokers." This term is somewhat confusing when used also to designate those wholesalers who do not take title to goods. There is obvious need for a revision of our nomenclature.

Full-Service Wholesalers Businesses in this group include wholesale merchants, voluntary group wholesalers, converters, exporters, importers, and industrial distributors.

Wholesale Merchants. These are the regular or full-service wholesalers who exist in many lines of business. They sell goods principally to retailers. They buy and sell merchandise on their own account; carry stocks in their places of business; assemble in large lots and redistribute in smaller quantities, usually through salesmen; extend credit to customers; and render advice to the trade. In some lines of business, particularly where the merchandise is of a perishable nature or is derived from unstandardized substances, wholesale merchants also perform the functions of grading and standardization. Although in most kinds of business they sell primarily to retailers, substantial quantities of merchandise are sold by them also to industrial and commercial users, such as restaurants, hotels, public institutions, public utilities, manufacturers, and to other wholesalers. The term "jobber," which still persists in a few lines of business and which had at one time a special significance, is now regarded as being synonymous with "wholesale merchant."

Voluntary Group Wholesalers. These are wholesale merchants who sponsor voluntary organizations of independent retailers. The retailers affiliate themselves with the wholesalers for the purpose of achieving certain advantages in buying, advertising, and other merchandising activities. Voluntary group wholesalers do not always confine their sales to the affiliated retailers. The I.G.A. (Independent Grocers Alliance) is an example of this type of wholesale operation.

Converters. Merchant middlemen in the textile trade are known as *converters.* In addition to performing the usual functions of wholesale merchants, they perform or have performed for them some of the functions of manufacturing in its final stages, such as finishing, dyeing, and printing.

Exporters and Importers. Exporters and importers are wholesale merchants who sell and buy, respectively, in the foreign, rather than in the domestic, market.

Industrial Distributors. These wholesalers are distinguished from wholesale merchants by the fact that they sell primarily to industrial users rather than to retailers.

Limited-Function Wholesalers Among those businesses that do not perform all of the usual wholesale functions are cash-and-carry wholesalers, drop shippers, mail-order wholesalers, retail co-operative warehouses, and wagon distributors.

Cash-and-Carry Wholesalers. Wholesalers of this type buy and sell merchandise in their own name, carry stocks, usually assemble in large quantities, and sell in smaller amounts to retailers and other dealers who call for the goods at the wholesalers' places of business and pay cash for them. They are to be distinguished from full-service wholesale merchants by the fact that they usually carry a limited line of products, mostly staples and fast-moving items, and do not generally extend credit to their customers or make free deliveries. This type of wholesaler came into being in the 1920's to permit independent retailers, who were willing to call for their goods and pay cash, to secure them at lower prices. Thus they were enabled to compete with chain stores on a more advantageous basis. Cash-and-carry wholesalers are found principally in the grocery field. Not infrequently wholesale merchants operate cash-and-carry departments in connection with their regular business, in order to accommodate those of their customers who wish to pay cash for their purchases and take them away in their own conveyances.

Drop Shippers or Desk Jobbers. These are distinguished primarily by the fact that they do not perform the functions of warehousing or storage since they do not handle the goods; nor do they perform the delivery function, for all orders solicited from retailers and others are shipped directly from the manufacturers or other sources of supply to the drop shipper's customers. While drop shippers buy and sell in their own name, assume some risk, and may extend credit, they are sharply distinguished from full-service wholesalers who actually handle the goods and make deliveries from stock. They operate in the fields of staple groceries, iron and steel scrap, furniture, and coal.

Mail-Order or Catalog Wholesalers. Wholesalers of this type sell all or the bulk of their goods by mail. Otherwise such establishments operate as full-service wholesalers, extending credit, making deliveries, and so on. Some of them employ "goodwill" traveling men who tend to become active in the solicitation of orders.

Retailer Co-operative Warehouses. These are wholesale establishments owned and operated co-operatively by groups of independent retailers who buy collectively. In addition to collective buying and performing of wholesale services at low costs, many retailer co-operatives have entered actively into collective selling and are giving increased attention to the merchandising methods of their members. The principal difference between the retailer co-operative warehouses and voluntary-group wholesalers is that of ownership. The former type is owned by the retailers whereas the latter is owned by private wholesalers. Their methods of operation are practically identical. The National Retailer Owned Grocers, known as the N.R.O.G., exemplifies this type of wholesaler.

Wagon Distributors. Wagon distributors perform the wholesale functions of buying, selling, warehousing or storage, and delivery or transportation. They are found principally in the grocery field. Occasionally they extend credit to their customers. They differ from ordinary or full-service wholesalers chiefly in the following points:

1. They combine the functions of salesmen with those of deliverymen. Usually no separate sales force is employed; the work of selling and delivering is carried out by salesmen-drivers.
2. They normally carry a limited assortment of merchandise, consisting of nationally advertised specialties and fast-moving items of a perishable nature.
3. Their practice is to sell for cash and in original packages.

In some lines of trade, manufacturers have in recent years established their own wagon distribution systems.

Functional Middlemen This group of wholesalers—agents and brokers—includes middlemen who are in business for themselves and who negotiate purchases and/or sales in domestic or foreign trade, but who do not, as a rule,

take title to the goods. They may or may not take possession of the goods with which they deal. An important additional function is the furnishing of marketing information. Such wholesalers commonly receive their remuneration in the form of commissions or fees.

Auction Companies. These concerns sell at wholesale by the auction method. Sales are conducted under definite rules and are usually made to the highest bidder. These establishments provide places for public inspection and sale of merchandise consigned to them. Sometimes they extend credit to customers on their own responsibility. They operate in the tobacco, and fresh fruit and vegetable fields.

Brokers. Brokers are wholesale middlemen whose function it is to negotiate transactions between buyers and sellers without having direct physical control of the goods and without taking title or assuming the risk of price fluctuation. They act as agents for their principals, who are usually wholesalers or producers, although sometimes they represent retailers as well. Brokers may represent either buyers or sellers in any given transaction, but not both. They do business in the name of their principals. They do not take title to the goods to which their negotiations apply, nor do they finance their clients. Their power as to prices and terms of sale is usually limited by their principals. When the emphasis is placed on the purchase of goods, such brokers are frequently designated as *buying brokers.*

Brokers are not bound to any set of clients but operate freely in the wholesale field. Their relations with any one client are sometimes not so continuous as they are in the case of selling agents or manufacturers' agents. The remuneration of brokers is in the form of a commission or fee, based upon the value of the goods or upon the physical quantity of merchandise involved in the transaction. In addition to negotiating purchases or sales, their chief function consists in advising their clients as to market conditions, inasmuch as knowledge of market conditions, of sources of supply, and of outlets is their main stock in trade. In the grocery trade it is difficult to distinguish between brokers, selling agents, and manufacturers' agents, because the three terms are frequently used to

describe similar methods of operation. The term "broker" is also commonly applied to those individuals and institutions that are active in the investment securities field. Here they act for buyers or sellers of stocks and bonds, and they may or may not have access to organized security exchanges. The term is also found in real estate and personnel placement. In the former case the broker aids in the purchase or sale of real estate; and in the latter he helps people to find jobs.

Commission Merchants. These are functional middlemen who transact business in their own names on a commission basis and who have direct physical control over the goods consigned to them. Acting as commission merchants, they do not take title to the goods they sell. In some few lines of trade, commission merchants or commission houses act purely as shippers' agents, but in most lines of business they combine some merchant business with commission dealing. When acting in the capacity of agents for their principals, it is the practice of commission merchants to prepare the goods for the market, when the goods require it, to sell them at the best possible prices, and to remit the proceeds after deducting commissions and other charges. They operate in the fields of groceries, livestock, cotton, and grain.

Export and Import Agents. Functional middlemen who specialize in the purchase of goods for, or the sale of goods to, foreign buyers are known as *export agents. Import agents* are functional middlemen who represent foreign sellers in the American market. In addition to negotiating sales, they usually attend to customs formalities.

Manufacturers' Agents. These are functional middlemen who sell part of the output of certain manufacturers on an extended contractual basis. They are limited in respect to territory of operation and to prices and terms of sale. Their principal duty is to sell goods in accordance with the desires of their clients, although they may also warehouse some of the merchandise. They usually represent two or more producers whose goods are noncompetitive in nature. They are to be distinguished from salesmen in that they are in business for themselves and receive payment in the form of commissions

or fees as agents rather than as employees. Manufacturers' agents are prominent in the fields of machinery, industrial equipment and supplies, dry goods, men's and women's clothing, furniture and house furnishings, and groceries.

Selling Agents. These are independent business enterprises operating on a commission basis, whose principal function is to sell the entire output of a given line of goods for one or more manufacturers with whom they maintain continuous contractual relationships. They are found in such fields as textiles, coal, metals, and food.

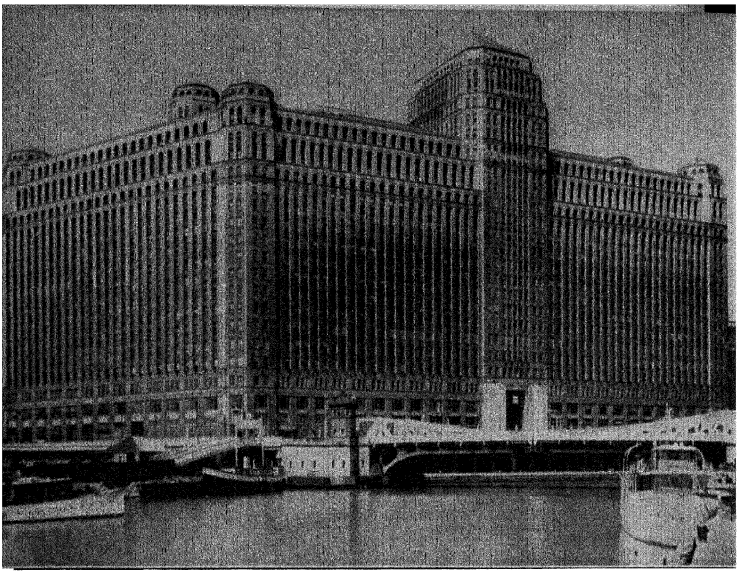
Selling agents differ from manufacturers' agents in the following respects:

1. They normally handle the entire output of one or more products of the clients they serve.
2. They are less limited in sales territory.
3. They have full authority in regard to prices, terms, etc., while the authority of manufacturers' agents is limited in this respect.
4. They frequently finance their clients and offer assistance in connection with their advertising and other sales promotion activities.

Other Agents. Purchasing agents, resident buyers, and other agents who are in business for themselves fall into the agency classification. As a rule they buy merchandise for their clients and also supply them with market information. Occasionally such organizations are maintained co-operatively by a number of wholesalers or retailers for whom they perform the buying function.

The term "resident buyer" is one that is apt to be confusing to the student because it is applied not only to independent individuals or companies operating in the wholesale market in behalf of their clients, but also to the employees of certain large department or specialty stores, or groups of such stores, which are also located in the wholesale markets. These latter groups, however, buy in the name of the employing store or stores and purely in the role of employees. Such buyers are in no sense wholesalers.

The same confusion exists in the use of the term "purchasing agent." This term also describes employees of industrial



The Merchandise Mart, Chicago—A Large Wholesale Market Center

concerns who, customarily, do all of the purchasing for their employers. Unlike their namesakes in the wholesale field, however, they are not customarily located in the wholesale market but usually operate from the plants of their employers.

Other Classes of Wholesalers There exist a number of other classes of wholesalers that should be mentioned in order that the wholesaling picture may become clear.

Assemblers. This group includes establishments engaged primarily in the purchase or sale of farm products at local producing points or in the cities of producing regions. The emphasis is on the buying phase, since the principal function of these organizations is to assemble and concentrate farm products, which are produced on a relatively small scale, into quantities large enough for economical shipment and handling. Most of them operate in what may be termed the local growers' markets; they include firms and individuals who do business on their own account, as well as those who operate on a salary or commission basis for others. The chief distinction between some of these different types, as indicated below, rests upon the commodities involved rather than functional performance.

Country Buyers of Farm Products. These independent, country buyers operate on a commission basis. As a rule, independent buyers of agricultural commodities forward or consign the goods purchased to wholesale receivers or distributors in another and usually a larger market or to manufacturers or processors. Some of the larger handlers of agricultural commodities also maintain assembling and packing plants at points of concentration in producing regions.

Cream Stations. This classification includes collecting stations or depots located in fluid-milk producing regions. They may be maintained by city milk distributors, by creamery companies, by co-operative milk associations, or by independent firms. Some of the cream station operators devote their full time to the purchase and shipping of milk or cream. In other cases they purchase eggs, poultry, and other farm products in addition to the milk and cream. However, the majority of cream stations are operated in conjunction with some other business, which may be a retail store, an elevator, or a general country buying business.

Co-operative Marketing Associations. These associations are formed largely by farmers for the purpose of disposing of their goods at the most advantageous prices for the mutual benefit of the members. In addition to actually selling the products, they often grade, pack, store, finance, and in some cases advertise the commodities they handle. Such associations may also buy for their members various supplies, such as feed, seed, fertilizer, and coal.

Elevators (Grain). Country elevators purchase and handle grain, either on their own account or for their principals.

Packers and Shippers. Packers and shippers engage primarily in the assembly of fruits and vegetables and of sea foods. Normally they also pack, grade, and ship such products.

Manufacturers' Sales Branches (With Stocks). These are wholesale outlets owned and operated by manufacturers apart from their plants for the purposes of selling and delivering, as well as carrying, their own products.

Manufacturers' Sales Offices (Without Stocks). A group of offices may be maintained by manufacturers apart from

their plants for the purpose of selling their products. Sales offices are differentiated from sales branches by the fact that they do not include facilities for physical storage, handling, or delivering of merchandise.

Bulk Tank Stations. Some wholesale firms are set up for the storing and distributing of gasoline, oil, and other petroleum products.

WHOLESALE SERVICES

Field of Wholesaling Wholesaling is an activity that has been the subject of much misguided discussion and comment in this country. Few economic spheres have been less understood and more maligned by the public at large. Shortly after World War I, the phrase "eliminate the middleman" came into rather common usage. It appeared to be the outward sign of a somewhat deep-seated belief that middlemen, who were presumed to be wholesalers of one kind or another, had somehow inserted themselves into the channels of distribution of the country where they took a larcenous toll on all goods passing through their hands.

It is probable that the growth of chain grocery stores, which was most notable during the 1920's, was measurably helped by the widespread conviction that they, by buying direct from the producers, were helping in many instances to eliminate the middlemen, an illusion that the chains doubtless did nothing to dispel. One who is attentive to present-day advertising will occasionally encounter advertisers who are endeavoring to capitalize on this same theme.

As stated in Chapter 2, page 13, capitalism operates through the efforts of a number of competing institutions to realize profits through the sale of goods or services in a situation in which competitive advantage is frequently attained through lower prices. These lower prices may be based on more efficient operation or on lower costs of goods bought for resale. Thus there is a constant pressure of the system for the reduction of present costs and the elimination of high-cost, useless, or surplus functions or institutions. Businessmen are constantly seeking ways of reducing their costs in order to

permit them to offer their goods or services for less than their competitors are charging.

In circumstances such as these, it is hardly probable that wholesaling as a field of economic activity, or wholesalers as institutions, would have survived for these many years unless they were performing services for which their vendors or customers were willing to pay, and performing them more cheaply than these vendors or customers could themselves.

For relatively brief periods of time and during intervals that might be classed as abnormal, institutions of doubtful economic value may come into being and remain operative; but in the long run or when conditions again become normal, they are eliminated. This is hardly the case with wholesaling, however, because this part of marketing dates back at least to the early 1800's in this country, and it has both persisted and grown since that time. Therefore it should be obvious that, while there may have been many inefficient, high-cost wholesalers who should have been, and doubtless were, eliminated during the past hundred and fifty years, wholesaling, as an economic activity, must have earned its right to exist in a tough, competitive situation, or it could not have survived for such a long time. Stated again briefly, for emphasis, it is substantially correct to say that the continued survival of any group of institutions in our economic system is *prima facie* evidence of the fact that they are performing functions that are necessary to the smooth operation of the system and for which businessmen are willing to pay.

Services Performed by Wholesalers

An examination of the services that wholesalers perform for manufacturers on the one hand, and for retailers on the other, should be productive of additional evidence to combat the belief that they are unnecessary in the distributive system.

In approaching the discussion of services performed by wholesalers, it should be remembered that there are a great many manufacturers producing the goods that are offered for sale in the average retail store and that they are located in all parts of the country. It should likewise be recalled that there are many millions of retailers scattered throughout the length and breadth of the country. Many of the producers

are quite small, with limited financial resources; and it is, of course, recognized that many retailers operate on a extremely small scale. With this circumstance in mind, let us examine the services rendered by wholesalers.

Services Rendered to Manufacturers. (1) *Wholesalers contact retailers in relatively small areas on an intensive basis.* A manufacturer, seeking anything more extensive than the purely local distribution afforded by the community in which he is located, may establish his own sales force to contact the retailers in other localities, or he may employ a number of wholesalers to do the job for him. The latter choice will reduce his sales cost and probably give him a more intensive coverage than he could secure through the efforts of his own salesmen unless he has a rather wide line of merchandise to offer.

(2) *Wholesalers store for manufacturers.* In many lines of merchandise, particularly staples, it is customary for the producers to manufacture the goods considerably in advance of their being sold to the retailers. This permits the manufacturers to routinize their productive processes, keep their factory personnel and facilities continuously employed, and usually lower their production costs. But it also means that the goods have to be stored until the retailers are ready to accept delivery of them. If the channels of distribution flow through wholesalers, these institutions remove a sizable part of this storage burden from the manufacturers. They do this as a part of their buying routine and in order to permit them to make rapid and frequent deliveries to their retailer customers.

(3) *Wholesalers assume the local credit burdens.* If a manufacturer sells direct to retailers, he must assume the extension of credit that goes with this type of distribution. If he distributes to retailers on any basis other than a purely local one, the credit problem may assume Gargantuan proportions. It will necessitate the careful appraisal of the risk attached to the granting of credit to many hundreds, if not thousands, of retailers located at distances from the factory varying from a few miles to across the continent. The ad-

ministration of such a system, with the need for collection procedures to be established and maintained, would be a well-nigh impossible task for all but the largest manufacturers. Wholesalers with their local operations are able to assume this burden on a much more favorable basis than are most manufacturers. Manufacturers thus find their credit task reduced to that of extending credit to a comparatively few wholesale houses, many of whom are well rated financially and constitute sound risks.

(4) *Wholesalers render to manufacturers still other services.* Among these may be the granting of financial assistance to producers who happen to be in need of funds for the time being, as well as interpreting local needs to manufacturers and thereby assisting them to so fabricate their goods as to make them more salable than would otherwise be the case.

Services Rendered to Retailers. (1) *Wholesalers simplify retailers' buying problems.* In any given retail store there are goods manufactured in many different parts of the country, if not of the world. Without the wholesaler as a source of supply, each retailer would have to travel long distances to contact the producers of the wares he wished to purchase, or he would constantly have to take time out from his store-keeping duties to interview manufacturers' salesmen who would be calling on him.

Wholesalers save retailers all of this trouble and greatly simplify their buying practices by concentrating these diverse wares in one or more convenient places where retailers may purchase.

(2) *Wholesalers are able to give retailers prompt delivery service.* Because of their nearness to their customers, wholesalers are able to give them much more rapid delivery service than retailers could normally expect from manufacturers. This is important from the standpoint of enabling retailers to maintain balanced stocks and not run short of needed merchandise.

(3) *Wholesalers absorb a part of the retailers' storage burdens.* As indicated above, when wholesalers buy from the producers and hold the goods until the retailers are ready for

them, they are performing a storage service for the retailers. If the retailers were buying direct from the manufacturers, they would have to store the goods themselves, frequently in larger amounts than they could conveniently handle. As many manufacturers ship only in carload lots, the quantities might far exceed any single retailer's capacity to receive and store the goods.

(4) *Wholesalers grant credit to retailers.* The fact that many wholesalers operate solely in a fairly small market area permits them to offer credit to their customers on a basis that would be difficult, if not impossible, for the retailers to secure from the producers. This may be exceedingly valuable to retailers who find themselves temporarily short of funds or in some other short-time condition of financial stress.

(5) *Wholesalers offer merchandising aid to their customers.* Wholesalers' salesmen are frequently able to help their retailer customers through making suggestions to improve their displays, selling techniques, accounting procedures, and so on. Some go so far as to prepare and distribute sample advertising insertions, store layouts, and accounting books. It is doubtful that many manufacturers could duplicate these services.

By-Passing Wholesalers Despite the services that wholesalers render both to manufacturers and retailers, many manufacturers and retailers have undertaken to deal directly with each other, thereby by-passing the wholesalers. Instances of this are to be found in the buying practices of department stores, chain stores, and mail-order houses, and in the selling policies of many producers who deal with these types of retailers, as well as those who maintain sales offices, with or without stocks, in various parts of the country.

A variant on this practice, by manufacturers, is where the producers sell direct to retailers located in large urban areas, and through wholesalers to retailers in the more remote rural territories.

Why Manufacturers By-Pass Wholesalers. The reasons why manufacturers sometimes by-pass wholesalers in distributing their goods are as follows:

(1) *To secure a better control of the retail market.* Because manufacturers are sometimes dissatisfied with the aggressiveness with which wholesalers push their products, they decide to sell directly to retailers in order to secure a better control of the retail market and to prevent their competitors from obtaining too large a share of the available business. They feel that their own salesmen will push their products more aggressively than do the wholesalers' salesmen.

(2) *To further their own promotional plans.* Many manufacturers develop carefully worked-out plans designed to further the sale of their goods at retail. When a wholesaler is confronted with the task of distributing and pushing these plans from a large number of manufacturers, his salesmen are often too busy to devote much time to such tasks, with the result that much of the force of these campaigns is lost by the time they reach the retailers.

In order to counteract this more or less inevitable condition, many manufacturers undertake to bring their promotional material directly to the attention of the retailers through setting up their own sales forces and entrusting this job to them.

(3) *To meet competition.* Some manufacturers find it necessary to follow the actions of their competitors. A manufacturer who achieves increased sales after his decision to sell direct stimulates his competitors to do the same thing in order to protect their share of the market.

Why Retailers By-Pass Wholesalers. The reasons why retailers buy direct from manufacturers are as follows:

(1) *To secure lower prices.* Unquestionably this is the main reason that retailers by-pass wholesalers. Through their willingness to take over the performance of some of the wholesalers' functions, retailers are frequently able to obtain their goods from manufacturers at lower prices than they could enjoy from their wholesale suppliers. This enables them to compete in the retail market on a more advantageous basis than if they were buying from wholesalers.

(2) *Because of the nature of the merchandise.* Certain types of merchandise, such as women's apparel, are subject to

style changes that may take place with startling rapidity. In handling such merchandise, the time element is of considerable importance, and the ability to be the first in the community to show certain styles may be of great value to the store concerned. Here direct contact between the manufacturers and the retailers is a necessity, at least for those cities where "style firsts" are important.

(3) *Because of competition.* Retailers may decide to buy direct from manufacturers because their competitors follow this practice and are enabled thereby to undersell them. Price competition is strong in many lines of merchandise, and any practice that holds out the promise of lowered merchandise costs is one which retailers in these fields will be quick to follow.

Wholesale Functions Performed by Retailers There are a number of circumstances where wholesale functions are performed by retailers without the interposition of any independent wholesalers. Two examples should suffice to illustrate most of this activity.

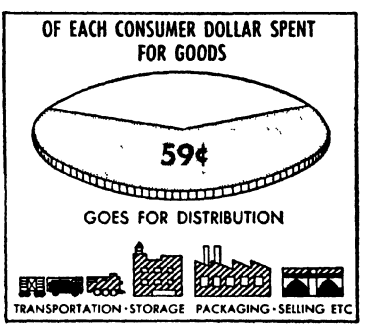
Chain-store warehouses, particularly in the field of food, perform nearly all of the wholesale functions with the exception of the granting of credit. They buy goods, store them, and transport them to the chains' retail outlets. Strictly speaking, they do not "sell" the goods to the stores because both the warehouses and the retail stores are under a common ownership and management. The movement of merchandise from one to the other is more in the nature of an intracompany transfer than a true sale.

Department stores customarily maintain warehouses where their reserve stock of many commodities is stored until it is sold. Goods are bought by the departmental buyers directly from the manufacturers and are shipped to the stores' warehouses, where they remain until delivery is effected to the purchasers.

Wholesale functions may be performed by manufacturers or by retailers; but, except for such activities as they are able to eliminate through the goods not passing through an independent wholesaler's hands, these functions persist and must be accomplished.

Does Direct Buying Lower Costs? In order to answer this question accurately, it would be necessary to make rather detailed studies of the distribution costs of a large number of different lines of merchandise, a procedure that is not in order in a book such as this.[1] It is possible, however, to observe what happens when goods are sold direct and to draw certain rather general conclusions from this examination. Much has been said about the savings that are inherent in direct manufacturer-retailer sales, and probably with a considerable measure of truth in many instances. However, the picture is not entirely a clear-cut one because of the presence of many factors that are difficult to measure.

The movement of goods in the marketing channels involves the performance of some or all of the marketing functions by the institutions handling the merchandise; and it is in the performing of these functions that marketing costs arise. When the wholesaler is by-passed in any line of merchandise, the marketing functions incidental to the movement of the merchandise, which would usually be taken care of by the wholesaler, are taken over by the manufacturer and/or the retailer. Hence the costs of the functions are added to the other marketing costs of the manufacturer and the retailer. If these two are able to perform the functions only as cheaply as the wholesaler, then the saving is to be found largely in the presumed elimination of the wholesaler's profit. If they are more efficient than the wholesaler, there may be additional savings; likewise, if they are less competent than the wholesaler, the savings may be reduced, even to the point where they may vanish and extra costs may arise.



Pictograph Corporation for the Twentieth Century Fund

The Cost of Distribution

Not revealed by the chart is the fact that the profits of the entire distributive system amount to less than 3 cents out of every consumer dollar.

[1] A start has been made in this direction in the book *Does Distribution Cost Too Much?* published by the Twentieth Century Fund, 1939. The student is referred to it for further information on this subject.

Direct buying is prevalent in the department and specialty store fields and is practiced by nearly all chain store groups and mail order houses. This means that these institutions must perform the storage, financing, market risk, and delivery functions that would otherwise be done by wholesalers. Comparative cost data are not available for the alternate distribution channels, but the fact that direct buying has persisted in these areas would appear to indicate that it is cheaper to the buyers than the utilization of wholesalers.

How Wholesalers Have Reacted The wholesalers have not been unaware of the tendency for retailers to go around them, nor have they sat idly by while it has progressed. In a number of ways they have endeavored to combat this trend, with varying degrees of success.

(1) *Through increasing their own efficiency.* By a careful examination of their costs, through better selection and training of their employees, and a general streamlining of their practices, many wholesalers have succeeded in reducing their own distributive expenses. This has enabled them to pass part or all of these savings on to their customers in the form of lowered prices.

(2) *Through the development of their own private brands.* If a wholesaler is handling the branded merchandise of a manufacturer, he has no protection against the manufacturer's selling direct to the retailers, as the latter still have the same brands to offer to their customers. To overcome this situation, and to entrench themselves with their retailer customers, many wholesalers have developed their own brands. If they are successful in selling these to retailers and if they are accepted by consumers, the wholesalers are in the enviable situation of controlling the distribution of these brands, which no manufacturer can take away from them.

(3) *Through the formation of voluntary chains.* Through associating a number of retailers with themselves on a voluntary chain basis, many wholesalers have been able to become firmly established in their communities and to be virtually immune from the possibility of being eliminated through the actions of either the manufacturers or the retailers, or both.

QUESTIONS

1. Mention several lines of merchandise for which you would expect to find wholesalers and several for which you would expect them to be absent. Give reasons for their presence or absence.

2. Manufacturers of apparel frequently employ wholesalers to reach dry goods retailers in small towns, but sell direct to department, specialty, and chain stores. Why is this so?

3. The compensation, per unit of merchandise handled, of functional middlemen is customarily lower than that of full-service wholesalers. Why should this be true?

4. In those instances where direct manufacturer-retailer contact has replaced the manufacturer-wholesaler-retailer channel of distribution, which of the wholesaler's functions are probably absorbed by the manufacturer and which by the retailers?

5. What savings can be achieved through by-passing the wholesalers?

6. Why might a wholesaler be indifferent to a manufacturer's sales promotion plans?

7. What would be the manufacturers' attitude toward wholesalers' bringing out private branded merchandise?

8. Can a wholesaler of drug products or of groceries expend much time or energy in pushing a single manufacturer's products? Why?

9. Would the establishment of a large number of small stores result in more or fewer wholesalers in the field of food? of drugs? of dry goods? of electrical appliances?

10. The field of fluorescent lighting is one that is experiencing a phenomenal growth. Would you expect this expansion to result in an increase in the number of electrical wholesalers or of manufacturers' sales forces, or both? Why?

PROBLEMS

1. "The producer-wholesaler-retailer channel of distribution, which is the traditional pattern by which American products reach consumers, should be preserved. If necessary, laws requiring that all goods be distributed through wholesalers should be enacted." Do you agree or disagree with this statement? List the reasons for your answer.

2. From the most recent Census data on wholesale and retail business, compute for the city or county in which you live the ratio of wholesalers to retailers in a particular field, such as food, hardware, or drugs. Compute this ratio for the country as a whole, also.

Compare the two ratios. What conclusions do you draw from this investigation?

3. Outline the various types of wholesalers discussed in this chapter. In as many cases as possible add to your outline the name of a local wholesaler as an example of each type. In order to secure the necessary information for this problem, consult the office of the local chamber of commerce, and refer to the city directory and the classified (yellow) section of the telephone directory.

4. For a local retail store list some products that are purchased through wholesalers and others that are bought directly from producers. For the latter group indicate the reasons for the by-passing of the wholesalers.

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CHAPTER 13

RETAILING

Place of Retailing in Marketing

Retailing is that segment of the marketing or distributive process that is concerned with the sale of goods to the ultimate consumer. The institutions found in it are usually, but not always, known as retailers. In most instances their places of business are called stores.

Retailing is the part of the business structure with which people are most familiar because of their lifelong contacts with stores. It is likewise a field concerning which a number of mistaken beliefs exist. One of the most common of these is a conviction that retailing is a simple business, in which almost anyone, regardless of his ability or previous experience, can easily achieve success. Every year, large numbers of persons—with or without adequate capital, ability, and experience—enter the retail field with high hopes for success, only to discover that it is a field of business in which competition is keen, profits are low, and mortality is high. Every year, many of these entrepreneurs go out of business, frequently via the bankruptcy route, as living testimony to the fact that the road to retail success is a hard one, requiring a good measure of business ability as well as training, and a certain amount of luck.

The few studies that have been made of retail mortality [1] indicate that lack of experience is one of the prime causes of this phenomenon. If more people realized that retailing is a calling that requires ability of a high order, coupled with a willingness to work long hours and to utilize the latest in accounting and statistical methods, there would be considerably fewer poorly qualified entrants into the field and, consequently, a smaller number who are forced to leave it because of failure.

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[1] The student is referred to *Mortality in Retail Trade*, by Edmund D. McGarry, University of Buffalo Bureau of Business and Social Research, 1930, for an exhaustive and interesting analysis of failures in retailing.

Methods of Classifying Retailers Retailers are classified by their locations, such as downtown or neighborhood; by the types of goods handled, such as food, drugs, shoes, and hardware; by the types of operation; and on the basis of ownership. The treatment in this chapter will be on the basis of the last two methods—the types of operation and the basis of ownership.

RETAILERS CLASSIFIED BY TYPES OF OPERATION

House-to-House Sellers Although house-to-house selling is not usually regarded by the public as a method of retailing, it is, nevertheless, a true retail operation. Its outstanding characteristic is that the sellers go to the buyers, instead of the buyers to the sellers, which is the more common method in the retail field.

In this phase of retailing, the salesmen call at the homes and endeavor to persuade the housewives to purchase their wares. They customarily demonstrate their goods from samples and, if a sale is made, return at a later date to make delivery and receive payment. Some companies ask the purchaser to make a small down payment when the order is taken and to pay the balance when the goods are delivered. Delivery is sometimes made by mail or express.

A wide variety of goods is sold through the house-to-house method, among which are clothing, lamps, hosiery, brushes, food, and vacuum cleaners. Two companies that have achieved outstanding success in this field are the Fuller Brush Company and the Real Silk Hosiery Mills.

House-to-house selling is generally regarded as a rather expensive method of distributing goods, principally because of the high turnover of salesmen, with the attendant costs of constantly recruiting and training new ones. There is a pronounced prejudice among housewives against door-to-door salesmen, and this constitutes one of the major obstacles in the path to success in this business.

This type of business frequently encounters organized opposition on the part of the local merchants, who resent the intrusion of outsiders in the field that they regard as theirs. In some communities so-called "Green River Ordinances" have

been enacted by the local governments, the purpose of which is to exclude all out-of-town canvassers. The legality of these laws is doubtful, and their adoption has not been widespread. However, they are indicative of the difficulties that house-to-house selling must encounter.

Hucksters A huckster is one type of house-to-house salesman, in that the seller goes to homes to make his sales. He differs from the conventional house-to-house salesman in that (a) he carries his stock of goods with him and makes deliveries on the spot and (b) he calls repeatedly on the same customers, frequently every day, and comes to be well known to them. Hucksters are customarily residents in the cities where they operate. Huckstering includes the fields of fresh fruits and vegetables and fish.

Mail-Order Houses These retail institutions sell and deliver their goods by mail. Customers are advised of the availability of the merchandise through catalogs, magazine and newspaper advertising, or by direct mail.

Mail-order houses distribute a wide variety of goods, such as food, clothing, electrical appliances, plumbing supplies, tools, and furniture. There are a large number of mail-order houses, but most of them are comparatively small businesses. Only a few, principally Sears, Roebuck and Company, Montgomery Ward and Company, Alden's, Inc., and the New Process Company, are notable for their outstanding size.

There is strong reason to believe that the mail-order business was greater in the days before the advent of the automobile and good roads. This type of business offered farm families an opportunity to shop through the pages of catalogs for the goods that they needed rather than making long trips to the shopping centers. In recent years the automobile has brought the farmers and small-town dwellers within comparatively easy reach of city stores where they can see and feel the merchandise before buying it, with the result that mail-order sales have diminished somewhat. The fact that both Sears, Roebuck and Montgomery Ward have opened a large number of retail stores in the last fifteen years lends credence to this belief. But during the last years of the nineteenth cen-

tury and the first three decades of this one, their prominence in the retail picture cannot be denied.

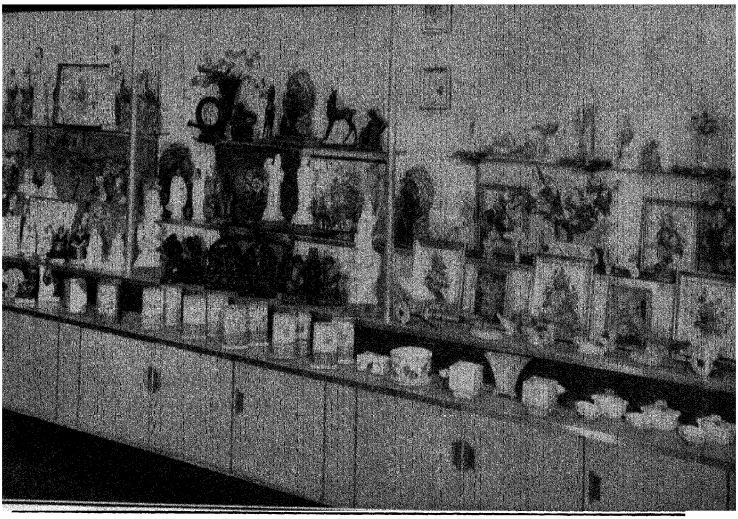
General Stores Probably the earliest type of retail outlet in this country was the general store. In the early years of our county, it was to be found in villages or at country crossroads because it was admirably suited to the needs of a sparsely settled country. It carried a broad range of goods, from food and clothing to farm implements, feed, and seeds; and it frequently housed the post office. It was the social, as well as the shopping, center for the community and the surrounding countryside.

The growth of the cities, the development of better roads, and more adequate transportation, together with the competition of more specialized or better-managed stores, have all worked together to relegate the general store to a rather minor role in our retail economy.

There are still a few thousand such stores, usually located in the more remote parts of the country where conditions are still such as to require a single store carrying a wide range of goods. But generally speaking, the country general store, in a large part of this country, is a vestigial relic of a period long past.

Single-Line or Unit Stores Neither of the terms *single-line* or *unit store* is in common usage today, but they are useful to classify the type of store to which they refer. Both terms refer to the small store, independently owned, which carries a single line of merchandise, such as food, hardware, drugs, shoes, millinery, or men's furnishings. To be strictly accurate and consistent, gasoline filling stations, automobile dealers, flower shops, tire and accessory stores, furniture stores, radio dealers, jewelry stores, antique and gift shops, and restaurants should be included in this category. Chain stores handling the same kinds of goods are excluded because many of their merchandising methods are different from those of the independents.

The typical single-line or unit stores, which are usually locally owned, are to be found both in the downtown and in the neighborhood shopping areas. They offer free delivery, extend credit to their customers, and accept telephone orders.



Dennison Manufacturing Company

A Unit Store

A gift shop is an example of a unit store because it carries a single line of related merchandise.

A trend in the grocery business in recent years is the growth of the cash-and-carry system among unit stores.

Single-line stores range in size from those that are literally "holes in the wall" to fairly large establishments with modern fixtures, adequate lighting, and general attractiveness. Unit stores customarily buy their goods through wholesalers, although some of the larger ones deal direct with the manufacturers. Their advertising is usually of a very limited nature, except in very small towns, as they are not customarily able to afford to use the newspapers. Their principal appeal, as distinguished from the chains, is the personal touch of the proprietor and clerks, plus the three kinds of services mentioned above. Their prices are frequently higher than those of the chains, although this is by no means always the case.

Although it is among these stores that the high mortality mentioned earlier in this chapter is to be found, numberwise the unit stores have long been dominant in the retail picture. They have been regarded as symbolic of the "American way of life" in that they epitomize the individual enterprise upon which the economic life of this country was founded. From their ranks, in times past, have come most of the giants in the retail world of today. Despite their high

mortality, there is a constant stream of new entrants into this field, from which will come the retail leaders of tomorrow.

Department Stores Department stores are large establishments located in the downtown shopping areas of cities. They handle a wide range of goods, including clothing, furniture, housewares, floor coverings, toys, millinery, lamps, draperies, yard goods, and small wares such as notions, cosmetics, handkerchiefs, and many others. They are housed in attractive buildings, are often air-conditioned, and sometimes are in a position to feature such nonmerchandising items as lectures, concerts, and art exhibits.

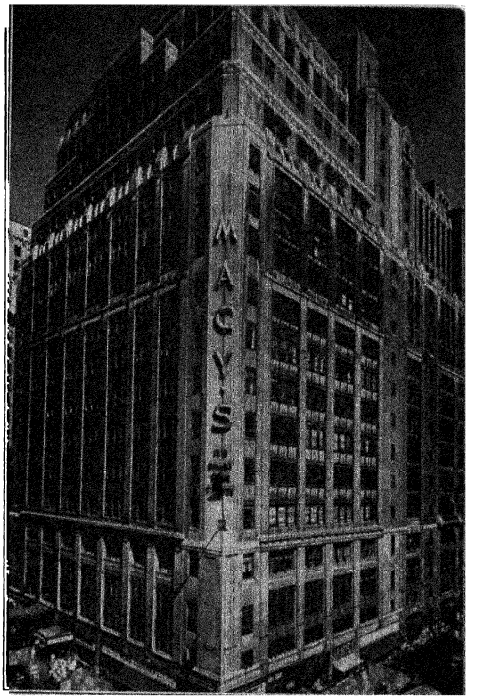
Department stores date back to the time of the Civil War. They owe their growth to the merchandising genius of such pioneers as Marshall Field, John Wanamaker, A. T. Stewart, and others whose names adorn these large stores throughout the country. The philosophy that "the customer is always right" was introduced in the early days of department stores and has been one of the basic principles of this phase of retailing ever since. In no other form of retailing are the customers' whims, desires, and comfort catered to as in these large stores.

Department stores stress the service side of their business. Free delivery, liberal credit, the acceptance of telephone and mail orders, gift wrapping, the privilege of almost unlimited return of purchased merchandise, rest rooms, nurseries for infants and children, and restaurants are among the inducements held out to their customers.

These stores may be independently owned, or they may be units of chains. At this level of retailing there is practically no difference in the operating practices and merchandising policies of chains and independents. As far as the customers are concerned, most of them are unaware of whether their favorite department store is a member of a chain or not.

Most department stores buy direct from the manufacturers. Their organizations include a number of highly skilled buyers, who travel extensively in their efforts to secure acceptable merchandise for their customers. Some of the larger stores maintain buying offices in New York to aid their buyers in obtaining desirable goods. Other stores, not able to afford

their own buying offices, join with stores similarly circumstanced in maintaining more or less cooperative buying offices in New York. In these offices their buyers make their headquarters while on buying trips; here also a staff of merchandise specialists is on hand to assist the buyers or to care for the stores' interests when the buyers are not in the market. The department store chains maintain their own buying offices. A number of independent buying organizations serve any stores desiring their assistance.



A Large Department Store

Department stores rely on newspaper and direct-mail advertising, together with elaborate window and floor displays, to inform their customers of the availability of their merchandise and to attract them into their stores. Highly skilled advertising and display personnel direct these activities, which are outstanding in artistic qualities and sales appeal.

In recent years there has been a discernible trend for the department stores located in downtown areas to establish branch stores in the suburban communities surrounding some of our larger cities. Examples of this are to be found in the suburbs of New York, Boston, Philadelphia, Chicago, and Los Angeles. It is not possible to tell at this time whether this trend represents a move toward the breaking up of the downtown shopping centers, as some observers think, or whether it is just a move on the part of progressive retailers to secure the business in the suburbs that had formerly gone to the local suburban stores.

Specialty Stores There is considerable confusion, in the minds of writers in the field of marketing, between the specialty store and the specialty shop (sometimes spelled "shoppe"). In most instances there is a tendency to use the two terms interchangeably for the purpose of describing the same type of retail outlet. The differentiation that will be made here is in accord with the practices of the retail trade rather than with those of the writers on the subject.

A specialty store might be defined as a department store minus the merchandise customarily known as home furnishings, such as housewares, furniture, floor coverings, electrical appliances, toys, china, and glassware. It is located in the downtown shopping area and is directly competitive with department stores. There is a tendency for specialty stores to confine their apparel offerings to women's wear, although this is not always the case.

The buying, advertising, and service policies of these stores are identical with those of department stores. Some specialty stores do not have their own delivery systems but use some public facilities such as the United Parcel Service. A number of the more prominent specialty stores have formed a buying group, known as the Specialty Stores Association, which maintains a buying office in New York for the benefit of the member stores.

Specialty Shops This type of store is one that confines itself to a small segment of the merchandise in any single category, although specialty shops are more commonly found in the apparel field. They handle dresses, or millinery, or shoes, or lingerie, and sometimes a combination of apparel items, such as hosiery, handbags, and shoes, or millinery and neckwear. Their outstanding characteristic, however, from the standpoint of merchandise carried, is that they do not carry a complete line. Specialty shops carry men's wear also, but they limit themselves to hats or shoes.

Since specialty shops are relatively small, they usually occupy single store rooms and rarely involve more than one floor. This is in contrast to specialty stores, which are customarily only slightly smaller than department stores and cover several selling floors. Specialty shops are to be found

in all retail areas, in the downtown as well as the neighborhood business communities.

Their buying practices vary according to their sales volume. Those with larger sales tend to buy direct, while the smaller stores buy through wholesalers. They rely heavily on window displays to attract customers as only the largest shops can afford to use newspaper advertising. Specialty shops are quite similar to unit stores in the apparel fields; but they differ from unit stores in other lines in many important characteristics, such as elegance of store layout and fixtures, buying practices, etc.

Supermarkets One of the most outstanding developments in retailing in recent years has been the supermarket. Although most people know what is meant by the term "supermarket," there is no generally accepted definition for this type of retail outlet.

The supermarket came into being during the early 1930's. It was characterized by very large floor space, enormous displays of merchandise, self-service, cash and carry, free parking facilities, and dramatic sales promotion, which featured extremely low prices. While most of the early supermarkets handled only food, some of them embraced a variety of other goods. As they have developed, however, they have come to confine themselves almost exclusively to food.

There have been two phases in the evolution of supermarkets. The first, and more flamboyant, was notable for the tremendous size of the units, as compared with any form of food retailing previously known. Here was mass merchandising of food on an unheard-of scale. Supermarkets came into being mainly on the eastern and western seaboards, with a few units located in the interior of the country. Not infrequently they were situated at considerable distances from the older established shopping centers, often right out in the country where large parking spaces were available. Their novelty, spectacular advertising, and low prices attracted hordes of customers, who bought food in unbelievably large quantities. Sales checks of $10 to $25 were not uncommon. A notable feature of this period was that these gigantic food markets were all independently owned; the chains did not enter the field until somewhat

later. In some cases the proprietors ran the entire operations themselves; in others concessionaires ran some of the departments. There appears to have been little uniformity in this regard.

The second phase of supermarket development came about when, somewhat belatedly, the chains entered the picture. Frankly labeling their new ventures as supermarkets, the chains set about to establish self-service units on a larger scale than they had operated before,[1] but generally smaller than their independently owned predecessors. Under chain auspices, layouts became more or less standardized, and store sizes were tailored to the buying needs of the communities that they served. Incidentally, with the opening of the chain supermarkets, large numbers of their smaller, counter-service grocery store units were closed.

There is some reason to believe that the supermarket is still in the process of evolution. While World War II put an effective stop to the expansion plans of many of the independent operators as well as to those of the chains, the post-war years probably will witness another flurry of growth and experimentation. Such features as the merchandising of precut meat items and the expansion of the frozen food part of grocery retailing, together with the addition of such items as electrical appliances, gasoline and oil service stations, and other attractions are awaiting only the availability of building materials to appear as integral parts of the supermarket of the future.

A variant on the supermarket idea is the *superette*, a self-service grocery store on a smaller scale than the supermarket itself, which has made its appearance in certain communities that are not large enough to support the larger outlets. Its future, along with that of the supermarket, appears to be assured, as there seem to be enough people who are willing to serve themselves, pay cash for their goods, and take them

[1] As early as the mid-1920's the Loblaw Groceterias had been opened as small, self-service, cash-and-carry food stores in Buffalo, New York, and parts of the surrounding territory. Clarence Saunders' Piggly-Wiggly self-service stores, featuring a maze through which customers were required to walk in order to select their goods, were in operation during World War I. These were, however, on a relatively small scale, not approaching in size the supermarkets of the 1930's and later.

home in their own automobiles to make them profitable ventures. It is not probable that they will drive the small, independent, full-service grocery stores out of business; but the effects of their competition on the orthodox operators can hardly be termed beneficial. Many of the latter group have endeavored to meet this competitive threat by transforming part or all of their stores into self-service operations. The public seems to like the idea of mass merchandising in the food field and appears to be willing to put up with the inconvenience of standing in line at the cashiers' gates—the most serious drawback to the supermarket—in order to patronize these stores.

Variety or 5 and 10 Cent Stores

While many people tend to think of 5 and 10 cent stores as being exclusively chain operations, actually there are a large number of independent operators in this field. The independents do about 10 per cent of the business in this field and the chains obtain the rest. Nevertheless, the variety store constitutes a separate and distinct type of retail outlet, and for that reason it merits inclusion in the present list of retailers.

Variety stores handle a wide array of small wares, toys, housewares, candy, toiletries, stationery, electric appliances and bulbs, and light hardware—all in the low-price ranges. They are all on a cash-and-carry basis, with a minimum of additional store services.

In appearance there is a rather startling degree of uniformity, both inside the stores and out. While it might be difficult to prove, it is quite probable that the independent variety stores have copied the appearance and much of the store layout of their chain competitors.

The buying practices of the independent variety stores almost invariably involve the use of wholesalers, whereas all the chains buy direct. At least one group of independent stores, linked up with Butler Brothers, Chicago wholesalers, operates on more or less of a voluntary chain basis. Their advertising consists almost exclusively of that unique type of window display known as the "dime-store windows," in which the massing together of large quantities of items achieves the highest degree of merchandise display space utilization.

Public Markets A time-honored form of retailing is the public market, where large quantities of foodstuffs, particularly fresh fruits and vegetables, are distributed to the consuming public. These markets are to be found in most large cities, frequently in the poorer sections, and sometimes adjacent to those areas populated by foreign-language groups.

The physical set-up of public markets consists of a number of buildings and covered areas that are divided up into a series of stalls, which are leased to the storekeepers. The market is therefore merely a central location where a large number of food merchants congregate to offer their wares to the public. There may also be facilities to accommodate farmers who may wish to offer their produce to the public, usually from their trucks or wagons. The city, which usually owns the market buildings, may furnish refrigeration facilities for the storing of perishable products.

Someone has compared the public market to the supermarket, since both are examples of high-volume sale of food at retail. There the comparison ends because the public markets are confined almost exclusively to green goods, meats, poultry, eggs and fish, with relatively small amounts of staple grocery items. There is, furthermore, comparatively little unanimity of effort among the storekeepers, who are competitors in most cases. No common name is used since each merchant uses his own or a firm name, and there is no common sales promotional policy.

The buying practices of the merchants in public markets vary according to the circumstances and opportunities peculiar to each vendor. Some of the sellers buy from carlot receivers in the wholesale produce markets; some buy direct from the growers, driving their trucks out into the neighboring countryside at regular intervals; still others purchase their goods from farmers who bring their produce into the wholesale markets; and a few grow their own produce to sell.

The sellers in the public markets do little, if any, formal advertising. They rely upon their continued presence in the market to build up a clientele among the shoppers. Some of these merchants keep up a continual hawking of their wares, apparently in the belief that this attracts trade.

Roadside Stands Many farmers set up roadside stands in front of their property for the purpose of selling their produce to passing motorists. The selling appeal is presumed to be freshness and low prices. The first appeal is usually present, but there has been a marked tendency for roadside farmers to ask city prices for their goods. This has been particularly true since city market quotations are available to growers via the radio. There have also been instances where pseudo-farmers bought produce on the city wholesale markets and trucked it out into the country for sale as alleged country-fresh green goods.

Service Retailers There has been a tendency among writers in marketing to ignore the presence of a considerable number of retailers who sell service rather than goods. This is probably because their merchandising problems are different from those of retailers who sell goods. Many of the service retailers possess more or less professional skills that comprise their stock in trade, while others maintain facilities for processing their customers' belongings.

Included in this category of retailers are barber shops, beauty parlors, bowling alleys, laundries, dry cleaning and pressing shops, plumbing shops, shoe repair and shoe shining places, and automobile and bicycle repair shops. Because of the varied nature of their merchandising practices, no attempt will be made to analyze them here.

RETAILERS CLASSIFIED ON THE BASIS OF OWNERSHIP

Independents This group includes all stores that are individually, and usually locally, owned. The Census definition permits the inclusion of one or two additional stores without becoming chains; thus three stores under a common ownership are regarded as independents by the Census, an arbitrary but possibly useful characterization.

This classification of retailers takes on significance mainly in regard to small stores in the lines where the chains are prominent, such as grocery, drug, shoe, and variety stores, as it is the conflict between the two types of operation that provides some of the most controversial issues in the retail picture.

The typical independent retail store, of the sort to which attention is being directed here, is a small operation, locally owned and usually managed by the owner. It is rarely incorporated;[1] sole proprietorships and partnerships predominate. These stores are usually rather inadequately financed, and many of them are never very far from insolvency. As a general rule they buy through wholesalers and do little advertising. Their selling efforts could hardly be called aggressive. Their accounting methods are often most rudimentary. Their profits are low if, indeed, many of them ever realize any profits at all. It is likewise probable that many of them are conducted inefficiently and at a high cost. There are, of course, notable exceptions to these statements. In every community there are a few exceedingly capable independents, whose methods are up-to-date and whose profits reflect their ability. But they are quite definitely in the minority.

The question naturally arises, Why should this condition exist? The answer is not a simple one, but it can be discovered without too much difficulty. Broken down into its more important aspects, it would appear to be made up of two causes.

(1) *Ease of entrance into the business.* This cause can be further subdivided into two parts: (a) The presence of too many store buildings or too many vacancies. This leads to an eagerness on the part of many landlords to secure tenants and results in all kinds of inducements to prospective retailers to occupy the premises. (b) A laxity on the part of wholesalers, who have often been willing to stock the stores of new entrepreneurs without requiring advance payment. In recent years this condition has been corrected to some extent.

(2) *The widespread belief that retailing is a simple business requiring no great amount of effort or ability.* This belief is part of the economic folklore of this country.

The conditions just enumerated have resulted in the entrance into small-scale retailing of many people who have brought with them little in the way of ability or experience. Some have eventually achieved success; others have left the

[1] For several years one of the authors taught classes made up of independent retailers. Of the 150 or more members of these classes, less than half a dozen had incorporated their businesses.

business, either voluntarily or perforce; while many have remained in the field, attaining only an indifferent success with mediocre business methods.

Corporate Chains The Census classifies as a chain any four or more stores that are under a common ownership and management, with central buying, and merchandise usually supplied from one or more central warehouses.

Historically the chain system of retail outlets is quite old; the Mitsui chain of Japan came into existence around 1643, and the Hudson's Bay Company in 1670. In this country the Atlantic and Pacific Tea Company was founded in 1858. It was followed by the F. W. Woolworth Company and the Kroger Grocery and Baking Company. The period from 1920 to 1930 was one of rapid growth for the chains, reaching a total of 7,061 chain systems with 159,638 stores. Since then, the number of stores has declined somewhat because of the policy of the grocery chains of closing many small stores and establishing, in their places, large outlets or supermarkets. It is probable that the number of chain store outlets has become practically stabilized. Chain stores are to be found in the fields of groceries and drugs; in variety, apparel, automobile accessories, shoes, tobacco, and department stores; and in filling stations.

The chain method of operation is of importance as it furnishes the key to the truth of the claim that chain store prices are lower than those of independents. In this discussion department store chains are excluded, as they do not follow the customary pattern of chain operation. The significance of department store chains is in their ownership rather than in their operating methods.

Buying. Chain systems customarily practice central buying; that is, all of the merchandise for the stores is purchased at some central office rather than by the individual store managers. This policy results in the purchase of large quantities of merchandise and, as a result, the chains obtain quantity discounts and carload freight rates, both of which effect savings in merchandising costs.

Chains also buy direct from the manufacturers, instead of through wholesalers, thereby saving at least the wholesaler's profit.

Warehousing. The grocery and drug chains maintain warehouses to which nearly all of their merchandise is shipped and from which it is distributed to the stores as needed. Because of their control over the stores, the chains are in a position to plan their buying, warehousing, and delivering so as to incur the least possible costs in this over-all procurement operation.

Merchandising Policies. Chain retail merchandising policies are designed to bring about reduced store operating costs, which can be reflected in competitively lower prices. Among the principal merchandising policies are the following:

Sales for cash only.
No delivery service.
Telephone orders not accepted.
Only fast-moving items carried.
Vigorous exploitation of private-branded merchandise.
Ruthless marking down of old or slow-moving merchandise.

These policies, which require no further comment, result in certain obvious savings, which may be passed on to the customers.

Modern, Uniform Accounting. Retail accounting has been brought to a high state of development in the chain systems. With all stores subject to the same accounting systems, the chain management has a very effective tool to detect weaknesses and remedy them.

Central Advertising. Unlike their independent competitors,[1] chains are able to utilize the daily papers as effective and inexpensive advertising media. A single insertion, identified with the chain, serves as an advertisement for each store in the chain, and the cost per store is relatively low. The copy for the newspapers, as well as for the store posters, signs, and other forms of advertising, is prepared at the central office. This results in uniformity and low cost.

[1] An exception to this is to be found in the case of voluntary chains.

Real Estate Operation. Many chains maintain real estate departments, staffed by experts in this field who endeavor to secure the best leasehold terms for their stores, check on the adequacy of present or prospective sites, assume responsibility for the remodeling or moving of stores, and generally seek to operate this phase of the business as efficiently as possible.

Personnel Policies. The careful selection and training of personnel are outstanding characteristics of chain store operation. Many firms have formal training courses for their employees, particularly those that are designated for promotion to executive positions within the stores or the central offices.

Merchandise Specials. It has long been the practice of chain stores to select certain items from their stock, reduce their prices somewhat, and feature them in their advertising for the purpose not only of selling these items, but also of attracting customers who will buy other full-priced goods. In certain instances the depth of the price reduction and the prominence of the goods affected have brought into being the term "loss leaders," which are those specials where the prices are so low as to give rise to the suspicion that they are being offered at or near their cost to the stores. These are almost always goods that are nationally known, both as to their quality and their customary price. In recent years, the public has come to recognize loss leaders as bait and has bought them avidly, but has not purchased enough of the other full-priced goods, at the same time, to warrant the stores' continuing the practice on the scale at which it was formerly used.

Store Supervision. Against these operational policies that may produce savings must be set the system of store supervision, which is inherent in chain store retailing. An elaborate organization of supervisors must be maintained in order to assure the management of the best possible, uniform store operation.

The foregoing policies are those that set chains apart from their independent competitors. To the extent that the chain managements are able to capitalize on the potential savings inherent in them, such policies will result in lowered costs, which can be translated into lower prices.

A Retail Store Owned by a Mail-Order House

The large mail-order houses sell more than half of their merchandise through their retail store outlets.

Mail-Order House Chains Somewhat apart from both the grocery and other type chains on the one hand, and the department store chains on the other, are the groups operated by Sears Roebuck and Company and Montgomery Ward and Company. In classes of merchandise carried they resemble the department store chains, with which they are competitive; while in operational policies they are more like the grocery and drug groups. All of the stores bear the name of one or the other of the two large mail-order houses; their merchandise is centrally bought; they have cash and carry for most merchandise; and they feature the private brands of the parent companies. These two systems and their apparent success indicate that the field of retailing is anything but stereotyped and that imagination and daring in merchandising methods frequently bring rich rewards.

Voluntary Chains Opinions differ regarding the effect that the rise of the corporate chains has had upon the independent retailers. Some writers and storekeepers feel that it has been most devastating and that great numbers of independents have been driven out of business because of the entrance of the chains into the retail scene. Others believe that the stores that left the field were due to go anyway, as they constituted the more or less submarginal fringe that has always been present in retailing, and that the most the chains could have done was to hasten their departure through a progressive raising of the standards of the business.

Regardless of which is right, and the argument will probably go on indefinitely, there is no question but that the competitive tempo of retailing has been stepped up measurably since the chains rose to prominence. It has been more difficult recently for the independents to achieve profits in this field than in the pre-chain days.

One of the results of this intensified competitive struggle is that many independents have studied the chains' methods of operation and have endeavored to copy them, to the extent that their independent status would permit. This has resulted, among other things, in the development of the voluntary chain.

There are two types of voluntary chains—those sponsored by independent wholesalers, and those sponsored by groups of co-operating retailers, who customarily, but not always, establish and own the wholesale houses that serve them. The former group is more important than the latter as far as numbers are concerned. Their merchandising policies and practices are practically identical and are listed below.

1. Through the wholesale houses, they buy collectively and thereby secure quantity discounts and carload freight rates. This is perhaps the greatest advantage that voluntary chains have over the unaffiliated independents.
2. They develop and push group private brands, which they control and on which they sometimes make larger unit profits than on nationally advertised manufacturers' branded goods.
3. They advertise collectively, employing a common layout identified with their group. Because of the number of stores involved, they are able to use the daily papers at a very low cost per store. This is a second important advantage that voluntary chains have over the independents not thus associated.

4. They feature weekly specials in direct imitation of the chains.
5. They adopt standard store fronts and, as far as possible, standard interior layouts.
6. They adopt standard accounting methods and record keeping.
7. The latest developments in retailing are noted by the members or the wholesalers, and information concerning them is disseminated to all of the stores.

The strength of the voluntary chains has been in the cooperative spirit of the members, and, by the same token, their principal weakness has been the lack of positive control within the group. Nevertheless the voluntary chain system has permitted thousands of retailers to achieve many of the savings of chain operation while still maintaining a large measure of their independence. It has likewise made better storekeepers of many of them.

Chain versus Independent Controversy

One of the most violent conflicts in our economic system has centered around the so-called chain versus independent controversy. As chains grew in numbers and importance, there arose an outcry among certain independent merchants to the effect that the chains were trying to drive all the independents out of business and that, unless something were done about it, the result would be a monopoly in which the chains would control the distribution of many lines of merchandise and be able thereby to raise their prices to unheard-of heights. These independents were joined by wholesalers who had been adversely affected because of the chains' success. It was claimed not only that the chains were driving the independent merchant (who was always described as a "little fellow") out of business, but also that they were doing it by dishonest means. The spokesmen for the independents accused the chains of short changing and short weighting their customers, of using so-called "loss leaders" to entice the public into their stores, and of securing unwarranted price concessions from their suppliers.

To the charge that the chains cheat their customers, the only answer that can be given is that such surveys as have been made fail to substantiate this accusation. The loss-leader charge falls apart because all stores have adopted this mer-

chandising practice to a greater or less degree, and the chains have modified it to the extent of making the price reductions less drastic. That the chains, with their enormous buying power, had been able to secure price concessions from their suppliers that were greater than those the independents or even many of the wholesalers could obtain, is true; but there are excellent arguments to support the ethics of such a situation.

There were other charges hurled at the chains by their accusers. Among these were that the chains took money out of the community. This accusation was true, but it applied also to almost all other businesses that did not buy all of their goods locally. It was claimed that the chains paid low wages and were rather ruthless in handling their personnel. There was probably a considerable measure of truth in this, but it is an open question whether they were much different from most other businesses.

Other charges were that the chains were taking away the opportunity for the youth of the land and that the chains were making them mere clerks. These charges are too broad for consideration here, and they involve a lot more than just the chain store systems.

Not only did the traducers of the chains give their charges as much publicity as possible, but they approached the legislatures in the various states and sought relief from the competition to which the chains were subjecting them, which was mainly that of lower prices. They succeeded in convincing the lawmakers of some twenty or more states that something should be done about it, with the result that tax laws aimed at the chains appeared in these states. The so-called Fair Trade Laws, which all but one or two states have adopted, together with the Miller-Tydings Act of the National Government, were designed to prevent the chains from cutting prices on certain branded items. The Robinson-Patman Act, a national law, forbade most of those practices whereby the chains had secured price concessions from their vendors.

This controversy has been raging for several years, and while the anti-chain forces have been somewhat less vocal in recent years, there is no evidence that their attitude has changed in the slightest.

Consumer Co-operatives

The discussion of retailers on the ownership basis should not close without mention of the consumer co-operative. This type of store is owned by a group of consumers who operate it, not for profit, but rather for the lower net prices which it is presumed to afford them. Their price policy is that of charging the going prices in their community and of refunding the store's profits to their members on the basis of the volume of their purchases in these stores. Such refunds are known as "patronage dividends." These stores also sell only for cash, advertise only on a factual basis—giving information concerning their products rather than resorting to emotional appeals—and stress grade-labeled merchandise.

As far as merchandising policy is concerned, consumer co-operatives are conducted about the same as any other store, except that they do not extend credit and frequently do not make deliveries. Numerically they have never been of much importance in the retailing picture, except in a few communities where they have had some connection with farmers'

A Consumer Co-operative

The typical consumer co-operative store is a small business

Consumers' Guide

co-operatives. Among the types of merchandise handled are groceries, gasoline and oil, electrical appliances, paints, insecticides, seeds, and feeds. The future of consumer co-operatives would appear to be somewhat uncertain, but it is anticipated that they will continue to hold their own, although not experiencing any rapid growth.

QUESTIONS

1. In view of the high degree of business mortality in retailing, would you recommend that persons wishing to enter this field be required to pass a qualifying examination before they would be permitted to open their stores?
2. House-to-house selling has certain advantages over retail-store selling. Can you name several?
3. The advent of the movies was one of the causes of the decline of mail-order selling. Why?
4. The modern drugstore has been called "the city general store." Do you agree? Why?
5. Will neighborhood department stores eventually replace those presently located downtown?
6. In what important respects do specialty stores and specialty shops differ?
7. Is the supermarket principle applicable to all types of merchandise? Why?
8. Do independents or chains predominate among service retailers?
9. It has been said that the small independent retailer is the heart of retailing and will never be replaced. Is this statement true?
10. The strength of the voluntary chains lies in the wholesalers rather than in the retailers. Do you agree? Why?
11. Should corporate chains be taxed to prevent their translating their lower operating costs into lower prices to consumers? Discuss.
12. If corporate chains are taxed because of the competition that they bring to bear on the small independents, should not voluntary chains and co-operatives be taxed for the same reason?

PROBLEMS

1. From such sources of information as the city directory, the classified section of the telephone directory, the office of the local chamber of commerce, and real-estate agencies, prepare a list of the retail stores that have opened for business in your community since the end of World War II. Classify these stores (a) by types of operation and (b) by ownership.

2. From the most recent Census data on retailing and population, compute for the city or county in which you live the ratio of retailers in a particular field such as food, hardware, or drugs to population. Compute this ratio for the country as a whole also. Compare the two ratios. What conclusions do you draw from this investigation?

3. Select several well-known products in the fields of groceries, drugs, and variety store merchandise of the types that are carried by both chain and independent stores. Check the prices of these products in at least two stores of each type. For each product compare the prices in chain stores with those in independent stores. Are there significant differences in the prices? Prepare a report summarizing and interpreting your findings.

4. A manufacturer of men's and women's shoes who distributes his product through independent retailers desires to increase his sales. He is considering a plan of employing salesmen who would call at homes, show samples of the shoes together with photographs illustrating their appearance with costume ensembles, take measurements, and arrange for shipment of the shoes by parcel post C.O.D. Do you think that this is a sound proposal? Prepare a brief report stating specifically the reasons for your answer.

SUGGESTED READINGS

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Store Modernization Check List.

CHAPTER 14

PRICING

Prices in a Capitalist Economy Prices are essential to the operation of a smooth-running, modern capitalist economy. It is inconceivable that the great variety and quantity of goods that we make and sell to each other would continue to move in the channels of trade if we had no price system whereby the values of each of these commodities could be expressed.

The origin of prices is lost in antiquity. It is probable that, sometime in the dim, distant past, man's life was so simple and primitive that he was able to satisfy all of his wants by growing or finding his own crops and by hunting animals. At some later date, as his needs grew, a rudimentary form of economic specialization came into being; instead of providing all of his requirements by his own efforts, each man undertook to do that thing for which he was best fitted and traded his surplus products for those of his neighbors. This exchange of goods called for the expressing of the value of one man's goods in terms of another's. For example, one bearskin might be worth ten bushels of wheat. Such a system for effecting the exchange of goods is *barter*. It is inconvenient and cumbersome. Not only must the man with surplus bearskins and a need for wheat find a man with a surplus of wheat and a need for a bearskin, but there must be a meeting of the minds between them as to the value of the bearskin in terms of wheat and vice versa.

Somewhere along the march of history, money came into existence as a medium of exchange; and a method of expressing the values of goods in terms of it, known as the "price system," was evolved. The exchange of goods was greatly facilitated thereby.

Theories of Price Writers on economics have advanced a number of theories to explain the movement of prices, how the price of any given commodity is set,

and why the so-called price level is where it is at any one time. Among these are the quantity theory of money, the gold content of the dollar theory, the marginal utility theory, and the equilibrium theory of prices. One school of economists maintains that prices and the price level can be plotted and foretold with the aid of certain mathematically determined curves, which are plotted on graph paper. Because of the complicated nature of these theories and the fact that the validity of all of them is open to question, only one will be discussed here.

Equilibrium Theory of Prices This theory, which probably has the largest number of adherents among economists, assumes that two forces operate in the field of price—supply and demand. These forces bring about a price at which the quantity demanded by buyers equals the quantity that sellers are willing to supply. Some of the units of the commodity that are necessary to make up this quantity are produced by those whose costs of production are so high that they make little or no profit, but who decide, nevertheless, to remain in business. The theory further assumes that if, for some reason, the current price for a commodity is found to be above the theoretical equilibrium point, two things will happen, both of which will have the effect of forcing the price downward: (1) the higher price will discourage would-be buyers, thereby reducing the demand; and (2) the opportunity for profits afforded by the higher price will attract new producers into the field, whose added product will increase the supply. The effect of reduced demand and increased supply will be to reduce the price, probably below the equilibrium point. When this takes place, the results are the reverse of the condition just described: (1) the lowered price attracts buyers, increasing demand; and (2) the diminished profits, which then occur, force some high-cost producers to leave the field, thereby reducing the supply. This brings about an upward movement of price, toward the equilibrium point.

This process may go on indefinitely, but the prices produced in the long run will tend to be at the equilibrium point. Stated in terms of supply and demand, this theory points out that an increase of supply and/or a decrease in demand tend

to cause prices to drop; conversely, a decrease of supply and/or an increase in demand will cause prices to rise. The unceasing interplay of the forces of supply and demand are assumed to be always at work with the result that the prices that prevail tend to be at the equilibrium points for the various commodity fields.

Unrealistic Assumptions in the Equilibrium Theory. This theory probably comes nearer to reflecting what actually takes place in the price picture than any of the others. But it is an over-simplification and is based upon certain unrealistic assumptions that prevent its being a true explanation of why prices act as they do. These assumptions are as follows:

(1) *Complete homogeneity of product.* According to this assumption, there is no difference between one producer's product of any given commodity and any other producer's product of that same commodity. This may be true of wheat, oats, corn, and a few other items, but obviously not of such commodities as washing machines, radios, clothing, and automobiles.

(2) *Complete knowledge of all market conditions.* These conditions include supply, demand, and price on the part of both buyers and sellers. This knowledge would be possible only in a primitive economy, or on a limited scale at the present, as in certain organized commodity exchanges such as the Chicago Board of Trade.

(3) *Purchases made only on the basis of price.* According to this assumption, buyers do not purchase because of whim, caprice, or prejudice but solely on the basis of the lowest price offered. This may be true in the case of certain agricultural items where the sellers' identities are unknown to the buyers, as on a commodity exchange, but hardly with most other articles of trade.

(4) *Absolute freedom of competition.* There may have been some time in the early stages of man's economic evolution when perfect competition existed, but that time is long past and will never return. Perfect competition assumes the presence of the preceding three conditions.

Factors Ignored by the Equilibrium Theory. In addition to the limitations already mentioned, there are other reasons why the assumptions of the equilibrium theory are not applicable to present-day business practices. Some of the more important of these are listed below:

(1) *The presence of other factors influencing purchases.* These include quality, service, vendors' prestige, and chance.

(2) *Monopolies and quasi monopolies.* While there are comparatively few pure monopolies in our economic system, there are many firms that enjoy certain aspects of monopoly because of location, patent rights, control of sources of raw material, and so on.

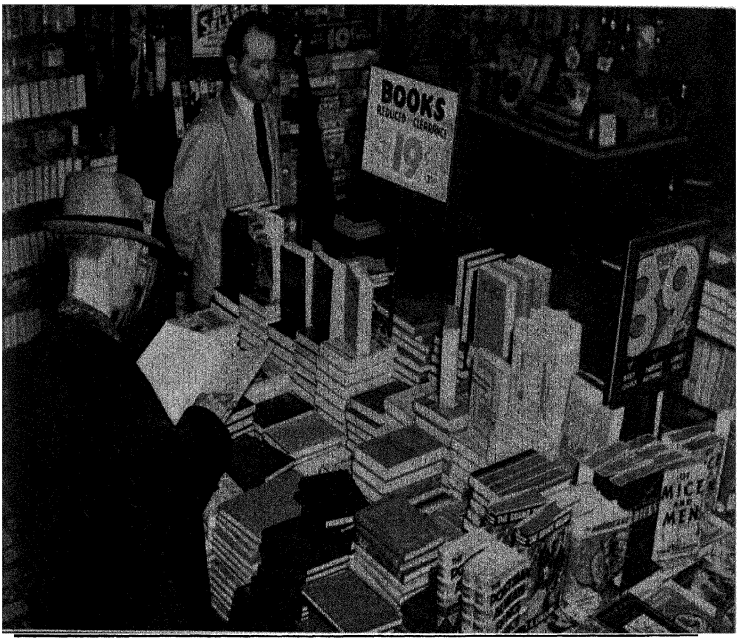
(3) *Brand influences.* These cause many consumers to demand the products of certain manufacturers merely because they have come to prefer their brands and without much regard to the value of competing brands. Thus a housewife may insist on a certain soap, tooth paste, or hair shampoo because "radio operas" have convinced her that they are the only satisfactory products on the market.

(4) *Price-fixing through private agreements.* These may be illegal, but they sometimes remain in force for long periods of time until they have been detected.

(5) *Price regulation.* This may be either legislative or administrative. Examples of the former are seen in the various state Fair Trade Acts, and of the latter in the Maximum Price Regulations of the Office of Price Administration, which were in force during World War II.

(6) *The one-price system.* This prevails in most retail stores. The price of an article is determined by the storekeeper, is customarily displayed on or near the goods, and is not subject to bargaining by the customers. Where this system prevails, the customers must either pay the established price or go without the article.

(7) *Consumer indifference toward the prices or characteristics of many items.* This is manifested by the failure of consumers to give heed to informative labeling or advertising, to employ rational buying motives when making purchases, or to bother to inform themselves concerning the prices of



G. A. Douglas

Prominent Display of Book Prices

Most retailers have a one-price system, a characteristic of which is a prominent display of the prices on or near the goods.

competing stores on certain common items. It is a fairly common phenomenon for two or more competing stores to offer eggs of the same grade at different prices, and for consumers to buy the high- as well as the low-priced ones.

Concepts of Supply and Demand Despite the unreality of some of the aspects of the equilibrium price theory, it probably comes nearer to describing the price picture as it really exists than does any other theory that has been propounded. In the absence of restraining factors, such as wartime price control or governmentally-supported prices for certain agricultural products, prices tend to rise when demand exceeds supply, and to fall when the reverse is true.

However, there is one important phase of the price-determining process that the student should always remember, that is, prices are the result of human activity and are never arrived at impersonally. In all situations where goods are offered for sale, the seller has a fairly definite idea of the

price that he hopes to receive, and the buyer likewise knows about what he will be willing to pay. At all levels of sales other than at retail, it is common for buyers and sellers to bargain before settling upon the prices at which the goods will be sold. In these situations the concept of supply and demand has considerable validity.

At the retail level, however, the long-established one-price system has tended to prevent the demand from being as effective as it is at other sales levels. While it is true, as a broad general rule, that raising the prices of many articles at retail will result in lowered sales volume, there are so many exceptions to this condition and so many other factors that influence consumers in their buying, that it must be concluded that the power of the demand at this sales level is considerably less than in wholesale transactions.

Elements Affecting Prices Sought by Sellers. When a seller undertakes to establish the price at which he hopes to sell his goods, he takes the following elements into account:

(1) *Cost of the goods.* If the seller is a manufacturer, his costs will include not only the costs of manufacture, both direct and overhead, but also his cost of selling. If the seller is a wholesaler or a retailer, he will consider how much he paid for the goods originally, together with his costs of doing business.

(2) *Profit philosophy.* All sellers follow one or the other of two profit philosophies. Either they seek relatively high profits per unit of goods sold with a restricted sales volume, or they are willing to accept lower unit profits in order to sell more goods.

(3) *Competitive trade conditions.* In some lines of business, competition is such that sellers must follow closely the prices of their competitors; in others they can be fairly indifferent toward them.

(4) *Sellers' attitude toward competition.* At all levels of trade, but particularly at retail, some sellers pay little attention to the prices of their competitors and rely on other appeals to sell their goods. Certain department and specialty stores are adherents of this pricing philosophy. On the other

hand, there are sellers who will not be undersold by their competitors on identical or similar merchandise. A third type follows the practice of always being below the prices of its competitors.

(5) *General or local business conditions.* A factor that must always influence a seller in determining his price is the state of general or local business conditions, whether good or bad times are at hand. This is a complicated matter that cannot be expounded here; but the effect, as far as price-setting is concerned, is that during bad times a seller will set his prices with greater regard for competition and, perhaps, at figures that include lower unit profits than during good times.

Elements Involved in the Prices Buyers Are Willing to Pay. In many of the sales transactions that occur in our economy, the sellers name the prices that they wish to receive for their products; and in a considerable number of instances buyers either pay them or simply refrain from buying. At the retail level, the fact that in most stores prices are clearly marked for all goods and are not subject to bargaining between retailers and consumers, has the effect of placing such retail prices in a sort of a take-it-or-leave-it category. In the industrial goods field, and in consumers' goods at other than the retail level, considerable bargaining takes place between would-be buyers and sellers, before sales are consummated. Both at the retail level and elsewhere, however, the buyers approach their prospective purchase transactions with rather definite ideas as to how much they are willing to pay, and often with sharply defined upper limits beyond which they refuse to go. A brief discussion follows of the factors that influence the buyers in arriving at these conclusions in regard to the prices that they will pay.

(1) *Consumers' subjective value reactions.* In every consumer's mind, when he decides to make a purchase, is the idea that any given item of merchandise is worth just so much to him. The value thus approximated may or may not bear a close relationship to the price being asked for the item in question. If it is close, the purchase will probably be

made; if it is not, the consumer may refrain from buying at the time.

(2) *Consumers' personal economic status.* Constantly underlying the attitude of every consumer toward the price picture is his own personal economic status. In other words, the poor man's outlook toward a purchase transaction is different from that of a well-to-do or a rich man.

(3) *Effect of advertising or sales efforts of sellers.* Advertising and the sales efforts of sellers tend to create in the minds of consumers an uncritical attitude toward prices. Consumer preference is created for certain brand names on a wide variety of bases such as service, prestige, pride of ownership, and many others. The result of this condition is that consumers approach the purchase of these goods with the price element as a secondary consideration.

(4) *Buyer's knowledge of his resale market.* This factor and the two following factors apply principally to the buyer who purchases goods for resale, either in their present state or altered in some way. Examples of such buyers include the wholesale or retail buyers who buy apparel for resale to their respective customers, and the industrial purchasing agents who buy steel sheets, for example, to be formed and fabricated into automobile bodies.

In instances such as these, the buyers usually have rather clear ideas concerning the prices that their customers will pay for the goods that they are about to purchase or make. Hence their attitudes toward the prices that they are willing to pay are customarily well formulated and frequently committed to writing in advance of the buying situation. Industrial purchasing agents are often not permitted to pay more than certain stated prices for the items that they buy; these figures are computed on the basis of the relationship of the costs of the component parts of the products that their companies manufacture.

(5) *Buyer's knowledge of producers' costs.* It has been said that the officials of the Ford Motor Company know almost exactly the costs of the suppliers from whom they purchase the items that go into the Ford automobile. This knowledge,

which is probably characteristic of certain other skilled buyers, fixes the upper price limits above which they will not go.

(6) *Condition of the supply market.* This factor applies with equal force to the prices that sellers seek and those that buyers will offer. When supplies are short, these prices tend to rise and when the market is oversupplied, they tend to fall. This is also true of the consumer market.

Actual Price-Determining Factors

As a matter of general practice, the establishing of prices is usually undertaken by the sellers or their employees or representatives. When an article is offered for sale, a price is customarily set for it; the seller does not ask the buyer how much he will give for it. Certainly this is true of most formalized business sales transactions. The notable exception consists of auctions, in which the buyers set the prices in competition with each other, although they are urged on by the suggestions and entreaties of the auctioneer. Aside from this exception and the casual sales that come outside of the purview of organized business, most sales proceedings start with prices set by the sellers. An example of a *casual sale* is the sale of a piece of furniture or of a garden tool by one person to his neighbor.

Aside from the elements that make up the supply price just mentioned, there are a number of other factors that must be taken into account by the individuals charged with the duty of setting the prices.

What the Traffic Will Bear. Although this phrase has a more or less unpleasant sound since it implies excessively high profits, it is nevertheless, a rather widely used indicator of the upper limits to the prices that may be set by sellers. A seller who knows his market will be perfectly aware of the price limits above which he cannot go and retain his customers. These limits cut across many of the other factors that enter into his price-determining procedures.

Markup Percentage. At all levels of business, but particularly at wholesale and retail, it is customary for sellers to arrive at their prices through the use of markup percentages.

These markups are expressed as percentages either of cost or of selling prices.[1]

A markup is supposed to cover the cost of handling the article to be priced, a portion of the firm's overhead expenses, and a certain amount of profit. Because of the difficulty of establishing these costs accurately for individual articles, it is customary to group like items into classes for which costs can be discovered and to use the average or group markup to establish the retail price for a single item. Thus, in a store using the retail price markup method and having established an average markup of 50 per cent for a given merchandise group, the person setting the price for an article in the group that cost $5 per unit would arrive at $10 as the selling price of a unit. The accuracy of the figures may be seen by the following example:

Retail price	$10 (100%)
Cost	5
Markup	$ 5 (50% of the retail price)

RETAIL PRICE MARKUP TABLE

Find the desired markup percentage based on selling price in the column at the left. Multiply the cost of the article by the corresponding percentage in the column at the right. Add this amount to the cost in order to determine the selling price.

DESIRED MARKUP PERCENTAGE (BASED ON SALES PRICE)	EQUIVALENT PERCENTAGE OF COST	DESIRED MARKUP PERCENTAGE (BASED ON SALES PRICE)	EQUIVALENT PERCENTAGE OF COST
5.0%	5.3%	20.0%	25.0%
6.0	6.4	23.1	30.0
7.0	7.5	25.0	33.3
8.0	8.7	28.5	40.0
9.0	10.0	30.0	42.9
10.0	11.1	33.3	50.0
11.1	12.5	35.0	53.9
12.5	14.3	37.5	60.0
13.0	15.0	40.0	66.7
15.0	17.7	42.8	75.0
16.7	20.0	50.0	100.0

[1] In the retail field there is a sharp divergence of practice in this regard. Some stores use the markup on cost, while others figure it on the retail price. Most large stores and the chains follow the retail method, whereas smaller stores adhere to the cost, and older, method. Leading retail authorities are in agreement that the retail method is the more advanced and useful of the two, although it is a trifle more difficult to apply.

If this store were using the cost markup method, and wished to secure a retail price that would involve a markup of 50% on cost, the resulting price would be $7.50.

Cost	$5.00 (100%)
Markup	2.50 (50% of cost)
Retail price	$7.50

Price Lines. These consist of a series of predetermined prices that are the only ones at which merchandise is offered for sale. For example, goods in a certain department might be offered only at $1.95, $3.95, and $5.95. No intermediate prices, such as $2.50, $3.25, or $5.00 would be used.

There are certain drawbacks, as well as distinct advantages, to the use of a limited number of price lines. The principal disadvantage is that the store's stock may be inadequate to care for the trade. This is known as "starving the stock" and results from the use of so few price lines that customers are unable to find goods at, or near, the prices that they are willing to pay. The advantages have to do with the possibility of reducing the stock carried in a store, through the elimination of goods that would otherwise need to be carried at the in-between prices. Carrying a smaller stock of goods should accelerate the rate of turnover, reduce the capital investment in merchandise inventory, and simplify the problems of selling the goods.

Suggested Prices. Manufacturers sometimes print suggested retail prices on the containers of their products. Retailers may or may not care to adhere to these prices when determining their own resale prices. Cut-rate stores frequently make a practice of pricing these goods below the prices suggested by the producers with a view to effecting thereby a price comparison.

Price Leadership. In any business at whatever level, there are certain acknowledged price leaders, who set their prices without much regard for the other members of the trade but whose prices are rather slavishly followed by their competitors. To a considerable extent the United States Steel Corporation in the steel business, and the Standard Oil companies in the oil field have been price leaders in their fields. The

reasons for this price leadership are usually prestige, size, aggressiveness, or prominence.

Legislation. As already mentioned, there are several instances of legislative regulation of prices. To the extent that the goods to be priced come within the purview of these enactments, the seller must be governed by them when establishing his prices.

Basing-Point System. In a few industries, notably iron and steel, the so-called basing-point system is in effect. The most famous example of this was the Pittsburgh-Plus plan, whereby the prices of all iron and steel products were quoted as the base price in Pittsburgh plus freight from there to the destination of the goods. Thus a buyer of steel always paid the freight from Pittsburgh to the place where the goods were to be delivered, regardless of the location of the seller. For example, a buyer in Chicago, purchasing steel from a plant in Gary, Indiana, would be forced to pay freight from Pittsburgh, even though the steel should be delivered by truck because of the short distance.

The reason for this arrangement was that originally Pittsburgh was practically the only source of iron and steel in the country, and the Pittsburgh-Plus system accurately reflected the actual manufacture and transportation conditions. Later, when the steel industry expanded, the Pittsburgh producers were able to maintain their dominance of the business and to keep the Pittsburgh-Plus system in force. This was done both because of their size and potential competitive threat, and also through the agency of friendly persuasion, as exemplified by the famous "Gary dinners," at which Judge Elbert H. Gary, Chairman of the Board of the United States Steel Corporation, served as host to the heads of other, and usually smaller, steel companies. It is said that agreements were worked out at these occasions that kept the Pittsburgh-Plus practice in operation. This not only caused steel buyers throughout the country to pay a considerable amount of fictitious freight charges, but also had the effect of preserving the competitive status of the Pittsburgh producers in all steel markets in the country.

In 1921, the Pittsburgh-Plus system was modified by the establishing of Chicago as an additional basing-point for numerous steel products. Shortly after 1924, when a cease and desist order was issued by the Federal Trade Commission outlawing the Pittsburgh-Plus plan, some 48 additional cities were designated as basing-points for a wide variety of iron and steel products.

Demand Elasticity. This is a somewhat academic term that refers to the effect that changes in price have on the demand for an item. If changing the price of an article produces a significant alteration in the demand for it, it is said to have demand elasticity or an elastic demand. Likewise, if these price changes do not bring about a significant difference in demand, the article is said to have inelasticity of demand. The assumption is, of course, that demand will move in the opposite direction from price. Examples of goods with demand elasticity are to be found in the items advertised as week-end specials by grocery stores, such as breakfast foods. The classic example of demand inelasticity is salt. Regardless of the price of salt, people use a fixed amount.

Most sellers have probably never heard of the term "demand elasticity" and would not know what it meant if they did. But they all know what will happen to the demand for the items that they have for sale if they vary the prices to any extent. Accordingly they take this knowledge into account when they are setting their prices. If a storekeeper wishes to attract a large number of customers into his place of business through price cuts, he will select only those items that he knows have elasticity of demand, and he will avoid marking down the goods whose demand is inelastic. In like manner, if he wishes to raise some of his prices without driving away trade, he will pick out items with a relatively inelastic demand.

There are obviously certain limits to the effectiveness of this concept, particularly as prices are raised, but it is sufficiently valid to furnish a trustworthy guidepost for sellers in setting their prices.

Monopoly Price. The presence of a monopoly implies the complete control of the price by the monopolist and the ab-

sence of competition. In the business world at large, there are very few pure monopolies. Those that do exist, such as the public utilities in most localities, are subject to governmental regulation to the extent that their freedom to set their prices (without let or hindrance) is greatly, if not completely, curtailed. With this type of monopoly this discussion is concerned only to the extent of pointing out that prices are established or changed only with the consent of some governmental regulatory commission.

There exist, however, a large number of businesses that enjoy some of the aspects of a monopoly, whether they are of location, of goods, or of processes protected by patent or copyright, in the case of printed material. In a very real sense, the crossroads country general store of an earlier generation was a monopoly. There was often no competition within miles, and the consumers had to patronize it or do without the articles they wanted. This does not necessarily imply that the general store proprietors overcharged their customers; but they probably were able to obtain higher prices for their wares than would have been the case had there been any effective competition nearby.

A type of competition, called "monopolistic competition," pertains to competition between firms that have certain of the characteristics of monopolies. These firms endeavor to "differentiate" their products from those of their competitors in an attempt to escape the rigors of pure price competition. Thus, the development of brand names and of minor differences between products are regarded as evidences of monopolistic competition in practice. In recent years a school of economic thought has arisen that embraces the belief that monopolistic competition more closely describes present-day business than the pure monopoly or pure competition of the more orthodox economists. The term originated with the members of this new group, and their doctrine endeavors to take some cognizance of the fact that advertising and selling are essential to the distribution of goods, a view that the older economists refused to admit.

The seller who enjoys some aspects of monopoly, or who is subjected to monopolistic competition, will price his wares at a level that will afford him the largest measure of profit,

at least theoretically. If he has a good accounting system, he may be able to come quite close to achieving this ideal situation. He must always remember, however, that there are very few commodities for which there are no substitutes; and if he raises his prices too high, he may cause his customers to turn to other products that may serve the same purpose.

Price Policies Somewhat aside from the factors just enumerated, there is another group of items that affect the setting of prices by sellers. These items, called price policies, might be regarded as the basic, underlying philosophies that sellers follow. They determine the general framework around which each seller fits his pricing structure. A study of these policies should make their meaning and function clear.

Low Prices. Some sellers follow the plan of always having low prices for their goods. A well-known Eastern grocery chain uses the slogan "We sell for less," and the price setters in this organization are instructed to price their wares at the lowest prices consistent with the company's operating expenses and profit philosophy. Macy's, the great New York department store, stresses the fact that it "will not be undersold."

High Prices. This policy is embraced by numerous department and specialty stores, dealers in fancy groceries, and manufacturers of quality goods. In most shopping centers there are one or more stores that carry merchandise much the same as that of their neighbors, but whose prices are noticeably higher than those of the others. In some instances these prices represent better merchandise; in others they reflect merely a desire to secure higher prices and a higher profit per unit.

Stable Prices. Many, if not most, sellers follow their merchandising and operating costs rather closely in pricing their goods. Thus when these costs go up or down, prices likewise go up or down. Opposed to this is the philosophy of stable prices, whereby a price, once established, tends to remain constant for long periods of time regardless of the fluctuations

of the costs of the goods or of the sellers involved. Examples of this policy are to be found where the retail prices are printed on the packages by the manufacturers, in the five-and-ten-cent stores, and in similar instances.

Odd Prices. There is a school of merchandising thought that holds with the idea that $2.95 is a more appealing price than $3, that 19 cents will sell more goods than 20 cents, and $99.95 is more effective than $100. The underlying theory of this policy is that $1.95 makes the prospective buyer think of $1 plus some cents, rather than of a price slightly less than $2. A secondary reason for so pricing merchandise is that salespeople are compelled to make change and are therefore discouraged from pocketing the customers' money, as they might be tempted to do were even prices used.

Delivered Prices. Some manufacturers adopt the policy of establishing their prices on what is called a "delivered basis." This means that the price quoted to any seller includes all transportation and is the price that he must pay to take delivery of the goods at his own place of business. Opposed to this is the practice of quoting f.o.b. factory prices, that is, the seller will place the goods on a common carrier at the factory loading dock and that all further transportation charges are to be paid by the buyer over and above the quoted price. The pricing of automobiles is an example of this latter policy.

One Price versus Varying Price. As indicated earlier in this chapter, most retail pricing is of the "one price" variety, that is, the established price applies to all comers and is not subject to "higgling" by individual customers.

At other sales levels, however, this policy does not always hold true. While some manufacturers and wholesalers follow it rather rigidly, many others may lower their prices, from time to time, in favor of particular purchasers. This flexibility of price may come about because of the superior bargaining skill of certain buyers or because of the size of their purchases. Since many large buyers had been able to secure lower prices than their smaller competitors, the Robinson-Patman Act was passed in June, 1936, as an amendment to

the Clayton Anti-Trust Law, and the Federal Trade Commission was authorized to administer it. The purpose of this act is to prevent sellers from discriminating in price among their customers, "where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with the customers of either of them. . . ." It forbade a number of practices by which price concessions had been made to favored buyers, unless these were made available to all other buyers "on proportionately equal terms." There were a number of other provisions, but the main purpose of the act is to enforce a one-price policy for all sellers.

For several years after the passage of the Robinson-Patman Act, a number of cases were heard for alleged violations of its various provisions. The principal effect has been to force sellers to conform their pricing policies to the requirements of the Act, and to grant only those price concessions that will stand up under examination by the Federal Trade Commission.

Discount Policy. For those sellers who elect to pursue a varying price policy, there are two principal methods by which they may put this plan into effect: (1) through simple price concessions and (2) by means of a discount policy. An example of the first method is the lowering of a price of $1.50 per unit to $1.35.

Under the second method, however, there are several alternatives, which should be examined.

Chain of Discounts. When a chain of discounts is used, the list price is followed by several discounts, which are customarily applied in turn to an ever-lessening figure. For example, an invoice for $100, less 40%, 10%, and 5%, would be figured as follows: $100 — $40 (40%) = $60; $60 — $6 (10% of $60) = $54; $54 — $2.70 (5% of $54) = $51.30, which is the net amount paid by the buyer. This method is used by sellers who desire to discriminate legitimately between their customers by granting or withholding one or more of the discounts in the string. It also permits them to

change their prices by adding or subtracting a discount, without the necessity of reprinting their price lists each time such a price change becomes necessary.

Quantity Discounts. A quantity discount is offered by some sellers as a reward to buyers who order in large quantities. Presumably this saves the vendors storage, packing, and perhaps transportation charges.

Functional Discounts. A functional discount recognizes the different functions performed by wholesalers and retailers. It is sometimes used by manufacturers as a means of protecting the wholesalers' position; it is frequently expressed through a discount chain. Thus, in the example cited above, a wholesaler might receive all three discounts, while a retailer might be allowed only the 40 per cent. Functional discounts can be used to denote the difference in functions performed between full-service wholesalers and functional middlemen. (See page 223.)

Cash Discounts. A cash discount differs somewhat from the foregoing group in that it is given neither as a reward for large purchases nor in recognition of differences in functions performed. It is simply an inducement offered by the seller for the purpose of encouraging the buyer to pay his bill within a short time after the goods have been delivered. The cash discount takes many forms, the most common of which is in the form—2/10, net/30; that is, if the invoice is paid within ten days of its date, the buyer may deduct 2 per cent of the amount of the invoice in making his remittance, and if the buyer elects not to pay the bill within the ten days, he has twenty additional days in which to pay the full amount before the invoice becomes overdue. In some lines of business, notably apparel, cash discount rates run up as high as 6 per cent and 8 per cent. Unlike some of the other discount types, cash discounts are usually available to all the customers of a seller.

Resale Price Maintenance. One of the most controversial aspects of the entire pricing picture is that which is known as "resale price maintenance." The term, explained as simply as possible, means that the manufacturer of a branded prod-

uct may, if he so desires, prevent the wholesalers and/or retailers who sell it from establishing a price on it that is lower than the price at which the manufacturer wishes it sold. For example, a producer of a branded toothpaste may wish retailers to sell it at 50 cents, whereas the retailers might prefer to price it at 39 cents. If the manufacturer wishes to enforce his will in this regard on the retailers, he may do so, provided he can induce a single retailer in each state (in all but three states) to sign a contract with him agreeing to maintain the 50 cent price. These contracts then become binding on all other retailers in these states provided they are informed of the existence of the contracts.

The legal authorization for this remarkable circumstance is to be found in the State Fair Trade Acts, which have been made law in forty-five of these United States, and in the Miller-Tydings Act of the Congress, which specifically exempts these contracts from violating the Sherman Anti-Trust Act.

The purposes of resale price maintenance are two-fold: (1) to protect the manufacturers of branded products from whatever ill will may result from their prices being cut by retailers and (2) to protect retailers from the competition of price cutters. The wholesalers' part in the resale price maintenance picture is relatively secondary; they are permitted or required to make contracts with retailers for the purpose of maintaining prices. As these contracts are customarily drawn, no mention is made of the second purpose of resale price maintenance, but the sole objective is said to be that of protecting the goodwill of the manufacturers of branded or trade-marked goods. During the period when the State Fair Trade Acts were being considered by the various state legislatures, opponents of these measures claimed that the main purpose of the acts was to protect inefficient retailers from the competition of the more efficient members of the trade, which usually included the chains, and that the whole movement was a part of the larger, anti-chain idea. It was likewise claimed that the manufacturers, for the most part, were indifferent if not actually hostile to the notion.

On the other hand, those who favored this legislation asserted that the price cutting of branded products caused retailers to lose interest in handling or promoting these goods,

with resultant loss of retailer, if not customer, goodwill by the producers. It was also claimed that retailing would be on a sounder basis if competition could be diverted from price to some other basis. With the entry of this country into World War II, debate on the subject ceased rather abruptly, and retail conditions of cost and supply were such as to remove the emphasis from price cutting as a serious problem.

The problem of resale price maintenance affects the seller of goods in several ways in his pricing. If he is a retailer and the merchandise he wishes to price is subject to Fair Trade contracts, he will have a stated minimum below which he may not go. If he follows a policy of having prices lower than those of his competitors, he may refuse to handle the price-protected merchandise and seek that which is price free. He may also endeavor to develop his own private brands on which he may place any price that he wishes.

The problem of the wholesaler, if he is pricing Fair Traded merchandise, will probably be simple, as he will be certain that there will be little, if any, price cutting among his customers. If the merchandise that he is pricing is price free, he may be subjected to pressure for lower prices by his customers to enable them to meet the prices of their price-cutting competitors, who may be the chains or supermarkets. As the chains rarely buy through wholesalers, their reluctance to handle Fair Traded items will not affect the wholesalers to any extent.

For the manufacturer, the problem is not so much one of actual pricing as it is one of deciding whether or not to maintain the price on his product or to allow it to be price free. If he maintains the price, he runs the risk of having the chains and supermarkets decline to handle it; if he allows the product to be price free, he will please the chains but will create indifference or antagonism on the part of the independents. Some manufacturers are in the fortunate position of having created sufficient public demand for their products that all retailers will carry them, whether they are Fair Traded or not.

Wartime Price Control During World War II and for some time thereafter, this country was committed to a system of price control, which was designed to prevent the

inflation that might have followed the dislocation of supply and demand brought on by the exigencies of the war. The Office of Price Administration, which was established by an act of Congress, was charged with the duty of controlling prices of nearly all goods and services. The measure of its success is open to considerable debate, but it was unquestionably instrumental in preventing a runaway inflation.

QUESTIONS

1. Are prices a necessary part of a capitalistic system? Why?
2. "A price system is a method of expressing the values of goods in terms of the medium of exchange." Explain.
3. Do you believe that the equilibrium theory of prices reflects present pricing conditions? Discuss.
4. Comment on this statement: "Competition should be on some basis other than price, such as quality or service."
5. To what extent does the so-called one-price system, which is prevalent in retail stores, operate to prevent the free working out of demand and supply at this level?
6. Is "what the traffic will bear" a defensible basis for setting prices?
7. Can you think of any reasons why the practice of expressing markup as a percentage of the retail price is preferable to expressing it as a percentage of cost?
8. Give examples other than those mentioned in this chapter of goods with an elastic demand and of goods with an inelastic demand.
9. To what extent can present-day competition in business be appropriately described as "monopolistic competition"?
10. What is meant by the terms "2/10, net 60"? What kind of discount is indicated by these terms?
11. Do you think that resale price maintenance helps or hinders the effective operation of competition at the retail level?
12. Should chain stores be prevented by law from selling at lower prices than do independent competitors?
13. During the postwar period of price control, the OPA was widely accused of stifling production by holding down prices of manufacturers whose costs had advanced. Do you believe that this accusation was true? Explain.
14. Should the Federal Government undertake to fix prices for our economy? Is governmental price control consistent with the principles of a competitive capitalistic economy?

PROBLEMS

1. (a) If the cost price of an article is $20 and the sales price is $25, what is the markup percentage on selling price? (b) on cost?

(c) If the markup is 33⅓ per cent on sales price and the sales price is 60 cents, what is the cost?

(d) If the markup of $2.50 is 16⅔ per cent of the sales price, what is the cost?

2. Using the Retail Price Markup Table on page 276, calculate the selling price for each of the following items: (a) cost price, $1; desired markup on sales price, 33⅓%; (b) cost, $2; desired markup, 50%; (c) cost, $10; desired markup, 16⅔%; (d) cost, $56; desired markup, 20%; (e) cost, $75; desired markup, 40%.

3. (a) A merchant buys $150 worth of merchandise, terms 2/10, net/30. The invoice is dated October 5. If he pays the invoice on October 10, how much should he remit to the seller?

(b) An article of merchandise has a list price of $200, subject to the following chain of discounts: 50%, 15%, and 10%. What is the net price of the article?

4. When the terms of a sale are 1/10, n/30, the discount is considered equivalent to an interest rate of 18 per cent a year. (One per cent of the purchase price is saved by paying on the tenth day following the date of the invoice rather than on the thirtieth day, a difference of 20 days. Since a year—360 days—includes 18 twenty-day periods, a 1 per cent saving for 20 days is equal to an annual interest rate of 18 per cent.)

Calculate the equivalent interest rate for each of the following discount terms: (a) 2/10, n/30; (b) 2/30, n/60; (c) 2/10, n/60.

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CHAPTER 15

ADVERTISING

Place of Advertising in Marketing The purpose of advertising is to announce the goods that sellers have available for sale and to persuade buyers to make purchases of those goods. It is a form of selling and has the same objectives. When a manufacturer has completed the production of his wares, he will employ salesmen to seek out prospective buyers at whatever level his goods are first sold—industrial buyers, wholesalers, retailers, or, in the case of direct sellers, consumers. As a means of assisting his salesmen to make sales, he may advertise. He may take this method of acquainting his prospective customers with his product before the salesmen arrive, thus shortening their tasks and making them easier.

Wholesalers send their salesmen to call on retailers and frequently augment their efforts with advertising designed to inform the retailers of the goods handled by the wholesalers and particularly of new merchandise that they are carrying. Here again advertising is an adjunct to personal selling.

Retailers rarely send out salesmen to call on consumers. About the only exceptions to this are automobile and vacuum cleaner salesmen. Hence, retail advertising not only must tell consumers about the merchandise that the retailers have for sale but also must impel them to visit the stores and ask to see the advertised goods.

Basic Types of Advertising The two basic types of advertising are commodity and institutional. *Commodity advertising* is designed to help sell one or more definite, identified commodities, and usually describes and extols their good qualities or prices. *Institutional advertising* on the other hand is created for the purpose of getting some message across to the public, which may or may not be closely related to the sale of any particular merchandise. By means of institutional advertising a firm may announce a change in location,

the adoption of a new policy, the acquirement of a new line of goods, or anything else that might be of general interest to their customers.

Another form of institutional advertising exists when several advertisers issue a joint advertisement for the benefit of all of them. Advertisements of this sort may be devoted to trying to sell goods or merely to promoting ideas. The advertisements of the Airlines of America that appeared right after the end of World War II are examples of group institutional advertising, the purpose of which was to sell the public on air travel and to indicate that additional facilities would be available. Another example is the series of advertisements put out by the American Meat Institute explaining the uses of meat by the armed forces during World War II.

The Demand-Creation Concept A large number of advertising people believe that demand creation is one of the main functions of advertising. In view of the fact that advertising is considered a form of selling and that creating a demand for things is a part of the selling process, there can be little quarrel with this idea. A demand for a commodity cannot exist without a knowledge of the availability of the commodity on the parts of potential users; hence, the purely informative part of advertising comes under the heading of demand creation. But demand must be more than just knowledge of the existence of a commodity. It must involve the desire for it on the parts of prospective purchasers. Thus the part of advertising that endeavors to persuade buyers to purchase the advertised commodity also comes under the heading of demand creation.

As was pointed out in a preceding chapter, it is very difficult for consumers to make their wishes known to the producers in such manner as to serve as a guide for production schedules. In order to avoid the stalemate that might otherwise theoretically follow this situation, it is only natural that manufacturers should make what they think the public wants and then try to convince consumers that they should buy the advertised goods. There is obviously opportunity for the promotion of goods that may be of little value to consumers, but this seems to be a risk inherent in a situation where the buyers

are practically inarticulate and where the producers must gamble on producing what the consumers will eventually be willing to accept.

It seems, therefore, that the demand-creation concept is a perfectly defensible philosophy, considering the inability of buyers to make known their wants in advance.

Types of Advertising Media The advertising medium is the vehicle by which advertising reaches its audience. The term "media," which is very commonly used in the advertising world, is merely the plural of medium. This subdivision of the chapter will present a listing of the various types of media commonly employed, with brief descriptions of them and some comment on their use and effectiveness.

Newspapers. The daily and, in smaller communities, weekly newspapers are exceedingly useful media for certain kinds of advertising. They have a high circulation, relative to the number of people who might see them, and their readers are usually concentrated in a comparatively small area.

Newspapers are peculiarly adapted to carrying the advertisements of local merchants who wish to reach all parts of the cities concerned. Department and specialty stores and food and drug chains commonly use newspapers to good advantage. Small stores usually find the cost of newspaper advertising too great and the coverage too extensive to be able to employ this medium satisfactorily.

National advertisers find newspapers an excellent way to secure local coverage and to tie in their messages with the sales efforts of their dealers in the community.

Newspaper advertising is not selective, by which is meant that most newspapers reach all economic and social levels of the people, rather than selected groups. Hence it is not the most suitable medium for advertising goods or services that appeal only to small groups such as racial minorities, the very wealthy, or religious sects.

A favorable characteristic of newspaper advertising is its flexibility or timeliness. In most cases, changes in advertising copy can be made up to within a few hours of the time the papers go to press. This permits advertisers to follow national

or local events, the weather, or changes in their own internal situations with great speed. It is even possible in times of great urgency to alter advertising insertions between editions.

Magazines. America has a large number of magazine readers, and magazines, therefore, constitute a very important advertising medium for certain classes of advertisers. These are the makers of goods that have national distribution. Most magazines have country-wide coverage; hence, they can be used advantageously only by manufacturers whose products are similarly widespread.

Magazines, unlike newspapers, are quite selective in their coverage, being directed at easily identifiable interest or economic groups. While a few magazines, such as the *Saturday Evening Post*, *Collier's*, *American*, and *Life*, probably reach groups of rather divergent interests and are therefore effective media for a wide range of consumer products, most other magazines are consciously directed toward readers who are included in rather specifically defined interest classes. This is particularly true of magazines catering to farmers, women, young people, and the various so-called trade journals, which circulate only among the trades affected.

Magazine advertising is not flexible, in that the lapse of time between the deadlines for advertising copy and the public appearance of the issues is so great as to incur the risk that the themes of the insertions may be out of date by the time they reach the readers. Examples of this are to be found in almost all magazine issues immediately after the end of the Japanese war. These numbers contained advertisements that stressed the theme that the war was still going on or that victory was still in the future sometime. Circumstances as extreme as this are, of course, quite rare, but the lack of flexibility of magazine advertising makes it rather difficult for national advertisers to use this medium to tie up their advertising with unscheduled but important events.

Radio. Radio advertising is one of our newest media, and its use may be regarded as being in the experimental stage. The advent of television, with its opportunities for the use of visual materials along with the purely audible effects to which

radio advertising is presently confined, has opened up revolutionary possibilities for the presentation of advertising.

Radio can be utilized for local, regional, or national coverage by the simple process of employing more stations to broadcast the advertising message. It is thus useful to the local department store, the regional chain group or manufacturer, and the national producers or distributors.

Regarding selectivity, radio advertising probably is not as good as magazines, from the standpoint of listener interest groups. As far as local areas are concerned, it can be demonstrated quite clearly just where the limits of each station's listening audience are to be found. This may differ somewhat at night from the daytime, but researches made or in progress are defining the territorial coverage for most stations in a rather convincing fashion.

Radio advertising is exceedingly flexible because it is possible to effect changes in the copy even while a program is in progress, if such a thing should become necessary. This permits advertisers to capitalize to the fullest possible extent on sudden events to which they may wish to tie in their messages. Thus on the night that the war with Japan ended, radio advertisers were able to speak of the war in the past tense and relate their sales appeals to this fact.

Radio advertising is the one form that relies on sound to deliver its story. Unlike some of the other media, where the printed message may be accessible for varying lengths of time with the chance of its being seen more than once and thus acquiring the advantage of repetition, the *radio commercial*, as it is called in the trade, must be heard when it is spoken, or it is forever lost. Furthermore, if a listener is tuned in to one program, he can hear none of the others that are on at the same time and they are lost forever to him unless he learns of them from others who did hear them.

Direct Mail. Direct mail is a widely used form of advertising medium and takes on a number of different forms. Postcards, letters, catalogs, folders, and booklets are among the more common ones used. Direct mail can be used by any advertiser, large or small, because of the extreme flexibility of its coverage. Mail may be sent to a few prospects in a

single neighborhood or to millions of persons located in all parts of the country.

The basis of all direct-mail advertising is the mailing list. Lists may be compiled from a variety of sources and may be classified almost endlessly. It is most important that the lists be assembled with the utmost care and that they be kept continuously up to date. One of the leading critics of direct-mail advertising uses the following as an example of how this type of advertising can misfire if the list is allowed to become obsolete. A grown man in his employ received by mail, from a magazine to which he had subscribed as a boy, a chance to win a pony by selling certain products.

Through the manipulation of the list, direct-mail advertising can be made extremely selective, regarding both geographical location and consumer interests. Depending somewhat upon the elaborateness of the copy, this medium can be changed rather quickly in accordance with important events, and of course any copy can be changed or discarded entirely up to the time that the mailing is effected.

Billboards. This type of medium—utilizing either paper posters, painted signs, or electrically illuminated displays—is one of the older forms of advertising. It is available to almost any type of business, from the largest to the smallest, through the utilization of a large number of boards down to a single one. It is directed at people who are outside of their homes or offices and are, presumably, bound on some sort of errand, business or social. This means that the time that each reader is exposed to the advertising is necessarily brief and limits, for this reason, the amount of subject matter that can be placed on a billboard. The most satisfactory results are achieved with trade names, slogans, and pictures of the product in use. Certain very elaborate and costly displays, known as "spectaculars," may command sufficient attention to permit the use of relatively long advertising messages, but these are exceptions to the rule that billboard advertising must be brief. Their size, intricacy, brilliant illumination, and location enable them to command large audiences of passersby.

This type of advertising is quite selective, particularly in terms of geographic coverage. The ability of an advertiser to

reach any locality that he wishes is limited largely by the availability of billboard sites. As far as interest groups are concerned, billboard advertising is effective only insofar as such groups are located near the places where the advertising is displayed.

Regarding timeliness, billboards are limited to the time required to reprint or to repaint those displays that are out of date for some reason. Inasmuch as this may take several days or weeks, there is always the chance that some event which will make the selling theme obsolete may take place.

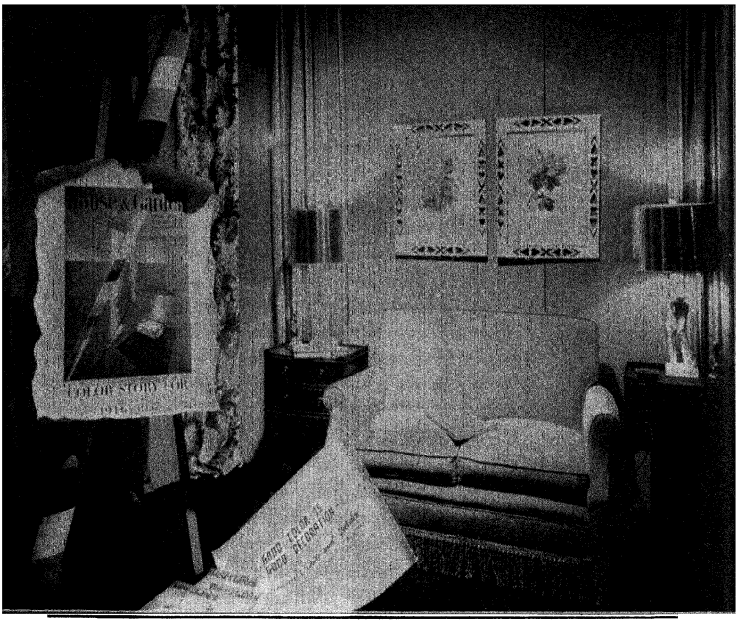
Car Cards. These are used in street cars, busses, and commuters' railroad cars where they are seen by people on their way to and from work and on shopping trips. They are available to national and regional advertisers and to local merchants with city-wide patronage. This type of advertising medium is not well suited to the small merchant who draws his trade from a single community within a large city.

Car-card advertising is selective only insofar as it reaches the readers in any given locality. It is likewise only about as flexible as billboards, as far as timeliness is concerned. It may reach some people who do not read magazines or newspapers.

Other Media. There are a few other advertising media such as store displays, packages, and motion pictures. All stores feature merchandise displays to some extent, ranging from the artistically appealing show windows and interior displays of department and specialty stores to the crudely assembled piles of unassorted goods to be seen in some of the smaller neighborhood shops. Many manufacturers provide store displays for their dealers, who are thus spared the necessity of planning and creating these things themselves.

Most manufacturers utilize the exterior of the packages in which their goods are enclosed for the purpose of getting across brief advertising messages. They may use inserts, describing and praising their wares. Labels are also used to carry short selling messages.

Moving pictures have not been very satisfactory media for consumer advertising, although the automobile manufacturers have used sound slidefilms for several years. At whole-



The Higbee Company

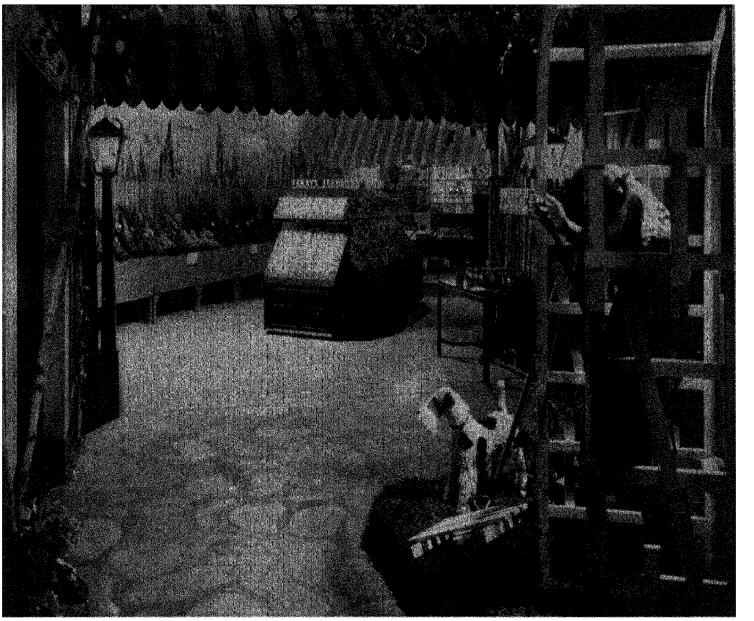
Show Window Advertising

Department and specialty stores frequently advertise their merchandise by means of elaborate show window displays.

sale or retail levels, however, they may be quite effective. In the early days of the movies, slides were used to advertise the wares of local merchants, and this practice survives to a limited extent in some of the smaller towns. Trailer movies, which are very short advertising films attached to the ends of the feature films, have been used with some success in a number of theaters.

Another form of advertising that has been used with a certain amount of effectiveness is merchandise sampling. Crews of distributors go from house to house, leaving either small samples of the products being advertised or coupons that can be redeemed at the local stores. Sometimes a combination of these two methods is used. In most instances, sampling is confined to the fields of food, candy, and gum.

The Advertising Agency This is a specialized institution established for the purpose of assisting businessmen in all phases of their advertising effort. Advertising



The Higbee Company

Interior Display Advertising

This unusual interior display on an upper floor of a large department store features seeds, plants, garden tools, and related merchandise.

agencies were originally media space sellers, and their present form of compensation is the result of this historic relationship. They are paid on the basis of the value of the advertising placed by the agencies in behalf of their clients. The payment amounts to a 15 per cent discount given to the agencies by the media in which space or time is purchased. The client pays the agency and the agency pays the media, less the discount.

The general advertising agency is equipped to undertake all phases of the preparation and execution of advertising for its clients. The agency handles the complete advertising campaign, which includes writing copy, creating art work, making contracts with the media, hiring talent for radio shows, providing the complete script, and supervising the actual production. Such secondary activities as product and market research, designing of packages and labels, and consultation on marketing matters generally are among the services of the larger agencies.

Practically all national magazine and newspaper advertising and radio network shows are produced by agencies, whose specialized talents enable them to perform these functions better than the advertisers could themselves. The agencies are used by almost all firms that advertise on a large scale with the exception of department stores, most of whom maintain their own advertising staffs who create and execute their stores' advertising.

Advertising in the Small Business In this country there are thousands of small businesses, manufacturers, wholesalers, and particularly retailers with restricted markets and even more restricted advertising budgets who have difficulty telling people about their wares and creating a demand for them. For most of these businessmen, an advertising agency is out of the question; consequently, they must prepare their own copy and find a medium to carry it. Furthermore, many of the better-known media are too costly for them to use and are not suited to their needs because of over-coverage. City newspapers, radio, and most magazines, aside from being too expensive, are uneconomical from the coverage standpoint, as they reach many people who could never be customers of the small business.

For the small manufacturer, there are trade journals in which can be placed a modest advertisement that will reach the eyes of prospective customers. He may also use direct mail, if he can assemble a list. If he can afford them, dealer display pieces are often helpful in promoting his sales.

The small wholesaler faces a different type of problem. His customers are probably confined to the city where he is located, and there are very few trade journals with so small a circulation. He must rely on direct mail and augment this with broadsides, which can be enclosed with the merchandise when it is delivered to customers. *Broadsides, dodgers,* or *throwaways* are printed sheets containing advertising matter that can be distributed by hand to prospective customers. They are frequently done on colored paper of a cheap grade and are thrown away after being read.

Small retailers usually confine their advertising activities to window and interior displays. For those who wish to go

beyond this, there is direct mail, if they can secure good lists and the facilities for duplicating their copy. They may also find the local community newspaper, if one is published, of value. Those who live in small towns or villages, with single shopping centers, can profitably use the newspapers, which are frequently on a weekly basis. It is not advisable for them to utilize the city newspapers because of the cost and the over-coverage.

Many manufacturers create for their products advertising that small retailers can use. These are usually in the form of throwaways or direct-mailing pieces, with the stores' individual names imprinted. Some manufacturers, with wide distribution, undertake co-operative advertising with their dealers, by which method there is inserted in the city newspaper an advertisement, featuring the manufacturers' products and then a list of the names and addresses of the retailers where these products may be purchased. The cost of the advertising is prorated among the retailers so that each one is required to pay only a small sum—far less than would be required if he should undertake such a project alone. The coverage is more satisfactory because he is paying for reaching only his own customers.

A somewhat similar situation is possible for retailers who are members of voluntary chains. They can advertise co-operatively, using common items of merchandise and prices and the group's emblem, with or without listing the names and addresses of the participating stores.

Is Advertising Effective? There can be no question but that advertising is effective, that is, it helps to sell goods. The question, however, is not quite so simple as that. It resolves itself into weighing the effectiveness of one medium as against another, of one type of radio program as compared with another, of one advertising theme against another, and many other equally pertinent questions.

To discover the answers to some of these problems, the practice of testing advertising effectiveness has come into being. There are many methods of testing in common usage, each peculiarly suited to the medium employed or the appeal to be weighed. The more common methods will be described.

The Consumer Pretest. The customary procedure of this method consists of selecting a group of consumers to whom are submitted samples of advertising copy that has not yet been released for publication, for the purpose of selecting the one that appeals to them the most. They may be asked to rank the advertisements in terms of attractiveness, attention getting, or persuasion. The consumers may be contacted through personal interviews or by mail. This method is useful for prejudging the effectiveness of different advertisements but not that of competing media.

The Inquiry Test. This method consists of devising a procedure whereby those who are exposed to the sample advertisements are induced to make inquiry concerning the advertised merchandise. Then the inquiries are counted and the advertisement with the greatest number of responses is regarded as the most effective.

The readers of such advertisements in newspapers or magazines, for example, may be encouraged to reply by the use of coupons, keyed to reveal the media whence they came or the advertisements of which they were a part; or they may be offered some sort of a reward, such as a sample of the advertised merchandise or a souvenir. The requests for box tops, or reasonable facsimiles thereof, frequently heard on the radio, are usually parts of inquiry tests.

A follow-up on the effectiveness of the inquiry test is to relate the number of inquiries to the number of sales resulting from each advertisement. This is sometimes rather difficult to do, but where it is possible it provides a good check on the test itself. For a test to be satisfactory, there should be a close correlation between the number of inquiries received and the sales that followed as the result of each advertisement.

The Sales Test. The procedure in this case is to select two cities, as nearly alike as possible, and run new advertising in one while not advertising in the other. The sales that occur in both areas during the test period can then be compared for the purpose of judging the effectiveness of the advertising. There are a number of possible variations on the sales test, such as running one set of advertisements in one

area and a different set in the other. Care must be taken to choose cities that are similar, and an examination should be made of the chosen areas during the test to make certain that no external factors enter the picture to destroy the validity of the comparison.

The Identification Test. In this method, consumers are presented with advertisements that have appeared in recent issues of magazines, but with all identifying marks obscured, and they are asked to identify the products or the companies concerned.

A variant of this method is found in the procedure by which the slogans or advertising themes of certain products are presented to consumers and they are asked to identify the products or companies. By the use of these methods, it is possible to learn something of consumer reaction to the attempts of advertisers to impress their products on consumers' minds.

Testing Radio Advertising. One of the major problems in connection with testing the effectiveness of radio advertising is to discover who is listening to the programs. The presence of a radio in a home merely indicates that programs may be received, but it does not tell whether or not the radio is turned on or, if it is, to what station it is tuned.

Various methods have been devised to answer these questions, one of which is the telephone test. Batteries of telephone operators are employed to call homes at random during any given broadcasting period and to ask if the radio is tuned to the station and program that is being tested and, if not, to what station. Much has been learned about listener reaction to radio programs in this manner.

Another method that has been used with some success involves the installation of a mechanical device in the home radio set. This instrument indicates on a tape the hours that the radio was turned on and the stations to which it was tuned. These little machines must be serviced frequently and the tapes removed. Through an analysis of the information gathered from a large number of these devices, it is possible to determine the characteristics of the listening audiences for the various radio shows.

Does Advertising Make Goods Cost More? Critics of advertising have frequently made the charge that advertising makes advertised goods cost more than would be the case if they were not advertised. It is obviously impossible to prove or disprove this accusation on any sort of an accurate, demonstrable basis without access to certain types of industry records that are not available to the public. It is possible, however, to enter a categorical denial of the charge and to indicate the reasons underlying such a position.

Advertising is a selling cost and, like all other costs, must be covered by the selling price of the advertised article. One might say, then, that anything that increases the cost of an item increases its price. This is, however, an oversimplification of the cost-price relationship, which needs to be examined more closely.

There are two types of costs—direct and indirect. *Direct costs* are those that can be directly allocated to the production of a commodity, such as materials and labor. *Indirect costs* are those that can not be directly allocated, such as occupancy expenses, superintendence, power, and administrative costs. Roughly speaking, the total direct and indirect costs divided by the number of items produced will give the cost per item, which is most important from the standpoint of the present inquiry. By dividing the totals of each type of cost by the numbers of units of product, the direct and indirect costs per unit can also be determined.

A peculiarity of indirect costs is that they tend to remain fixed over wide ranges of output. It is conceivable that the total indirect cost of producing an item would be the same whether the production were 100 or 1,000. It is obvious, then, that the indirect cost per unit would be much less at 1,000 than at 100 or even 500.

Advertising is generally regarded as an indirect cost and, if the result of advertising a commodity is to increase its sales greatly, it is entirely possible that this sales increase may be of sufficient magnitude to bring about a decrease in unit costs that more than offsets the increase in cost due to the advertising expense. If this is true, then the lowered unit cost would permit the producer to lower his price, which might give him a competitive advantage.

It may be stated, then, that (1) when advertising results in increased sales, (2) when these increased sales result in lowered unit costs, and (3) when the lowered unit costs result in lowered prices, advertising not only does not increase the price of goods but actually decreases it.

There are probably many instances where all of these conditions are not present, in which cases it may be said that advertising either increases the prices of goods or at least does not decrease them. It is obviously impossible to apply this statement to individual, identified items, without access to the records of the business. It may be said, however, that there is a constant urge in business to reduce unit costs, by whatever means possible, in order to permit a lowering of prices for the purpose of attracting customers and achieving competitive advantage. Advertising is one of the means employed to reduce unit costs and may be regarded as a factor in reducing prices, rather than in increasing them.

Truth in Advertising Among the criticisms of advertising that have been voiced, none has been more cogent than those that have flayed the prevalence of untruth in its messages. This does not mean all advertising is untrue, for such is not the case; but it does mean that too many advertisements have contained statements or claims that were not strictly true.

It is practically impossible to define untruthfulness to the satisfaction of all concerned. The advertiser who proclaims that his product is the best in the world may believe that it is, but what of his competitor who makes the same statement about *his* product? Obviously they both cannot be right. In fact both products may be inferior to any number of others. This sort of thing is quite common and is called "harmless trade puffery." It does no one any harm and merely amounts to a certain amount of public breast-beating.

On the other hand there is the patent medicine manufacturer who prints an alleged testimonial from a professed user of his potion, in which it is claimed that a few bottles of the stuff cured some disease that the medical profession regards as incurable. Investigation of the authenticity of the testimonial may reveal that there is no such person at the address

given and that the whole thing originated in the fertile brain of some copy writer. Not only was there no person, but the medicine itself may have been completely useless as a therapeutic agent, if, indeed, it was not injurious in some such cases. This sort of thing is obviously untruthful and perhaps harmful. Somewhere in between these two examples is a point where "harmless trade puffery" merges into untruth and deception.

Untruthfulness in advertising assumes many forms, among which are false testimonials, exaggerations, false claims, misrepresentation, false or near-false labeling, and the use of confusing terminology. It is a sad commentary on the gullibility of many consumers that they can be misled by such frauds. Another unfortunate aspect of this is that it tends to undermine public confidence in all advertising, to the detriment of those advertisers who follow the policy of censoring their copy to make certain that it contains nothing but the truth. There are many such firms, and they are keenly aware of the transgressions of their less ethical competitors.

Ensuring Truth in Advertising There is no single method of ensuring that a certain amount of untruth will not appear in the advertising of the country, as long as a system of free private enterprise continues. It is furthermore probable that we will never be able to purify our advertising copy to the complete satisfaction of everyone. There have been, however, a number of steps taken that are designed to protect the public and ethical business leaders from some of the more flagrant and harmful types of false advertising. Some of these are listed below.

Industry Self-Regulation. Recognizing that false or misleading advertising reflects unfavorably on all members of the trade, some industries have endeavored to establish the machinery for a certain amount of self-regulation. The Proprietary Association, made up of manufacturers of pharmaceutical preparations and patent medicines, is a good example of this. By means of argument and moral suasion, they have endeavored to prevent some of the members of the trade from continuing advertising that was manifestly false.

A number of industries have co-operated with the Federal Trade Commission in setting up Trade Practice Agreements, which, among other things, may prohibit false advertising, misbranding, and deception on the parts of its members. Some of the radio networks undertake to censor certain types of medical advertising that refer to bodily functions not normally a part of polite conversation.

A great many business houses enforce strict codes of ethics upon themselves and go to some lengths in order to make certain that their advertising is as strictly in accord with the truth as human watchfulness can assure.

The major difficulty with self-regulation is that it is entirely a voluntary matter. There is no method of compelling recalcitrant members of the trade to hew to the straight and narrow path, if they wish to break away from it. This method, therefore, democratic and desirable as it is, can be only partly successful.

Better Business Bureaus. These organizations, which are well known for their activities to protect consumers, were originally established by businessmen for the purpose of protecting themselves from the unfair competition of the less ethical members of the community and were only incidentally protectors of consumers. The critical examination of all local advertising, particularly that of retailers, has long been foremost among the duties of these bureaus. Their weapons have been twofold—publicity for the offending firms and recourse to the Federal courts when false advertising was sent through the mails.

The Federal Government. The two principal agencies for the combating of fraudulent advertising are the Federal Trade Commission and the Pure Food and Drug Administration. The Federal Trade Commission Act of 1914 established the Commission and gave it authority to prevent the use of unfair methods of competition in interstate commerce. In 1938 the Wheeler-Lea Act added to the duties of the Commission by giving it authority to prevent "unfair or deceptive acts or practices in commerce." [1]

[1] Section 5. The Federal Trade Commission Act as amended by the Wheeler-Lea Law.

Section 12 of the amended Federal Trade Commission Act makes it "unlawful for any person, partnership or corporation to disseminate, or cause to disseminate, any false advertising (1) by United States mails, or in commerce by any means, for the purpose of inducing, or which is likely to induce, directly or indirectly, the purchase of food, drugs, devices or cosmetics; or (2) by any means, for the purpose of inducing, or which is likely to induce, directly or indirectly, the purchase in commerce of food, drugs, devices or cosmetics."

This permits the Federal Trade Commission to investigate instances of alleged or suspected false advertising and to issue cease and desist orders when the advertising is found to be in violation of the Federal Trade Commission Act.

The Federal Food, Drug, and Cosmetic Act of 1939 strengthened the hands of the Pure Food and Drug Administration in its dealing with false labeling of "foods, drugs, devices and cosmetics." Both this agency and the Federal Trade Commission have been diligent in their efforts to run down and suppress false advertising. It is not to the credit of a fairly sizeable segment of the manufacturers in the food, drug, and cosmetic fields that they opposed both the Wheeler-Lea Act and the Federal Food, Drug, and Cosmetic Act with all of the energy at their command.

Printers' Ink Statutes. Twenty-five of our states have passed laws prohibiting false or misleading advertising based on a model statute prepared in 1911 by the Printers' Ink Publishing Company. A number of others have adopted somewhat similar laws. These laws obviously are confined, in their application, entirely to intrastate advertising.

Action by Media. Nearly all media have certain minimum ethical standards to which all advertising must conform in order to be acceptable for publication. This is mainly because they recognize that false advertisements reflect not only on the advertisers but also on the media in which they appear. Many of the publishers also feel a certain sense of moral obligation toward those of their advertisers whose copy is on the level and with whom the unethical advertising would be unfair competition.

These and other methods have gone far to clean up the advertising picture, which is unquestionably on a far higher plane than it was a few years ago. It will be only through unceasing efforts on the parts of all those committed to the principle of truth in advertising that these gains can be held and additional ones achieved.

QUESTIONS

1. Differentiate between institutional and commodity advertising.
2. What is the demand-creation concept of advertising?
3. What types of advertising media are best suited to the neighborhood grocer? the downtown dress shop? the community movie house?
4. In your opinion, are morning or evening newspapers preferable for department store advertising?
5. What effect do you think television will have on the use of radio as an advertising medium?
6. What do you think of stunts, such as sky writing, as effective advertising media?
7. Why have department stores never used advertising agencies successfully?
8. Under what circumstances is radio broadcasting a desirable advertising medium for independent retailers?
9. Of the tests devised for the purpose of checking the effectiveness of advertising, which do you consider the most satisfactory?
10. If all cigarette advertising were subjected to a 50 per cent reduction, would fewer cigarettes be sold? Would the price be affected?
11. Why has the controversy concerning false advertising always centered around consumers' goods and rarely affected industrial goods?
12. What can consumers do to help the truth-in-advertising movements?
13. Would the adoption of compulsory grade labeling result in the eliminating of brand names and hence of all advertising?

PROBLEMS

1. Of the various advertising media discussed in this chapter, which ones are best suited for each of the following types of businesses: (a) a department store, (b) an automobile manufacturer, (c) an independent grocery store, (d) a local chain of drugstores,

(e) a manufacturer of fur coats, (f) a manufacturer of men's hats with distribution limited to the New England states?

2. From current newspapers and magazines select six examples of what you believe to be effective advertising and six that you believe are ineffective. Submit these advertisements with a report setting forth the reasons for your evaluations.

3. Many retail stores prepare appropriate window displays for holidays, anniversaries, and other special dates throughout the year. Prepare a calendar for such special window displays. Arrange the information in four columns, using the headings: Date, Day or Event, Colors, and Emblems. For example, Date: January 1; Day or Event: New Year's Day; Colors: apple green and white; Emblems: Father Time, baby, hourglass.

4. According to one study, beauty shops, department stores, jewelry stores, men's apparel shops, radio shops, and specialty stores spend a larger percentage of their net sales for advertising than such retail businesses as bakeries, cigar stores, confectioners, filling stations, grocery stores, and restaurants. Prepare a written explanation for the difference in percentages for these two groups of businesses.

5. Corporations that manufacture the following types of products spend a larger percentage of their net sales for advertising than for personal selling expenses: (a) cereal preparations, (b) cigar and tobacco products, (c) perfumes and cosmetics, and (d) soaps, cottonseed products, and cooking fats. The opposite situation is true for corporations manufacturing (e) bakery, biscuit, and cracker products, (f) milk and milk products, (g) petroleum products, and (h) hardware. Select one type of manufacturer from each group and list for each as many reasons as you can for the relationship that exists between advertising costs and selling expenses.

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CHAPTER 16

THE CONSUMER IN THE MARKETING PROCESS

Importance of the Consumer No understanding of the operation of our economic system can be complete without an examination of the part played by the consumer in the marketing process. This is particularly true at present because of the somewhat altered status of consumers, compared with that of a few years ago. This changed status, which will be discussed in the pages that follow, has brought in its train a host of problems to many of which satisfactory solutions have not yet been discovered.

The Consumer as an Entity in Our Economic System The *consumer*, as referred to in this chapter, is the ultimate consumer of such goods as food, clothing, automobiles, houses, books, concerts, toothpicks, and all the myriad other things that people buy and use. The consumer, in this sense, is a person, a human being, as contrasted with industrial consumers such as factories, mines, and quarries.

The fact that consumers want things and are willing to work (as producers) to secure them is the basic reason for our economic system. A capitalistic system, as has been pointed out before, functions and produces the things that consumers want, only if producers see, or think they see, profits in undertaking to make them. Thus we have the apparent paradox of an economic system set up to satisfy consumers' wants, being motivated only by the profit-seeking of the producers. Certain so-called consumer economists appear to believe that the system can be operated without profit to producers—"production for use, not for profit"—but it is difficult to see how this could be done in a civilization as complex as ours, or where production involves large investments in capital goods with the attendant risks.

Writers in the field of economic theory have given consumers scant attention, placing most of the emphasis in their

teachings on the production and exchange of wealth. Adam Smith noted that "consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only insofar as it may be necessary for promoting that of the consumer" and that "the maxim is so perfectly self-evident that it would be absurd to attempt to prove it." [1] Still he gave little additional evidence of an understanding of the consumers' part in the economic system. Other writers have occasionally referred to consumers as the means by which goods are removed from the economic scene; they have said that production arose because of human needs. However, the economics of which they were writing was production, and not consumption, economics.

Consumers were supposed to have unlimited wants, which they satisfied by purchasing the goods produced by the system, and their buying power resulted from their earnings either as entrepreneurs or as employees of firms engaged in making these goods. The buying habits of consumers were supposed to be based on purely rational actions and in strict accord with their needs, which were, presumably, clearly recognized by them. Furthermore, consumers were assumed to have complete knowledge of market conditions, as well as those of supply and demand, and to buy strictly on the basis of price.

This description of consumer buying activity is a purely imaginative one, derived from the economist's concept of trade, in which only consumers acting as these do could uphold the demand side of the supply-demand equation. That it is a fantastic picture is obvious, but it fits rather accurately into the early economists' ideas of business transactions.

Our present concept of the consumer is somewhat different from that of the early writers on economics. No longer is the consumer slighted, nor is he presumed to be an economic automaton. It is clearly recognized that consumers have the power to bring success to the producers whose goods and services they like and failure to those whose offerings do not please them. This is particularly true of retailers, who have closer contact with consumers than does any other type of business.

[1] Smith, Adam. *Inquiry into the Nature and Causes of the Wealth of Nations*, (Cannan Edition). London: Methuen & Co., Ltd. Book IV, Chapter VIII, page 159.

From this new understanding of the consumers' importance to business has come a new respect for their power and an attitude that is expressed by the slogan "the customer is always right," which emerged into the retail picture shortly after the Civil War. The outstanding success of the Statler Hotel chain is said to be based on the fact that E. M. Statler, the founder, was a pioneer in endeavoring to discover what consumers liked in hotel service and in seeing that his hotels gave it to them. All over the country are examples of notable business successes that have come about through the owners' catering to consumer whims and fancies.

A noteworthy development of the last few years has been the growing realization by consumers of their importance in the general business picture. This has manifested itself in a belief that their interests as consumers were not always the same as those of the producers [1] and that they should act in their own behalf to protect their interests. A convenient label for all of this activity is the "Consumer Movement."

The Consumer Movement The phenomenon that bears the title "The Consumer Movement" must not be thought of as a cohesive, co-ordinated action on the parts of all consumers, which sprang into being as of any given date, with well-defined objectives, a national organization, a constitution and by-laws, and all that sort of thing. Quite on the contrary, it has been a sporadic, un-co-ordinated process, which apparently has its roots in a distrust of business and a desire to protect the interests of consumers that manifested itself in a number of different ways. Groups materialized in various parts of the country, under a variety of guises and identities, whose principal common meeting ground was that of protest against certain business practices that the members and their leaders felt were inimical to their interests as consumers.

Origins of the Consumer Movement In the late 1920's and early 1930's, there were published several very cleverly written books, which set forth a number of apparently well-authenticated examples of skullduggery on

[1] The term "producer" is used here in its economic generic sense and includes not only manufacturers, but also wholesalers and retailers.

the part of business, at the expense of consumers. Among these books were *Your Money's Worth*, *100,000,000 Guinea Pigs*, *Skin Deep*, *Counterfeit*, and several others. The occurrences portrayed were seemingly true and represented some rather sharp practices on the part of the firms concerned, who, incidentally, were named. The method of portrayal, however, was such as to leave the inference that all business was equally crooked and that the examples given were selected almost at random and were quite typical of business generally.

These books had a rather wide circulation, particularly among the more literate members of our populace, with the result that a considerable number of people began to doubt the basic integrity of our business institutions. A circumstance that doubtless contributed to the growth of a questioning attitude toward business at that time was the gradual deepening of the depression of the early 1930's and the almost complete inability of businessmen to do anything about it. There were probably other factors contributing to this public distrust of business, but these are the more obvious ones.

Evidences of the Consumer Movement

The growth of the consumer movement was made manifest in a number of ways and shortly became something of a double-barreled entity. Part of it stemmed from the evident actions of the consumers themselves and their groups, and another part, which developed somewhat later, came about through the efforts of certain businessmen either to combat the claims of the consumers or to assist them in their efforts to protect themselves and to learn more about the goods that they bought.

Consumers' Research and Consumers Union. About the time that the books just mentioned began to appear, there came into being a service known as "Consumers' Research," the purpose of which was to provide consumer-subscribers with information concerning the goods that were offered to them for sale. A laboratory was established in New Jersey to make such tests on merchandise as were possible, and arrangements were made with private individuals who had access to other testing facilities to do the same thing on a broader scale. Issued to the subscribers were regular printed

bulletins, which presented the results of these tests and rated the tested products in accordance with these results.

Consumers Union was formed somewhat later to give the same service by a group of disaffected employees of Consumers' Research, following a strike at the laboratory. Both of these concerns have continued to disseminate merchandise information for several years, the major difference between them being that Consumers Union seems to be somewhat more hostile to business than is Consumers' Research. Both of these services were established by consumers for the avowed purpose of helping them to buy more intelligently and advantageously.

Institute for Consumer Education. In 1938 the Alfred P. Sloan Foundation, which had been established in December, 1937, by the Chairman of the Board of General Motors Corporation, made a grant to a group of consumer-minded individuals for the purpose of organizing the Institute for Consumer Education, located at Stephens College in Columbia, Missouri. The purpose of the Institute, as indicated by its title, was to further the education of consumers for the economic roles that they must assume in our society.

The Institute established offices at the college, accumulated an extensive library on all phases of consumer activities, published bulletins on their work, and sponsored a number of conferences on consumer education. With the coming of World War II, the Institute became inactive. While the funds that enabled the Institute to function came from a foundation set up by a prominent businessman, it must be regarded purely as a consumer activity.

Formation of Consumer Groups. During the early 1930's, a considerable number of consumer groups were formed for the purpose of furthering the interests of the consumers involved. In some instances, these were old, well-established women's organizations that added an interest in consumer problems to their former activities. Among these were the American Association of University Women, various women's clubs, and the American Home Economics Association. Aside from these, consumer councils were formed in various parts

of the country, some of the earlier ones being established under the aegis of the National Recovery Act of 1933.

The activities of these groups were varied, ranging from food testing projects to holding educational meetings and issuing bulletins on many subjects of interest to consumers. Some groups endeavored to induce the Federal and state governments to take a more aggressive position in behalf of consumers. At one point the creation of a Department of Consumption, with its head to hold cabinet rank, was proposed.

There was no central directing body for all of these groups, which caused them to lose much of their latent power and effectiveness. Their intentions were doubtless of the best, but it is difficult to discover much in the way of concrete accomplishment. These groups, of course, originated with consumers.

Consumer-Retailer Councils. As the consumer movement gained headway, certain farsighted retailers, disturbed by the anti-business bias that characterized so much of it, began to wonder whether there might not be some aspects of it that could be turned to their own advantage. Much of the publicity emanating from consumer organizations stressed the fact that producers were not giving consumers what they (the consumers) wanted but were giving what the producers thought they wanted. It therefore occurred to these alert retailers that they might be able to capitalize on this belief by inviting consumers to tell them what they really wanted so that the stores could offer these goods and refrain from offering merchandise that the consumers did not like.

In order to effectuate the decision, many of the stores formed Consumer-Retailer Councils, on a more or less formal basis, whereby the consumers could meet with the store executives at frequent intervals and discuss present and forthcoming merchandise offerings. A number of stores have reported very favorable results from these groups, which, aside from placating some of the more vocal of the consumers, served as a sort of merchandise barometer whereby the stores could pretest the customer reaction to some of the goods that their buyers were considering.

These Consumer-Retailer Councils were not very widespread, nor did they have any appreciable effect on the con-

sumer movement, but they constituted a phase of it and were important to the stores that established them. As indicated, they were initiated by the retailers.

Merchandise Information for Consumers. One of the outstanding complaints of consumers was that they were not given sufficient information concerning the merchandise that they were asked to buy to enable them to purchase wisely and to secure the best values for their money. Consumers' Research and Consumers Union were two examples of the attempts of consumers to furnish this information to themselves. However, these two organizations disseminated their information only to paying subscribers and never reached more than a small fraction of the consumers of the country. There was need, therefore, for business to make the requisite merchandise information available to consumers and in several notable instances this was done with a considerable measure of success. A few examples will be illustrative of this phase of the consumer picture.

R. H. Macy and Company, a large department store in New York City, established a testing department, which they called their "Bureau of Standards." Its avowed purpose was to subject incoming merchandise to a number of tests, not unlike those administered by the Federal Bureau of Standards to goods purchased by the United States Government. The results of these tests were featured in Macy's advertising and displays and purported to show that the store handled only the best merchandise as proved by the tests. A few other stores followed Macy's lead and set up their own testing departments, which were well publicized.

Good Housekeeping Magazine established the Good Housekeeping Institute for the purpose of testing merchandise that was advertised in the publication and more or less guaranteeing the claims made for it by the makers. The so-called Good Housekeeping Seal of Approval was imprinted in the advertising of the tested goods. Because of certain criticisms leveled at the project, it was abandoned several years ago.

Sears Roebuck and Company, a prominent mail-order house with a chain of retail stores, brought out their *Infotag*, a system whereby the pertinent information about their merchan-

dise is printed on tags affixed to the goods. Montgomery Ward and Company, another large mail-order firm, undertook a rather simple method of grading the goods in their catalogs, by instituting a "good, better, best" system of designation. Marshall Field and Company, in their manufacturing division, offered certain information on the tags that accompanied their merchandise bearing the Fieldcrest label.

These are only a few instances of what has become a rather widespread effort to provide consumers with information that will enable them to buy more intelligently.

Labeling of Goods. While this topic is closely related to the one just discussed, it is of sufficient importance to warrant its being treated separately.

It has long been the practice in many lines of merchandise to produce different grades of goods and to offer them for sale at different price levels. In some instances the underlying cause for these grade differences is innate in the basic substances from which the goods are made, as is the case where the products of agriculture constitute the principal raw materials, while in other cases it is a matter of merchandising (and hence manufacturing) policy on the producer's part. Examples of the former are to be found in the field of meats and canned fruits and vegetables; of the latter, in automobiles, clothing, and consumer durables generally.

With certain types of goods, it is a relatively simple matter for the prospective buyers to observe the variations between products of different grades. Such matters as size, finish, and power are things that lend themselves easily to objective evaluation by even the most unskilled observer, and hence are not much of a problem to consumers who are endeavoring to detect the differences between grades of goods.

In other cases, however, this is a much more difficult problem. Canned fruits and vegetables, for example, are a type of commodity where the goods themselves usually cannot be seen and inspected by consumers prior to their being opened for use, *after* purchase. Furthermore, there are instances where it is difficult for the inexpert layman to tell one grade from another, even when the goods are readily available for inspection. Certain textiles exemplify this latter situation.

Under circumstances such as these, the opportunity is presented to the unscrupulous manufacturer to upgrade his products, with comparative immunity from detection by consumers. At the same time, this sort of thing, or the possibility of it, serves to create a feeling of distrust on the parts of consumers toward those producers whose products lend themselves to this sort of deceptive practice.

As a means of meeting this situation, it has been suggested that manufacturers indicate the grades of their goods by marking them on the labels. The development of this practice has brought into being one of the most controversial subjects in the field of business, because there have emerged three methods of designating the grades of goods, none of which is completely acceptable to all interested parties. This dispute has been called "grade labeling" and represents differences of opinion not only between consumers and businessmen, but also within consumer groups and between various businesses.

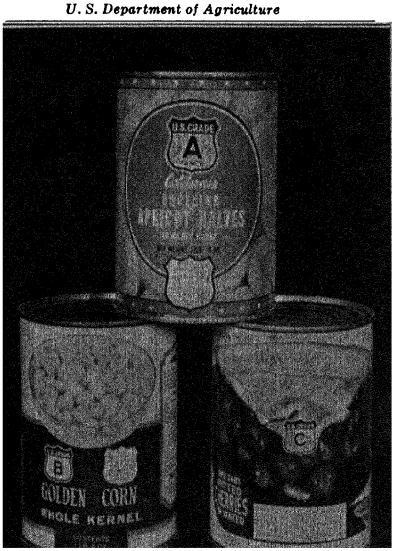
The three types of grade labeling are:

(1) The *A B C type*, in which the grade designation is effected through the use of certain letters or symbols, which can be easily and simply translated by consumers into the grade represented. The letter "A," for example, or the figure "1," on the outside of a can of peas, would presumably mean that the peas were of the highest grade. The main argument for this method of grade labeling is its simplicity. The principal drawback to it is that the letter "A" does not reveal the specifications that go to make up the top grade. There is also the problem of determining upon the grade standards to be used. Many consumer groups are ardent supporters of this method of grade labeling, and the Great Atlantic and Pacific Tea Com-

U. S. Grade Labels

The U. S. grade labels for canned goods are of the A B C type.

U. S. Department of Agriculture



pany has been using it on many of its private branded goods for several years.

(2) The *descriptive type*, where the label bears certain information that describes the goods and indicates the pertinent data necessary to guide consumers in determining whether or not to purchase. In favor of this method, it is said that adequate facts can be set forth so that the consumers know exactly what they are getting and do not have to rely on some grading symbol. In opposition, it has been claimed that consumers will not take the time to read the subject matter of descriptive labels, hence the main objective of the method is not achieved. Furthermore, descriptive labeling does not indicate relative grades but merely the specifications for the goods concerned.

(3) A *combination* of the two foregoing types, whereby a symbol indicates the relative grade and a brief description gives the specifications. It is to be hoped that the two factions that are unable to agree on the first two types may find common ground in this one.

Regardless of the methods used to convey the information, there is a notable trend toward telling customers more about the merchandise that they buy, the impetus for which appears to be coming from both business and consumers. Eventually some method will be worked out that will be acceptable to all parties and that should go far toward dispelling the distrust that many consumers have felt toward business.

Specification Selling. As a result of the requests by consumers for more information about the goods that they were being asked to buy, a number of department stores undertook to supply this need through what was called "specification selling." This consisted simply of furnishing the salespeople with technical information about the goods that they sold and instructing them to use these facts judiciously in their sales talks with customers. Many stores conducted classes for their salespeople and codified the technical data into manuals.

Consumers and the Government. Early in the development of the consumer movement, the Federal Government mani-

fested a sympathetic attitude toward its aims and aspirations. Consumer councils were established under the N.R.A. and later continued under the Agricultural Adjustment Act of 1933, which was another Federal measure designed to bring the nation out of the depression of the early 1930's. At one time an attempt was made to permit the records of the Bureau of Standards to be made available for consumer guidance, but this was unsuccessful. A Consumers' Counsel Division was established in the Department of Agriculture for the purpose of gathering and disseminating useful information for consumers. As our entry into World War II became a possibility and Defense Councils were established, there were consumer representatives included in their membership. When the OPA was established, there was a consumers' division in the original organization, although it was later dropped. A considerable number of the leaders of the consumer movement found employment in the various war agencies in Washington, particularly the OPA, and were more than a little influential in shaping its policies, particularly in the earlier days of its existence.

Better Business Bureaus. The Better Business Bureau project preceded the consumer movement by several years and was set up by groups of businessmen for the avowed purpose of discovering and rooting out chiselers, frauds, and crooks in the business community, in order to protect the "legitimate" businessmen from the unfair competition that these gentry afforded them. As the consumer movement came along, many of the bureaus identified themselves with it to the extent of claiming that part of their function was to protect consumers from the crooks.

Consumer Co-operation Founded in Rochdale, England, in 1844 by a group of indigent weavers, for the purpose of providing themselves with certain goods that they were unable to buy at the local stores, consumer co-operation spread slowly until at one time it was an important economic factor in England, Scotland, Germany, Russia, and the Scandinavian countries. Beginning with retail stores, it worked its way backward until not only wholesale houses, but also

Co-op League

Co-op Service Station

Petroleum associations represent the second most successful type of business operated by consumer co-operatives

manufacturing establishments, were owned and operated by the co-ops. The rise of the Nazis in Germany resulted in the liquidation of co-operatives in that country, while World War II in the other European nations caused the movement to be at least temporarily abandoned, except in England and Sweden.

Consumer co-operation came to this country in the middle years of the nineteenth century but up until the 1930's made relatively slight headway here. It was largely confined to a few midwestern states where there live considerable numbers of people of Scandinavian origin or ancestry. More recently it has spread to parts of Missouri, Indiana, Kansas, Ohio, Oregon, and Washington with isolated stores in other parts of the country.

Principles of Consumer Co-operation. There are certain fundamental principles of policy in consumer co-operation that set it apart from other business enterprises. The more important of these are listed below:

1. Each co-operative unit is owned by the consumer-members of the group
2. Each member has only one vote, regardless of the extent of his stockholdings.

Estimated Membership and Business of Consumers' Co-operatives, by Type of Association, in 1945

TYPE OF ASSOCIATION	NUMBER OF ASSOCIATIONS	NUMBER OF MEMBERS	AMOUNT OF BUSINESS
Local associations			
Retail distributive associations ...	4,550	1,760,000	$657,500,000
Stores and buying clubs	3,000	825,000	360,000,000
Petroleum associations	1,500	910,000	290,000,000
Other	50	25,000	7,500,000
Service associations	602	369,200	12,356,000
Rooms and/or meals	180	18,500	2,700,000
Housing	60	2,700	1,600,000
Medical and/or hospital care:			
On contract	55	100,000	1,500,000
Own facilities	20	51,000	2,500,000
Burial:			
Complete funeral	36	35,500	300,000
Caskets only	6	1,500	6,000
Other	245	160,000	3,750,000
Electricity associations (Data are for 1944)	850	1,149,700	60,960,000
Telephone associations	5,000	330,000	5,485,000
Credit unions (Actual figures, not estimates)	8,882	2,838,034	210,885,783
Insurance associations	2,000	10,550,000	200,000,000
Federations			
Wholesales:			
Interregional	1	20	6,755,900
Regional	23	3,649	160,400,000
District	11	234	11,217,661
Service federations	22	1,500	8,250,000
Productive federations	15	195	20,013,000

Source: *Monthly Labor Review*, Bureau of Labor Statistics

3. There is a limitation on the amount of stock that each member may own.
4. The capital for the enterprise is subscribed only by the members.
5. Interest is paid on the investment to each stockholder.
6. Dividends are paid on a patronage basis, in proportion to the amount of goods that each member has bought from the co-op. These are referred to as "patronage dividends." This provision has the effect of causing the members to confine their purchases to the co-op stores.

Consumer co-ops have been moderately successful in the sale of groceries, oil and gasoline, fertilizer, farm implements, seeds, feeds, electrical appliances, and in the development of rural electrification.

Consumer co-operation is probably the most completely organized form of consumer protest against certain business policies and practices. Its basic philosophy is that of a business organized to achieve savings for its members as opposed to the idea of profits for stockholders. It should be admitted at this point that an underlying theme in the consumer movement has been opposition to profits. For this reason, many of the leaders of consumer co-operation were quick to identify themselves with the consumer movement as it came along.

Reasons for Lack of Interest in Consumer Co-operation. The failure of consumer co-operation to attract more adherents in this country is a rather complex situation. The following factors are outstanding:

(1) *Efficiency of Chain Stores.* The operating efficiency of the chain stores in this country, with their accompanying low prices, has tended to discourage the opening of co-operative grocery stores. Consumers are attracted to low prices, in a large measure, and the co-operatives have been generally unable to meet the chain competition.

(2) *Inefficient Managers.* While this factor is not necessarily inherent in the co-operative system, it has been present in far too many such ventures to be dismissed as pure happenstance. The reason for the inefficient managers appears to be that the co-operatives are unwilling to offer high enough salaries to attract men of real ability. This situation, in turn, seems to be caused by the fact that the co-operatives' members are usually not successful businessmen, but rather poorly paid workers, who do not recognize the need for hiring competent managers, and who also dislike paying their employees more than they, as individuals, receive. Until this understandable but unfortunate attitude disappears, it may be expected that the co-operative movement will continue to be plagued by the inefficiency of its hired managers.

(3) *Opposition of Business.* A factor of unknown, but probably considerable, weight has been the opposition of businessmen to the growth of co-operatives. They have regarded the co-operatives not merely as competitors, but as the possible forerunners of a movement designed to overthrow the present

business system. Hence their opposition has been practically unvarying. It has been manifested not only in strong competitive measures, such as price cutting for the purpose of winning customers away from the co-operative stores, but also in the refusal of some manufacturers and wholesalers to sell merchandise to them.

(4) *Small and Deferred Savings.* The fact that the savings achieved by the co-operatives have been comparatively small and that they have not been realized until sometime after the purchases to which they applied were made has been another factor hindering the growth of co-operation. Consumers are accustomed to the point-of-sale savings that retail price cutting affords them and are not particularly attracted by the promise of unknown future savings on their purchases.

(5) *Lack of Group Loyalty.* This is a point that has very broad implications—far beyond the boundaries of this discussion. It must be sufficient to note that comparatively few of the co-operative ventures have been able to generate sufficient group loyalty—"we-feeling"—on the parts of the co-operators to ensure their confining their purchases to the co-operative stores for sufficient lengths of time and in large enough amounts to bring about their success. It is noteworthy, in this connection, that some of the more successful co-operatives are to be found in those areas where ready-made group loyalties exist, such as among those of Scandinavian origin in certain Northwestern states, and among farmers.

Does the Movement Represent All Consumers? This question has been asked many times and has never been satisfactorily answered. If one may judge by the number of persons who have been identified with the movement, the answer would probably be in the negative. However, the organizational aspects of the consumer movement have been such as to confine it to teachers, clubwomen, and certain professional consumer representatives. It is not possible to tell how many unorganized consumers may have experienced the same resentment as the more vocal consumer leaders.

Certainly a great many retailers acted as though they believed that large numbers of consumers were involved, al-

though there is reason for suspecting that some of them thought that they saw, in the movement, a new sales promotional opportunity to gain competitive advantage over their fellow merchants. However, in normal times, no retailer can afford to ignore the wishes of his customers and the bankruptcy records are filled with the stories of those who have tried to do so, to their sorrow.

Likewise, all intelligent producers, at whatever level, are quick to follow the slightest hint of a consumer preference or dislike for anything that concerns the goods that they handle. The General Motors Corporation maintains a Customer Research department for the sole purpose of trying to discover what consumers want in their new cars, and many other concerns spend large sums of money in endeavoring to divine consumer reaction to their prospective offerings. The question may well be asked, then, as to the real impact of the consumer movement on business.

Effect of the Consumer Movement on Business Despite the avowed hostility of many business firms toward the consumer movement and the apparent indifference of many others, it is probable that its influence has been far more pervasive than would appear to be the case at first glance. While producers generally have always tried to find out what the public wanted, in recent years they have redoubled their efforts in this direction. Department store buyers, who in other days spent most of their time away from the store on buying trips, are now required to put in a certain number of hours each day "on the floor" of their departments in order that they may get the "feel" of consumer demand and thus be guided more accurately in predicting probable customer response to merchandise that is offered to them by their resources.

Can Consumers Tell Business What They Want? In certain lines of goods and services, the answer is "Yes." In others it is definitely "No." In groceries, staple hardware, tools, and other standardized lines consumers could probably tell the producers exactly what they would want; and the information would be of no particular value to the producers because they

already know from past experience just what the consumers want and can continue making these goods. In fields where the merchandise is likely to change frequently, such as women's apparel, or where there are yearly models such as automobiles, radios, and other consumer durables, it would be the rare consumer who could spell out the details of what he or she would want for next year or next season. In these merchandise categories, consumers know what they like after they have seen what the market affords, and they are likely to be quite positive in their choices; but they probably would be unable to tell the producers what they will want in next year's cars, or what color dresses they will prefer and so on.

Producers, wholesalers, and retailers are thus faced with the problem of trying to discover the preferences of folks who do not themselves know what they want. Small wonder that many manufacturers adopt the attitude that "we will make what we think consumers want and then sell it to them." The important part of this philosophy and the part that has probably been most influenced by the consumer movement, is that the manufacturers will make what they think consumers want and employ all kinds of devices to discover the way consumer thinking is going regarding the type of merchandise that they (the manufacturers) are making. This is to be contrasted with the attitude, clearly discernible some twenty or more years ago in many lines, of making what the manufacturers wanted to make and leaving the job of selling the goods to the hapless retailers. As times goes on, it is possible that business will become continually more skilled in the art of interpreting consumers' wants in advance.

Are Consumers Consumption-Minded? There is fairly conclusive evidence that consumers are production- rather than consumption-minded. In this country, honor and social prestige attach to the successful producer, the successful executive or manager, the crack salesman, or the skilled mechanic, who commands a high monetary return for his efforts, rather than to the successful consumer who buys intelligently or carefully and to his best advantage. Men will go on strike for higher wages, with the risks of physical violence and loss of present earnings, but they will do little

or nothing to increase their family's real income by applying similar effort to becoming good consumers.

It is probably this one attitude that explains the relative indifference of most consumers to the consumer movement and the failure of consumer co-operation to make greater progress in this country. Until this condition changes, it is doubtful if the consumer movement will assume much larger proportions than it has during the last few years.

Installment Selling This is a topic that vitally affects consumers, although it is only indirectly connected with the consumer movement. It refers to a formalized system of financing consumer purchases, whereby consumers are permitted to take possession of the purchased articles and to pay for them in a series of installments, usually in accordance with predetermined payment schedules. For the privilege of doing this, consumers are required to pay certain interest or carrying charges, with the result that the goods cost them more than if they had been purchased for cash or on the usual charge credit terms.

Installment selling is customarily confined to goods that have a relatively long life, that cannot easily be hidden, and that have a definite resale value. Among these are real estate, pianos, automobiles, furniture, household appliances, radios, jewelry, and clothing.

An installment sale may be a transaction solely between the buyer and the seller, in which case the seller finances the transaction, or a third party, known as a finance company, may enter the picture and advance the amount of the unpaid balance to the seller and take over the task of collecting the payments from the buyer. In the installment sale of automobiles the use of finance companies is quite common, whereas most department stores carry their own installment paper without outside assistance. The General Motors Acceptance Corporation and the Universal Credit Company are prominent finance companies.

Installment Sale Procedure. The customary procedure, where a consumer wishes to purchase something on the installment basis, is for him to make a down payment in cash and

sign an agreement promising to pay the outstanding balance in a certain number of equal installments according to a stated schedule. He may be required to sign a chattel mortgage in favor of the seller, so that title to the article being purchased will revert back to the seller in case the purchaser fails to keep up his payments. As an alternative to this, in certain states, the buyer may enter into a conditional sales agreement with the seller, whereby the buyer takes possession of the commodity but the seller retains title until the outstanding balance is paid. In this case, if the buyer fails to continue his payments, the seller resumes possession of the article or, to use the terminology of the trade, he "replevins" it. When this happens, the buyer loses not only the article that he was buying, but all the payments that he has made so far. Sometimes he is further liable for the balance still remaining unpaid although he no longer has the article.

Carrying Charges. For the privilege of buying on the installment plan, the buyer pays an extra amount known as either interest or carrying charges. This is divided by the number of payments, and the result is added to each payment. There has been some difficulty in connection with the interest rates charged on installment contracts, because of the fact that the actual effective rate charged was frequently twice that of the nominal or quoted rate. The reason for this is that interest may be regarded as an amount paid for the use of money, expressed as a percentage on a time basis. Thus, if a man borrows $100 from a bank, at 6 per cent interest a year, and at the end of one year repays the loan, he will give the bank $106 of which $6 represents the interest. Having had the use of the $100 for a year, he pays a true 6 per cent interest charge.

However, if this same man borrows the $100 and agrees to repay it in 12 equal monthly installments, plus the $6 interest, he will actually be paying approximately 11 per cent interest because he does not have the use of the $100 for the whole year; rather he may be thought of as having the use of one half of the money for a year or of all of the money for a half year.

The same principle holds true for an installment sale. The buyer starts to pay the balance within a month after he arranges the purchase and continues making these monthly payments until the debt is liquidated. He thus does not have the use of his money for the full life of the contract, but, roughly speaking, only for about one half of the time. He pays, therefore, an interest rate that is approximately twice that which he would pay if he were to wait until the end of the contract period and then pay the full amount due plus interest on it.

Because of some of the criticisms that were directed at installment selling on account of this condition, many firms have ceased quoting interest rates but rather speak only of the total dollar cost or of the amount of each payment, leaving the consumers to do their own figuring.

QUESTIONS

1. Why are the problems of industrial consumers different from those of the ultimate or individual consumer?

2. Could we have "production for use" rather than "production for profit" in this country?

3. What are the evidences of the existence of a consumer movement?

4. Most consumer activities were suspended during the war. Can you give any reasons for this?

5. Do you think that many consumers are interested in the specifications of the goods that they buy?

6. What are the bases upon which customers choose between competing brands of goods?

7. Opponents of grade labeling claim it would result in the elimiation of all brands. Do you agree? Why?

8. Aside from the consumer movement, what other evidences are there of a distrust of business practices?

9. It has frequently been said that consumer co-operation is a depression phenomenon. Do you agree? Why?

10. What methods can you suggest for merchants to employ in order to discover their customers' merchandise preferences?

11. Are the following commodities suitable for sale by the installment method? Why? (a) Electric refrigerators, (b) Women's hats, (c) Beefsteaks, (d) Grass seed, (e) Tennis racquets, (f) Automobile repairs.

12. Do you believe that the interest rates or carrying charges in installment transactions are excessively high? Explain.

PROBLEMS

1. Select at least two advertised products that are sold by local stores. For each item of merchandise list the characteristics that the consumer should know in order to buy the product intelligently. Check at least two advertisements for each product to determine which of the characteristics in your list are included. Write a brief report of your findings.

2. Select a product for which you can obtain information from recent publications of both *Consumers' Research* and *Consumers Union*. (a) Compare the information from these two sources. To what extent do the two sources of information agree? (b) Check the information from these sources with your own experience in using the product or with the experience of a friend who is familiar with the product.

What conclusions do you draw from this investigation?

3. List the specific ways in which each of the following organizations helps consumers: (a) American Medical Association, (b) American Dental Association, (c) National Board of Fire Underwriters.

4. Outline the ways in which one of the following agencies of the Federal Government helps consumers: (a) National Bureau of Standards, (b) Food and Drug Administration, (c) Federal Trade Commission.

5. Secure the latest data on number of members and volume of business for consumer co-operatives. Compare these data with the table on page 321. Prepare a brief written report of your conclusions.

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CHAPTER 17

TRANSPORTATION

Scope of This Presentation The discussion of transportation, which follows, is that of a tool of business, and particularly of marketing, rather than of the intricate details of transportation as a separate industry. As an industry transportation has certain organizational structures, its own productive procedures, and financial, marketing, and labor problems that are peculiar to it. These matters are important, but not for the purposes of this book.

Transportation Defined *Transportation,* as the term is used here, might be defined as the movement of goods by regular and systematic methods of conveyance. Stated slightly differently, the purpose of transportation is to move goods from one place to another in accordance with the needs of business and of the general public.

There are two main functions or jobs of transportation. One is to move goods from the places where they happen to be to the places where they are wanted. This is, of course, the more obvious task of the transportation system. The second function is to get the goods where they are wanted at the time that they are wanted.

Geographical Nature of Transportation Transportation may be local in character, as exemplified by the delivery services of retail stores and wholesale houses; it may be on a regional or nationwide basis; or it may be international in scope, involving the use of ocean-going freighters or international air-freight service. For the purposes of this discussion, consideration will be given to both the national and the international aspects of transportation, but the major portion of the attention will be directed toward the former phase. This is not to be taken as implying that foreign trade is unimportant, but it is merely a recognition of the fact that the great bulk of our commerce is on a domestic basis.

Importance of Transportation It is merely stating the obvious to say that transportation is largely responsible for the industrial development of our country to its present position. Facilities for moving goods from their points of origin or manufacture to the place where they are to be consumed has resulted in the countrywide availability of a wide variety of commodities, with a consequently beneficial effect upon the standard of living.

Transportation has made possible the development of community specialization of manufacture or product by providing a means of shipping out the goods produced in these places and by providing a means of bringing in those articles that are made elsewhere. Thus the rise of such specialized centers as Pittsburgh for steel, Detroit for automobiles, Worcester for wire goods, and Akron for tires, to mention only a few, would have been difficult if not impossible without the means of transporting their products to the rest of the country and of bringing to them the multiplicity of wares that they required but which other communities manufactured.

Without adequate, fast, and relatively inexpensive transportation, the widespread development of this nation might have been retarded by many years, and all communities would have been forced to produce all of the goods that they needed or to endure lower living standards than their more fortunate neighbors.

To marketing, in particular, the importance of transportation is paramount. With it the manufacturer can have, if he wishes, a countrywide market for his goods instead of a purely local one. The wholesaler can have available for his retailer-customers goods made in all parts of the country instead of relying solely on the products of local factories. Similarly, retailers may offer their customers merchandise brought from almost everywhere, thereby contributing to the general well-being of the community.

There is no question but that the cost of many goods has been significantly reduced through the development of specialized centers of large-scale production, based on widespread markets served through the various modes of relatively cheap transportation.

Interstate Commerce Commission This is a Federal regulatory body established in 1887, which, among other things, has come to possess power over the establishing of transportation rates or the changing of those already in force. Its jurisdiction is limited to interstate commerce but, as the great bulk of goods shipped moves across state lines, most shipments come within the scope of its operations. For purely intrastate commerce, the various state public utility commissions have jurisdiction within their own state borders.

The economics and practices concerned with rate-making are highly complicated and are far beyond the scope of this discussion. All interstate carriers publish tariff schedules, which set forth the requisite data to enable a shipper to figure the costs of sending his goods to any given point.

Methods of Transportation The various methods of transportation are railroads, motor trucks, waterways, pipelines, and airplanes. These methods will be discussed at some length in the sections that follow.

Distribution of Commercial Freight Traffic in the United States

Millions of Ton-Miles

AGENCY	1939	1944
Steam railroads, including mail and express	338,275	744,529
Great Lakes (domestic traffic only)	69,060	105,620
Rivers and canals	19,937	31,343
Motor trucks	43,000	49,308
Oil pipe lines	63,107	132,336
Electric railroads	725	1,325
Air carriers	11	69
Total	534,115	1,064,530

Percentage Distribution

AGENCY	1939	1944
Steam railroads, including mail and express	63.3	69.9
Great Lakes (domestic traffic only)	12.9	9.9
Rivers and canals	3.8	3.0
Motor trucks	8.1	4.7
Oil pipe lines	11.8	12.4
Electric railroads	0.1	0.1
Air carriers	—	—
Total	100.0	100.0

Sources: Interstate Commerce Commission; Public Roads Administration; Office of Chief of Engineers, U. S. Army; Civil Aeronautics Board; and others.

Railroads By far the largest share of the transportation job in this country is handled by the railroads. The network of rail lines, which extends from one end of the United States to the other and reaches into all but the most remote settlements, includes approximately 226,800 miles of main line track and 398,000 miles of operated track, aside from many terminals, switching facilities, private sidings, and team tracks. In normal times this system carries from 1½ to 2 billion tons of freight each year. During World War II this total was stepped up markedly because of the pressures of the emergency.

The railroads are made up of a large number of companies, some of them great, sprawling giants such as the New York Central, the Pennsylvania, the Southern, and the Union Pacific, while others such as the Boston and Maine and the Central of Georgia serve rather limited areas. It is an interesting fact that there are no American lines that extend all the way from the East to the West Coasts. This does not mean that goods cannot be shipped from New York to San Francisco, for example, without unloading and reloading somewhere along the line, but it does mean that the shipment must be made over at least two different railroads.

Classification Areas. For purposes of rate-making the United States has been divided into three general freight classification areas known as the "Official," which includes all the territory east of the Mississippi River and north of the Ohio and Potomac rivers; the "Southern," which comprises all of the rest of the country east of the Mississippi River and south of the Official territory; and the "Western," which takes in all of the country west of the Mississippi.

Railroad Rates. The costs of shipping by rail are generally expressed in rates per 100 pounds or per ton from the point where the shipment originates to its destination. The rates are of two kinds—*class rates,* each of which applies to a related group of merchandise; and *commodity rates,* each of which is a special rate for a specific commodity.

The bases on which the rates are established are varied and depend upon such factors as the cost of the service to

the carriers, the bulk of the goods, their value, and "what the traffic will bear." This last item has occasionally had a somewhat unpleasant connotation, implying that it meant that the carriers were gouging the shippers, which may have been true to some extent in the past. At present, however, it is a defensible approach to the problem of rate-making, which takes into account the value of services to the shipper or the ability of the commodity to bear the transportation charge, and may or may not be closely related to the cost of service performed by the railroads.

Freight rates are not the same for all types of merchandise. Coal, sand, bricks, and cement are high in bulk and low in value; wearing apparel, and surgical instruments, on the other hand, are low in bulk but high in value. It costs the railroads about as much to transport a carload of one commodity as of another, but obviously sand cannot stand as high a rate as wearing apparel without increasing its cost to the buyers to a prohibitive extent. Accordingly, the rate structures are set up so that, as far as possible, all commodities can move without undue burden in cost to the shippers and so that the overall revenues to the carriers will exceed their costs by a reasonable margin. The Interstate Commerce Commission takes these factors into consideration in setting the rates for the railroads.

Carload versus L.C.L. Rates. A sharp distinction is made in the rates applicable to goods shipped in carload lots and those shipped in less than carload lots (l.c.l.). The rates for l.c.l. shipments are generally between 15 and 30 per cent higher than those for carload shipments. It is thus to the advantage of shippers to ship in carload lots when possible. The railroads specify certain minimum carload weights for different commodities.

Merchandise shipped in carload lots is customarily loaded by the shipper and unloaded by the consignee. Furthermore, the shipper of carload lot goods has the exclusive use of the car that his wares occupy. On the other hand, l.c.l. shipments are customarily loaded and unloaded by the railroad, and the goods of two or more l.c.l. shippers are generally placed in the same car.

Special Railroad Services. There are a number of special services rendered by the railroads, which are available to all shippers. Several of these are briefly described below.

Pool Car Service. This refers to the practice of permitting a consignor, who has a carload of goods that are to be shipped to a number of receivers located in different communities along the same rail route, to take advantage of the carload rates from the point of origin to the place where the first receiver is located and the l.c.l. rates from there onward until the car is empty. Thus a Chicago manufacturer of electric irons or washing machines, shipping via the New York Central Railroad to a group of customers located in the state of New York, would pay the carload rate from Chicago to Buffalo, where the first customer is located, and l.c.l. rates from Buffalo to Rochester, Utica, and Albany.

"In Transit Privilege." The "in transit privilege" permits a shipper to stop a shipment while it is in transit, store it or have something done to it, and then resume the journey to its destination without forfeiting the advantage of the through rate applicable to it. Some of the situations that call for this privilege are the milling of grain, the refining of oil, and the processing of lumber. A special charge is made by the railroads for the "in transit privilege," which, when added to the through rate, is generally lower than the sum of the local rates from the point of origin to the processing point and from there to the destination.

Diversion in Transit. A diversion or reconsignment while a carload shipment is in transit is a special service under which the shipper and/or consignee is privileged to divert a car of goods, while it is still rolling, from its originally specified destination to some other point. Where the diversion or reconsignment does not require a change of general direction, the through rate from the point of origin to the new destination plus the reconsigning or diversion charge applies, instead of the sum of the rates from the originating point to the diversion point and from there to the final destination.

An example may make this process clearer. A West Coast grower of oranges might use this privilege as follows. He

loads the car and starts it East, unsold, consigned to himself at Cincinnati. As soon as the car leaves his loading dock, he notifies his selling agents throughout the Middle West of this fact and they endeavor to effect its sale before it reaches or passes their cities. If the agent in Chicago sells the car, he so informs the shipper, who, in turn, notifies the railroad to divert the car (which at that time is just west of Kansas City) to Chicago. This the railroad does, and the shipper pays the through rate from the Coast to Chicago, plus the diversion charge, rather than the rate from California to Kansas City and the rate from Kansas City to Chicago.

This could not have taken place at the same cost if the car had reached Indianapolis, or some other point east of Chicago. Then the direction of the shipment would have been reversed, and the rate from the point of diversion to Chicago would have been added to the through rate from the Coast to the diversionary place. The California Fruit Growers Exchange, for example, uses this privilege in the marketing of the products of its members.

Store Door Delivery. This is a special service offered by a number of railroads, whereby goods are picked up at the shipper's place of business by vehicles controlled by the railroads, transported to freight stations, loaded into merchandise cars, and moved to the destination point, and then taken by other vehicles to the place of business of the consignee. This service is rendered usually without additional charge, except that it is subject to certain minimum rates which come into play in connection with relatively short hauls. It has had the effect of relieving congestion at rail terminals and on the streets and highways.

Peddler Cars. These cars are used principally by the meat packing companies. The shipper loads a car with products intended for a number of customers situated in different towns along a given railroad and has these goods delivered to them from the car on a prearranged schedule. The products are loaded in such a manner that those destined for the customer at the first stop are placed nearest the door, and the remaining merchandise is arranged in the same order within the car as the towns to which the deliveries are to

be made. The rates for this service are somewhere between the carload and l.c.l. charges.

Terminal Services. Railroads provide quite elaborate terminal services in cities of any size. These vary to some extent between cities and railroads, but generally loading and unloading docks and temporary storage facilities are provided, as are public delivery or "team" tracks, which permit the consignees' trucks to move alongside the cars for the purpose of unloading the goods. Frequently the more important firms that are located on or near the railroads' right-of-way have their own private sidings. This permits the placement of cars at their own private unloading facilities and, thereby, makes it possible for them to save the cost of moving the goods from the railroad terminals to the companies' places of business.

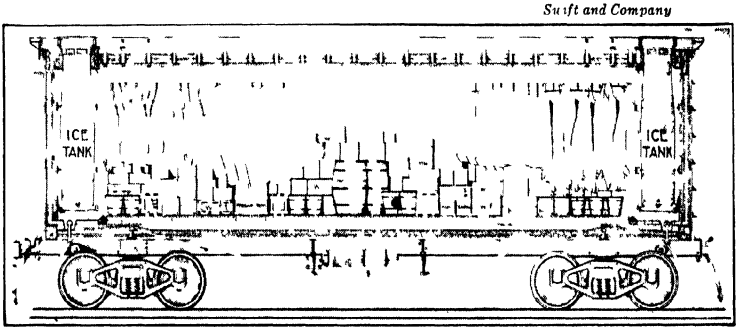
Special Equipment. In addition to the usual classes of freight cars such as box, gondola, hopper, and stock cars, the railroads provide other special equipment for the transportation of various commodities.

Refrigerator Cars. These are special cars used by shippers to protect and preserve their goods while in transit. Generally these cars are used for the protection against heat, being constructed with thick walls, which act as insulating agents, and large compartments for the storage of ice. During extremely cold weather these cars may be used to prevent

Refrigerator Car

This diagram of a refrigerator car shows the location of the ice compartments and the arrangement of fresh meat and other related items normally shipped from a meat-packing plant

Swift and Company



the contents from freezing. The shipment and distribution of fresh fruits and vegetables, and other perishables, has been greatly extended by the introduction and use of refrigerator cars. In this same category the railroads provide cars constructed for the protection of certain vegetables through the use of heaters which are fueled, generally, by charcoal.

Tank Cars. These cars are not usually owned by the railroads but are leased by shippers from tank-car-operating companies for the movement of liquid commodities. Such equipment eliminates the necessity for packaging such goods in barrels, drums, etc.

Closed Hopper Cars. The closed type "hopper" cars are generally owned by the railroads and furnished to shippers of bulk commodities. These cars may be loaded from openings in the top and unloaded from openings in the bottom. Numerous commodities, such as cement, peanuts, silica sand, and soda ash, are handled in this class of equipment at a material saving to the users.

Automobile Cars. Special cars with loading racks for the transportation of automotive vehicles are provided by the railroads. These cars save the cost of blocking and bracing on the part of a shipper and provide means for the loading of a greater number of vehicles than would otherwise be possible. The loading apparatus is a part of a car and is stored under the roof of a car when not in use, thereby permitting the equipment to be loaded with commodities other than vehicles.

Carloading Companies. While not strictly a service of the rail carriers, mention should be made of the carloading companies who collect l.c.l. shipments from various small shippers and combine them into carload lots, which can then be sent at carload rates. They charge the shippers somewhat less than l.c.l. rates for this service and use the difference between this and the carload rates, which they pay the railroads, as their remuneration.

Demurrage. This is a charge made by the railroads when freight cars are not loaded or unloaded within 48 hours after

the time they were available to the shipper for loading or to the consignee for unloading (Sundays and holidays are usually excepted). Demurrage is assessed for the purpose of compelling shippers and receivers of merchandise to load and unload cars promptly. Normally the demurrage rates are around $2 a day per car after two free days, and after four demurrage days the charge is about $5 a day per car. In periods of car shortage these rates are materially increased and the free time may be shortened.

Special Shipping Terms. Certain shipping terms that are in common usage are explained below. Although the discussion of these is confined to railroads, they are applicable to all forms of transportation.

F.o.b. means, literally, free on board. F.o.b. Chicago, when the shipper is located in that city, means that he will pay for loading the goods in the freight car, either at his own siding or at a freight terminal, and that the buyer pays the freight charges for shipping the goods to their destination and any unloading and trucking charges that may be incident to bringing the goods to his place of business.

F.o.b. destination means that, in addition to loading the goods in the car, the shipper will pay the freight to the buyer's home city. The unloading and local trucking charges are paid by the buyer. Occasionally shipping terms are specified f.o.b. the buyer's receiving dock, in which case the shipper pays all the charges necessary to lay the goods down at the buyer's place of business.

C.a.f. (*cost and freight*) means that the selling price for the merchandise includes the cost of the goods and the freight to the buyer's store or warehouse.

C.i.f. (*cost, insurance, and freight*) means that the selling price includes the cost of the goods, the insurance covering the shipment, and the freight to the buyer's place of business.

Motor Trucks The growing importance of motor trucks in the transportation of merchandise of many kinds can hardly be overemphasized, particularly for relatively short hauls. The paved roads in this country furnish well over 100,000 miles of good highways over which

roll several million trucks of all sizes and capacities. They range from small one-half ton delivery trucks up to the Diesel-powered giant tractor and trailer combinations capable of carrying many tons of pay load.

The uses of motor trucks are manifold. Farmers haul their produce to market in trucks. Retail stores use them to make deliveries to their customers. Wholesale houses deliver goods to their retailer customers by this means. Trucks transport goods from rail terminals to warehouses or to receivers. Oil and gasoline are furnished to gas stations via the truck method. In most of the instances just mentioned, the trucks are owned and operated exclusively by the companies whose goods they transport. The larger of these firms usually operate fleets of trucks, which may aggregate into the thousands for those companies whose business is nationwide.

The movement of goods by trucking companies is subject to regulation under state and Federal laws. Such companies are designated as "common" or "contract" carriers. Competition exists between these trucking concerns and the railroads, especially for short hauls up to 300 miles. The charges of the trucking companies vary from levels lower than those applied by the railroads to rates bordering on those charged by the express companies.

For those communities with infrequent or no railroad service, motor trucks have been most important. For the rapid hauling of many types of goods for relatively short distances, particularly where the trips can be made overnight, the motor truck fills a longfelt need. Goods can be loaded on the truck at the shipper's place of business and, at the end of the trip, be laid down at the consignee's receiving dock, thus avoiding the cost and bother of hauling them to the railway terminal, loading them into freight cars, and then reversing the process at the other end of the journey. In many parts of the country, trucks move at freight-train speed, and the operators maintain regularly scheduled trips, which permit shippers to rely on a high degree of regularity in planning their traffic activities.

Regulation of Motor Trucks. Broadly speaking, motor trucks engaged in interstate hauling are under the jurisdic-

tion of the Interstate Commerce Commission, while those engaged in intrastate traffic come within the purview of the various state regulatory commissions. All of the states exercise a certain amount of control over the trucks using the roads within their boundaries such as regulating the length, width, height, and the gross weight of the vehicle and contents thereof. Safety regulations covering the operation of motor vehicles have been prescribed by the Interstate Commerce Commission and the states generally follow such regulations. The differing or conflicting regulations of the states are being gradually eliminated so as to make for uniformity among the several states and thereby permitting the use of standard vehicles for intrastate and interstate movements.

Truck-Rail Service. In some parts of the country, a combination truck and rail service is available. This consists of loading the goods to be moved on trucks, which are then driven to the railroad yards where they are run up onto flat cars. These cars are then made a part of a train moving in the direction of the trucks' destinations, usually overnight. In the morning, at a predetermined point, the trucks are driven off the cars and proceed under their own power to the points to which the goods are consigned.

Special Truck Types. As with the railroads, the trucking companies, in conjunction with the truck body builders, have developed a number of special purpose truck types for hauling certain kinds of goods. Among them are refrigerated bodies for handling perishables, glass-lined tank trucks for hauling milk, concrete-mixer trucks that have revolving drums for mixing the ingredients of concrete while en route to the destination and facilities for pouring this concrete directly into the forms upon arrival, and many others.

Waterways The waterways of the country—rivers, canals, the Great Lakes, and the coastwise routes—are of considerable importance in the movement of certain kinds of freight. Water transportation is the cheapest form that the country affords. The fact that it is likewise the slowest is its principal drawback. Water transportation is usually limited to goods of large bulk and low

New York Central System

Loading a Great Lakes Freighter

In this scene at Ashtabula, Ohio, railroad hopper cars containing coal are being dumped directly into a freighter. On the return trip this vessel hauls iron ore.

value, such as coal, grain, ore, oil, lumber, and cotton. Specialized services, such as the movements from the North Atlantic and Gulf ports to the Pacific Coast and certain packet or merchandise transporters on inland waterways, move all kinds of goods at rates well under those charged by other modes of transportation.

The Great Lakes are important to the movement of iron ore, grain, and coal. The rivers are widely used for transporting cotton, coal, and building materials. Canals, which were once important highways of trade, have now shrunk to a relatively negligible position. The Barge Canal in New York State is almost the only one still in operation, and there exists a considerable body of opinion holding that it should be abandoned. Our coastwise shipping is useful for moving oil, cotton, lumber, and coal.

Pipelines The transportation of crude petroleum from the oil fields to the refineries and to certain coastal shipping points is accomplished by means of a network of pipelines. A small amount of gasoline is transported by this means from some of the inland refineries to the major markets. During World War II, this system be-

came exceedingly important when the action of German submarines off the East Coast resulted in the sinking of substantial numbers of the coastwise oil tanker fleet. During this time the Federal Government constructed two pipelines, the Big Inch and Little Big Inch, from the southwestern producing areas to the eastern part of the country.

The pipelines, including the last named that were sold by the Government in 1947 for the transmission of gas, are owned by private interests and are common carriers in interstate commerce. As such, they come within the jurisdiction of the Interstate Commerce Commission.

Airplanes The use of airplanes for the transportation of goods is a relatively new development whose final implications are not apparent at the moment. The forced development of large cargo planes in World War II unquestionably advanced the cause of air-freight transportation by many years. This postwar era should see a furthering of this trend for the general overall benefit of shippers. Costs of air freight, which have been prohibitively

A "Flying Boxcar"

This airplane cargo hold contains approximately 3,000 cubic feet—almost as much as a railroad boxcar.

Fairchild Engine & Airplane Corporation

high in times past, will undoubtedly come down to the point where the air lines will be able to compete with the other forms of transportation regarding the shipping of those commodities that can profitably use planes. These goods will probably be items of small bulk and high value or quick perishability. Other goods that require very rapid movement and that can absorb the comparatively high costs of air transport may be expected to utilize this method of shipment.

Express Express service, which is regulated by the Interstate Commerce Commission and the various state commissions, utilizes the several modes of transportation. The Railway Express Agency, owned and operated by the railroads of the United States, offers a country-wide service. Numerous motor bus lines and some of the air lines offer similar service between points reached by their operations. The service offered by these agencies contemplates a faster movement than is the case with ordinary freight. The Railway Express Agency generally utilizes special express cars, which are operated as express trains at passenger speed or attached to regular railroad passenger trains. Express service is more expensive than freight, but it is well suited to the shipment of goods that require speed in delivery and whose unit value is high enough to permit the payment of the higher charges. Express shipments are picked up at the shipper's place of business and delivered at the place desired by the consignee.

Parcel Post A considerable volume of small package shipments moves via the parcel-post service of the United States Post Office. The large mail-order houses are among those who make extensive use of this method of transportation. Many department stores use parcel post for the inbound movement of much of their merchandise. Delivery service is a feature of parcel post, but it is usually necessary for shippers to send their packages to the local post offices for mailing.

Foreign Transportation For those businesses that wish to send their products to foreign lands or to purchase goods that are made abroad, there are two methods

generally used for transportation purposes—ocean vessels and, more recently, airplane freighters. Railroad service is generally used in the trade between the United States and Canada or Mexico, but ocean vessels carry a considerable tonnage from the eastern sections of Canada to the Atlantic Seaboard in the United States. Between Cuba and the United States, in addition to the regular cargo vessels used, car ferries are utilized from ports on the Atlantic Ocean and the Gulf of Mexico for the movement of goods that have been loaded into freight cars at inland points, moved to the port of export by railroad and thence by car ferry to the port of import and, in some cases, moved beyond by railroad to the final destination.

There are many aspects of transportation to and from foreign lands that are different from domestic trade, some of which are discussed in the next chapter on foreign trade. There are such technical questions as packing, consular invoices, weight of packages, for the correct answers to which the prospective foreign trader should consult the Department of Commerce of the Federal Government.

Goods may be sent much like an l.c.l. railroad shipment; or, in those instances where the quantity of goods involved approximates the capacity of a ship, a vessel with its crew may be chartered for a single voyage or on a time basis.

The costs of ocean shipping are expressed in rates, not unlike railroad rates, except that they are fixed by joint action of the steamship companies and are not subject to the jurisdiction of the Interstate Commerce Commission. They are not so complex as rail rates, being based on cubic footage or weight.

The place of the airplane in foreign trade has not yet been clearly established. There are certain obvious drawbacks, such as the limited size of the planes and the cost of transportation that will probably serve to limit the cargoes to goods of relatively high value and low bulk.

The Traffic Manager Most concerns of any size employ a traffic manager to handle their transportation problems. Such a position requires a thorough knowledge of all available methods of transportation and of rates, sched-

ules, routes, and all the other details connected with the shipment and receipt of merchandise. A capable traffic manager can reduce his employer's transportation costs and, through an intelligent selection of carriers and a constant scrutiny of shipments en route and planned, he can assist in lowering the inventories required for the normal operation of the business and in reducing the financial requirements for this purpose. This latter service can be brought about by scheduling the shipments of purchase orders from the vendors so as to reach the receiving room at the latest possible time before the goods are required for fabrication or resale. This may be only a matter of a few hours or days for the individual shipment but, when applied to the many shipments that a firm receives, may result in a saving that is quite substantial.

Other duties of the traffic manager include the routing of both incoming and outgoing shipments, tracing lost shipments, handling claims for goods damaged in transit, and the correct preparation of the necessary shipping documents.

QUESTIONS

1. Why is transportation important in marketing?
2. How has transportation aided in the development of specialization among producing centers in this country?
3. In what manner does transportation involve the performance of the storage function?
4. Why should railroad rates for shipments that move across state lines be subject to Federal regulation?
5. Why are carload rates lower than l.c.l. rates?
6. To what types of commodities is the "in transit" privilege applied?
7. To what types of commodities is the "diversion in transit" privilege applied?
8. What commodities are best adapted to shipment by air?
9. Do you think that motor trucks will ever offer serious competition to the railroads for long hauls?
10. When the parcel post was first established, it was anticipated that there would be a considerable volume of traffic in direct shipments of farm produce from farmers to consumers. This expectation has not been realized. In fact, the volume of shipments of this sort has been very small. What reason can you give for this condition?

PROBLEMS

1. Secure the most recent data on the items of information included in the table on page 332. Compare these data for the three years and write a brief report of your interpretation.

2. List the types of transportation facilities available in your community. Indicate which type is principally used for incoming or outgoing shipments of each of the following commodities and state the reason for the use of that type: (a) fresh vegetables, (b) clothing, (c) automobiles, (d) lumber, (e) jewelry, (f) small hardware items, (g) staple groceries, (h) furniture.

3. Assume that you are the manager of your local bookstore and that you are placing an order for 100 copies of this textbook from the publishers in Cincinnati, Ohio. What would be the cheapest method of transportation for this shipment? Prepare a table showing the costs of the possible methods of transportation.

4. List several goods and services that have been made available in your community in recent years as a result of improvements in transportation. Indicate the specific improvement in transportation that has made each item available.

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CHAPTER 18

FOREIGN TRADE

Definition of Foreign Trade

Foreign trade may be defined as the business transactions—buying and selling—between businessmen of different countries, whereby goods and services and the payment therefor pass from one country to another. It is through the medium of foreign trade that the products of one country are made available to the rest of the world.

Reasons for Foreign Trade

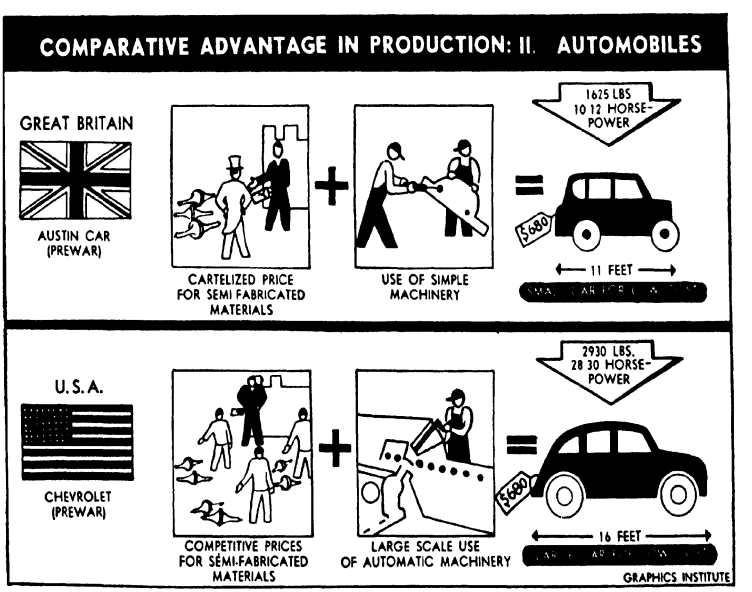
There are three reasons for the development of foreign trade, of which two are economic and one is political. The economic reasons are called the theory of absolute advantage and the theory of comparative advantage. The political reason is simply that of the need for foreign trade in order to promote world peace.

It should be stated at the outset of this discussion that the terms "theory of absolute advantage" and "theory of comparative advantage" are largely confined to the field of economic theory, where they originated. It is extremely doubtful that the average businessman ever heard of these terms or would know what they meant if he did. Nevertheless, they are useful as a means of indicating the underlying economic bases for the development of foreign trade and its persistence in the face of formidable obstacles.

Theory of Absolute Advantage. Certain countries possess, usually through pure chance, certain goods that cannot be obtained elsewhere. Examples of such goods are diamonds in South Africa, emeralds in Colombia, and helium in the United States. Each of these nations has an absolute advantage over all others in the production of these commodities, and for this reason trade must take place between nations if these items are to be available outside of the countries of their origin. Thus it is assumed that all countries will offer to sell those goods in the production of which they have an

absolute advantage. This doctrine is sufficiently self-evident so that it provokes no argument.

Theory of Comparative Advantage. This doctrine assumes that each nation will produce only those goods that it can make more cheaply than can any other country and will refrain from making those items that can be bought more cheaply elsewhere. Stated slightly differently, the theory holds that countries will concentrate their productive efforts on the goods in the manufacture of which they have a comparative advantage and abstain from the manufacture of those goods where they are at a comparative disadvantage. The surpluses of some goods thus produced and the need for other goods thus created bring about the movement of goods in the channels of foreign trade as each nation tries to sell the goods that it makes and to buy the goods that other nations make, both on the presumed basis of comparative advantage. Two examples of the operation of the law of comparative advantage are the manufacture of linen cloth in Ireland and of cheese in Switzerland.



The difficulty with this doctrine is that it does not always hold true, particularly for the presumably more highly developed industrial nations of the world. In those nations the trend has been definitely away from following the theory of comparative advantage, at least regarding the products of a mechanized economy. Instead of each country's making only those products in which it has a comparative cost advantage, the tendency has been toward the manufacture of everything that would come into this category and to employ trade barriers, usually tariffs, to equalize the cost differences on goods coming from countries that are able to produce them at less cost. It is, of course, obvious that the extension of this trend would have the effect of lessening the volume of trade between countries that follow this pattern of procedure.

World Peace. It has been felt that the greatest possible volume of world trade between nations is desirable as an important step in the direction of world peace. Countries, like individuals, who have extensive business dealings with each other are presumed to be on a more friendly basis than those whose contacts are few in number or virtually nonexistent. For this reason, which is greatly enhanced in importance with the discovery of the atomic bomb, it has been felt in some quarters that all possible effort toward the expansion of world trade should be put forth, even at the occasional sacrifice of the advantages that certain countries might otherwise enjoy. Prior to World War II the progress that had been made toward the general adoption of this philosophy was not very encouraging to its adherents.

Extent of Our Foreign Trade Foreign trade in which this country is a participant varies quite measurably from year to year, depending upon a number of factors, including trade barriers, price levels, the state of the economy in various nations, international trade agreements, and the presence or absence of war anywhere in the world. Absolute figures are not particularly meaningful, but they provide the only available method of portraying the quantitative aspects of our foreign trade and of setting forth the items of which it is composed.

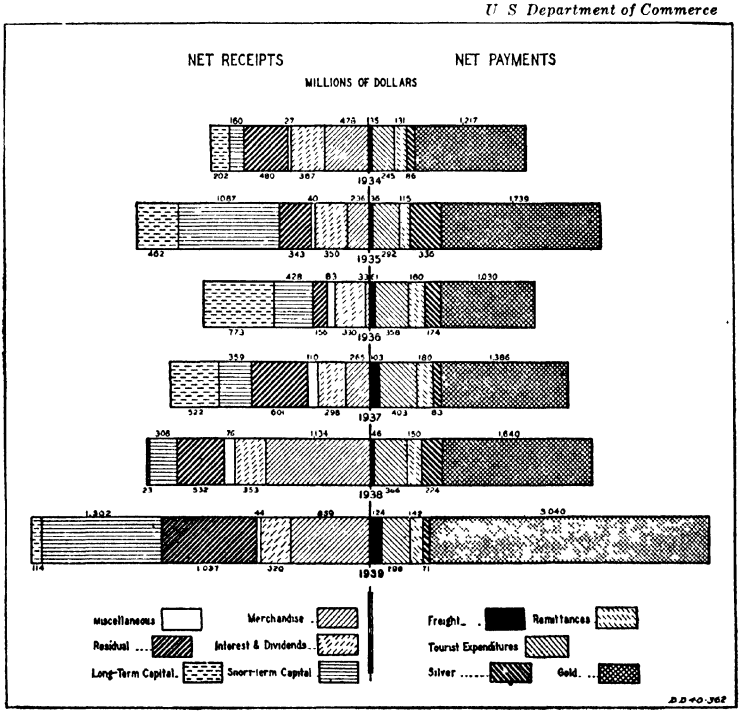
Our Balance of International Payments

A statement, released annually by the Bureau of Foreign and Domestic Commerce of the United States Department of Commerce, shows dollarwise the extent of the exports and the imports of this country. It also shows the concomitant movements of gold and capital items. A chart, based on this statement for the prewar period, 1934-1939, is shown below. During World War II, practically all normal foreign trade was suspended, including the shipment of gold as a means of settling international indebtedness that arose through foreign trade.

Balance of International Payments of the United States, 1934-1939

The data in this chart represent net receipts and net payments, not the gross dollar volume of international transactions. The unusually large surplus of merchandise exports over imports in these years was offset to a relatively small extent by net payments to foreigners for various services. The resulting excess of receipts by this country on trade and service account, coupled with an influx of capital funds from abroad, was responsible for a heavy inflow of gold.

U S Department of Commerce



Characteristics of Foreign Trade These may be conveniently divided into those that are similar to domestic trade and those that are dissimilar. The former group includes the following: The goods and resources offered must have the power to satisfy human wants; there must be people somewhere who want them and are able and willing to pay for them; there must be a commonly accepted and trusted medium of exchange in which values may be expressed or quoted; and the goods and services offered must be quoted at prices that will find ready buyers for the entire amounts that are for sale and yet yield reasonable profits to the sellers. Sales effort is likewise required, both to bring the goods to the attention of prospective buyers and to effect their sale.

It is with the characteristics of foreign trade that are unlike those of domestic trade that this discussion is principally concerned. These are presented below.

Language Differences. Except for trade between countries speaking a common tongue, there are language differences that must be overcome. These affect the necessary correspondence, the creation of advertising, and the labeling and marking of the goods. To take care of this situation, some firms employ foreign-language speaking correspondents and interpreters. Translation services are available from a number of sources, such as the larger chambers of commerce, the Pan-American Union, and various foreign trade clubs. In recent years, the language barrier, particularly as it affects businessmen in this country, has diminished somewhat in importance, mainly because of the spread of English to virtually all parts of the world. The penetration of the armed forces of the United States during World War II has been a factor in this movement.

Different Monetary Standards. Every nation has its own peculiar currency—the dollar in this country and Canada, the yen in Japan, the drachma in Greece, the peso in Mexico, the guilder in Holland, and the lira in Italy are examples. This situation requires not only a mechanism whereby the seller may be paid in his own currency while the buyer makes payment in his, but also a method whereby each of these

national currencies may be expressed or valued in terms of every other one. At one time gold served as more or less of a common denominator for all currencies, but for several years the so-called gold standard has been nonexistent, and this has greatly complicated this problem. The fact that these relative values are subject to possible constant fluctuation does not help to simplify this situation.

Trade Barriers. Practically all countries, for one reason or another, interpose barriers that tend to restrict the free flow of goods across their borders. These barriers apply, in most cases, only to imports or goods moving into these countries. They consist of tariffs, quotas, exchange restrictions, barter arrangements, and, occasionally, absolute prohibitions to the import of certain commodities. These are discussed in some detail later in this chapter but are mentioned here because of their dissimilarity to domestic trade. It is true that interstate trade barriers exist in this country, to a limited extent, but their influence on the movement of goods in no way approximates that of international barriers.

Transportation Costs. A factor in which foreign trade differs from the domestic, mainly in degree, is that of transportation costs. Although it may cost less to ship goods from Boston to Quebec than from Seattle to Miami, in general the transportation costs incident to foreign trade are considerably higher than those incurred in moving goods within this country.

Miscellaneous Differences. There are certain other differences such as those of customs, habits, legal systems, governmental attitudes toward business, political systems, and the like in the various countries that serve to differentiate foreign from domestic trade. In every instance, it is important for those engaged in foreign trade to realize these differences and to keep informed concerning them.

Nationalism and Its Effect One of the basic characteristics of foreign trade is the fact that it is or should be a two-way arrangement, by which is meant that a country should buy as well as sell goods and services. While it is to

be expected that exports and imports will not balance out evenly in every instance and that the differences will be settled through payments of gold or in some other acceptable fashion, it is an economic falsity to assume that a country can always sell more than it buys and receive the difference in gold. Yet this is exactly what the growth of economic nationalism has endeavored to bring about. Great emphasis has been placed on the exporting of goods to other countries, but the notion that imports should play a prominent part in the economy of the nation has been decried and barriers have been erected in the path of the free inflow of goods.

The concept of a nation's relationship to world trade as being purely that of a seller is one that dates back to the days of the Mercantilists in England. These folk believed that the country's prosperity, as far as foreign trade was concerned, depended on its exporting merchandise and importing only gold as payment for the exports. There are still, however, a considerable number of businessmen and politicians in all countries, including the United States, who cling tenaciously to this same belief.

This philosophy has been further emphasized by the phraseology employed to describe our country's position as a buyer or seller in world trade. The term "favorable balance of trade" has been used to describe the situation when our exports exceeded our imports, and "unfavorable balance of trade" has been employed when imports exceeded exports. Furthermore, the balance of trade idea embraced purely "visible" or merchandise items such as machinery, shoes, and typewriters, and ignored the "invisible" items such as loans to foreign countries, payments for insurance abroad, or money spent by tourists. The use of these terms has been most unfortunate in that it has appeared to portray a situation of advantage or disadvantage that was not necessarily or even usually true.

The measure of the prosperity of a country, as far as its foreign trade is concerned, is not to be found in its export or import position, but rather in the effect that its foreign trade has on the standard of living of its people. If a people can import goods at lower prices than they can make them themselves, they should do so and concentrate their produc-

tive efforts on making those things that they can produce cheaper than other countries can and sell them abroad. The nationalistic philosophy operates to prevent this from happening.

Another aspect of nationalism is the "buy at home" idea. Great Britain's "Buy British" slogan of a few years past is a good example of this sort of thing. Obviously this type of thinking is not compatible with the notion of foreign trade as a two-way deal.

The idea that a nation should be economically self-sufficient, as far as the United States is concerned, received considerable impetus during World War II because the early Japanese conquests cut off our supply of many essential raw materials, necessitating our searching for substitutes, or doing without until the Japanese were defeated. Many business and political leaders hold to the belief that, so far as possible, we should never permit ourselves to be caught in this position again. The implementation of this conclusion would result in our endeavoring to produce a number of commodities that can be grown much more cheaply abroad. This may be regarded as a purely defensive measure, but it is bound to have an adverse effect on the extension of our foreign trade, particularly our imports.

Broadly stated, then, the conclusion is inevitable that the growth and continuance of nationalism will have a restraining effect on foreign trade at least as concerns imports and, if all countries embrace this philosophy, world trade is bound to suffer.

Role of Government in Foreign Trade

Since the earliest days of its existence, our Government has felt compelled for one reason or another to exercise its influence in the field of foreign trade. In certain of its aspects, this has been done in a genuine and sincere effort to safeguard and promote the interests of the citizens in their international transactions, on the ground that individually they were not strong enough, or could not afford, to do this for themselves.

These activities of the Government have manifested themselves in a myriad of ways. Merchant fleets have been sub-

sidized or built with public funds. The diplomatic and particularly the consular services of the Government seek to assist foreign traders in establishing and extending their commercial activities by advising them concerning foreign governmental regulations. Commercial treaties have been concluded with general and specific agreements concerning the rights and obligations of the signatory states.

One of the oldest, and formerly most controversial, aspects of the intrusion of Government into foreign trade is in the levying and administering of tariffs on imports. This subject is of sufficient importance to warrant a rather thorough discussion, particularly as it is through the manipulation of tariff schedules that foreign-made goods are encouraged or discouraged from entering the country.

Types of Tariffs A *tariff* is a system of duties levied against goods being imported into the country. There are two types of tariffs, the revenue tariff and the protective tariff.

Tariff for Revenue Only. This is a tariff that is designed principally to help raise revenue for the Government and is not designed primarily to discourage imports. Revenue rates are usually relatively low since the lower they are, the greater the quantity of imports and hence the larger the amount of revenue. Historically the Democratic party has been an advocate of low tariffs, and no small part of the support for this position has come from farmers who felt that they wanted low prices on the imported goods that they had to buy.

Protective Tariff. The purpose of this kind of tariff is to keep out of the country goods that would otherwise undersell domestic goods of the same or similar kind—goods in the production of which other nations have a comparative advantage. In order that the meaning and implications of the protective tariff may be understood, it is necessary to inquire into the arguments that have been advanced in its behalf and to examine their validity to some extent.

The Home Industry Argument. This argument holds that, if foreign goods are kept out of the country, domestic manu-

facturers will enjoy a larger home market than would otherwise be the case. It has come into being as an instrument for arousing popular support behind the protective tariff idea, a project that has been quite successful. Actually the argument has been used by selfish business interests that were interested more in protecting their own existence from foreign competition than in promoting American industry generally. With high tariffs to keep out foreign competition, individual firms, thus protected, are able to get higher prices for their products than if tariffs were lower. High-cost producers, who might be forced out of business if subjected to the competition of efficient foreign producers, are enabled to continue to operate while thus protected.

This argument is economically unsound since the imports without protective tariffs would be lower in price, leaving American buyers with extra funds with which to buy additional or other goods. Likewise, foreign businessmen, by being able to sell in the American market, would have purchasing power with which to buy American exports, which, according to absolute or comparative advantage, they could not produce themselves or, if they could, it would be at a higher cost than they can be produced in the United States. In gaining a larger home market by means of a protective tariff, the same or other American producers are losing foreign buyers and the world as well as the country is economically poorer.

The Wages Argument. The theme of this argument is that, by excluding foreign goods made by lower paid labor, goods made by higher paid domestic labor can be sold in this country, thereby serving to maintain or raise domestic wages. This idea is basically false for two reasons. First, by keeping out goods made by lower paid foreign labor, the prices of competing domestic goods are raised to American buyers, thus leaving them less money with which to buy other goods. Second, the important factor in the labor remuneration picture is not whether labor is paid on a high or a low scale but its productivity. High wages are the result of high productivity on the part of labor; they do not cause high productivity. Generally speaking, in industries where labor

productivity is high, wage and labor unit costs are low; hence, prices are low and tariff protection is neither wanted nor needed. If labor productivity is low, high wages can be paid only if tariff protection is granted, which then results in subsidizing uneconomic production, to the long-run disadvantage of all parties concerned.

The Infant Industry Argument. The tenor of this argument is that young, struggling, industries in this country should be protected from competition from foreign producers until they have had a chance to get well started. There is a certain amount of merit to this thesis, provided that the protection is continued only until the infant has attained competitive maturity. The difficulty, from this standpoint, arises in determining how long this protection is needed and when the point is reached after which it should be discarded. It is likewise probable that each industry might require a different period of time to mature. Administratively, this part of the problem is extremely difficult.

The notion, that infant industries once started and later found not to be economically feasible should be forced to survive or perish when protection is removed a given number of years later, is a difficult one to enforce in the latter instance. The producers will claim that they did their best but that the enterprise did not turn out as expected. These then become the so-called "vested interest" of producers, and they fight the harder to retain protection on the grounds that their investments will be wiped out if protection is withdrawn. This argument has force, but continued tariff protection is a dangerous solution. As a possible answer to this, it has been proposed that the Government step into those enterprises not found to be economically sound after the time for protection has elapsed and either pay off the producers and wind up the businesses or continue to protect them by means of subsidies if their production is deemed necessary for the national good. This would at least get rid of tariff protection and might deter the granting of it to infant industries in the first place.

The Military Argument. This argument holds that all industries vital to the national defense should be kept alive through tariff protection, if necessary. It has been proposed

that, when this needs to be done, the subsidy method mentioned in regard to the infant industry argument be employed, perhaps even from the outset, and that the costs be properly labeled as those of national defense.

The Favorable Balance of Trade Argument. This argument has been discussed earlier in this chapter and does not require reiteration here.

Despite the evident weaknesses in the arguments in favor of protective tariffs, the fact remains that, with comparatively few exceptions, the movement of tariff rates throughout our history has been distinctly toward the protective level. Historically the Republican party has embraced the doctrine of protection, drawing its support from big business and certain of the labor unions. In the past decade or more, the distinction between the two parties regarding the tariff has become much less marked than in previous years.

Types of Tariff Duties There are three types of tariff duties, specific, ad valorem, and compound. *Specific duties* are amounts levied at so much per unit, or pound, or ton, of the commodities affected. These duties bear no relationship to the value of the items concerned.

Ad valorem duties consist of levies, such as 10 per cent, based on some aspect of the value of the goods in question.

Compound duties involve both a specific and an ad valorem levy against certain goods. The rates affecting all commodities are set forth in the Tariff Acts, of which the latest is that of 1930.

The Flexible Tariff System Introduced in 1922 and continued up to the present, Federal legislation has empowered the President of the United States to change tariff rates without reference to Congress, subject to certain restrictions or limitations. The purpose of this was to speed up the adjustment of rates in accord with changing conditions, as compared with the cumbersome and log-rolling methods of legislative changes in the tariff laws.

Foreign Exchange Foreign exchange is concerned with the methods whereby buyers and sellers in foreign trade pay and receive payment for the goods that

they handle. It is very seldom, in modern times at least, that actual money is shipped abroad in the settlement of foreign trade transactions. The typical method of settlement is by means of *bills of exchange,* which are nothing more nor less than the drafts used in domestic trade, except that they may be written in terms of francs or marks in place of always being in dollars.

When an individual exporter sells a bill of goods or renders service to a foreign importer, he draws a bill of exchange ordering the importer to pay him a stated amount of money either on sight or a stated number of days in the future. Ordinarily he will not want to wait until it matures to cash it, so he takes it to his bank and has it discounted. This means that the bank gives him cash for it, less certain interest and accommodation charges. This transaction may be effected before the bill is presented to the importer if his credit standing is good; otherwise, time must be allowed to send it to him for acceptance and for its return before the exporter can present it for discount.

The discounting bank, or its larger city correspondent, simply credits the bill of exchange to its account in the country where it was drawn; and when the bill becomes due, it is presented to the importer by a bank in his own country, and payment is effected and the transaction completed without any money being sent from the importer to the exporter. This same discounting bank is then in a position to sell drafts on its foreign balances to American importers who thus reimburse the bank for the money it paid to the American exporter when it discounted his original bill of exchange. Likewise the importer has funds available abroad for the payment of the amount that he owes to the exporter in that country without having to bother to send actual cash.

These bills of exchange are bought and sold in a so-called foreign exchange market, which is located in the large financial centers of the United States and of the world. The prices of these bills are known as the "rates of exchange." Before World War I, when gold could be shipped between countries, these exchange rates were kept within narrow limits because of the possible alternative of actually shipping gold in or out of the country if the price of the bills of exchange

exceeded the cost of shipping the gold. At present, this factor does not exist, so it is just a question of the demand for and the supply of the bills of exchange determining their price (rate of exchange). Thus if American exporters sell a lot more to importers in India than our importers buy from India exporters, the supply of bills will exceed the demand, the rate of exchange will go down, and the exporters will be harmed as their bills will bring less in the market. Likewise, importers will be encouraged to buy more in India by virtue of the lower price of the instruments used to pay for their purchases. In time, the exports will diminish, the imports will increase, and a balance will be reached that will bring the rate up again, a process that will continue indefinitely unless other factors arise to prevent it.

Recent International Tariff Developments During the years since the end of World War I, and particularly since the onset of the depression of the 1930's, the intrusion of all governments into the foreign trade picture has been noteworthy. A brief discussion of the principal events in this regard follows.

Quotas. When all nations, including England, came to adopt tariff protection as a national policy, its effects were more or less neutralized, and other methods of accomplishing the same result were instituted. Quotas, whereby only specified amounts (quotas) of designated commodities would be allowed to enter a country in any one year, were used by a number of nations, notably France. The advantage of this method was that the quotas could be set and revised more quickly than it would take the legislatures to revise tariff rates. Likewise, once the quotas were filled, no more imports were possible, whereas under the tariff system imports might continue to come in unless the tariff rates were so high as to be prohibitive.

Exchange Restrictions. Following the depression of the 1930's exchange restrictions were adopted, especially by South American countries. Several modifications of this method were used, but basically it meant that exporters sold all their bills arising from selling goods abroad to their government

at a fixed price. The government, in turn, decided how much exchange would be released to importers and at what price. In many cases, certain importers (of necessities) were given lower prices than others (importers of luxuries). In any event, it was possible for the government to effect any degree of favorable trade balance that it desired, regardless of economic consequences. This method worked since it affected all transactions by regulating the means by which payment was made or received, namely, bills of exchange.

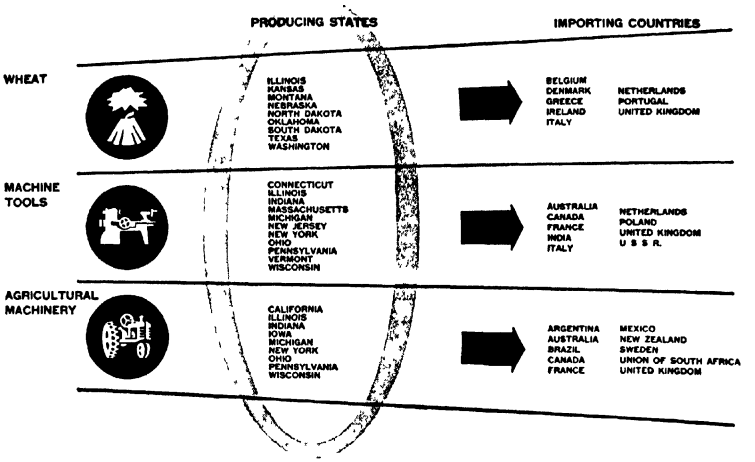
Barter Agreements. As the depression wore on and the shadows of another war lengthened, foreign trade was tied up more and more with political maneuvering. Commercial treaties have long been used as a means of promoting, and especially for safeguarding, trade and the rights of traders. However, in the 1930's Germany led the way in using barter agreements, by which she agreed to buy so much from Austria, for example, only if Austria would buy so much from Germany. Here again, the stronger of the negotiators would effect a balance of trade in its favor.

The result of the increasing and severe efforts to channelize foreign trade in the 1920's and the 1930's was unquestionably one of the causes of the international economic maladjustment that helped to prepare the world for World War II. Free and unhampered international trading in accordance with the laws of absolute and comparative advantage is the most profitable arrangement and the one that is most conducive to world peace, as nations are thereby interdependent and engaged in large scale trade with one another.

However, when some one nation decides to secure a temporary advantage by instituting trade restrictions, others begin to follow suit and sooner or later a stalemate is reached, trade is at a minimum, and war is likely to result.

Reciprocal Trade Agreements. In 1934 the United States made a valiant effort to stem this tide by passing the Trade Reciprocity Act, which provided for the negotiation of reciprocal trade agreements. By means of such agreements, under certain limitations, this country would lower tariff rates on imports from countries that, in turn, lowered their duties on imports from America. Many criticisms have been

THREE IMPORTANT EXPORT PRODUCTS



U. S. Department of State

These three important export products, which are produced by 21 states and sold to 20 foreign countries, may become the subject of reciprocal trade agreements.

leveled at the detailed operation of this policy, but it was undoubtedly a step in the direction of reducing the barriers to the free flow of international trade. More than two dozen such agreements were consummated prior to the attack on Pearl Harbor when World War II changed the entire foreign trade picture.

Postwar Outlook At the present it is extremely difficult to foresee the postwar foreign trade situation. That there is great need of goods in many, if not all countries, after the devastation and the deprivations of the war period, is obvious even to the most casual observer. However, the experience of the nations of the world during the prewar period will be difficult for them to forget, and the impoverished condition of many countries as a result of the war will operate to prevent their being able to pay for the goods that they so desperately need. The United States is obviously the most solvent nation in the world, but even here a staggering national debt raises questions of national fiscal policy that suggest the need for measures of economy.

The stark economics of the postwar situation are that trade between the nations of the world will depend upon many countries being furnished, at least at the start, with the means of paying for the goods that they need, and that this country, as the principal source of many of the needed items, must be willing to buy the products of foreign countries in order that they may continue to have the means of paying for the goods that we export to them.

As a means of making short-term funds available to many of these countries, the Bretton Woods plan for the establishment of an International Monetary Fund has been proposed. The operation of this Fund, as indicated by an economist of the Department of Commerce, would be as follows:

Stripped of all their technical features, the operations of the proposed Monetary Fund would consist, in essence, of the sale of foreign currencies to member countries, in limited amounts and under adequate safeguards, to meet temporary shortages of exchange for conducting regular business transactions among themselves. Such assistance in time of need should make it easier for countries maintaining restrictive exchange controls to remove them and to keep their other obligations as members of the Fund. Likewise countries having difficulty in balancing their international accounts should find it less necessary to institute measures that disrupt and destroy trade. The Fund Agreement prohibits competitive exchange depreciation but provides for the orderly adjustment of exchange rates by international consultation and agreement. It is designed to bring about the elimination of exchange controls which burden trade, after a period of transition to allow for their gradual relaxation.

To supplement the Fund, the Bretton Woods meeting put forth a proposed Bank for Reconstruction and Development which is primarily a device for facilitating the flotation of foreign loans in the private capital markets of members by giving them an international guarantee. The Bank may also provide long-term capital through direct loans out of its own resources of paid-in capital or out of the proceeds of the sale to the public of its own obligations. In either case the loans, except in special circumstances, must be for specific projects of reconstruction and development.[1]

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[1] August Maffry, Chief, International Economics and Statistics Unit, Bureau of Foreign and Domestic Commerce, Department of Commerce, in *Foreign Commerce Weekly*, October 7, 1944.

How well these proposals will serve as a means of sparking the initial movement of goods in postwar trade cannot be determined until sometime after they have been put into effect. One thing is certain, however, the Fund and the Bank are purely devices for starting the resumption of foreign trade and for helping to eliminate certain practices that experience indicates are inimical to widespread trading.

To ensure the resumption and continuation of international trading on a really big scale, it will be necessary for large, long-time investments to be made abroad and for this country to be willing to import the products of foreign countries, which they produce on the basis of absolute or comparative advantage. It will require a drastic downward revision of many of our tariff schedules and the development of an international mindedness of our people. The events of the first few postwar years may go far toward influencing our thinking in this regard as will the success that attends the efforts of the United Nations to establish and maintain an effective world peace. The next few years will be crucial, regarding both foreign trade and the hoped-for peace to which it can contribute so greatly.

QUESTIONS

1. Discuss the validity of the theory of absolute advantage.
2. Discuss the validity of the theory of comparative advantage.
3. Why is foreign trade an important factor in world peace?
4. What is meant by "invisible imports"?
5. Discuss the validity of the various arguments in behalf of a protective tariff.
6. Should a country strive to become entirely self-sufficient?
7. What would be the effect on the standard of living in this country if all tariffs were abolished and free trade was adopted throughout the world?
8. Should the role of government in foreign trade be increased or decreased?
9. Should the shipment of gold for the settlement of foreign balances be resumed?
10. How can the resumption of large-scale foreign trade in the postwar period be assured?

PROBLEMS

1. "Tariff barriers that were raised by many countries after World War I were responsible in a large measure for World War II." Do you agree or disagree? List specific reasons for your decision.

2. Write a brief interpretation of the pictorial chart on page 349.

3. The three export products in the chart on page 363 are important because they are produced by so many states and sold to so many foreign countries. Select three important import products. List for each product (a) the foreign countries that produce the product and (b) the states in this country that use the product.

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CHAPTER 19

LONG-TERM FINANCING

Fixed Capital Needs Every business requires some capital that takes the form of a permanent or semi-permanent investment. The bootblack who sells his services on a street corner must have a footrest, brushes, polishing cloths, a supply of polishes and cleaners, and a container for these articles. A manufacturing firm needs land and buildings, machinery, raw materials, and thousands of other items such as benches, lockers, typewriters, and desks. The methods used to secure funds for such items may have an important bearing on the ultimate success or failure of the business.

Long-term financing often becomes a serious problem when an existing firm decides to expand. A gradual growth can be attained by allowing earnings to remain in the business instead of paying them out to the owners. However, if a sudden opportunity develops to buy out a competitor, or if a decision is reached to build a new factory, it is unlikely that sufficient funds would be on deposit for the purpose. In this case funds must be secured in a manner not unlike that used when a new enterprise is started.

The raising of funds for fixed-capital needs calls for types of securities that do not need to be repaid for several years. It is satisfactory to borrow money from a bank on a sixty-day note to purchase merchandise that will be sold in less than sixty days, because the receipts from the sales will provide the cash with which to repay the bank. However, if land, buildings, and machinery are purchased, it may be years before their use will produce the money necessary to liquidate a debt contracted for this purpose. In many instances the problem of repayment can be avoided by having the owners invest money in the firm on a permanent basis.

Long-Term Noncorporate Financing Sole proprietorships and partnerships, normally, do not have as many possibilities for securing long-term funds as does the corporation. If the owner or partners are wealthy men or

women, it may be possible to transfer their private wealth to the business, provided such funds are available in cash or in some other liquid form. Another avenue that may be productive is the mortgaging of fixed assets already owned, such as land or buildings, or the acquisition of such property by paying only a portion of the purchase price and signing a mortgage for the balance. This gives rise to a *mortgage payable*, which may not become due for from five to twenty years, or even longer.

For example, George White has been operating a retail grocery store in a rented building. An opportunity presents itself for him to buy the building for $12,000, which is a reasonable price. Unfortunately, Mr. White has no excess cash in his business and can supply only $3,000 from his personal capital. He may go to a building and loan association, to his bank, or to a private individual and, by signing a note, which pledges the building as security for this promise to pay, he can borrow the needed $9,000. This mortgage note may be due in fifteen years with interest at five per cent payable annually. In case Mr. White fails to pay the interest each year, or fails to pay the entire $9,000 at the end of fifteen years, the holder of the mortgage note can foreclose the mortgage. The building will be sold at public auction, and, should the sale price be less than the amount owed, Mr. White will have sacrificed his original $3,000 payment and may still owe an unpaid balance on the note.

If a going proprietorship or partnership is exceptionally strong financially, it might secure additional funds by selling long-term notes without the security of a mortgage. Banks and other investors would be willing to buy one- to five-year notes signed by the owner or owners of business firms whose credit standing is of the highest order. Because such securities do not run for as long a time as most long-term obligations, they are sometimes given a separate classification called *intermediate credit.*

The dictates of sound financial practices prescribe that the sole proprietorship or partnership should secure practically all of their long-term capital needs from the owners. Borrowing part of the cost of a building may be satisfactory, but even in

this case the annual interest charge may prove to be a serious burden, particularly for a new organization. Borrowing to buy machinery and equipment is risky, and the customary requirement of regular payments on the principal of these loans, as well as interest, is a drain on the cash resources of the firm. Many business failures, especially among small proprietorships and partnerships, can be traced to excessive reliance on outside sources for fixed-capital requirements.

Long-Term Corporate Financing

Both of the methods available to sole proprietorships and partnerships for securing long-term funds, namely, mortgage notes and long-term unsecured notes, may also be used by corporations. In most instances, however, this form of business ownership would be more likely to seek long-term capital by selling either bonds or stocks. The chief distinction between these two classes of securities is that *bonds* are a debt of the corporation, which must be repaid at some definite maturity date, whereas *stocks* represent ownership without obligation for redemption at any time. Another difference is that bonds usually specify a definite rate of interest, which is normally payable semiannually, whereas a return to the investor in stocks is obtained only if dividends are declared by the board of directors of the corporation. Interest is an expense of doing business; dividends are a distribution of profits.

A corporation may issue numerous kinds of bonds and stocks. The choice of security to be sold depends on a number of factors, many of which are beyond the scope of this discussion, although enough information will be given to make clear why a company chooses one form in preference to another. The remainder of this chapter will be devoted to a discussion of the general and specific features of bonds, preferred stocks, and common stocks.

BONDS

General Features of Bonds

All bonds issued by private companies contain some common features. In addition, there are many special provisions, one or more of which may apply to a particular issue. Provision for a trustee, the de-

nomination of the bonds, maturity dates, and the form—registered or coupon—are considerations applying to all issues sold by industries, railroads, public utilities, and financial enterprises.

Provision for Trustee. Bonds represent a debt, which is usually held by a large number of investors, of the issuing corporation. These investors may be widely scattered over the country and may not be acquainted with each other. They need someone to act in their behalf and to safeguard their interests. Such a person is known as a *trustee* and is chosen by the corporation at the time the bond issue is sold. Modern practice usually calls for a trust company or large bank to serve in the capacity of trustee.

The duties of the trustee are included in the agreement under which the bonds are issued. This legal document is called the *indenture.* Under it the trustee certifies that the bonds are genuine, holds any collateral that may be used as security for the issue, and collects money from the corporation to pay the interest and also the principal. In addition to these specific duties, the trustee undertakes, in behalf of the bondholders, to make sure that all provisions of the indenture are carefully followed during the lifetime of the issue.

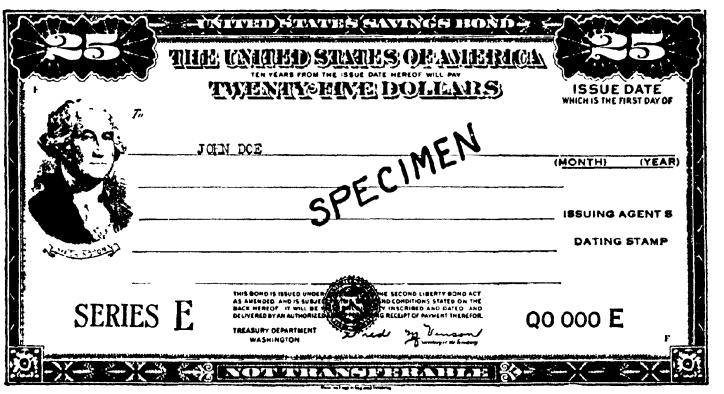
Denomination of Bonds. Most industrial, railroad, financial, and public utility bonds are issued in units of $1,000. Sometimes the denominations of part of the issue will run higher, such as $5,000, $10,000, and $50,000 units, or may be printed in lower amounts, usually $500 or even down to the $100 level. If bonds have a face value of less than $500, they are frequently referred to as *baby bonds.*

Many individuals are more familiar with United States Government bonds than they are with corporation bonds because of the extensive sale of these securities before, during, and after World War II. Although there were many types of bonds sold, the average investor bought the "E" series, which was available in units as small as a $25 maturity value. Another distinctive characteristic of this series was the method used to provide compensation for the use of the money loaned. Instead of paying interest on an annual or semi-

annual basis, these bonds were sold at a discount and, if held for ten years, interest amounting to almost 3 per cent could be obtained when the full maturity value was paid. The bonds were sold at $18.75 or multiples thereof, and matured at $25 or proportionally higher amounts. Securities that pay interest in this fashion are known as *accumulation bonds.*

Maturity Dates. Because bonds are a debt, they must be repaid at some future date. The length of time between the issue and repayment varies considerably, but practically all bonds will run for at least ten years and may not mature for as much as one hundred years. As an instrument of long-term financing, a period shorter than ten years would hardly be satisfactory. Twenty, thirty, and forty years are common lives of bond issues. Railroad bonds frequently have such durations as sixty and seventy-five years. A few bond issues have been sold on a perpetual basis.

Registered versus Coupon Bonds. A *fully registered bond* shows the name of the owner on the face of the security; a record of the owner is kept by the issuing corporation; and interest checks are mailed to the holder. A *coupon bond* shows no evidence of the owner; the corporation does not know who holds it; and interest is paid to the party that presents the dated coupons which are clipped from the bond.



United States Savings Bond, Series E

United States Savings Bonds are one example of registered bonds.

The advantage of a registered bond is that the owner is protected against loss in case it is stolen, while the coupon bond, which is a bearer instrument, is usually assumed to belong to the person who has it in his possession. The disadvantage of a registered bond is that title cannot pass unless the owner indorses the bond to a purchaser, and this fact is recorded on the books of the issuing corporation. The coupon bond is easier to sell and is more satisfactory to deposit with a bank as security for a loan. Corporations floating a large issue may sell both types of bonds.

In some instances a coupon bond is registered as to principal only. Interest is collected by the coupon method as in the case of the ordinary bearer bond but the owner is protected by registration against loss by theft as to the principal sum. This is known as partial registration.

Special Features of Bonds Practically every bond issue is different in some respect from one issued by another company or from another series sold by the same organization. These special features are concerned with such details as the security behind the issue, method of repayment, and many other miscellaneous provisions, which frequently are of major importance. The name by which bond issues are advertised and sold usually contains a descriptive phrase indicating the inclusion of certain special features as will be noted below.

Security. Since bonds are a debt of the corporation, investors usually expect some type of security as protection in case the issuing party finds it impossible to live up to the terms of payment of interest or principal. The most common type of security is a mortgage on real estate, which can be foreclosed by the trustee acting for the bondholders. Such bonds are called *mortgage bonds.*

If there is only one series outstanding, or if an issue ranks ahead of any others, the bonds are known as *first-mortgage bonds.* Such securities are also known as *senior-mortgage bonds* in contrast to those of a *junior* issue, which would be called *second-mortgage bonds,* or *general-mortgage bonds* if the term "second" was judged to be injurious to sales appeal. When both first and second mortgage bonds are outstanding

and foreclosure takes place, the holders of the senior securities must be paid in full before any of the money received from the forced sale of the property is paid to the junior mortgage bondholders.

In order to strengthen the security, an *after-acquired* clause may be inserted in the indenture. This means that all property built or purchased after the original mortgage bond is issued is also covered by the mortgage. Such a clause may cause difficulty later in raising funds to buy property.

If a corporation decides to raise money by selling mortgage bonds, the usual practice is to dispose of the entire issue at one time. This is known as a *closed-end issue.* If only a portion of the bonds that have been authorized are sold, the series is known as an *open-end issue.*

Mortgages may also be given against machinery and equipment. These are known as *chattel mortgages,* in contrast to real estate mortgages, which are restricted to land and buildings. A special type of chattel mortgage is used by railroads to secure funds to buy engines, freight cars, and passenger coaches. This type of security, in which rolling stock is pledged with the trustee, is called an *equipment trust bond.* These bonds command a strong market because, in case of default, it is easy for the trustee to sell such equipment to another railroad.

Another type of security frequently used as backing for a bond issue consists of stocks and bonds of various companies that are owned by the corporation desiring to borrow funds from the investing public. These stocks and bonds are deposited with the trustee who, under the terms of the indenture, can sell them for the benefit of the bondholders in case of failure to meet interest and principal payments. These bonds are called *collateral trust bonds.* If the pledged stocks and bonds were issued by excellent companies, and if the value is greater than the amount of the bond issue, collateral trust bonds are an attractive investment.

Other terms sometimes appear in connection with mortgage bonds. If several companies are united into one corporation, and some of the companies already have mortgage bonds outstanding, the corporation may issue *consolidated-mortgage bonds.* These could be secured by a first mortgage on some of

the property of the new organization but would certainly include a second mortgage on a portion of the property. The word *refunding* is also added to many mortgage-bond issues. This is done when an old issue is paid off from proceeds received by a new series.

Occasionally a firm is so strong that it does not feel the need for stating any security behind the issue except the general good credit standing of the organization. In this case the bonds are called *debenture bonds.* The Standard Oil Company of New Jersey has outstanding an $85,000,000 issue of 25-year, 3 per cent, debenture bonds due in 1961. All United States Government bonds are of the debenture type.

Method of Repayment. Prospective investors would like to be sure that, when their bonds mature, the company will be financially able to pay back the money borrowed. Consequently, the plan by which this objective is to be attained is announced at the time the securities are sold. If the total issue runs into millions of dollars, the problem of repayment might be a very grave one, as most corporations do not have this amount of idle money on hand at any given time.

There are two common methods of repayment, which result in liquidating the debt. One is to issue bonds that mature in different years so that the impact of the full amount will not be felt at a given date. Such bonds are known as *serial bonds.* For example, a twenty-year $1,000,000 issue might run for ten years without any bonds maturing. At the end of the tenth year, and annually thereafter for ten years, $100,000 worth of bonds mature and are redeemed by the company.

Another method of repayment is the establishment of a sinking fund. Under this plan, the issuing corporation deposits annually with the trustee an amount of money that, at the expiration of the bond issue, will equal the amount due. Using the same size of issue as that in the preceding illustration, the corporation might deposit $50,000 a year with a trustee. At the end of twenty years, assumed as the life of the bonds, the deposits would amount to the face value of the total issue. Actually, the size of the annual deposits could be smaller because of interest earnings on the funds in the hands of the trustee. Such bonds are called *sinking-fund bonds.*

Callable or Redeemable Bonds. Although bonds must be retired when they mature, it may be desirable on the part of the debtor corporation to liquidate the debt at an earlier date. To make this possible a clause is frequently inserted in the indenture providing that the bonds can be called at the option of the issuer, usually at a premium. Such bonds have what is known as a callable or redeemable feature. In recent years, due to a declining interest rate, the opportunity to repay a bond issue prior to maturity has been used in numerous instances. For example, a company issued ten million dollars' worth of bonds in 1924, which were to run for fifty years, and carried an interest rate of 6 per cent. Later, this corporation believes it can sell a new issue at 3¼ per cent at par. Even though it may cost $1,050 to redeem a $1,000 bond, because of the premium provision on early redemption, the saving in interest will more than offset this added cost. Within two years the interest saving will amount to $55, which will more than offset the $50 premium, and after that an annual saving of $27.50 will be in effect on each $1,000 bond outstanding.

Convertible Bonds. Bonds, by their very nature, appeal to a conservative class of investors. These people prefer a regular annual return of a stated amount and the relative stability of the value of their investment. In order to attract buyers who usually restrict their purchases to the more speculative possibilities of common and preferred stocks, some bond indentures provide for the exchange of such bonds into stocks at the option of the holder. These are known as *convertible bonds.*

A typical convertible feature would allow the holder of a $1,000 bond to exchange this for forty shares of preferred stock. If, at the time the bond is sold, the shares of stock are selling for $20 each, the conversion privilege is of no value. However, if the stock advances to $30 per share, either the bond will rise in value to $1,200 or it can be exchanged to yield a profit of $200. Convertible bonds are frequently sold by corporations without a national reputation in order to enhance the sales appeal of such issues, although a contradiction to this statement is found in the 3 per cent convertible-debenture bonds, due in 1956, convertible into common stock of the American Telephone and Telegraph Company.

Income Bonds. One of the strongest objections to bond issues is the problem faced by the corporation of paying, usually semiannually, a fixed charge in the form of interest. In order to avoid this hazard to continued financial solvency, some corporations have issued income bonds, which pay interest only if it has been earned during the year of payment. These bonds usually result from a reorganization of a company that has been in financial straits, as income bonds would be difficult to sell in competition with bonds not containing such restrictions. The Wabash Railroad has two issues of general income bonds outstanding, bearing 4 per cent and 4½ per cent interest, due in 1981 and 1991.

Premium or Discount. If the corporation selling an issue is particularly strong, or if the bond market is good, or if the interest rate offered is relatively high, an issue may be sold for more than its face value. The excess amount is called a *premium.* If a bond with a face value of $1,000 can be sold for $1,037.50, the $37.50 is the amount of the premium. If conditions are the reverse of those indicated above, a $1,000 bond may be sold for $950 and, in this case, the $50 reduction from the face value is known as the *discount.* Strictly speaking, a premium or discount on a bond is not a feature of a bond issue as it is not incorporated into the indenture. Nevertheless, the ability to buy a bond at less than its face value, or the need for paying more than its stated value, may influence a prospective purchaser more than many bond features.

PREFERRED STOCKS

General Features of Preferred Stocks Some investors feel that preferred stocks occupy a middle ground between bonds and common stock. Preferred stocks resemble bonds in that a stated rate of annual return is indicated, and they are similar to common stocks in that they do not mature and any return on the investment is known as a dividend rather than as interest. In a legal sense, however, preferred stocks are closely allied to common stocks and have nothing in common with bonds. They are a form of ownership and, despite the stated rate of return, such as a 6 per cent

preferred stock, this dividend is not owed until so declared by the board of directors of the corporation.

The right to sell shares of preferred stock must be obtained from the state, and the general and specific features of these securities are usually noted at this time. These features are also printed on the face of the stock certificate. All preferred stocks have a preference as to dividends, and are either participating or nonparticipating, cumulative or noncumulative, voting or nonvoting, and par or no-par.

Preference as to Dividends. The very name "preferred stock" indicates that this type of stock must have a preference over another type. Without exception, preferred stockholders receive dividends before common stockholders. If a company has some earnings, but not enough to warrant declaring dividends on both preferred and common stocks, the preferred stocks will be favored. The board of directors of a corporation have the right to "pass" the dividend, which means that the dividend that might be expected by the preferred shareholders is not declared. However, it is not legal to declare a dividend on the common stock unless the dividend on the preferred stock has been declared.

Participating or Nonparticipating. Preferred stocks have an established dividend rate. For example, an issue may state that the return shall be six dollars a year per share. When the firm is particularly successful, however, the preferred stockholders will be limited to an annual return of the amount stated unless the stock is participating. In other words, participating preferred stock allows the owners to share in excess earnings, whereas nonparticipating preferred stock limits the annual dividends to the amount stated at the time of issue.

If a company has outstanding 1,000 shares of preferred stock on which the established dividend rate is $5 and 1,000 shares of common stock, and has earnings of $25,000 available for dividends, the distribution of this amount will vary between the two stockholding groups depending on whether the preferred is participating or nonparticipating. If the latter, $5,000 will be paid to the preferred stockholders and $20,000 to the common stockholders. If the preferred stock

A Certificate for Shares of Preferred Stock

The features of the preferred stock are printed on the back of the certificate. They include the dividend rate, the accumulation of dividends, the voting rights, and the conditions under which the preferred stock may be redeemed.

Because the directors are elected by the common stockholders, it might follow that the preferred stockholders would not receive fair treatment. In order to protect such investors against arbitrary acts of the board, restrictive voting rights are usually permitted. For example, if a bond issue that might jeopardize the favored position of the preferred stockholders was contemplated, the stockholders might be granted the privilege of voting on this matter. Or, if several dividends on the preferred stock have been passed, the right to vote may be achieved by this group. In some instances preferred stockholders acquire exclusive voting rights in electing a board of directors if a stated number of dividends have not been declared and paid.

Par or No-Par. Almost all preferred stocks are issued with a stated value printed on the face of the certificate, which is known as its *par value*. If no stated value is so indicated, it is

known as *no-par stock*. The fundamental distinction is whether the stock certificate does or does not carry a printed monetary value. The board of directors have the right to assign an arbitrary stated value to a share of no-par stock, but such an action does not change its nature.

When the preferred stock has a par value, for example, $100 a share, the dividend rate is given as a percentage, such as 5 per cent. Also, the stock may be sold at a premium or discount, above or below par, as in the case of bonds. If the stock has no face value, the dividend rate must be stated in terms of dollars, such as a $5 preferred stock. As stated, most preferred stocks have a par value although an example of a well-known corporation with no-par preferred stock is the Goodyear Tire and Rubber Company.

Special Features of Preferred Stocks There are fewer varieties of preferred stocks than there are of bonds. Nevertheless, special features are incorporated into the agreement or contract under which authority is granted for the sale of this type of security. These include provisions for conversion, redemption, and special preferences. Other features may arise also as a result of issuing another series or of having dividends guaranteed by another corporation.

Convertible Preferred Stock. Although preferred stocks are more subject to market fluctuations in price than are bonds, they represent a more conservative investment than do common stocks. In order to enhance their attractiveness to investors, a clause providing for conversion into common stocks is sometimes included in the preferred stock contract. If a preferred stock selling for $100 a share is convertible into four shares of common stock, and the common stock is quoted at $22 a share, there is no value to the conversion privilege. Should the selling price of the common shares exceed $25 a share, either the preferred stock will advance in price in proportion or the option could be exercised for a profit. A practical illustration of a convertible preferred stock is an issue of the United Aircraft Corporation, which can be exchanged for two and one-half shares of the common stock of that corporation any time prior to January 1, 1952.

Callable or Redeemable. Another special feature of some preferred stocks, which is similar to a common provision in bond issues, is the inclusion of a call price at which preferred stocks may be redeemed at the option of the issuing corporation. If no such feature is included in the original agreement, there is no legal right by which a corporation can call in any outstanding preferred stock. The only possibility in this case would be to buy the shares on the open market; but, if some owners refused to sell, these shares would remain outstanding as long as the corporation was in existence. The 5 per cent preferred stock of the United Aircraft Corporation, referred to in the preceding paragraph, is redeemable at $105 a share plus accrued dividends on or before January 1, 1952 and thereafter at $102.50 a share plus accrued dividends.

Preference as to Assets. Most preferred stocks have a prior claim on assets in case it is necessary to dissolve the corporation. This means that preferred stockholders will be paid the amount due them before any distribution is made to common stockholders. In case a corporation is liquidated, the first task is to sell all of the assets. Cash received must be used to pay off all liabilities including all bond issues, before giving any consideration to the ownership group represented by preferred and common stocks. At this stage the preferred stockholders will be in an advantageous position if their stock is preferred as to assets. Otherwise they would share equally with the common stockholders in any distribution that could be made.

Guaranteed Dividends. Another special feature in some preferred-stock issues is a guarantee of dividend payments. This must be made by another corporation and is valuable only if the ability of the other corporation to pay these dividends is so great that there is no question of the value of the guarantee. If Company H guarantees the preferred-dividend payments of Company A, Company A pays the dividends if it is able to do so. If not, Company H makes the payments; but if it, too, is in financial straits, it is obvious that the guarantee is worthless.

The conditions that create the need for such a guarantee are illustrated by the following. Company H wishes to secure

control of Company A but, because the preferred stock does not have voting rights, it is interested only in buying a majority of the common stock of Company A. The preferred stockholders may become alarmed at this change in ownership, perhaps justifiably so, and threaten a suit against Company H or the stockholders who are proposing to sell their common stock holdings on the grounds that their interests are being jeopardized. In order to prevent such an action, which at least would delay the completion of the purchase, Company H may allay the fears of the preferred stockholders by agreeing to guarantee the dividend payments on their stock.

Series Issues. Some corporations have issued more than one series of preferred stock, in which case there exists a preference even among the outstanding preferred stocks. For example, a corporation may have sold a first-preferred stock and a second-preferred stock. Usually the rate of return varies on the different series with a higher rate going to the less desirable preference stock. The Goodyear Tire and Rubber Company has a $5 convertible preferred stock, cumulative, no-par value, and a second-preferred stock, $7, cumulative, no-par value. Public utility and railroad companies frequently have three or more different series of outstanding preferred stocks.

COMMON STOCKS

General Features of Common Stocks Common stocks are the least complicated of all long-term securities. No dividend rate is ever stated. Except as noted below, voting rights are not restricted. Common stocks represent ownership at the lowest or residual level. Consequently, common stock cannot be convertible because conversion rights always provide for an exchange into a lower level security. Also, dividends on common stocks are not cumulative, as there would be no point to such a provision. If it is possible to make up dividends not declared in former years, the procedure is to pay a large dividend in the current year.

In exactly the same manner as preferred stocks, common stocks may have a par value printed on the face of the certificate, or the stock may be of the no-par variety. As a gen-

eral observation it might be stated that a majority of common stocks are no-par, whereas most preferred stocks are of the par-value type. If the common stock does have a par value, it is likely to be $10 or $25 while most preferred stocks have par values of $100.

Special Features of Common Stocks In order to retain control of voting rights and, at the same time, avoid the restrictions of preferred stocks, some corporations have issued more than one class of common stock. The main distinction between Class A stock and Class B stock, which are the names given to different issues of common stock, is voting privileges. One class votes, the other does not. Usually the Class B retains the exclusive right to vote, although, in some instances, the Class A votes and the Class B does not. This is true of the Class B common stock of the American Tobacco Company as the Class A has exclusive voting power. A provision rarely included is a difference in dividend rates or dividend preferences. In this event, Class A stock assumes many of the characteristics of a preferred issue.

Examples of Corporate Long-Term Securities Although the examination of the long-term securities of any one corporation will not reveal all of the classes of securities discussed in this chapter, the following examples taken from the published balance sheets of several businesses of different types dated December 31, 1945, are typical:

The Cincinnati Gas & Electric Company

First Mortgage Bonds, 2¾% Series, due 1975	$ 45,500,000
Preferred stock—authorized 800,000 shares; issued and outstanding 270,000 shares of cumulative 4% series; par value $100 per share	27,000,000
Common stock, no-par value—authorized 1,000,000 shares; issued and outstanding 771,545 shares	7,715,450

Deere & Company

Twenty-year 2¾% debentures, due April 1, 1965	19,500,000
Preferred stock—authorized 2,000,000 shares of $20 par value each; issued 1,550,000 shares	31,000,000
Common stock—authorized 5,000,000 shares of no-par value; issued 3,007,908 shares	30,079,080

The Goodyear Tire & Rubber Company

First Mortgage and Collateral Trust 3½%-2¾% bonds	$ 36,090,000
$5 convertible preferred stock, cumulative, no-par value; authorized, 666,792 shares; issued, 614,719 shares; in treasury, 6,865 shares; outstanding, 607,854 shares	60,785,400
Second preferred stock, $7 cumulative, no-par value; authorized, 189,025 shares; outstanding, none	
Common stock, no-par value; authorized, 5,000,000 shares; issued, 2,060,965 shares; in treasury, 2,288 shares; outstanding, 2,058,677 shares	10,997,032

Inland Steel Company

First Mortgage Series "F" 3% Sinking Fund Bonds, due April 1, 1961	22,157,000
Serial Notes 1½% payable to bank in installments of $625,000 on June 28 and December 28 in each year to 1953	8,750,000
Capital stock—authorized 1,650,000 shares of no-par value; issued and outstanding 1,633,105 shares	62,500,000

The Quaker Oats Company

Twenty-year 2⅝% Debentures, due July 1, 1964	10,000,000
Serial Notes 1⅞%, due $500,000 annually July 1, 1946-July 1, 1954	4,500,000
Preferred, 6% cumulative, $100 par value. Authorized 250,000 shares, issued 180,000 shares	18,000,000
Common, no-par value; authorized 800,000 shares; issued 702,000 shares	16,155,660

Swift & Company

Twenty-year 2¾% debentures, due May 1, 1961	12,500,000
Serial debentures—1.55% to 2.05%, due May 1, 1947 to May 1, 1951, inclusive	6,250,000
Capital stock, par value $25; authorized and issued 6,000,000 shares	150,000,000

Westinghouse Electric Corporation

Debentures, 2⅛%, due November 1, 1951	20,000,000
Preferred, 7% cumulative participating; par value $12.50 per share; authorized 320,000 shares; issued 319,896 shares	3,998,700
Common, par value $12.50 per share; authorized 15,680,000 shares; issued 12,856,394 shares	160,704,925

QUESTIONS

1. Why is proper long-term financing important to all types of business?
2. Is it satisfactory to borrow money from a bank for fixed capital needs?
3. What are the normal sources of long-term funds available to sole proprietorships and partnerships?
4. What are the chief sources of long-term funds used by corporations?
5. What is the chief distinction between bonds and stocks? What are some additional differences?
6. Why is it necessary to appoint a trustee for a bond issue?
7. Under what circumstances would it be desirable to own a registered bond? a coupon bond?
8. What is the difference between an indenture and a debenture?
9. Do preferred stocks have any advantages over bonds to either the corporation or the owner?
10. Do common stocks have any advantages over preferred stocks to either the corporation or the owner?
11. Assuming that a corporation can issue any type of bonds, preferred stocks, and common stocks that it wishes, what features would prove least restrictive in each class of security?
12. Assuming that an investor can purchase bonds, preferred stocks, and common stocks, what features in each class of security would prove most beneficial to him?
13. It is a fact that the largest number of investors in corporation securities own common stocks. Why?
14. Corporations have access to more sources of long-term capital than do sole proprietorships and partnerships, and this factor tends to promote large corporate units in contrast to small proprietorships and partnerships. Is this condition desirable for business in the United States?

PROBLEMS

1. Company A has outstanding the following securities: First Mortgage Bonds, 3½%, due 1980, $10,000,000; Serial Debenture Bonds, 4½%, due 1975-85, $5,000,000; Cumulative, Nonparticipating 5% Preferred Stock, $5,000,000; and No-Par Common Stock, 50,000 shares, $5,000,000. Company B is just as large, but it secured all of its capital from the sale of 250,000 shares of common stock with a par value of $100 a share.

Neither company has paid any dividends for three years, although Company A has kept up interest payments on the bonds outstanding. The operations for the next year are successful, and both Company A and Company B desire to pay $1 per share on the common stock. Compute the amount of net income (before interest or dividends) needed for each company.

2. The capital funds of two corporations, A and B, are obtained as follows:

	COMPANY A	COMPANY B
5% Bonds	$100,000	None
5% Cumulative Preferred Stock	200,000	None
Common Stock, $100 par value	200,000	$500,000
Total	$500,000	$500,000

The two companies made the same profits before the payment of interest on bonds for a period of three years. These profits were as follows: first year, $15,000; second year $25,000; and third year, $45,000.

If all the profits available for dividends on common stock were paid each year, how much would a stockholder receive per share in each of the two companies in each of the three years?

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CHAPTER 20

SHORT-TERM FINANCING

Short-Term Capital Needs Practically every business firm secures part of the funds that it uses in its operations from individuals, corporations, or financial institutions who expect to be repaid within a relatively short time. The extension of credit on the part of the seller to the buyer is general throughout all lines of business, and short-term borrowing is also very common. Debts with a maturity of less than one year are usually classed as *short-term obligations.*

In the preceding chapter it was noted that funds used for permanent or semi-permanent items, such as land, buildings, and equipment, were most appropriately secured from long-term sources. A minimum stock of merchandise or raw materials and of supplies, as well as a minimum cash balance, should also be financed in this manner. However, increases in these items beyond minimums, which may occur for any number of reasons, such as seasonal variations, may be financed on a short-term basis and justifiably so.

For example, a retail department store may find it necessary or desirable to buy a large stock of many types of merchandise in September and October in order to have an adequate stock of merchandise available for Christmas buying. Payment for these goods is made before they are sold by borrowing money on terms of sixty or ninety days. Within this time the merchandise is sold to customers and cash is realized from such sales. This cash provides the means to repay the loan, which is the reason that transactions of this type are known as *self-liquidating loans.* Because the need for such large purchases may not occur at any other time during the year, it would be foolish to secure necessary funds from long-term sources. If bonds were the basis for the necessary funds, it would be necessary to pay interest for twelve months each year rather than for sixty or ninety days.

The above example illustrates the difference between fixed capital and circulating capital. The assets of a firm that will

be retained for a long time are classed as *fixed capital* and such assets should be purchased by using invested funds or through the sale of long-term securities. The assets of a firm that are converted rather rapidly into cash, which in turn is used to pay off current obligations, are called *circulating capital.*

The need for buying a large stock of seasonal merchandise is only one of many possible business conditions that call for capital most appropriately secured from short-term sources. The firm may have an opportunity to buy supplies adequate for several months at a reduced price because of the quantity involved. The payment of taxes at specified dates may deplete the cash balance to a dangerously low level, or even exceed the available balance, unless the firm resorts to borrowing. Other situations that tend to cause large outlays of cash are payments of interest and dividends and payments for bond-redemption purposes. Such payments are due at certain dates, and these dates may come at a time when the cash balance has not been built up to a total large enough to handle a large withdrawal.

Short-term borrowing is caused most frequently perhaps by the seasonal nature of the operations of many businesses. Businesses that are considered stable usually have some seasonal variations and other businesses, such as canning factories, resort hotels, and manufacturers of fireworks, have extreme fluctuations in their month-by-month business. In these cases it is better to borrow for the necessary number of months from sources that specialize in short-term capital rather than to secure permanent financing, which will result in large sums of idle money for many days or months of each year. The cost of having available as much money as is needed for the necessary length of time will be less if short-term rather than long-term borrowing is used.

Types of Short-Term Obligations There are several types of short-term obligations. Differences in the need may dictate which one to use. The credit standing of the firm may be the deciding factor, or expediency may determine the choice. An examination of the types most commonly used will clarify distinctions among them and indicate their appropriate uses.

Open-Book Accounts. A very common form of borrowing, although it is frequently not thought of as a loan, is the purchase of merchandise, supplies, or equipment on credit. The housewife who makes day-by-day purchases from a grocery store or a department store without paying for the goods immediately is actually borrowing money from the store owner. *Charge accounts*, as they are called in the retail trade, are encouraged by the merchants, as this easy method of buying increases sales, and losses on unpaid bills have proved to be small. Short-term loans of this type in which the seller keeps a record of the amount owed by the purchaser are known as *open-book accounts.*

Somewhere between 85 and 90 per cent of all business transactions involving the sale of goods in the United States make use of the open-book account. The manufacturer buys raw materials on credit terms, converts them into finished products, and sells them to a wholesaler on open account. The wholesaler sells the goods to retailers without requiring immediate payment, and the retailer may do likewise in the case of the consumer. When consumers pay for their purchases, the cash received by the retailer permits him to pay the wholesaler who, in turn, can pay the manufacturer. Although the manufacturer may have already paid for the raw materials involved in producing the goods that have now been sold to the ultimate consumer, the receipt of cash from the wholesaler will permit him to pay for more recent purchases that have not yet been converted into finished products.

Length of Credit Terms. Credit terms vary in length of time. The consumer is usually expected to make monthly payments. The retailer is more likely to be given thirty days from the date of his purchase, and the wholesaler and manufacturer may receive as much as sixty or ninety days in which to make settlement. An exception to these general statements occurs whenever purchases are made on the installment plan.

Frequently the maximum length of the credit terms is not used because the seller allows the purchaser a cash discount if payment is made within a few days from the date of the invoice covering the shipment. For example, an invoice may carry the terms: 2/10, net 30. Under this arrangement a $100

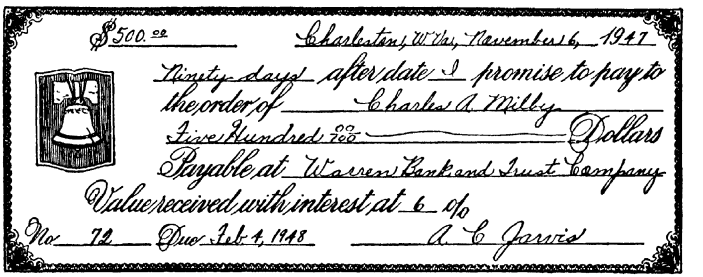
purchase can be paid in full by mailing a check for $98 within ten days after the date of the invoice. If this option is used, it means that the short-term capital secured from the other party is only of ten days' duration. Moreover, the firm that receives the cash can also take advantage of cash discounts, and the flow of payments described above is speeded up all along the line.

Credit Ratings. Not all business firms and individuals enjoy the privilege of buying on credit. Most established businesses have a proved reputation for prompt payment of their accounts, and the seller is willing to ship goods without requiring any tangible promise to pay. However, new customers must establish a credit rating in order to be trusted by the seller. This can be accomplished in several ways. A firm may list the name of its bank on its letterhead and invite concerns with whom it wishes to do business on credit to write the bank to verify the financial responsibility of the organization. Dun and Bradstreet, a nation-wide mercantile credit-rating company, lists thousands of large and small business organizations in their publications. Subscribers to this service can determine the credit standing of a prospective customer on a moment's notice.

Some types of businesses, such as retail department stores, have established credit-rating agencies, which operate within their special field. This agency is supported by all of the stores in a particular city and can supply accurate information on individuals who have maintained accounts at any of the stores. Personal interviews, by which information is gathered concerning the employment and banking connections of the person who wishes to open a charge account, are also used by retail stores. Several credit organizations operating on a nation-wide basis will make an investigation of a prospective purchaser.

Promissory Notes. A *promissory note* is a written instrument in which the maker promises to pay to the party named a definite sum of money at a determinable future date. The *maker* is the signer of the note and eventually becomes the payer. The person in whose favor the note is drawn is called

the *payee*. Most promissory notes bear interest at a rate that is stated on the face of the instrument. A common form of promissory note, or note payable as it is frequently called, is illustrated below.


$500.00 Charleston, W. Va., November 6, 1947

Ninety days after date I promise to pay to the order of Charles A. Milby

Five Hundred 00/100 Dollars

Payable at Warren Bank and Trust Company

Value received with interest at 6 %

No. 72 Due Feb. 4, 1948 A. C. Jarvis

Promissory Note

The above note carries the words "pay to the order of" before the name of the payee. Either this phrase or the words "or bearer" following the name of the payee make it possible for that individual to pass the note on to another party by signing his name on the reverse side of the instrument. This signature is known as an *endorsement*, and the note is known as a *negotiable instrument*. Most notes are designed to be negotiable and may pass through many hands before they mature.

The maker of a note fills in the name of the payee. This may be a bank or a business firm from whom he has purchased merchandise or equipment. If a bank is named, the usual purpose is to borrow money. For example, the Remy Corporation may sign a $1,000 note in favor of the Second National Bank, the note to run for three months with interest at the rate of 6 per cent. This means that, for the privilege of using the bank's money for three months, the firm is willing to pay a fee of $15, which is the amount of interest involved. The customary bank practice is to deduct this $15 fee in advance and to allow the borrower the use of $985. Interest taken in advance by a bank is known as *bank discount*.

If a note is given by the buyer to a seller for merchandise or equipment purchased, the interest and the face value of the note are both due at maturity. In this case the note is a

substitute for an open-book account. The advantage to the payee of the note is that he has a written promise to pay on the part of the maker of the note, the amount involved and the time of payment are clearly stated, and he will probably receive interest in addition to the principal. At maturity, if the maker does not pay the note, it is much easier for the holder to establish his claim in a court of law than would be the case if an open-book account were involved.

Sometimes, the maker of a note does not have a satisfactory reputation for payment of such obligations, or he may not have had the opportunity to establish a proved performance record. If such an individual attempts to borrow money from a bank, he will run into difficulty as the bank wishes to be reasonably sure that payment will be made at the expiration of the loan. In this event, the bank may ask that someone else guarantee the performance of the terms of payment by signing his name on the back of the note, even though the third party has no direct interest in the transaction. Such an individual is known as an *accommodation endorser.*

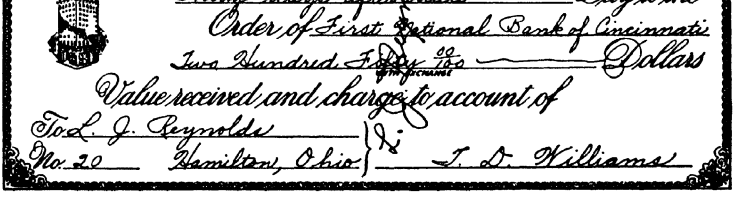
Every person who endorses a note is liable to any person who holds the note after the endorsement was made. An accommodation endorser, by placing his name on the note, is liable for payment in case the maker does not meet the terms at the maturity date. For example, Mr. Blake borrows $300 from the City National Bank and Mr. Sutton signs as an accommodation endorser. If the note is due on June 1st and Mr. Blake cannot pay on that day, Mr. Sutton is liable for the full amount.

Another method used by some lending agencies, particularly loan companies, to protect themselves against possible loss is to require that the note be signed by more than one person. The individual or individuals who sign the note, in addition to the party receiving the money, are known as *comakers* or *cosigners.* The only difference between this procedure and that of the accommodation endorser is that cosigners are directly liable for the note, whereas the accommodation endorser is not required to pay until after the maker has defaulted on his obligation.

Another possibility of securing a loan from a bank is to discount a customer's note instead of an original note payable.

If Mr. Jacobs gives the Pine Tree Manufacturing Company a note in payment for merchandise purchased, the company may secure cash by discounting this negotiable instrument at its bank. Because the note is made out to the Pine Tree Manufacturing Company, it must be endorsed by that organization, which gives the bank two sources of repayment, the signer and the original payee who has endorsed the note over to the bank. In the hands of the bank this note would be known as *double-name paper.*

Commercial Drafts. The main distinction between a commercial draft and a note is the impetus that gives rise to this type of short-term obligation. In the case of a note the maker gives the note to the payee. In the case of a commercial draft the person who draws up the instrument, known as the *drawer,* is frequently the payee. He sends the draft to the *drawee,* the person from whom he expects to receive payment, and this individual, if he accepts the draft, is known as the *acceptor* and eventually becomes the payer. The act of acceptance is very similar to signing a note.



Time Draft

A commercial draft sometimes originates in a manner similar to the following. Mr. Williams, a distributor of tobacco products, sold a shipment of cigarettes and pipe tobacco to the Reynolds Drug Store, owned and operated by Mr. Reynolds. The amount involved was $250, and at the conclusion of the usual thirty-day credit period for open-book accounts, Mr. Reynolds failed to make payment. Mr. Williams asked him for a note but, despite promises, the note was not forthcoming.

Consequently, Mr. Williams drew up a commercial draft, which he sent to Mr. Reynolds' bank with the request that the bank present the draft to Mr. Reynolds for acceptance. When the draft was presented by the bank for acceptance, Mr. Reynolds wrote his name on the face of the draft in the manner shown in the illustration on the preceding page. The draft was then returned to Mr. Williams.

Drafts may be time drafts or sight drafts. In the space provided, the drawer may insert such words as "sixty days after date" or "thirty days after sight," which means that a period of time elapses between the time of acceptance or the date of the draft and the maturity date of the draft. However, if the words "at sight" are inserted in the proper space, the drawee indicates his acceptance by making payment.

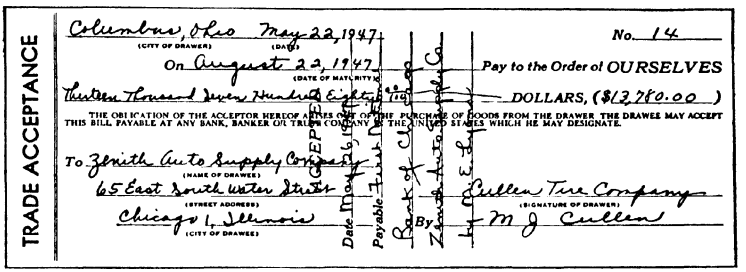
A sight draft may be used to make a shipment by freight on a cash-on-delivery basis. The shipper secures an *order bill of lading* from the railroad company. This means that the railroad agent at the destination point is not to release the goods until this bill of lading is presented. The shipper attaches a sight draft to the order bill of lading and mails it to the bank of the purchaser of the goods. In order to secure delivery on the shipment, this individual must accept the sight draft by paying it. Following his acceptance of the sight draft, he is given the order bill of lading, which permits him to secure the goods from the railroad company.

Trade Acceptances. A *trade acceptance* is very similar to a time draft with the restriction that it must arise in connection with a shipment of merchandise. For example, the Cullen Tire Company receives an order for a carload of passenger-car tires from the Zenith Auto Supply Company. The tires are shipped and at the same time a trade acceptance is mailed to the buyer. He receives the merchandise, checks the quality and quantity, and signs the trade acceptance. This may provide for payment three months from the date it is signed and is held during this period by the Cullen Tire Company unless this firm decides to discount the trade acceptance at its bank.

Trade acceptances are considered preferable to ordinary notes and drafts because they always originate in connection with a sale of merchandise at the time of the sale. When this

merchandise is sold, the firm accepting this type of a draft should be in a position to pay the amount owed because the disposal of the goods will provide the funds with which to meet the obligation. This would not be true if the note or draft were given for many other possible reasons, such as payment for a past-due open account.

A standard form of trade acceptance is shown below. Note the similarity to a draft with the addition of the phrase, "The obligation of the acceptor hereof arises out of the purchase of goods from the drawer."


TRADE ACCEPTANCE

Columbus, Ohio May 22, 1947
(CITY OF DRAWER) (DATE)

No. 14

On August 22, 1947
(DATE OF MATURITY)

Pay to the Order of OURSELVES

Thirteen Thousand Seven Hundred Eighty & 00/100 DOLLARS, ($13,780.00)

THE OBLIGATION OF THE ACCEPTOR HEREOF ARISES OUT OF THE PURCHASE OF GOODS FROM THE DRAWER. THE DRAWEE MAY ACCEPT THIS BILL PAYABLE AT ANY BANK, BANKER OR TRUST COMPANY IN THE UNITED STATES WHICH HE MAY DESIGNATE.

To Zenith Auto Supply Company
(NAME OF DRAWEE)

65 East South Water Street
(STREET ADDRESS)

Chicago 1, Illinois
(CITY OF DRAWEE)

Date Received SEP 6 1947

Payable at First National Bank of Chicago

Accepted Zenith Auto Supply Co.

By

Cullen Tire Company
(SIGNATURE OF DRAWER)

By M J Cullen

Trade Acceptance

Although trade acceptances offer an efficient method of settlement for business transactions involving the sale and purchase of goods by wholesalers and retailers, they are not widely used. The reasons are that the open-book account is preferred by the purchaser and that there is an implied lack-of-credit standing when the trade acceptance is required. Competition for customers forces the seller to extend credit on account rather than to insist on a trade acceptance.

Bank Acceptances. Bank acceptances provide a method of borrowing from a bank, which has the advantage of securing only those funds actually needed and at the time of need. The method of operation is illustrated by the following. The Fairmount Corporation wishes to buy some raw materials and, before ordering, arranges with its bank that it will accept drafts drawn against the bank for the goods to be purchased. If the bank approves this procedure, it will issue statements, known as *letters of credit.* The Fairmount Corporation will

send the letters of credit to the producers of the raw materials with instructions to send the bills of lading to the bank and to draw on the bank for the amount of the purchase price.

When the materials arrive, the bank accepts the drafts and the purchasing corporation executes a *trust receipt* in favor of the bank, which means that the goods are given to them in the capacity of trustee for the bank. Before the draft comes due, it is expected that the raw materials will have been converted into finished products, sold, and that collection of the sales price will have been made. This income provides the means by which the corporation can repay the bank for the amount on which it is liable when the drafts mature. Although this procedure may sound very complicated, in actual operation the use of bank acceptances is relatively simple. They can be used when the credit standing of the buyer is unknown to the seller. By substituting the unquestioned ability of the bank to pay the draft for the individual with only local credit standing, a business transaction that otherwise might not be consummated can be completed.

Overdrafts. A form of borrowing, which is almost unknown in the United States, is to permit a customer of a bank to overdraw his account. This is a common practice in England. The procedure is very simple in that the businessman writes checks for more money than he has in the bank and is charged a fee for the amount and length of time the overdraft is in effect. Usually he arranges in advance the amount by which the bank is willing to allow him to exceed his balance. In the United States most banks insist that the customer maintain a favorable balance and, if a check that will overdraw the account has been written, a loan will have to be made on the basis of a note or the check will not be honored.

Commercial Paper. With the exception of the open-book account and overdrafts, the types of short-term obligations mentioned are given the general classification of commercial paper. However, in a restrictive sense, commercial paper may refer to a special type of credit instrument. This type is the short-term note that is sold by a business to the general public or to financial institutions, such as banks.

Mention has already been made of the fact that notes are usually given to a bank in order to borrow money, or to creditors following the purchase of merchandise. Firms that have a national reputation of excellence in their performance concerning payment of all loans may issue notes payable in convenient amounts, usually $2,500 to $10,000, and sell them to *note brokers* who will place them with clients who are in the market for such short-term securities. These notes may be issued for such short periods of time as sixty or ninety days, but more commonly would not mature for from six months to one year.

The advantages of commercial paper are that money can be borrowed at a lower rate of interest than would be charged by a bank, and the borrower can secure more funds than most banks would be willing or able to lend. The interest rate will depend on the credit strength of the issuer plus general financial conditions existing at the time of sale. The note broker will charge a commission, usually a fraction of 1 per cent, or will make his profit by paying less than the price he assumes he can receive when he sells the notes.

Security for Short-Term Loans

Most of the methods of obtaining short-term funds discussed up to this point have not involved the matter of security. In all open-book accounts, and in most instances of short-term commercial paper, the ability of the individual to repay and his reputation for prompt settlement of such claims are more important than any security behind the loan. Because of the early maturity dates it can be assumed that immediate past performance will be continued in the immediate future. In the case of a bond, which will not mature for several years, it is not possible to make such predictions, and security is frequently an important item in order to make the issue salable. However, even in the case of short-term obligations, there is sometimes security behind the loan. This may take several forms that are not found in long-term securities.

Warehouse Receipts. If goods are stored in a warehouse owned by an independent warehousing company, sometimes known as a *bonded public warehouse*, the owner of the goods

receives a *warehouse receipt.* This paper provides that the merchandise in storage will be delivered to the holder of the receipt upon payment of the accumulated storage charges. Usually such receipts specify that the goods will be released to the person who rented the space, or to his order, or to bearer. This wording makes warehouse receipts negotiable and allows firms to pledge the goods owned as collateral for a loan.

The procedure for borrowing of this type might work out as follows. The Jenny Jones Candy Company purchases one hundred tons of sugar, which is sold on terms of 2/10, net 30. The shipment arrives and is stored in a warehouse because adequate room is not available in the factory. The warehouse receipt is endorsed in favor of the firm's bank and serves as collateral for an ordinary bank loan involving the use of a promissory note. The cash received from the bank allows the candy company to pay the invoice within the discount period. When the note is due, the firm will have to pay it or sacrifice the right to have the warehouse receipt returned. If necessary, the bank can sell the sugar to other users in order to avoid any loss on the defaulted note.

Trust Receipts. A *trust receipt* is a business paper given to a bank to replace other collateral already in possession of the bank, or to secure possession of goods in which the bank holds title. The use of a trust receipt was mentioned in the discussion of bank acceptances. Both of these instruments are used most widely in financing importation of goods from foreign countries. In this case it is obvious why the seller is not always sure of the credit standing of the purchaser.

An example of a local use of a trust receipt arises when the merchandise under control of a bank on a warehouse receipt must be released to the borrower in order for him to obtain funds to repay the loan. If Mr. Wilman has borrowed $5,000 to help finance the purchase of one thousand wool blankets, using a warehouse receipt as collateral for the loan, he has no means of obtaining control of the blankets until the loan is repaid. However, he arranges for the sale of the entire lot for $7,500, payable on delivery to the purchaser who lives in a city five hundred miles away. In order to complete the

transaction, Mr. Wilman gives his bank a trust receipt and, in turn, is given his warehouse receipt. The bank has title to the goods pending their sale, but the seller is able to move the blankets from the warehouse to the home city of the purchaser. When the seller is paid by the purchaser, he has the means to repay the loan.

Pledging Accounts Receivable. Another source of collateral for a loan is to pledge as security all or a portion of the amounts due from customers who have been sold goods on open account. This type of collateral is not usually acceptable to banks, and such loans must be secured from commercial credit houses, which have been organized for this purpose.

Usually, a firm that resorts to this type of borrowing is not very strong financially. It may be that all other sources of short-term funds have been exhausted and more money is needed to avoid failure. However, there are some firms that regularly borrow on their accounts receivable. If the credit terms extended customers are longer than normal, perhaps as high as 120 days, the business may feel that too much of its circulating capital is tied up in accounts receivable, and the commercial credit house provides a means for prompt conversion of some of these accounts into cash.

The usual procedure followed involves the allocation of certain accounts to the commercial credit house with a resulting loan of from 75 to 80 per cent of their total value. The borrower promises to forward all cash received from these customers until such time as the loan plus all other charges has been paid. These extra charges would include the cost of a fidelity bond taken out with an insurance company to guarantee performance of the contract, and a fee for making the loan.

In most cases, the debtor of the firm that borrows the money is not aware that his account has been pledged as security for a loan. He pays the company he owes, and this company remits the amount to the commercial credit house. This is called a *nonnotification plan,* as contrasted with a *notification plan* in which the debtor is told to send payments directly to the finance company loaning the money. Normally, the knowledge that an account has been pledged is detrimental to future business relations.

Occasionally, a commercial credit house will purchase all or a portion of the accounts receivable of a particular business. This condition is particularly true in the textile manufacturing industry. Concerns that specialize in buying accounts receivable outright are known as *factoring companies* or *factors*. When accounts are sold, notification is usually necessary. The factoring company selects the accounts it is willing to buy and offers a price below the possible realizable value. If all of the accounts are collected, a profit will result amounting to the discount at which the receivables were purchased.

Chattel Mortgages. Another form of security for a short-term loan is the chattel mortgage. The chief difference between a mortgage of this type and a real estate or chattel mortgage used in connection with long-term financing is the kind of property that is pledged. A chattel mortgage used for short-term financing gives the holder a lien or possible title to movable property, such as merchandise, supplies, and even cattle or sheep, if ownership of animals is involved in the business. The borrower usually gives a note, which is secured by property already owned or by the property being purchased. In case he fails to live up to the terms of the loan, the loaning agency secures title to the "chattel," as the mortgaged property is called, and can sell it. By doing this, the agency satisfies its claim against the original owner.

The most common use of the chattel mortgage is in connection with the purchase of automobiles both by business organizations and by individuals who use cars for pleasure and not for profit. For example, the Springfield Auto Sales Company sells a delivery truck for $1,600 to Abner Storms, who operates a grocery store. Mr. Storms makes a down payment of $400 on the purchase price and gives a note for the balance, which is secured by a chattel mortgage on the truck. In case payments on the note are not made in accordance with the terms of this loan, the owner of the note can repossess and sell the truck.

Although it is possible that the Springfield Auto Sales Company would retain Mr. Storm's note, or discount it at a local bank, the normal procedure would be to dispose of the note to a finance company. Because of the demands created by

installment sales of durable consumers' goods, particularly automobiles, finance companies that specialize in chattel-mortgage paper have been organized.

In some states, instead of using a chattel mortgage for a transaction such as explained above, a *conditional bill of sale* would be given to Mr. Storms at the time he purchased the truck. Aside from the legal distinction, the general operation of the transaction would be the same. Instead of receiving title and then issuing a mortgage, the owner has a conditional title depending upon his fulfillment of the terms of the sale.

Other Forms of Security. Banks and other loaning agencies will accept other forms of security as protection against possible loss. Bonds, particularly United States Government bonds, and stocks that the borrower purchased from good companies can be deposited as collateral. This procedure is similar to issuing a collateral trust bond, but the amount of the collateral would usually be much smaller in amount and the length of time on the loan would be less than one year. A first mortgage on property may also be used although it is unlikely that a bank would ask for any security from an individual who owned property free from encumbrances unless the amount of the loan was sizeable. The cash surrender value of a life insurance policy, endorsed over to a bank, provides an excellent type of security for a short-term loan. In case the loan is not paid at maturity the loaning agency would not suffer a loss if the amount of the cash value of the policy was equal to or exceeded the size of the loan.

Cost of Short-Term Financing The cost of using other people's money for short-term financing varies tremendously, ranging from zero up to as high as 42 per cent per annum. A comparable condition does not exist in long-term financing. Interest rates on bonds are rarely as low as 1 per cent and seldom exceed 7 per cent. Because interest, which is the customary method of computing cost on a loan, varies so widely on short-term loans, this factor may become an important item in the efficient conduct of the business.

The least expensive method of borrowing is the open-book account. No interest charge is made on current accounts and

rarely on overdue balances. Loans of this type are available to large and small businesses provided their credit standing is satisfactory. Large corporations can borrow money on commercial paper by selling these obligations at their face values even though interest rates are as low as 1 per cent.

As a general proposition, the better the security, the lower will be the cost of borrowing. Security is not the only factor, but a commercial bank, for example, will loan money at a lower rate of interest if the borrower is able to pledge merchandise, bonds, stocks, insurance policies, or to secure the signature of a cosigner or accommodation endorser. A rate that might be 6 per cent on an "honor" or "character" loan, which means that the borrower's personal integrity is the sole basis for repayment, will drop to 4 or 3 per cent if the security offered presents a generous margin of safety.

Another factor to be considered in computing the cost of a short-term loan is the effective interest rate rather than the announced rate. By this is meant the interest rate on the average available unpaid balance. For example, a 12-month $600 loan is taken out with a loaning agency at an announced rate of 6 per cent. A discount of $36 and the service charge of $12 are subtracted from the face of the loan, and the borrower receives $552. In the second month only $502 can be used by the borrower, for he must repay $50 at the end of the first month. Detailed calculations for the year show that the effective rate is 17.3 per cent as follows:

	AVAILABLE FOR USE BY MONTHS	PAYMENT AT END OF MONTH
First month	$ 552	$ 50
Second month	502	50
Third month	452	50
Fourth month	402	50
Fifth month	352	50
Sixth month	302	50
Seventh month	252	50
Eighth month	202	50
Ninth month	152	50
Tenth month	102	50
Eleventh month	52	50
Twelfth month	2	50
	12) $3,324	$600
	$ 277 Average	

$$\frac{\text{Total Cost of Loan } \$48}{\text{Cash Available for Year } \$277} = 17.3\% \text{ (effective interest rate)}$$

QUESTIONS

1. What length of time normally determines whether a debt is a short-term or long-term obligation?

2. Should merchandise, raw materials, supplies, and other consumable items be bought entirely with funds secured from short-term sources? Why?

3. What is the difference between fixed and circulating capital?

4. Most individuals pride themselves on keeping out of debt. What are some of the reasons why a business might find it desirable to carry a short-term debt at least part of the time?

5. Why are businessmen willing to sell on open-book accounts?

6. What methods are used by businessmen to determine the credit standing of a prospective purchaser who wishes to "charge" the amount involved?

7. If merchandise is sold with terms of future payment, would it be better to secure a note from the purchaser rather than to carry the amount in an open-book account? Why?

8. What makes a business paper negotiable?

9. What is the chief difference between a note and a draft? between a draft and a trade acceptance?

10. What reasons would induce a well-established firm to issue commercial paper?

11. What are some types of security that may be used for short-term borrowing?

12. If a firm borrows money by pledging open-book accounts under a nonnotification plan, is such a loan radically different from one made without any security?

13. What factors might result in a so-called 6 per cent loan actually costing the borrower a higher effective rate?

PROBLEMS

1. Using the following facts, compute the effective interest rate. Mr. Shell borrows $240 at 6 per cent for one year on a note that is discounted and is repayable in twelve monthly payments of $20 each. In addition to the discount, a 1 per cent service fee is deducted as well as a $3 credit investigation fee.

2. Mr. L. M. Nottingham sells merchandise of the value of $750 to Mr. O. P. Quink. A trade acceptance dated February 1, 1947, is

sent to Mr. Quink at the time shipment is made, requesting payment thirty days after the merchandise is received. Mr. Quink accepts the draft on February 4, 1947.

Refer to the illustration on page 395 and construct a trade acceptance form on a blank sheet of paper, inserting the information provided above.

3. For a number of years the Craig Manufacturing Company has found it necessary, because of the seasonal nature of their inventory buying, to borrow $100,000 on March 1 for a period of four months and $50,000 on October 1 for a period of three months. Bank loans have been secured on the basis of a 5 per cent discount rate.

The management of the company feels that it might be desirable to borrow $100,000 on a more permanent basis in order to avoid the necessity for bank loans. An investigation proves that a twenty-year 4 per cent mortgage can be sold for $100,000.

Without regard for other factors that might enter into the decision, would it be advantageous for the Craig Manufacturing Company to make the change that has been suggested?

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CHAPTER 21

FINANCIAL INSTITUTIONS

Financial Institutions Aid Business

To aid business in securing long-term and short-term capital, several types of financial institutions offer their services. In addition to this function, these organizations also render other valuable aids to business. While it is true that a fee is charged for most of these services, the business firm is usually glad to pay. Without the assistance of banks and similar agencies, our modern economic society would find it difficult to operate.

There are companies operating in the financial field that specialize in serving individuals, either as consumers or in connection with their personal financial problems. Still other financial institutions restrict their activities to particular areas, such as automobile financing and home loans. Regardless of their main purpose, all are directly or indirectly helpful in keeping the wheels of industry and commerce turning.

The descriptions of the different types of financial institutions that follow attempt to stress the services rendered by them to the business world and the businessman. The order in which they are presented follows a general pattern of (1) institutions that are primarily of assistance in the field of long-term securities; (2) institutions that are concerned with financing short-term capital needs; and (3) commodity exchanges. The last type of financial institution is not particularly associated with either long-term or short-term capital requirements. Because many types of services may be offered by one financial organization, such a classification cannot avoid being arbitrary.

FINANCIAL INSTITUTIONS FOR LONG-TERM CREDIT

Investment Banks

Investment banks perform a major role in the very important function of raising long-term capital for corporations. Such banks are sometimes

called "security houses," and this title describes, in part, their operations. Banks of this type sell bonds, preferred stocks, and common-stock issues of old and new companies.

If the Trentham Manufacturing Company decides it wishes to construct a new factory building and equip it with the necessary machinery, more capital funds may be needed. If a decision is made to authorize a $1,000,000 issue of mortgage bonds, the problem of selling these securities to the public would loom as almost insurmountable to a company unversed in this field of finance. An investment bank can be contacted and, if it agrees to handle the bonds, the entire problem is solved so far as the manufacturing company is concerned.

Under the circumstances outlined above, the investment bank would make an investigation of the Trentham Manufacturing Company prior to making any commitment regarding the proposed bond issue. Engineers, accountants, and other experts might be employed to examine the firm's existing physical assets and its financial standing. After such an investigation, the investment bank might decide that the proposed expansion was unwise or might recommend a differerent type of security, such as preferred stock or common stock.

Assuming that the reports from the experts employed to examine the firm were favorable, the investment bank would then enter into negotiations to *underwrite* the bond issue. This means that an offer would be made to the Trentham Manufacturing Company to buy the bonds. An acceptance would result in immediate access to the cash involved and the elimination of problems of distribution. The price that the investment bank would be willing to pay would depend on the amount that it anticipates can be realized from the sale of the securities. If their experts guess that the bonds can be sold at par, the firm might pay $960,000 for the issue. The discount of $40,000 would represent the gross profit to the bank, and is technically known as the *spread.*

If the issue is not too large in relation to the size of the investment bank, the institution may handle the entire transaction through its central office and branches. However, if the issue is too large for one firm or if the risk is too great,

several other investment banks may be invited to participate in the financing. Such a group is called a *syndicate.*

Some investment banks specialize in organizing syndicates and in wholesaling blocks of securities to smaller dealers located in various cities. Kuhn, Loeb and Company and J. P. Morgan and Company were for many years the leaders in their field, particularly in issues of railroad bonds. Other investment banks operate a number of retail outlets and are much closer to the actual investor. A few, such as Halsey, Stuart and Company, operate extensively in both the wholesale and retail security fields. This firm originates many issues and also conducts an extensive series of branch offices, with retail salesmen.

Trust Companies Trust companies were originally a special type of bank that performed certain functions not undertaken by commercial banks. Most trust companies today have a commercial banking department, and many commercial banks have a trust department. Some of the former retain in their name an indication of the emphasis placed on trust functions, such as the Fiduciary Trust and Savings Bank of New York City.

Although the major portion of a trust company's business consists of the management of estates and serving as trustee under the provisions of a will, the function of most interest to business is that of serving as trustee of a bond issue. The indenture under which bonds are issued provides that there shall be a trustee to act for the bondholders in their interests. It usually also provides that the amount due for semiannual interest payments shall be deposited with the trustee and that periodic payments shall be made into a sinking fund managed by the trustee.

Another financial service rendered many businesses by trust companies is that of acting as registrar and transfer agent for stock issues. In the role of *registrar,* the trust company guarantees to the investing public that the various issues of stock that may be outstanding are accurately stated and within the limits established by the charter. The duties of *transfer agent* involve recording changes in ownership following each sale of stock. For large businesses with thou-

sands of outstanding shares of stock, which are traded daily on stock exchanges, the service of a transfer agent is necessary and important.

Still another function rendered business by a trust company is serving as a special depository for important papers that are not to be delivered until certain terms are met. For example, the Acme Construction Company agrees to build a factory addition for the Reliable Tool Company provided this company will sell a bond issue in order to raise the necessary funds. The contract for building may be placed in the hands of the trust company to be delivered to the Reliable Tool Company when it completes the agreement to sell the necessary bonds. The legal term "in escrow" is used for such papers while they are in the hands of the trust company.

Investment Companies Investment companies, or investment trusts as they are popularly known, sell shares to individual investors and use capital raised in this manner to purchase securities in other companies. These stocks and bonds are known as the *portfolio* of the investment company. Because these investments are diversified among bonds, preferred stocks, and common stocks and also among many corporations, the investment company offers the individual with limited funds a chance to own, indirectly, an interest in many companies and types of securities.

Investment companies buy securities in the open market and also directly from issuing corporations. In the first instance, they are only indirectly a source of long-term funds because the corporation involved has already received its funds from an original purchaser. To the extent that direct purchases are made of new issues, either from a corporation or from an investment bank, investment companies become a direct source of long-term capital.

There are two main types of investment companies, the management trust and the fixed or semifixed trust. In the *management trust* the managers have the right to change the portfolio whenever they deem it wise to dispose of securities owned, or to purchase shares of any company. In the *fixed trust* the types of securities, companies represented, and the proportions of investment among the corporations are

planned in advance and may not be changed by the management. The *semifixed trust* allows some modifications to be made within stated limits.

Brokerage Firms A *broker* is an individual who buys and sells for others, and charges a commission for this service. Brokers operate in many fields, including investment securities in which they play an important part. In the financial field it is very common for a group of brokers to form a brokerage firm, which not only buys and sells stocks and bonds for their customers, but also assists in financing these transactions.

Some brokerage firms or houses function as investment banks on occasion, and some investment banks also do a brokerage business. In the main, the activity of the brokerage firm is to buy and sell securities that have already been issued. They may be issues that are sold on organized exchanges, or stocks and bonds that have not been accepted for trading by a stock exchange. This latter group are known as *unlisted securities*, and they are traded in what is known as the *over-the-counter market*. A brokerage firm makes contacts with individuals who wish to buy unlisted securities and with others who wish to sell. The price the prospective purchaser is willing to pay is called the *bid price*, as opposed to the *asked price* of the present owner. These bid and asked prices are frequently published; and, if either party meets the offer of the other, a transaction takes place.

Security Exchanges A *security exchange*, commonly called a stock exchange, is an organization that provides facilities for its members to buy and sell securities, which have been certified by the exchange as eligible to be traded. Members of the exchange are individuals, usually partners in a brokerage firm, who are said to own a "seat" on the particular exchange. Securities of corporations that have been approved for trading on the exchange are known as *listed securities*. The most famous and largest security exchange is the New York Stock Exchange.

Trading on Security Exchanges. The chief function of a security exchange is to provide a convenient means by which

individuals or corporations can buy or sell stocks or bonds of well-known corporate enterprises. The prospective investor places his order with a broker, who may or may not be a member of the exchange, and who may be located any place in the world. This order is routed through a brokerage firm in which one or more members own seats on the exchange, and is wired to New York, assuming that the purchase is to take place on the floor of the New York Stock Exchange. Within the space of a few minutes from the time the order is first placed, it is in the hands of the member of the exchange.

On the floor of the exchange there are a number of trading posts at which a specified list of stocks are bought and sold. If the order placed by the investor were for one hundred shares of common stock of E. I. duPont de Nemours and Company, the member would locate the post and make an offer to buy under the terms specified. This might be "at the market"—the current price at which the stock is being sold—in which case the order would probably be filled immediately, because someone is always ready to sell if his offering price is accepted. If a limited order is given, such as $215 a share, and the stock is selling at $220 a share, the member will leave the order with another broker who spends most of his time at one post and is known as a *specialist* because he concentrates his attention on a limited number of securities. The specialist will make a memorandum of the order and, if at a later time in the day or at a later date an offer is made to sell duPont shares at $215, he will execute the order.

Trading is conducted in "round-lots" which normally are one hundred share units. If the order is for twenty-five shares, it will be placed by the member with an *odd-lot broker* who makes a specialty of handling such orders, for which he receives a special commission. By grouping several odd-lot orders he may be able to buy one round lot, which will be distributed to the several purchasers, or he may purchase the additional shares for his own account.

Another interesting feature of stock-exchange trading is the *short sale*. In this transaction, the seller disposes of stocks he does not own and makes delivery by borrowing the shares. If the price goes down after the sale, he will make a profit

Life Photograph

Floor of the New York Stock Exchange

During a marketing session the floor of a security exchange is a scene of intense activity, with brokers milling about the trading posts.

when he purchases the shares to return to the lender; if the price increases, he will lose.

Investors and Speculators. Considerable interest in the fluctuations that take place in stock prices is apparent from the daily market reports carried by most of the metropolitan newspapers, from the announcements over the radio, and from the number of people who visit the offices of brokerage firms in all large cities to watch the "ticker tape," which reports stock sales from the floor of the New York Stock Exchange within a few minutes from the time the transactions are completed. Millions of people own stock in the hundreds of corporations listed on the various exchanges; trading on the New York Stock Exchange frequently exceeds one million shares a day. Many persons buy securities with their savings in the hope of securing a return on their accumulated capital funds, as do some corporations and trusts.

In addition to *investors* who purchase securities with the idea of holding them on a more or less permanent basis, stocks and bonds are bought and sold by *speculators*. In general these are individuals who hope to make a profit by buying and selling within a few days or weeks. Speculators who

buy stocks in anticipation of a rise in price are known as *bulls*; and others who sell short, expecting the market to go down, are known as *bears*. In order to buy or sell more shares than could be financed by his own resources, the speculator may borrow part of his capital from the brokerage firm. This is known as buying securities on *margin*.

Security exchanges are not a primary source of long-term capital because the vast majority of the stocks and bonds sold have already been issued and sales are between holders of these securities and investors and speculators. Some new financing is handled by the security exchanges, but this is relatively minor. However, the stock exchanges render extremely valuable service in the field of long-term financing. Issues that have been listed on the stock exchange can be sold by investment banks much more easily than "unlisted" securities. The maintenance of a free market, with prices established at all times by the forces of supply and demand, makes listed stocks and bonds valuable for purposes of collateral for bond issues and loans. Furthermore, by providing a channel through which millions of individuals have invested their savings in long-term securities, the stock exchanges have made possible the growth of hundreds of corporations.

Insurance Companies Companies that insure individuals and businesses against many types of risks are an important source of capital funds, particularly for corporations that choose to issue bonds. The cash received by insurance companies from premiums paid by policyholders normally exceeds the payments on claims and other business expenditures, which leaves a balance to invest. Life insurance companies are the largest holders of industrial and government bonds. In recent years some corporate-bond issues have been sold in their entirety to a life insurance company, thereby eliminating the usual selling costs.

Insurance companies also render a valuable financial service in assuming risks that an individual in business, or even most corporations, could not afford to carry. For example, many firms carry group health, accident, and life insurance on their employees. If a company were subject to losses that might be caused by accidents to employees working on the

job, a particularly severe disaster, such as a mine explosion, might give rise to so many claims that the firm's solvency would be in question. By carrying insurance, the company limits possible losses to the amount of the annual premiums.

The practice of insuring the life of an officer or executive in favor of the company is also rather common. The success of a business may be tied up with the personality of the president or the aggressiveness of a sales manager. If such an individual should die, the organization might suffer a setback from which it would take weeks or months to recover. By insuring the official in favor of the company, the firm is assured that at his death it will receive a lump sum settlement large enough to make up the loss of revenue that might take place until a satisfactory replacement is trained or hired to fill the vacancy. Partners sometimes take out life insurance in favor of the other partner or partners so that the survivor or survivors will have funds to purchase the partnership interest of the deceased.

Savings Banks Savings banks as separate organizations are the exception rather than the rule; the common situation is a savings department in a commercial bank. In either case, funds deposited by customers are invested in bonds and other securities within limits fixed by law. Interest earned on these investments makes it possible for the savings bank to pay interest on the savings accounts. Savings banks assist in long-term financing because they are able to purchase sizeable blocks of securities with funds assembled from many thousands of individuals whose savings may not amount to more than a few dollars a week.

Building and Loan Associations If a businessman wants to construct a building to house his grocery store, garage, or restaurant, he may find it advantageous to make use of the loaning facilities offered by the local building and loan association. These organizations can be found in practically every city and town throughout the country and are particularly numerous in the Middle West. They specialize in making loans on real estate. Money is secured from investors who are attracted by the higher interest rate offered as contrasted

with the rate paid by savings banks. This money is loaned for new construction or to individuals who are buying property and cannot finance the entire purchase price. A mortgage for part of the purchase price is taken by the building and loan association, which is paid off by monthly payments over a period of years.

Governmental Agencies Under ordinary circumstances, the businessman would not expect his government to be a source of capital funds, nor would he feel that the government should enter into competition with the many financial agencies that exist for the purpose of earning profits. However, during the last two decades, there have been numerous activities on the part of the Federal Government that have resulted in direct or indirect loans to corporations, businessmen, and individuals. Some of these will be discussed to show the reasons for such loans and the direction they have taken.

Reconstruction Finance Corporation. One of the most famous agencies is the Reconstruction Finance Corporation, which was created in 1932 under the Hoover administration. At that time, the great depression of the thirties was under way, and many banks and businesses were in danger of failing unless they could borrow some money. The usual sources for such loans were "dried up" because of the general low level of business activity. In this crisis, the only hope for necessary loans was an agency of the Government that could afford to accept the risks involved.

The R.F.C., as it is popularly called, loaned money to banks, building and loan associations, railroads, and all types of business enterprises. It also gave financial assistance to many other governmental agencies including Federal, state, and municipal operating units. Year by year, its operations were expanded in many directions, notably agriculture and manufacturing facilities for war production. The Defense Plant Corporation, which constructed many war plants, is one of many subsidiaries controlled by the R.F.C. It is interesting to note that the business activities of this Government corporation have been profitable.

Housing Agencies. Another area in which the Federal Government has been active is the housing field. Several agencies were created, of which the best known are the Home Owners' Loan Corporation and the Federal Housing Administration. The H.O.L.C. financed about three billion dollars' worth of home mortgages in an attempt to give relief to owners who were unable to continue payments. The F.H.A. insured loans on new homes up to 90 per cent for low-cost construction and allowed as much as twenty-five years for repayment at the low interest rate of 4½ per cent. Again, the reason for entering this field of finance was the collapse of the normal business procedures. The depression created such an extent of foreclosures in 1933 that it became in the national interest to halt business practices that dispossessed people from their homes. Also, it was in the interest of economic recovery to encourage new construction, even though established financial institutions did not feel able to accept the risks.

Agricultural Financing. Government-financed agencies have also been extremely active in their efforts to assist agriculture. In addition to the reasons mentioned above, commercial agencies for meeting one of the credit needs of farmers did not exist. Reference has been made to long-term and short-term credit, but the agricultural industry needed three- to five-year loans in order to finance machinery and to tide farmers over a possible crop shortage in one or two consecutive years. Loans for these periods are in the time area known as *intermediate credit.* A series of Federal Intermediate Credit Banks were established, which loaned money to co-operatives formed by a group of farmers wanting such loans.

Other agricultural agencies include the Federal Land Banks, the Federal Farm Mortgage Corporation, the Farm Credit Administration, and the Farm Security Administration. The figures of the Farm Security Administration show about a quarter of a billion dollars loaned to approximately 600,000 individuals by these agencies.

With the return of a measure of prosperity to the nation, the activities of loaning agencies of the Government have

been curtailed, and liquidation of loans greatly exceeds new commitments. If the country maintains a high level of national income, it can be predicted that private finance will replace Government finance to a considerable extent.

FINANCIAL INSTITUTIONS FOR SHORT-TERM CREDIT

Commercial Banks The most important institution in the field of short-term credit is the commercial bank. Without question, it is the organization in the financial field with which any business has the most frequent dealings. The relations between a banker and his customer frequently are close and also helpful and friendly.

Commercial banks are chartered by the Federal Government or by the state in which the bank operates. The former are known as *national banks*, and such names as the Second National Bank or National City Bank identify this group. Banks securing a charter from a state are known as *state banks* or, rarely, may be private banks with a state charter. A name such as the First State Bank identifies an institution of this type.

Checking Accounts. From the viewpoint of its customer, the chief function of the commercial bank is to accept money for deposit and to pay out these funds on order. The value to the business firm in having such a service available is extremely high, and yet there is usually no charge involved.[1] If it were necessary to keep large amounts of currency on hand, the risk and cost of providing adequate protection would become a serious matter. The commercial bank provides a solution to this problem, and many business establishments make deposits several times during each working day. By means of night deposit facilities, which are available at most banks, it is possible for the businessman to close his doors each evening with little or no cash on his premises.

[1] Many banks make a service charge if the account is allowed to fall below an established minimum, or they calculate a fee based on the number of deposits and checks drawn, minus an interest credit on the average daily balance. Most business firms maintain large enough bank balances to avoid a service fee.

Currency and checks are the usual items deposited. These are taken to the bank after being listed on a *deposit slip.* A duplicate of this slip is kept by the business firm and, if stamped by the bank, serves as evidence of the deposit. More commonly, a *pass book,* in which the bank teller enters the amount turned over to the bank, is employed.

After money is on deposit, it may be withdrawn or used to pay debts by the use of checks. A *check* is a negotiable instrument signed by the bank customer directing that the amount of money specified be paid by the bank to the payee or his order. The convenience of making payments by check and the advantages of this procedure to the business world can hardly be overemphasized. With the exception of some sales at the retail level, a check is used in the settlement of practically every business transaction.

After a check has been written and mailed but before it has been cashed, it is possible to *stop payment* on the check by notifying the bank in writing. This is not done unless a good reason for the procedure exists, such as discovering that a person obtained the payment under false pretenses. In sharp contrast to this is the *certified check.* This is a regular check of the individual or firm that has been taken to the bank before delivery and "certified." At the time the bank stamps the check as certified, it also charges the amount against the proper bank account. Payment cannot be stopped on certified checks because they represent a liability of the bank.

Bank Loans. Another important function of the commercial bank is to grant credit to its customers. Before a bank will accept a deposit from a new customer, it investigates the reputation and general standing of the individual, partnership, or corporation. It is interested in the integrity and character of the owners or officials. If this investigation proves satisfactory, the bank not only accepts the new customer's original deposit but is willing to grant what is called "a line of credit." This means that the firm is notified in advance that it may borrow on a short-term basis $10,000, $50,000, or whatever the appropriate figure may be, without further examination of the firm's ability to repay the loan.

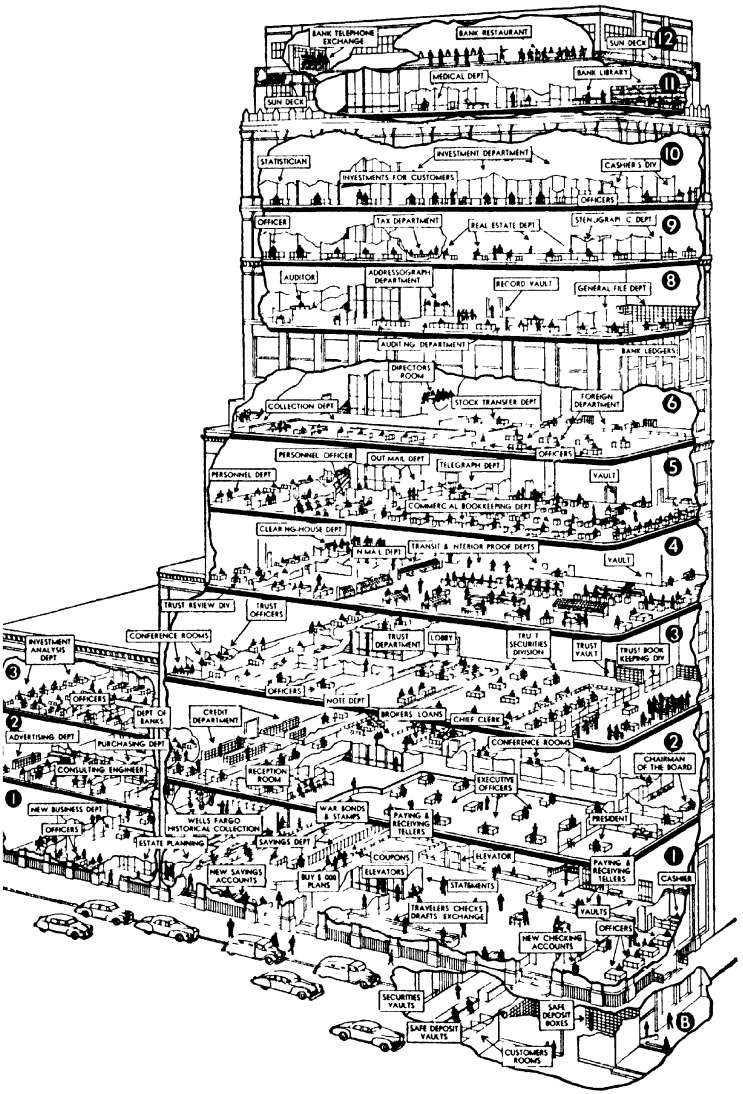
The advantage to a business concern in having available at all times a potential source of short-term capital is easily apparent. If a proposition that would require more cash than is on deposit in the bank is under discussion, the owners or officers know exactly the amount of additional resources that are available on a moment's notice. All that is necessary is to draw up a promissory note and discount it at the bank.

Other Functions of Commercial Banks. In addition to the functions of receiving, paying out, and loaning funds, commercial banks render several other services. Some of these may be listed as follows:

(1) *Safe deposit boxes.* All businesses have valuable papers including stocks and bonds, insurance policies, incorporation papers or Articles of Copartnership, and contracts. The place to store these is in a safe deposit box in the bank's vault constructed for this purpose. Access to these papers can be restricted by instructions to the bank concerning those authorized to present the firm's key. In order to open the box, two keys are required, one of which is retained by the bank. This fact, plus the requirements of an authorized signature each time the box is opened, provides a real safeguard against possible loss, which is far more effective than if the valuable papers were kept in possession of the firm. The rental charge for such boxes, which varies with the size of the box, is nominal.

(2) *Collection of notes, drafts, bond coupons, etc.* When a deposit consisting of currency and checks is made, the bank gives immediate credit for the total of these items. The bank will also accept notes, time drafts, bond coupons, and other similar items for collection and subsequent credit to the account of the business firm. Although a small fee may be charged for such services, the convenience to the businessman is worth much more than the charge made.

(3) *Foreign exchange.* If a business engages in any foreign business, it must face the problem of making payments in foreign currencies or receiving payments involving, for example, pounds sterling in place of dollars. The bank is willing to handle the conversion of United States dollars into



Wells Fargo Bank & Union Trust Co.

A Cut-Away View of a City Commercial Bank Building

The numerous and varied activities of a large, modern commercial bank are indicated in this drawing.

the proper amount of foreign currency, or convert foreign currency into United States dollars.

(4) *Credit information.* Commercial banks are frequently used as a source of information for determining the credit standing of a potential customer of the business or in furnishing similar information about the customer to other banks or business firms. Individuals who open charge accounts with retail stores are usually required to furnish the name of their bank.

(5) *Bank drafts.* If payment is to be made by check to a business located in a large city some distance away, this firm might raise some question about accepting the check, particularly if the local firm is small and unknown. In order to avoid delays that might otherwise occur, the businessman can give his bank a check for the amount, and the bank will write a *bank draft.* This draft is really a check of the bank drawn on another bank, sometimes located in the city in which the other business firm is located. This is possible because the bank has on deposit certain amounts with the larger bank in the other city. The big city bank is known as the *correspondent bank* in relation to the local institution.

(6) *Business advice.* Both small and large banks are prepared to render advice to their customers. In a small bank either the president, vice-president, or cashier is available for this purpose, and many large banks maintain a separate department that employs economists and other experts. Most frequently, this advice is concerned with suggestions regarding investments in bonds and stocks. However, some banks also are prepared to assist their customers with recommendations on such matters as expansion and purchasing of additional inventory. Their specialists study general business conditions and render reports based on such studies.

(7) *Pay rolls.* If a business firm pays its employees in cash, many banks will perform the mechanical job of placing the correct amount of currency in pay-roll envelopes. All the business firm needs to do is to provide a list of names with amounts and a check covering the total involved. The bank will make up separate envelopes for each employee within a few hours after the list is presented.

(8) *Sale of traveler's checks.* If the owner or official of a company, or perhaps a salesman, is taking a business trip and does not want to carry large sums of currency, traveler's checks may provide the most satisfactory solution to this problem. These are retailed to customers by most banks, who purchase them from The American Express Company or from a few other suppliers, notably the National City Bank of New York. Traveler's checks are issued in convenient denominations such as $5, $10, $20, and larger figures. At the time of purchase, the user signs his name to each check and must sign again when the check is cashed. This identification through comparison of signatures permits traveler's checks to be cashed in any part of the world.

(9) *Savings department.* Most commercial banks also maintain a savings department that receives deposits and credits interest against these amounts at six months' intervals. The ordinary business firm rarely makes use of this service.

(10) *Personal loans.* Banks have always loaned money to individuals whose credit standing was excellent or to those who could deposit satisfactory collateral. Within recent years, many banks have installed a personal loan department, which makes small loans of from $100 to $500 to individuals on the basis of their signature or, more commonly, on the basis of double-name paper involving an accommodation endorser or cosigner. These loans differ from ordinary bank loans in that they are made to individuals without adequate credit ratings, repayment is made by weekly deposits, and the rate of interest charged is much higher than for a bank loan involving less risk.

Federal Reserve System All national banks and many state banks belong to the Federal Reserve System. There are twelve Federal Reserve Banks distributed geographically over the United States, and banks do business with the Reserve Bank located in their particular district. Member banks obtain from the Federal Reserve Bank the currency that they pay out and they are permitted to discount certain notes and drafts that they have accepted from their

customers, in much the same manner as the original transactions. These notes and drafts, as well as bills of exchange and banker's acceptances, are known as *eligible paper*, and the process is called *rediscounting*.

One of the important functions of the Federal Reserve Bank is clearing interdistrict and intradistrict checks for its members. If a check that is drawn on a bank in San Francisco is deposited in a Chicago bank, it must be sent to the bank in California for collection. This process is known as *clearing a check* and is handled by the two district Federal Reserve Banks involved, the one in Chicago and the one in San Francisco. Or, if a check is received by a bank in San Antonio, Texas, drawn on a bank in Houston, Texas, it will be cleared by the Dallas Federal Reserve Bank as both of the other cities are located in the Dallas district.

Federal Deposit Insurance Corporation All members of the Federal Reserve System and most other banks belong to the Federal Deposit Insurance Corporation. This organization was created in 1933 by the Federal Government to insure deposits up to $5,000. An annual fee of one twelfth of 1 per cent of the average deposits is paid to the Corporation, which provides a fund to make payments to depositors in banks that are forced to close. Under this plan, a businessman can carry an account at a local bank with complete confidence that his bank balance up to $5,000 is guaranteed by the Federal Government if the bank is forced to close its doors.

Commercial Paper Houses Reference has already been made to the sale of notes, maturing within six months to one year, that are issued by firms with national reputations. Most of these notes are purchased outright or sold on a commission basis by commercial paper houses. These organizations specialize in handling such notes and employ salesmen who retail them to commercial banks, investors, and other purchasers interested in this type of investment. The commercial paper house serves a useful function in relieving the issuing firm from the problem of distribution, and in making available to its customers a diversified list of high-

grade short-term paper. It performs a function for business in the field of short-term credit similar to the service rendered by investment banks in the sale of long-term securities.

Finance Companies There are several types of finance companies, although all operate in a somewhat similar manner. Some companies of this type loan money on the basis of accounts receivable (see Chapter 20), others aid in the financing of durable goods such as automobiles, and another group specializes in small unsecured loans. Small businesses might use all three types, whereas the larger firms would not be so likely to ask for a small unsecured loan.

The principle upon which the finance company operates is relatively simple. Aside from a small amount of capital stock, it secures its funds by borrowing from banks on commercial paper, or by selling bonds. Because its credit standing may be excellent, these funds are secured at low rates of interest. Loans are then made to businessmen or to consumers at a considerably higher rate of interest. The difference in interest cost and interest yield represents the gross profit or margin.

Finance companies are organized under the laws of a state and may operate in several states, the same as any other corporation. The largest number operate in the automobile field, making loans to dealers and particularly to consumers who buy cars on the installment plan. Although a purchaser or dealer is not restricted in his choice of a finance company, the General Motors Acceptance Corporation does most of the financing of automobiles produced by the various operating subsidiaries of the General Motors Corporation; the Universal Credit Company finances Ford dealers and buyers; and the Commercial Credit Company gets most of the Chrysler business.

In addition to the above companies, there are several smaller organizations operating in the automobile field, and in some localities a particularly strong local company or agency may handle most of the business. Although buying an automobile on the installment plan might seem to be a consumer proposition, this type of financing can also be very

helpful to business. From the viewpoint of the automobile dealer, he does not need to finance his customer and literally makes a cash sale of each car sold. Furthermore, many types of businesses such as contractors, chain stores, taxicab companies, and laundries maintain fleets of trucks and passenger cars, and financing such purchases could present a difficult problem.

Loan Companies There is no clear-cut distinction between the activities of some finance companies and those of many loan companies. In general, loan companies operate locally or within the confines of a state border and limit their loans to individuals. The loans may be unsecured, or some type of collateral may be required.

Some of these organizations call themselves *personal finance companies* and specialize in loans of from $100 to $500 on single- or double-name paper. Such a loan allows an individual to borrow and then repay on the basis of weekly payments. In some cases, the loaning agency insists that the borrower be drawing a regular salary.

Morris Plan banks, or industrial banks, are another type of loan company. Individuals may borrow small amounts on their own signature if they are drawing a salary and have an excellent personal reputation in the community. If somewhat larger amounts are involved, the bank may request one or more cosigners of the note.

Pawnbrokers may also be included in the classification of loan companies. Loans are made on the basis of collateral deposited with the broker, which usually consists of articles readily sold, such as watches and rings. If the loan is not repaid at maturity, the pawnbroker will sell the collateral to recover his advance. Interest rates on pawnbroker loans are usually higher than for any other type of short-term borrowing.

Credit Unions Within recent years, the credit union has become an important source for borrowed funds on the part of members of these co-operative associations. A *credit union* is an organization of individuals in a community with a common interest such as religion, race, or, most commonly, employment in a particular company. In the

latter group, the credit union accepts deposits from workers and loans these funds to other employees. Interest is usually charged at the rate of 1 per cent a month on the unpaid balance, which compares favorably on an annual basis with the 6 per cent discount rate charged by most banks on personal loans. This earning is paid to the employees who have deposited the funds loaned. Loans may or may not be secured and usually do not exceed $300.

COMMODITY EXCHANGES

Functions of Commodity Exchanges Staple commodities that are produced in large quantities and can be stored are bought and sold on commodity exchanges. Examples of such products are wheat, corn, other grains, cotton, sugar, coffee, and minerals. The best known of the many exchanges is the Chicago Board of Trade. The New York Coffee and Sugar Exchange, the Wool Association, and the Commodity Exchange, all located in New York City, are some of the other prominent exchanges.

Perfect competition, which means that prices are determined by a free play of supply and demand forces, is unattainable, but the operation of some of the commodity exchanges approximates this goal. Most of the factors that are necessary for setting prices on the basis of a free market are present on the floor of these exchanges. There are many buyers and many sellers representing world production and consumption; the product is durable; it is standardized as to grade, quantity, or weight; and buying and selling are impersonal and unregulated except as to conditions guaranteeing fair dealing.[1]

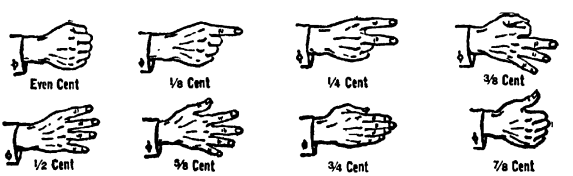
Buying and selling are conducted by members of the Exchange, who are usually brokers or partners in a brokerage firm. A commission is charged for executing orders, which are wired to the Exchange floor from all over the world in much the same manner as described for the purchase of stocks. Instead of trading posts, grain exchanges have cen-

[1] The commodity exchanges are regulated by the Federal Government, and some trading rules may prevent the free action of market forces. See Chapter 22.

Chicago Board of Trade

Trading in One of the Grain Pits

Trading is conducted by means of hand signals. For example, two fingers of the hand held vertically, then horizontally with the palm outward, and with the price of 98 cents posted on the blackboard, would mean an offer to sell 10,000 bushels at 98¼ cents a bushel. Each finger of the hand held vertically represents a unit of 5,000 bushels. An offer to sell is indicated by holding the palm of the hand outward and horizontally; for an offer to buy, the palm faces inward. The basic price in full cents is posted on the blackboard. The fraction of a cent at which the grain is offered is indicated by the following signals:



a "long" position. If he had ordered his broker to sell 10,000 bushels of May wheat, he would have sold "short." The price of May wheat is $1.06 a bushel, and the buyer must give his broker a deposit to "margin" his account. This deposit may amount to as little as 10 per cent of the total purchase price. In January, if the price of May wheat advances to $1.10 a bushel, Mr. Gordon may decide to sell 10,000 bushels. One

contract will offset the other, and the $400 difference represents his gross profit from which he must pay commissions and interest charges.

Hedging. The useful purpose of futures transactions is that speculators provide a market that can be used by a processor to protect his legitimate manufacturing profit. This is called *hedging* and may be necessary because the price of some manufactured articles follows the current quotation of the basic raw materials. The classic example is wheat, because flour sells in close relationship to the day-by-day price of wheat rather than on the basis of the cost of the wheat that was purchased two or three months earlier to be converted into flour.

A typical hedging operation would work in the following manner. If the Duluth Milling Company purchases 100,000 bushels of wheat in the spot market on January 15, it cannot expect to sell the flour made from this wheat until March or April. If the price of wheat remains constant, the selling price of the flour will reflect the cost of the raw material plus the manufacturing costs and profit. If the price of wheat should go down during the period from January to April, however, the flour would be sold at a loss. There is nothing the Duluth Milling Company can do to prevent a price decline in wheat, but it can hedge on January 15 by selling 100,000 bushels of wheat for delivery in April. If the price goes down between January and April, the speculative profit made by purchasing 100,000 bushels in April to cover the "short" sale will offset the manufacturing loss. If the price goes up, the loss on the speculative transaction will be offset by the extra profit that results from the sale of flour at a price higher than that anticipated. In either case, the legitimate manufacturing profit is protected.

QUESTIONS

1. What is the difference between an investment bank and an investment company?

2. Explain the services that a trust company renders to business.

3. How does a brokerage firm in the field of securities differ from an investment bank?

4. Some people feel that a stock exchange serves only the gambling interests of speculators. Is this true, or does it render a legitimate service to businesses and the businessman?

5. What is the difference between listed and unlisted securities?

6. What types of services do insurance companies render the business world?

7. What factors practically forced the Federal Government to loan money to industry, agriculture, and individuals?

8. What are the chief functions of a commercial bank?

9. How does a firm secure a "line of credit," and what are its advantages?

10. Name and explain several of the special services that commercial banks may render to their customers.

11. If a finance company must borrow money in order to make loans, how can it operate at a profit?

12. Name and explain three types of loan companies.

13. Why would an employee of an industry prefer to borrow from a credit union rather than from a loan company?

14. Describe the procedure used by a firm to "hedge" a legitimate manufacturing profit.

15. Do you believe that the Government should compete in the field of finance with privately owned business enterprises?

16. Finance companies do not produce goods or add anything to the value of products. Would the country be better off if they were abolished or partially eliminated?

PROBLEMS

1. (a) Refer to a current newspaper and list the opening price, high and low for the day, and the closing price of the following stocks listed on the New York Stock Exchange:

American Telephone and Telegraph Co., Common
E. I. duPont de Nemours and Co., Common
General Motors Corporation, Common
International Harvester Co., Preferred
R. J. Reynolds Tobacco Co., Common

(b) Follow the same procedure for the following bonds listed on the New York Stock Exchange:

American Telephone and Telegraph Co., 3% bonds due in 1956
Atchison, Topeka & Santa Fe Railroad Co., 4% bonds due in 1995
Jones and Laughlin Steel Co., 3¼% bonds due in 1961
National Dairy Co., 2¾% bonds due in 1970
Texas Corporation, 3% bonds due in 1965.

2. The Grand Forks Milling Company expects to net 10 per cent on its sales. Assuming the following facts, was the hedging operation successful in protecting this manufacturing profit? Show calculations.

On October 21 a purchase of 40,000 bushels of rye is made in the spot market for $1.50 a bushel. At the same time 40,000 bushels of rye are sold short for delivery on January 15 at $1.52 per bushel. Each bushel of rye is expected to produce 25 pounds of flour. Manufacturing costs per pound of flour are 3 cents.

On January 15 flour produced from the rye purchased on October 21 is sold at 8½ cents per pound. On the same day the short sale is covered by buying January rye for $1.20 per bushel.

3. What does each of the following signals in a grain pit mean: (a) when the price on the board is $1.25, one finger held vertically, then two fingers held horizontally with the palm outward; (b) when the price on the board is 87 cents, two fingers held vertically, then four fingers held horizontally with the palm inward.

SUGGESTED READINGS

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CHAPTER 22

REGULATION OF SECURITIES AND FINANCIAL INSTITUTIONS

Reasons for Regulation

In the United States millions of individuals invest savings in bonds and stocks, maintain bank accounts, buy homes with borrowed money, own insurance policies, and purchase durable consumer goods on an installment plan. Opportunities for fraud, manipulation, misrepresentation, or merely taking an unfair advantage of the investor or customer, naturally are abundant in the financial field. It is in the public interest that supervision and control of securities, exchanges, and other financial institutions be undertaken by the government.

People must have confidence in the soundness of the financial institutions they patronize or our economic society could not function smoothly. If Mr. Wheeler buys ten shares of stock of the Standard Oil Company of California through his broker, his only tangible evidence of ownership is a stock certificate. He assumes that this piece of paper is valid, that his ownership of the stock is recorded on the books of the corporation, and that he will receive any dividend that may be paid. In payment for the stock, the broker probably accepted a check, which he would prefer over actual currency. These transactions could not take place in the customary manner if past experience had indicated that it was unwise to trust brokers, exchanges, and banks.

Although other forms of business are regulated, as will be described in subsequent chapters, relations concerning money achieve a unique status. In many instances the financial institution becomes a custodian of funds belonging to other firms or people. In a sense a trustee relationship exists, for example, between a commercial bank and its customer. Also, the temptation to commit dishonest acts is higher when money is the object involved. Rather than to take legal action after losses have taken place, it is much better to exert regulatory controls which may prevent unsound or illegal practices.

Legislation to accomplish such purposes is a natural result of the concern of millions of people about their financial affairs.

Need for Regulation of Securities

Although corporations have operated in this country from early colonial days, ownership of corporate stocks did not become widespread until the growth of large companies began in the last quarter of the nineteenth century. Even up to the time of World War I, less than five hundred thousand people owned shares of stock in corporate enterprises. It is not surprising then that, prior to the early decades of the twentieth century, there was little interest in protecting the public against unscrupulous promoters who sold shares of stock in ventures having scant, if any, hopes of success. The old doctrine of *caveat emptor*—let the buyer beware—was considered reasonably sound. If a purchaser could prove gross misrepresentation or deceit, he was able to sue for damages in exactly the same manner as he could in connection with the purchase of any commodity. However, it was extremely difficult to support such charges, with the result that fear of the law did little to curb the activities of bogus stock salesmen.

Under these conditions, the public was the victim of many corporate swindles. A group of men would organize a corporation and peddle stock to a so-called "sucker" list. Widows, preachers, doctors, dentists, school teachers, and other individuals who might be expected to have small amounts of savings available for investment were considered the best prospects. Literature describing the golden opportunities of an oil company, a mining company, etc., would be mailed to these persons, with an invitation to subscribe to the stock. If an immediate acceptance was not forthcoming, wires, telephone calls, and personal solicitation would follow. Usually, a deadline was established, after which the stock would advance in price. Despite all of the obvious signs of a fraudulent promotion, the stock would be sold. After the promoters had secured all of the cash possible from a particular territory, they would disappear from their impressive office quarters and, usually, the stockholders would not hear from them again.

Strangely enough, in light of subsequent developments, the first concrete step taken to halt the malpractices of these

stock salesmen came from the Federal Government. In 1909, a law was passed making the practice of using the mails to defraud a criminal offense. The purpose of this law was not primarily to deter security salesmen although, fortunately, that result was attained. Promoters were not afraid of lawsuits because the limited finances of most injured parties were inadequate to employ outstanding legal talent and to follow through in an extended legal battle. If an individual could convince the Post Office Department that the mails had been used to defraud, however, the matter of investigation and trial was accepted as an obligation by this branch of the Federal Government.

The immediate result was that promoters whose activities were on the "shady side of the law" soon learned to avoid use of the mails. Literature could be sent by express or distributed by messengers or salesmen, and wires and telephone calls could replace any follow-up mailing pieces formerly used. The sale of fraudulent securities continued with the slight handicap of doing business without using the mails. This handicap was offset by the increasingly widespread ownership of stocks, which made sales easier.

State Regulation of Securities By 1911, the volume of complaints had aroused so much interest in Kansas that a law regulating the sale of securities was passed. This, and similar laws, passed by state after state in the years following, were known as "blue-sky" laws. This name came from a remark made on the floor of the Kansas legislature that some stock promoters would sell stock in the "blue sky" itself. When the Kansas law was declared constitutional by the United States Supreme Court in 1917, impetus was given to state regulation; and by 1933 all of the states, excepting Nevada, had passed "blue-sky" laws.

As might be expected when forty-seven different laws are involved, some states do an effective job of security regulation and others do not. The types of protection afforded may be divided into three categories, as follows: (1) registration of securities; (2) registration of dealers; and (3) protection against fraud. Some state laws combine all three features, others rely on two or even one of these safeguards.

Registration of Securities. The most effective means of protecting the public is to require the registration of the security issue to be sold, and this is the most common form of state law. A commissioner of securities, or some similar official or department, is established when the "blue-sky" law is passed. It is his duty to examine stocks, bonds, notes, debentures, and other forms of securities that are proposed for sale within his state. He may require such evidence as he deems advisable and, after investigation, he approves or disapproves the issue.

In all of the states with this type of law, some securities are exempt from the provisions covering registration. Typical illustrations include bonds of the United States, states, municipalities, and other governmental units; securities issued by charitable or educational organizations; and stocks and bonds that are already traded on organized exchanges that require high standards for listing. Also, some states permit the immediate sale of securities after registration, even before a decision has been reached covering approval or disapproval.

Registration of Dealers. Some states require dealers, brokers, and salesmen who sell stocks and bonds to register and secure a license. Individuals must submit some evidence that they are persons of good repute, and those who have had criminal records or have been guilty of questionable business practices can be refused. Furthermore, a license is usually issued for one year only. Therefore any dealer, broker, or salesman who wishes to remain in business needs to protect his reputation for fair dealing so that his license will be renewed.

This type of law may not protect investors in every case, because a promoter might sell stock within the space of a few months even though he was sure that his license would not be renewed or might even be revoked within the year. Before the state could investigate any complaints, great harm might have been done. However, the existence of such a law reduces to a minimum the opportunities for such manipulations, and the public is assured of a reasonable amount of protection.

Fraud Protection. Four states—New York, New Jersey, Delaware, and Maryland—rely exclusively on laws against

fraud in the field of security regulations. The usual provisions include the right of the attorney general of the state to stop the sale of securities deemed fraudulent and to prosecute the dealers and others engaged in the distribution of the issue. Dealers convicted are frequently barred from further activities in that state.

The fraud type of law is the least effective of the methods of state regulation. The public is not protected against promotions of a highly speculative character or ones that are legitimate but with almost no hope of success. Furthermore, some damage must be done before the attorney general has a right to step in and stop further sales. However, fear of prosecution may deter many dealers and salesmen, and this type of law is better than none at all.

Federal Regulation of Securities

With the continued growth of the corporation and the widespread holding of securities, which increased at an accelerated pace up to 1929, state regulation of security issues proved inadequate. State laws varied not only in type but also in efficiency of enforcement. Many times inadequate appropriations did not permit efficient operation by the individual or department charged with the responsibility of handling the problem. Even more serious was the fact that state laws could not cover more than sales between parties within the state. Transactions across state lines in what is known as interstate commerce were outside the right of the state to regulate intrastate commerce. Promoters could operate from one state and sell exclusively in other states, avoiding the restrictions of the law in either state involved.

A start along Federal lines had been made with the passage of the Transportation Act of 1920. At that time, the Interstate Commerce Commission was given control over the issuance of railroad bonds and stocks. The I.C.C. powers were extensive in that approval had to be obtained before the securities could be offered for sale to the public. This type of regulation was limited to the railroads, one of the largest sources of new issues of stocks and particularly bonds. Control over this volume was important, but it failed to touch the fields in which "get-rich-quick" schemes flourished.

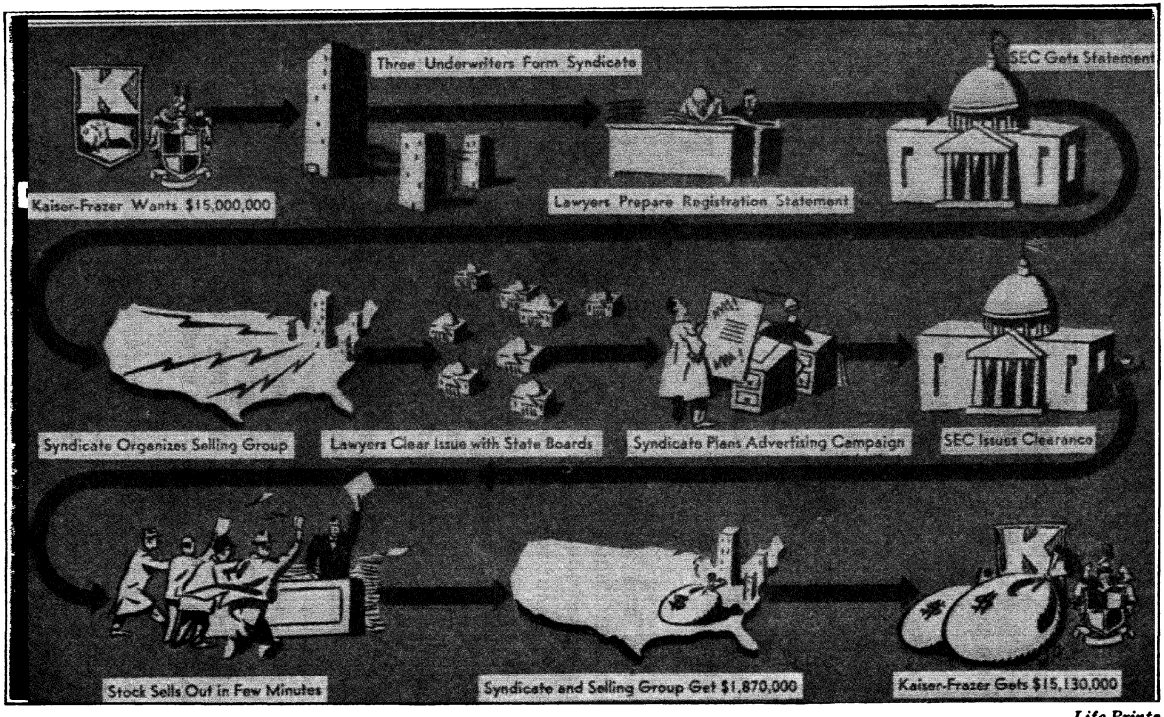
Securities Act of 1933. The first real effort on the part of the Federal Government to eliminate the abuses that thrived in the interstate sale of securities was the Securities Act of 1933. This Act was predicated on the assumption that investors have the right to know complete facts about the financial details of the company issuing new securities and that the officials of the firm should be held legally liable for supplying such facts. It has sometimes been called the "information" law because full disclosure of pertinent financial details is the major requirement of the Act.

Under the provisions of this law, any person who plans to sell securities in interstate and foreign commerce or through the mails must file a registration statement with a Federal agency known as the Securities and Exchange Commission. The form includes detailed information about the issue to be sold, other issues outstanding, a balance sheet no older than ninety days, profit and loss statements for the last three years, promoter's fee and expenses, and many other similar items. After the registration statement is on file, a period of twenty days must elapse before the securities may be distributed.

During the twenty-day interval, the Commission has a chance to examine the accuracy of the registration statement and, if errors or misleading statements are found, it can issue a *stop order*, which would further delay the sale. The information is public property from the date of filing and can be investigated by prospective purchasers or by interested financial agencies.

Of prime importance to the general public is the provision that a condensed version of the registration statement must be supplied to each prospective purchaser of the stock or bonds that are offered for sale. This is in the form of a booklet, which is called a *prospectus*, and any investor who will read the contents cannot claim ignorance about the financial details of the company in which he purchased an interest.

On the cover page of the prospectus, the following statement must appear: "The securities have not been approved or disapproved by the Securities and Exchange Commission. It is a criminal offense to represent that the Commission has approved these securities or has made any finding that the



How Kaiser-Frazer Raised $15,000,000

Life Prints

statements in this prospectus or in the registration statement are correct." This wording indicates that the public is still the responsible party and, unless the investor can prove that the registration statements are false, he has no claim for damages even though the securities purchased ultimately prove worthless.

The Commission, in addition to issuing stop orders, can request the Department of Justice to institute criminal proceedings against those who willfully violate the law. This threat, plus the liability of all persons who engage in making up the registration statement, including lawyers, engineers, and accountants, practically guarantees the correctness of the information provided in the registration statement and condensed in the prospectus.

It should be added that, in a manner similar to the state statutes, some security issues are exempt from registration. These include all forms of government securities, railroad issues subject to the I.C.C., and stocks and bonds of co-operatives and nonprofit institutions. Also, sales not involving the use of mails or interstate commerce are exempt, as well as those in which there has been no public offering. In recent years, many issues have been sold at private sale for the express purpose of avoiding registration.

Securities Exchange Act of 1934. Although the Securities Act of 1933 was a decided step forward in the abolition of evils existing in the financial world, it left much to be desired. Registration was not required for companies that were not issuing new securities, and the abuses that existed in stock-market trading were still uncurbed. Whereas the public relied on daily quotations to give some evidence of the market value of a stock, various manipulative practices permitted "insiders" to profit at the expense of small investors.

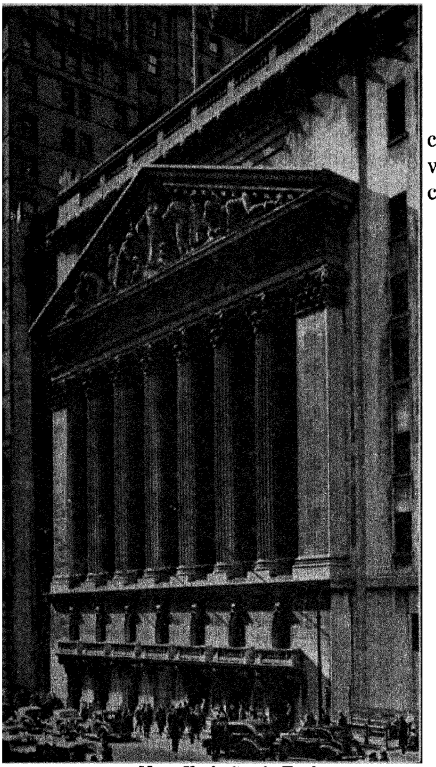
Company Registration. The Securities Exchange Act passed in 1934 provided for three important reforms. One of these was the registration of all companies whose stock was listed on one of the national exchanges. A registration statement similar to that already described was required, and furthermore it was specified that it must be kept up to date by the filing of annual reports. Whether or not the company was in

the process of selling new securities, an investor was able to find out the same type of information that, under the previous law, was available only when new securities were to be sold.

National Stock Exchanges. A second and more important measure was the provision that stock exchanges were to be classified, registered, and placed under the jurisdiction of the Commission, to the end that trading in securities could be regulated. Although each stock exchange had promulgated certain trading rules, this self-regulation had failed to stop numerous practices detrimental to the public interest. For example, one broker might sell stock to another broker at a fictitious price in order to give a false picture of the real value of this stock. The sale would appear on the stock market tape, but no shares would ever be delivered. Another practice was for a group of stock market manipulators to organize a "pool" to bring about an artificial rise in the value of a particular stock. These men would place buying orders for a stock at an increasing level of price and, at the same time, would cause rumors to circulate that the company in question was about to receive a large contract, to declare a large dividend, or anything else that would attract smaller investors into the market. After the price had advanced a few points, the pool would start selling to the new purchasers that had been attracted by such devices. As soon as they had sold all of the stock purchased, at a profit, they would devote their interest to some other security, and the price of the manipulated stock would fall to its normal market level.

These examples are illustrations of unfair practices by professional traders for speculative stock market profits at the expense of the investing public. The legitimate functions of the stock exchange were being abused, and the only solution seemed to be regulation by a Federal agency. It is the purpose of the Securities and Exchange Commission to employ competent individuals to watch the sales on the larger exchanges and investigate those that might be illegal or give rise to unfair trading.

Not all stock exchanges are deemed important enough to warrant such supervision. Those that were classed as national exchanges by the Commission were required to register and to comply with the regulations. The following national ex-



New York Stock Exchange

changes have been registered with the Securities and Exchange Commission:

Boston Stock Exchange
Chicago Curb Exchange
Chicago Stock Exchange
Cincinnati Stock Exchange
Cleveland Stock Exchange
Detroit Stock Exchange
Los Angeles Stock Exchange
New Orleans Stock Exchange
New York Curb Exchange
New York Real Estate Securities Exchange
New York Stock Exchange
Philadelphia Stock Exchange
Pittsburgh Stock Exchange
St. Louis Stock Exchange
Salt Lake Stock Exchange
San Francisco Curb Exchange
San Francisco Mining Exchange
San Francisco Stock Exchange
Standard Stock Exchange of Spokane
Washington (D. C.) Stock Exchange

The following stock exchanges have been granted exemption from registration:

Colorado Springs Stock Exchange
Honolulu Stock Exchange
Milwaukee Grain and Stock Exchange
Minneapolis-St. Paul Stock Exchange
Richmond Stock Exchange
Seattle Stock Exchange
Wheeling Stock Exchange

Margin Requirements. The third purpose of the Securities Exchange Act of 1934 was to restrict the amount of credit that would be available for financing the purchase of stocks. Control over this feature was placed in the hands of the Federal Reserve Board, which governs the Federal Reserve Banks. This Board determines the extent to which a purchaser can

margin his account and also limits the amount of loans that can be made by a member bank or by a broker for the purpose of financing stock purchases.

Further provisions of the law and subsequent amendments relate to regulation of over-the-counter markets and the control of exchange members and corporate officers. Trading in the over-the-counter markets is regulated in a manner comparable to that of securities dealt in on the organized exchanges, in order to close this possible loophole in the whole picture. Exchange members must indicate whether they are operating for their own accounts or as brokers and also whether they are floor traders, odd-lot dealers, or specialists. Each classification must conform to certain rules and regulations laid down by the Commission. A corporate officer who owns 10 per cent or more of the stock of a company that is listed on a national exchange must list his holdings with the Commission, must not sell the company's securities on a short basis, and must repay to the company any profits made by him in the company's stock within a period of six months.

Although the security laws passed in 1933 and 1934 have not worked out perfectly, the general results have been favorable. Millions of small investors now have fairly adequate protection against losses due to outright misrepresentation or fraud on the part of the promoters or others who offer the securities for sale. The small investor can purchase these securities in markets that are free of most of the manipulative practices that formerly characterized numerous transactions.

Commodity Exchange Act of 1936. The other national markets providing opportunity for speculation, in addition to securities, are the commodity markets. In 1922, a Grain Futures Act was passed, which made it unlawful for any person to use the mails or other interstate communication for the sale of grain futures except through members of a board of trade that had been approved as a contract market by the Secretary of Agriculture. This law was helpful but somewhat inadequate because other means of contacts could be used. In 1936, the Commodities Exchange Act was passed, which in brief enlarged the control over commodity exchanges to a basis comparable with the supervision of security exchanges.

This law created in the Department of Agriculture a Commodity Exchange Administration, which controls futures in wheat, cotton, rice, corn, oats, barley, flaxseed, grain sorghum, mill feeds, butter, eggs, and Irish potatoes. The Act provided that exchanges must register, and a number of commodity exchanges have now been designated as contract markets. Dealers, brokers, and commission merchants also must register with the Administration.

Following is a list of the contract markets presently operating and the commodities that they are approved to handle:

CONTRACT MARKET	COMMODITY
Chicago Board of Trade	Wheat, corn, oats, barley, rye, cotton, soybeans, lard
Chicago Mercantile Exchange	Butter, eggs, potatoes
Chicago Open Board of Trade	Wheat, corn, oats, rye, soybeans
Duluth Board of Trade	Wheat
Kansas City Board of Trade	Wheat, corn, millfeeds
Los Angeles Grain Exchange	Barley
Memphis Merchants Exchange Clearing Association	Cottonseed meal, soybean meal
Milwaukee Grain and Stock Exchange	Wheat, corn, oats, rye
Minneapolis Chamber of Commerce	Wheat, corn, oats, rye, barley, flaxseed
New Orleans Cotton Exchange	Cotton, cottonseed oil
New York Cotton Exchange	Cotton
New York Mercantile Exchange	Potatoes
New York Produce Exchange	Cottonseed oil
Portland Grain Exchange	Wheat
St. Louis Merchants Exchange	Millfeeds
Seattle Grain Exchange	Wheat
Wool Association of the New York Cotton Exchange	Wool tops

Another feature of the Act was a series of provisions to limit excessive speculation. The maximum fluctuation in the price of any commodity can be regulated on a daily basis, and the amount of trading that can be done by one person may also be limited. The maximum fluctuation in the price of wheat, for example, that has been allowed has varied from ten cents a bushel a day to as low as five cents.

The power to enforce these details of the law and the administrative regulations as laid down by the Commodity Exchange Administration is vested in a Commission. This is a three-party group consisting of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General. This Commission may suspend or revoke the license of any

dealer, and of any board of trade, provided serious infractions of the rules occur.

Regulation of Banks Banks are regulated by the Federal Government or by the state depending, in part, on whether they are national or state banks. Actually, the Federal Government plays the most important part because many state banks belong to the Federal Reserve System and to the Federal Deposit Insurance Corporation and must follow procedures prescribed by these agencies. Other regulations are administered by the comptroller of the currency for national banks, and the state bank examiner for state banks.

Bank Examinations. Of primary importance to depositors is the fact that all banks are examined periodically by Federal or state auditors who make a careful study of the financial condition of the bank and report any irregularities to the proper governmental official. Examiners also make unannounced visits so that the officers and employees do not have a chance to cover up any discrepancies or errors of poor judgment. National banks are examined at least twice each year, and the frequency of state examinations varies among the several states. Any irregularities discovered must be corrected promptly, or action will be taken against the officers by the proper Federal or state banking officials.

Members of the Federal Reserve System are subject to examination by auditors employed by the district Federal Reserve Bank, and all members of the Federal Deposit Insurance Corporation are visited by examiners from this organization. Furthermore, national banks must make a minimum of three financial reports each year and these must be published in a newspaper. State laws vary in this respect but most require a published financial statement in a manner similar to the Federal law.

Other Bank Regulations. National banks cannot be organized without the approval of the comptroller of the currency, and usually a state bank secures permission from the state banking department. The minimum capital for a national bank is set by law. In smaller cities the minimum is $50,000. In addition to the amount of capital, the need for a bank and

the character of the proposed officers may have an important bearing on the application. If a national bank wishes to open a branch, it must secure permission and the branch must be located within the state in which the main office is located. Some states do not permit branch banks, others encourage their formation.

Members of the Federal Reserve System are not allowed to pay interest on demand deposits or checking accounts, as such deposits are usually known. In the case of savings accounts, a minimum rate is prescribed. The maximum rate of interest charged on a loan is fixed for both national and state banks, usually at an upper limit of 7 per cent. The amount of a loan to any one individual or firm is limited to 10 per cent of the capital stock and undivided profits of the loaning bank. Straight loans on real estate cannot exceed 50 per cent of the value of the property, which must be located within a stated distance from the bank, and such loans must mature within a relatively short time, such as five years. Regular amortized loans on real estate, which means that a schedule of repayment is established, may go as high as 60 per cent of the value of the property, and may run for ten years. Savings banks are usually not permitted to invest funds in anything except bonds, and only in issues that have been approved.

Prior to 1933 some commercial banks maintained an investment banking department. This is now illegal. Commercial, savings, and trust banks cannot participate in the sale of new securities other than Government issues. Trust companies, or the trust departments of commercial banks, are subject to special regulatory measures, which deal with the separation of trust funds and the responsibility of acting as trustee for bond issues. Under the Trust Indenture Act of 1939 the trustee for a mortgage bond must take an aggressive position in behalf of the bondholders.

Regulation of Insurance Companies

The regulation of insurance companies is primarily a state matter despite the fact that most insurance companies sell policies in more than one state and hence engage in interstate commerce. The commissioner or superintendent in charge of the state department of insurance is responsible for all activities

within his state. The extent of regulation varies but is generally quite extensive.

Insurance companies cannot do business in any state without first securing a license, and frequently their agents and brokers must also secure licenses. These licenses run for a short period of time and are reviewed before renewal. The commissioner must be satisfied that the company has not invested funds in any securities not approved, and that adequate reserves are on hand. These reserves are funds that have been collected from policyholders in advance and which must be maintained to meet possible losses during the life of the insurance policy. In some states an actual deposit of securities with a proper state official is required as evidence of the ability of the insurance company to pay claims that may arise in that state.

Insurance Rates. Some states have gone into rate regulation, particularly for fire insurance and related coverages. The procedure is to require the insurance company to belong to a rating bureau, which is maintained on a co-operative basis by a group of fire insurance companies. This rating bureau works out the technical details, which are frequently very complicated, of the determination of rates on specific property; and the rate recommended is usually approved by the insurance commissioner. No comparable organization exists in the field of life insurance.

Other Insurance Restrictions. Policy forms are usually subject to the approval of the insurance commissioner on the theory that the insurance buyer does not read the long clauses inserted in his policy. Also, in cases of dispute over a settlement claim, the commissioner frequently acts as an adjuster or arbitrator. Of more importance is the requirement of annual reports and the examination of the financial standing of insurance companies authorized to sell policies within the state. The cost of such an audit is borne by the insurance company and sometimes is an expensive proposition for companies operating in practically every state. Fortunately, some states are willing to accept examinations that have been conducted by the insurance department of another state that has an outstanding reputation.

Building and Loan Association Regulation

Building and loan associations, or savings and loan associations as they are sometimes called, are subject to annual examinations by either Federal or state auditors. Most associations are organized under the laws of a state, but since 1933 it has been possible to establish a savings and loan association on a Federal basis under the supervision of the Federal Home Loan Board. Control is exercised over loans, interest rates, and terms of repayment of borrowed funds.

In 1934 the Federal Savings and Loan Insurance Corporation was organized. This government corporation insures accounts in eligible building and loan associations up to a maximum of $5,000 in exactly the same manner as the Federal Deposit Insurance Corporation insures accounts in commercial banks. Building and loan associations, in order to become eligible to join the Federal Savings and Loan Insurance Corporation, must comply with its requirements and operate in conformity with its rules, which are generally more stringent than those specified by the several states.

Regulation of Investment Trusts

The Wagner-Lea Act passed in 1940 by Congress provides for the regulation of investment trusts. Each must register with the Securities and Exchange Commission, as must investment counselors and advisory services. No investment trust can be organized with a capital of less than $100,000, the management must be elected by the stockholders, funds cannot be invested in other investment trusts or affiliated companies, and the types of securities that the investment trust can issue are subject to restrictions. Other technical details of the law are referred to the Securities and Exchange Commission for administration and enforcement.

Regulation of Loan Companies

Personal finance companies operate in most states under the provisions of a Uniform Small Loan Law, which was originally drafted by the Russell Sage Foundation. It provides for licensing individuals and corporations, who are then under strict state control. Maximum rates are usually stated at from 2½ to 3½ per cent a month on the unpaid balance. The Russell Sage Foundation

also drafted a model pawnbroking law several years ago, but it has not been adopted by many states. This law provides for licensing, for a maximum rate of 3 per cent a month on the unpaid balance, and allows one year for the borrower to redeem his pledged possession.

Credit unions are co-operatives and may secure a charter from the Federal Government or from almost every state. Interest rates are usually fixed at a maximum of 1 per cent a month although many credit unions charge as little as one half of this legal rate. Investments are restricted, and outside examinations are required. Loans up to $50 can be made without security; over that amount some security is usually required.

QUESTIONS

1. Why is the regulation of securities, exchanges, and other financial institutions desirable?
2. What factors were responsible for the fact that there was practically no regulation of security sales until the twentieth century?
3. Which governmental agency made the first effort to improve conditions in the sale of stocks and bonds, and what direction did this effort take?
4. How do the "blue-sky" laws of the several states operate?
5. What are the shortcomings of regulation by states of security sales?
6. What was the main feature of the Securities Act of 1933?
7. Did the Securities Act of 1933 accomplish anything that was not already a basic requirement in many states?
8. What is the value of a prospectus to one who is considering the purchase of securities?
9. What provisions were included in the Securities Exchange Act of 1934 that had not been covered in the 1933 legislation?
10. Why is it harmful to allow "pools" and other types of manipulative practices to operate in the stock markets?
11. Were all of the powers of the Securities Exchange Act of 1934 vested in the Securities and Exchange Commission?
12. What is the basis for classification as a national exchange? Name a few examples.
13. The Commodity Exchange Act of 1936 provided for the registration of contract markets. What are these and in what fields do they operate?

14. What agencies may exert regulatory powers over banks?

15. To what extent is the regulation of insurance companies in the hands of state officials?

16. What other financial institutions are subject to regulatory legislation?

PROBLEMS

1. The Blue and White Auto Supply Company operates a chain of retail stores in several midwestern states. The Company embarks on a $10,000,000 expansion program to be financed by a bond issue. In order to save financing costs, the Company decides to sell the bonds through the several retail stores. The bonds are printed, a quota is mailed to each store, and advertisements advising the public that bonds can be purchased at the Blue and White stores are printed in newspapers.

Assuming that no other steps were taken, itemize all of the legal errors made by the Blue and White Auto Supply Company in the sale of this bond issue.

2. Summarize the nature of the Federal and state regulations of financial institutions. For this purpose construct a form with columnar headings as follows: (a) Institution, (b) Government (Federal or State), (c) Law (Title and Date), (d) Regulating Agency. Include in the first column the following institutions: stock exchanges, commodity exchanges, state banks, national banks, insurance companies, Federal building and loan associations, investment trusts, loan companies.

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CHAPTER 23

FINANCIAL PROBLEMS AND POLICIES

Types of Financial Problems Old and new business organizations are constantly faced with many financial problems. This is equally true for sole proprietorships, partnerships, and corporations. If a firm is to continue successful operations, correct financial decisions must be made. Some individual or group in the business should have a knowledge of sound financial policies, or expert outside advice should be secured.

One of the frequent causes of business failure is an unsound financial structure. This is particularly true of the small businessman. He may not be able to invest an adequate amount of money in the business and must therefore start out with a heavy load of borrowed capital. The chances are that much of this capital has been secured on a short-term basis, which means that repayment may be necessary before the business has had enough time to earn profits sufficient to liquidate the debt. Such a financial plan is known as "starting business on a shoestring" and violates the principle that permanent capital should be secured from long-term sources.

This point suggests a common but important financial problem, namely, that of the best way to raise funds. A new organization, or an established business wishing to expand, should consider carefully the alternate sources available for needed funds. Other issues that must frequently be faced include revamping the existing financial structure, deciding on distributions of earnings, and deciding what to do when serious financial trouble is encountered. These will be discussed in sufficient detail to indicate the important types of decisions that must be made concerning money matters.

Factors in Selecting Sources of Funds An individual should not attempt to engage in a business that requires a large investment, unless he owns the capital or can borrow it on long-term arrangements. The operations of a

new business are less likely to be profitable than are those for an established concern, because of the inherent difficulties in starting any new venture. This means that only limited use should be made of such sources of capital as borrowing on open-book account, bank loans, and ordinary notes payable.

Unlike the sole proprietorship or partnership, the corporation has a choice in the types of securities or obligations that it will issue or assume in order to secure capital funds. However, there still remains the problem of selecting the best plan. A typical illustration of this problem may help to point out the difficulties involved.

The Automatic Washing Machine Company is planning an expansion program. It is estimated that $1,000,000 additional capital will be needed to erect a new factory building, to buy the necessary machinery, and to lease regional warehouses and district sales offices. It will also be necessary to secure an additional $100,000 in working capital to finance the added inventory of raw materials and purchased parts, the increased receivables, and added pay rolls.

At the present time, the Automatic Washing Machine Company has total assets of $750,000. Of this amount, $500,000 was raised by the sale of 5,000 shares of common stock with a par value of $100; another $175,000 has been secured from reinvested earnings; and only $75,000 is owed to short-term creditors. The latter sum consists of a bank loan of $25,000 and $50,000 owed on open-book accounts. The President, Vice-President, and Secretary-Treasurer own $100,000 worth of stock each, which as a total constitutes a controlling interest in the firm.

An investigation indicates that the proposed expansion should be profitable. In view of the fact that a new building must be constructed and equipped, it is obvious that most of the $1,000,000 needed for fixed capital should be secured from long-term capital sources. However, assuming that general financial conditions are such that either bonds or stocks could be issued, a decision would need to be reached as to the exact type of security that would be the most satisfactory to sell. Some of the factors that should be given careful consideration by this firm, or any other business facing a similar situation, are discussed in the following paragraphs.

Debt or Permanent Capital. If bonds are issued, the amount becomes a debt of the corporation, which involves repayment at some future date. If stock is issued, there is no need for building up a fund to liquidate the securities. If bonds are issued, it will be necessary to pay interest and, in the case of mortgage bonds, there is the danger of foreclosure if the business should lose money in future years. On the other hand, more stock means sharing the expected profits with more owners.

Tax Considerations. Interest on bonds is a business expense and is allowable as a deduction in computing net earnings for purposes of income taxes. Dividends are not a business expense and, under present laws, do not decrease earnings but rather are a distribution of profits. Also, taxes on the total stock outstanding will be assessed by the state of incorporation. This is not true for bonds outstanding. From the viewpoint of reducing taxes, a bond issue would be preferable to securing funds from the sale of stock.

Voting Control. In deciding whether to issue stocks or bonds, the corporation must consider the problem of voting power that is granted by some kinds of stock. If bonds are issued, the control of the corporation will remain in the hands of the three officers, as bondholders are not owners and never assume any voting control. If preferred stock is issued, there would be no difficulty in issuing such stock under an agreement that the stock would be nonvoting except under certain specific conditions. Most preferred stock issues are of this type, and investors would not object to customary restrictions on voting rights. If common stock is selected and it is desired to restrict or eliminate voting rights on the new issue, it will be necessary to divide the old and new stock into Class A and Class B. If Class A is to be nonvoting, the sale of such an issue might be difficult because the company does not have a national reputation, and investors might object to this unusual restriction on voting rights.

Market Conditions. Just as there are styles in clothing, which vary from year to year, so are there investor preferences in types of securities. Sometimes the market is particularly

strong for bonds, sometimes for preferred stocks, and other times for common stocks. It may be much easier to sell a preferred-stock issue today than it was a few months ago, and perhaps in a few more months the market will be unfavorable for anything except a mortgage-bond issue. This means that a choice at any given date must take into consideration the manner in which the proposed security issue will be received by the buying public. In general, stocks are more popular when prosperous business conditions indicate possibilities of a high rate of return. When the reverse situation exists, more investors favor bonds.

Stability of Earnings. The amount of capital that can safely be secured from bonds varies directly with the stability of the earnings. A business firm that has stable earnings year in and year out can best afford to sell bonds. It is obvious that such a concern can finance yearly interest payments and yearly deposits into a sinking fund for the retirement of the issue. A firm with highly fluctuating profits, on the other hand, can pay interest one year with ease and the next may be seriously handicapped by this fixed charge.

This factor explains why public utilities, such as gas and electric companies, frequently secure one half to two thirds of their total capital from bond issues. They are permitted by law to earn a fair return on their total investment, and people use about as much gas and electricity in good years as in bad. On the other hand, a firm that manufactures a luxury item is likely to have very good years and also very bad years. Unless the amount of the bond issue outstanding is small in proportion to total capital, outright failure may easily result.

Rate of Earnings. If a firm expects that it can earn 10 per cent on new capital employed in the business and can borrow money from bondholders at 4 per cent, the difference of 6 per cent will be available for the stockholders. The rate of 4 per cent on the bonds is fixed and, regardless of the profits earned on the money contributed by this class of investors, the rate of interest will not vary. The principle of borrowing money at a lower rate than the rate of expected earnings on these funds, with a resulting excess available to stockholders,

is called "trading on the equity." For example, if a corporation has $100,000 in assets that have been financed entirely by the sale of common stock, and if this company earns 10 per cent on these assets, it would have $10,000 in profits available for distribution to the owners. The corporation now decides to double its size and secures an additional $100,000 by the sale of bonds bearing interest at the rate of 4 per cent. If profits remain at 10 per cent, there will be $20,000 in earnings before bond interest is paid and $16,000 available to the owners after the interest payment. Without any additional investment on their part, the owners can share in an additional $6,000 profit.

Trading on the equity is a sound business principle, but it becomes increasingly risky as the percentage of borrowed capital increases in proportion to the total assets. Companies that have outstanding securities senior to the common stock, which are entitled to a fixed rate of return, have what is known as a "leverage" factor. The common stock of leverage companies is more speculative than that of companies with no senior securities outstanding.

A Financial Plan. After weighing all of the above factors, the Automatic Washing Machine Company decides to sell $500,000 in bonds and $500,000 in preferred stock in order to obtain the $1,000,000 needed for permanent additions. Some of the members of the board of directors wanted to issue bonds for the full amount, but the majority felt that the risks involved in owing such a large sum were excessive. On the other hand, the present officers did not want to lose voting control of the corporation, which was the determining factor in deciding on a preferred-stock issue instead of common stock. Although these decisions are fundamental to the solution of the problem, other details would also need to be settled before the new corporate securities would be ready for the market.

First of all, what kind of bonds should be offered, and at what rate of interest? The bonds could be mortgage bonds because sufficient real estate is available for this purpose but, if the bond market is so strong that debenture bonds can be sold at par, the risk of foreclosure would be eliminated and the real estate would be free for subsequent mortgage issues

if more capital should be needed in the years ahead. As to rate of interest, the firm does not want to offer any more than is necessary but would like to have the prestige of selling their bonds for par or at a slight premium.

As to preferred stocks, should they be par or no-par, should dividends be cumulative or noncumulative, and should the stock be participating? Furthermore, what dividend rate should be offered? Will it be necessary to offer a 6 per cent issue in order to sell the shares at par, or could a fair price be realized with a 4½ per cent stock. Expert advice on these matters can be secured from investment bankers or from other financial experts.

To complete the illustration, the Automatic Washing Machine Company decided to sell $500,000 in first-mortgage real estate bonds bearing interest at the rate of 4 per cent, and to issue $500,000 worth of 5 per cent first preferred stock, cumulative but nonparticipating and nonvoting except when four consecutive dividends had been passed by the board of directors.

Methods of Selling Securities Choosing the best method of selling these securities would be the next problem faced by the Automatic Washing Machine Company. Should they be sold to outsiders, owners, or friends of the firm? Should a financial agency be paid to handle the distribution of the securities, or can the corporation conduct the sale? In general, there are three possible methods of distribution as follows: (1) Sale to financial institutions; (2) sale to owners; and (3) sale to customers, employees, creditors, and acquaintances of the management.

Sale to Financial Institutions. An investment bank might be glad to purchase both the bond and preferred-stock issues, and there is a possibility that it would offer par for these securities on the theory that the bonds and the stocks could be sold at a premium. Even if the sale were made at a small discount, the firm would have immediate use of the proceeds and no worry about the selling details. Another possibility would be to sell the entire bond issue to an insurance company, which would leave only the preferred stock to be sold through investment-bank channels. The insurance company would not

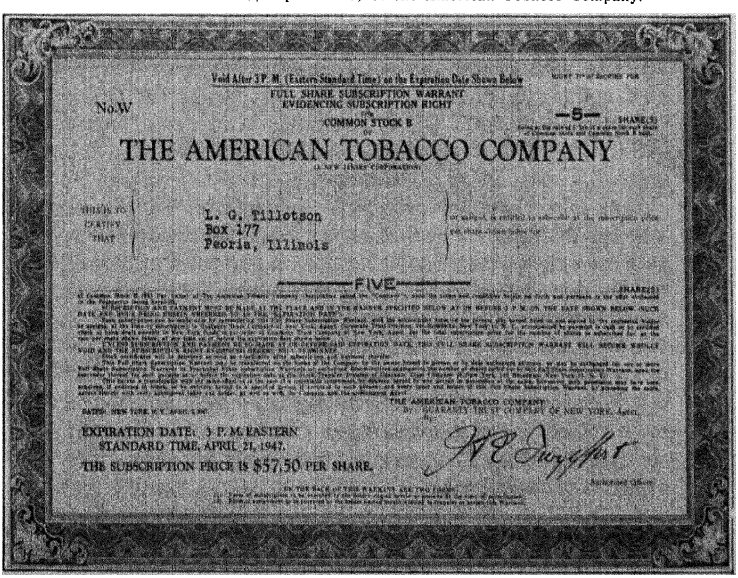
be interested in the preferred stock because such securities are not usually acceptable to state regulatory agencies.

Sale to Stockholders. Some companies make a practice of offering bonds and stocks to their stockholders before making any public offering, although the procedure is somewhat rare in the case of bonds. If shares of stock are to be sold, the law usually requires that this be done, unless the stockholders vote to waive this privilege. The legal requirement that each stockholder is entitled to subscribe to new issues of stock in proportion to his holdings is known as his *privileged subscription right.*

In the case of the Automatic Washing Machine Company, if the existing stockholders insist on having the preferred stock offered to them, it means that each common stockholder will be entitled to buy as many shares of the preferred stock as he owns of the common stock, because each issue totals 5,000 shares. This is called a "right," which he can exercise or sell to someone else if there is a market for this privilege. If the

A Subscription Right

This subscription warrant was evidence of a subscription right for five shares of common stock B ($25 par value) of the American Tobacco Company.



Void After 3 P. M. (Eastern Standard Time) on the Expiration Date Shown Below

FULL SHARE SUBSCRIPTION WARRANT
EVIDENCING SUBSCRIPTION RIGHT
FOR
COMMON STOCK B
OF

No. W —5— SHARE(S)

THE AMERICAN TOBACCO COMPANY

(A NEW JERSEY CORPORATION)

THIS IS TO CERTIFY THAT

L. G. Tillotson
Box 177
Peoria, Illinois

OR REGISTERED ASSIGNS IS ENTITLED TO SUBSCRIBE AT THE SUBSCRIPTION PRICE PER SHARE SHOWN BELOW FOR

FIVE (SHARES)

OF COMMON STOCK B OF THE AMERICAN TOBACCO COMPANY, A NEW JERSEY CORPORATION (HEREINAFTER CALLED THE "COMPANY"), HERE SO NAMED AND, SUBJECT TO THE TERMS AND CONDITIONS SET FORTH ON THE REVERSE HEREOF, PURCHASE SUCH SHARES OF COMMON STOCK B AS MAY BE PURCHASED BY THE EXERCISE OF THE SUBSCRIPTION RIGHTS EVIDENCED BY THIS WARRANT AT THE SUBSCRIPTION PRICE PER SHARE SHOWN BELOW AT OR BEFORE 3 P. M. ON THE DATE SHOWN BELOW (SUCH DATE AND SUCH PERIOD THEREIN REFERRED TO AS THE "EXPIRATION DATE").

THE SUBSCRIPTION RIGHTS EVIDENCED HEREBY ARE EXERCISABLE AT ANY TIME PRIOR TO THE EXPIRATION DATE BY THE REGISTERED HOLDER HEREOF OR BY HIS DULY AUTHORIZED ATTORNEY OR LEGAL REPRESENTATIVE UPON SURRENDER OF THIS WARRANT TOGETHER WITH THE PURCHASE FORM HEREON DULY EXECUTED AND ACCOMPANIED BY PAYMENT IN FULL OF THE SUBSCRIPTION PRICE FOR THE NUMBER OF SHARES OF COMMON STOCK B PURCHASED. AS SOON AS PRACTICABLE AFTER THE EXERCISE OF ANY SUBSCRIPTION RIGHTS, THE COMPANY WILL CAUSE TO BE ISSUED AND DELIVERED TO OR UPON THE WRITTEN ORDER OF THE PERSON OR PERSONS ENTITLED THERETO A CERTIFICATE OR CERTIFICATES FOR THE NUMBER OF SHARES OF COMMON STOCK B TO WHICH, AS SHOWN BY THE BOOKS OF THE COMPANY, SUCH PERSON OR PERSONS SHALL BE ENTITLED UPON SUCH EXERCISE, TOGETHER WITH A NEW SUBSCRIPTION WARRANT OF LIKE TENOR FOR A NUMBER OF SHARES EQUAL TO THE DIFFERENCE BETWEEN THE NUMBER OF SHARES SUBSCRIBED FOR AND PAID FOR AND THE NUMBER OF SHARES OF COMMON STOCK B WHICH THE SURRENDERED SUBSCRIPTION WARRANT WAS EXERCISABLE TO PURCHASE.

IF THE SUBSCRIPTION RIGHTS EVIDENCED HEREBY ARE NOT EXERCISED AT OR BEFORE THE EXPIRATION DATE, THIS FULL SHARE SUBSCRIPTION WARRANT SHALL BECOME VOID AND ALL THE SUBSCRIPTION RIGHTS EVIDENCED HEREBY SHALL THEREUPON CEASE AND TERMINATE.

This warrant is not valid unless countersigned by the Transfer Agent for the Common Stock B of the Company.

This full share subscription warrant and the shares of the Common Stock B issuable upon the exercise of the rights represented hereby are subject to the terms and conditions set forth on the reverse hereof, to all of which terms and conditions the registered holder hereof assents by acceptance hereof.

This warrant is transferable only on the books of the Company by the registered holder hereof in person or by his duly authorized attorney or legal representative upon surrender of this warrant properly endorsed. Upon any such transfer a new warrant or warrants will be issued to the transferee and a warrant for any balance not transferred will be issued to the transferor.

This warrant is not exchangeable for separate warrants except in connection with permitted transfers hereof. Upon any such transfer, upon surrender of this warrant for exchange, the Company will issue a new warrant or warrants of like tenor, in the aggregate for the number of shares purchasable hereunder, but in such denominations as shall be requested by the holder hereof surrendering the same.

No fractional shares of Common Stock B will be issued upon the exercise of any subscription rights, but the Company will pay the cash value thereof. Fractions of shares of Common Stock B issuable upon the exercise of subscription rights shall be computed on the basis of the subscription price and the value of a fractional share shall be the same proportion of the market price per share of Common Stock B determined as of the date of exercise of the subscription rights as the fraction is of a share.

The Company will not be required to issue or deliver any certificate for shares of Common Stock B upon the exercise of any subscription rights until it has received all amounts due it in respect of such shares, whether by reason of any tax or otherwise.

The Company will not be required to issue or deliver any certificate for shares of Common Stock B upon the exercise of any subscription rights until it has received all amounts due it in respect of such shares, whether by reason of any tax or otherwise.

DATED: NEW YORK, N.Y. APRIL 1, 1947

THE AMERICAN TOBACCO COMPANY
BY GUARANTY TRUST COMPANY OF NEW YORK, Agent

EXPIRATION DATE: 3 P. M. EASTERN STANDARD TIME, APRIL 21, 1947.

THE SUBSCRIPTION PRICE IS $57.50 PER SHARE.

Authorized Officer

IN THE EVENT OF THE EXERCISE OF LESS THAN ALL THE SUBSCRIPTION RIGHTS EVIDENCED HEREBY, A NEW SUBSCRIPTION WARRANT FOR THE BALANCE OF SUCH SUBSCRIPTION RIGHTS WILL BE DELIVERED TO THE REGISTERED HOLDER HEREOF OR HIS DULY AUTHORIZED ATTORNEY OR LEGAL REPRESENTATIVE.

preferred stock would sell to the general public for $105 a share and if the stockholder has been granted the privilege of buying a share at par, $100, his "right" is worth approximately $5. If he does not care to exercise this right in his own name, either because he has no money or does not care to invest more in this particular company, he can sell his privilege to someone else. Rights are sold on the national exchanges if the stock involved is listed.

Sometimes the privilege of purchasing stock is in a ratio, such as one new share for each ten shares held of the old stock. For example, if the common stock of the Automatic Washing Machine Company had been a $10 par stock, there would have been 50,000 shares outstanding in relationship to 5,000 shares of preferred stock available for sale. In this event a man who owned five shares of stock would receive five rights, but it would take ten rights to buy one share. He can sell the five rights or buy five in order to deal in the unit of a single share of the new stock.

Sale to Customers, Employees, Creditors, and Acquaintances. A company, if it wished, could offer stocks or bonds for sale to its customers. This is unusual except in the case of public utilities. Water, gas, electric, and telephone companies have sometimes used their retail offices as stock-selling agencies, with marked success. Such firms have considered it good business to have their customers as owners. The theory is that the firm is subject to less criticism in regard to the rates it charges if the public, which pays the bills, also receives a distribution of the earnings.

Sales to employees promote good relations with the workers who feel that they are owners as well as employees. However, such sales should be a continuing process and not a method of raising new capital. Creditors sometimes buy securities to secure a connection that may insure or at least predispose the corporation to continued business relations in the future as in the past. Probably the best source of direct sales for small corporations is that afforded by interesting the friends of the management in investing in the firm. The officers of the corporation are likely to know individuals who have funds available for investment.

Selection of Method by Automatic Washing Machine Company. Referring again to the Automatic Washing Machine Company, the decision might well be to sell both issues to an investment bank. The company does not have a nationwide reputation, which means that its securities will need to be marketed by an organization equipped to render this service. Both bonds and stocks should be included because the common stockholders do not have the private means to purchase even the preferred-stock issue. In order to avoid legal restrictions, the common stockholders will vote on the question of waiving their rights to subscribe to the preferred stock. The vote will be in favor of the proposal as the officers who planned the expansion control over one half of the votes. A sale to customers is out of the question as no retail outlets are maintained, and other means of direct sale are not promising.

Working Capital Needs The problem of raising an additional $100,000 for working capital has not yet been solved. Either the bond issue might be increased or the preferred-stock issue enlarged, or a combination of the two methods could be used. There is also the possibility of selling more common stock either to the existing stockholders or to outsiders. Even if it proves necessary to seek new investors, the three men owning $300,000 worth of common stock would still remain in control because the stock issue would be expanded only from $500,000 to $600,000. There is also the possibility of securing short-term credit for all or a portion of this additional amount.

If short-term credit is used, funds could be borrowed from a bank; or it should be possible to buy the inventory, at least, on open account, which would obviate the need for paying interest on this portion of the increased working capital. Another possibility would be the sale of commercial paper, with a maturity date of one year, by which time increased profits might be available to liquidate this debt. Considering the credit standing of the Automatic Washing Machine Company and the real question about the amount of time it might take before the planned expansion becomes profitable, the decision regarding the additional $100,000 needed should exclude short-term sources, if at all possible.

The best plan for raising the $100,000 in working capital would probably be to sell this amount of common stock, in light of the facts as given. This could be done by issuing stock rights entitling the existing stockholders to buy one share of the new common stock for each five shares of stock already owned. Those stockholders who possessed funds sufficient to exercise this option could do so; others could sell the stock rights. The chances are that by this method most of the $100,000 could be raised from the original stockholding group.

Refinancing Programs The above discussion had to do with raising additional funds. Sometimes, a business establishment desires to change the nature of the financial structure without increasing the total funds used. Frequently such changes take place in the normal operations of the business. An individual proprietor may have borrowed part of his original capital from a friend or from a bank. If the operations of his firm prove profitable and if he does not withdraw these profits for his personal use, he should be able to repay the loan from funds retained in the business. In this way, over a period of time the original capital structure of part debt and part ownership is changed to full ownership.

Another possibility, however, is a recasting of the original financial plan without making use of profits. This is particularly true of corporations that may replace one type of security with another. Some of the shifts that take place are as follows.

Bonds for Bonds. The indenture for practically every bond issue includes a provision that the bonds may be called or redeemed at the option of the debtor company. Usually a premium must be paid, which varies with the length of time the bonds have been outstanding. For example, a forty-year bond issue may be callable at 110 per cent of par the first ten years, at 105 for the next ten, with a future reduction of 1 per cent for each successive five years up to maturity.

Assuming that a company issued a 6 per cent bond issue ten years ago, which was to run for forty years, and that interest rates have fallen to a point where it now appears that a 4 per cent series could be issued at par, the question might well be raised whether it would be profitable to call in the old bonds.

For each $1,000 bond the company would have to pay $1,050. However, the saving in interest in one year would be $20, which means that within two and one-half years the call premium would have been matched. Since the bonds have thirty more years to run to maturity, the saving over the remaining life of the original issue would be material.

If many of the old bondholders are willing to accept a new bond and $50 in cash in payment for their original bond, this opportunity might be offered. To the extent that such trades could be made, the cost of selling the new issue would be reduced. The possible cost of this refinancing would need to enter the picture because, to this extent, the net savings would be reduced.

Stocks for Bonds. A few bond issues are convertible into stock and, if the conversion feature becomes worth while, there is a possibility that this shift will take place almost automatically. Normally, when a change in the financial structure involves stocks for bonds, the bonds outstanding are called and paid off with the proceeds of a stock issue. Because investors in bonds and in stocks are different classes of people or agencies, attempts to trade one security for the other would not meet with the favorable reception that is usually accorded a refinancing program of bonds for bonds.

The procedure is quite simple. The corporation sells preferred stock or common stock for cash. If necessary, the charter may be amended to provide for the additional shares, or authority may have been granted originally for more stock than is presently outstanding. The money received is used to redeem the bonds that are turned in by the holders. Interest is saved although dividends will need to be paid on the stock issued, provided any distribution is made of profits.

Stock for Stock. Corporations with preferred stock outstanding usually have a clause covering redemption in the contract under which this class of stock is issued. The provisions may be similar to those incorporated in a callable bond or may state a single premium at which the stock can be called any time at the option of the corporation. For example, a $100 preferred stock may have a redemption price of $110 that remains constant throughout the life of this stock.

The main purposes of redeeming a preferred stock issue are to refinance at a lower rate of preferred or to eliminate this class of stock entirely. If a corporation has outstanding a sizeable issue of 7 per cent preferred stock, the company may decide to replace this with an issue of 4½ per cent preferred. The result of this change will be to increase common stock dividend possibilities. Or, the corporation may come to the conclusion that the market is strong for common stocks and that now would be a good time to eliminate the preferred class. The advantage in this shift would be to remove a security senior to the common stock at an advantageous time. In later years, when more capital might be wanted and when the market was strong for preferred issues, there would not be the complication of adding other preferred stock shares.

Considerable trading might be done if one preferred stock was exchanged for another, and this might also be true if the issue was retired in favor of common stock. The officials of the corporation would have to decide whether to offer this option or merely to sell the new issue and, with the proceeds, redeem the called preferred stock. This freedom of action would not be available unless the common stockholders voted to waive their claim on the new stock issue as state laws rather uniformly grant old stockholders this privilege.

Long-Term for Short-Term Securities. Refinancing plans sometimes call for a change in the ratio of short-term to long-term securities. A corporation may find that there is no opportunity to reduce the short-term indebtedness and that these maturities are a constant source of financial difficulty as they have to be repaid with other short-term borrowing. In this case, a sale of bonds or stocks may prove to be the most satisfactory long-range solution.

Distribution of Earnings Policies Another financial problem faced by all businessmen is the proper policy regarding the distribution of earnings. In the case of sole proprietorships and partnerships, the owners usually pay themselves a modest salary if they are actively engaged in the operation of the business. This amount probably covers their normal living costs but does not provide for emergency needs or capital

requirements of a personal nature. Such withdrawals might seriously endanger the continued success of the business unless profits are high and the original capital structure did not include extensive short-term borrowing.

In some instances proprietors or partners have no personal needs for withdrawing any of the profits. The question would then arise as to whether better use of these funds would be in the business or in outside investments. If they are left in the business, the firm automatically will grow in size after all debts have been liquidated. If they are withdrawn, the firm will not expand, which may be desirable in view of location, available volume of sales, or nature of the business. The chances are that the profits could be used either in or out of the business and the policy of withdrawing all or part calls for the exercise of good judgment on the part of the owners.

The dividend policies of corporations are of more importance because the stockholders affected may be numbered in the thousands. If no legal or contractual restrictions are present, the board of directors has the sole power to declare dividends to any extent it believes prudent. A legal situation preventing a distribution of earnings would exist if there were no current profits and no accumulation from prior years. Or, in most states, if the current year showed a favorable picture but losses of former years had not yet been made up, no distribution could be made. A contractual restriction frequently exists if a corporation has bonds outstanding and the indenture limits dividends in order to conserve assets for the added protection of the bondholders.

Many corporations, particularly established concerns, operate profitably year after year. Most of these have retained a portion of the earnings in former years. This portion of the yearly profits has been invested in the business, thereby increasing the owners' equity. These companies can declare dividends even though the current year's operations show a loss, but their payment might place an undue drain on their cash balances. Assuming that this is not a restraining influence, then the problem would be a matter of policy.

There are several patterns of dividend payments. For the purpose of analysis, these may be divided into the following four categories.

Regular Dividend Rate. Some corporations have attempted to establish a reputation for the payment of annual dividends of a regular amount, regardless of business conditions or profitable or nonprofitable operations. If preferred stocks are outstanding, they are probably nonparticipating, and the contract rate is paid. In like manner, a steady dividend rate is applied against common stocks. The best example is the common stock of the American Telephone and Telegraph Company, which has yielded a $9 annual return for many years.

Some companies that have a regular dividend policy do change it on occasion to a higher or lower level, but such shifts are infrequent and usually are maintained for several years before another new rate is established. The Liggett and Myers Tobacco Company paid a $5 dividend per share of common stock from 1938 to 1942, at which time the annual rate was reduced to $3.50.

A great many corporations have adopted a variation of this type of dividend policy in that the stockholders receive more than the usual return in years of particularly successful operations. The regular dividends are declared as usual, normally on a quarterly basis, and in addition, the board of directors announces an "extra" and pays it in a special distribution. Actually, this means a higher yield, but from the psychological viewpoint the investor realizes that in another year he should not expect a like sum unless operations are again unusually profitable.

Variable Dividend Rate. A variable dividend policy is the exact opposite of a steady yield in that in some years no dividends are declared and in others the amount paid out is a handsome return on the investment. If operations are not profitable, no distribution is made even though the corporation could do so legally and with no damage to their financial structure. On the other hand, if profits are large, dividend payments are generous. In some instances, every dollar earned is distributed to the stockholders in the same year.

In 1936, Congress passed a tax law that included a provision assessing a special tax on profits of corporations that were retained during the year earned. The idea was to force corporations to pay out all of their earnings in order that the

dividends received by stockholders could be taxed on their personal returns. This law, which was in effect for only two years, was called the undistributed profits tax. It resulted in abnormal payments by many corporations that had formerly used a regular rate, with or without extras. For example, the Chrysler Corporation paid $12 a share for 1936 and $10 in 1937 even though the rate had been only $2 in 1935 and was reduced to this base again in 1938.

Conservative Dividend Plan. A modification of the variable rate policy is the program of declaring a certain percentage of earnings in the form of dividends and retaining the rest as a reinvestment of earnings. A board of directors might decide that one half to two thirds of the earnings should be distributed each year but that the remainder should be held.

In the early days of corporate finance, there was a widely held theory that manufacturing firms, because of the risk, should yield a profit of 10 per cent annually on capital invested. It was also felt that an investor should be satisfied with a 6 per cent return on his funds, which meant that the remaining 4 per cent would be retained by the corporation. These retained profits were referred to as "ploughed-in earnings" and had the effect of increasing the size of the organization year by year. Because of the geographical location of most industrial concerns in the earlier history of this country, this program became known as the "New England method of expansion." The best modern illustration of this type of growth is the Ford Motor Company, which grew to a billion-dollar industry from an original investment of $28,000.

Stock Dividends. Any corporation that fails to pay out all of its earnings will grow in size. The rate of growth will vary in relation to the cash dividend policy. After a number of years, the equities behind a share of stock will increase to such an extent that, even though earnings remain constant on each dollar of assets, the total earnings increase materially in relation to the original amount of stock. At this time the corporation might declare a stock dividend, in addition to a cash dividend. For each share owned, a stockholder might receive an additional share on which, in future years, he could expect

to receive a cash yield similar to that enjoyed on his original share. Stock dividends are also given on a proportionate basis, such as one new share for each five or ten already owned. One objection to this plan is that fractional shares result.

Dividend Payments Dividends are normally paid in cash if they represent a distribution of current earnings, and in stock if they represent a permanent capitalization of accumulated earnings retained from former years. However, in lieu of cash or stock dividends, a corporation may use other methods of payment as follows.

Scrip. The most common substitution for cash dividends is payment in scrip. This is short-term paper somewhat similar to notes payable, which may or may not bear interest. The purpose is to effect a distribution, even though the cash position of the corporation precludes writing checks at the usual dividend date. Of course, the scrip comes due in a few months, but it may be assumed that payment can be made at that time; otherwise the scrip would not have been issued in the first place.

Merchandise. An unusual method of paying dividends is to distribute merchandise instead of cash to the shareholders. A company in the business of raising oranges, for example, does not have the necessary current funds with which to pay a cash dividend, but it does have a stock of oranges in excess of what is required to supply the demand. Under these circumstances, the company could declare a merchandise dividend by shipping stockholders a certain quantity of oranges for each share of stock held.

Securities. Using securities owned by the corporation to pay dividends to stockholders is not uncommon. In some instances an investment is made in the stock of another corporation, which, as the years go by, it seems unwise, or even illegal, to hold. The shares of the other corporation can be distributed to the corporation's own stockholders as a special dividend or in payment of a regular distribution of earnings. Large purchases of United States Government bonds during war years create another condition under which a possible

distribution of securities as dividend payments may be justified. Rather than liquidate these securities, some corporations have used the bonds for dividend payments to the stockholders.

Stock Split-ups A *stock split-up* consists of replacing the original stock outstanding, usually common, with two or more shares of a new issue. A stock split-up may seem similar to a stock dividend to the stockholder, because his net result is to own more shares of the stock of a particular company than he did before the split-up or stock dividend occurred. Actually, they are very different. In the case of a stock split, the shareholder sends the company his original certificate and receives two or more new shares in return. If a stock dividend is declared, the old certificate is retained and a new one received for the number of the extra shares to which he is entitled.

If a stockholders owns one share of a $100 par stock, the board of directors, with the approval of the stockholders, may exchange four shares of a $25 par stock for the one share formerly outstanding. If the stock is a no-par issue, the problem is similar except that two, three, four, or even ten shares or more may be given in exchange for the original certificate.

The usual reason for a stock split-up is to bring the unit price into a "trading range," that is, a price at which practically all investors can afford to purchase one or more shares. For example, if the price of a single share of stock were quoted on the New York Stock Exchange at $250, there are a number of individuals who might care to hold an interest in the organization concerned but could not afford to buy even one share. If a stock split-up of five shares for one was effected, the price a share should decrease to $50, which would be more in line with the pocketbooks of many investors. Another reason for a stock split-up is to avoid the public criticism that might follow extremely high earnings or dividends on the original stock.

An interesting phenomenon of stock split-ups is that the price rarely drops completely to the level that should be expected. On October 23, 1945, Sears Roebuck and Company stock was selling at 143¼; and the next day, after a four-for-

one split, the stock dropped to 37½, which was equal to 150 for the old stock.

Failures and Reorganizations Many business enterprises, which begin operations with high hopes of profits, and others, which have enjoyed years of success, sometimes meet with financial reverses. The fault may lie with management or may be due to causes beyond the control of the owners. Whatever the reason or reasons, the fact remains that the owner, partners, or board of directors may be faced with a most important decision if a series of losses has seriously weakened the financial structure of the organization.

Under the National Bankruptcy Act a person is deemed *insolvent* whenever the aggregate of his property is not, at a fair valuation, sufficient in amount to pay his debts. It is not uncommon to note in the newspapers that Mr. Black, for example, has been adjudged a bankrupt with assets of $7,400 and liabilities of $35,000. It is also possible for an individual or firm to become insolvent under state laws merely because of inability to pay debts currently owing. A manufacturing firm may have assets valued at more than its liabilities but, because most of its capital is tied up in special machinery for which there is no general market, the assets cannot be liquidated to pay accounts payable and notes payable that have fallen due.

Creditor Agreements. When a business becomes insolvent, the first decision that must be made is whether to stay out of, or go into, the courts. There may be no choice, but at least the management can call the chief creditors together to discuss the best plan of action. The creditors know that, if the company is adjudged bankrupt by a court, the legal costs will be high, and it is most unlikely that they will receive full payment for their claims. Furthermore, a former customer, who might otherwise be saved for future business, is lost. If the creditors believe that the business can operate at a profit in the future, despite past reverses, they may agree to postpone the due date of their bills. Such an *extension agreement* must be signed by all, or at least the large, creditors in order to give the plan a fair chance to work out successfully.

A variation of the extension agreement is for the creditors to accept a reduction in the amount due, and this is called a *composition settlement.* Each creditor agrees to a reduction in the amount owed. This amount may be paid in cash immediately, or settlement may be postponed for a few months. In these voluntary agreements, the creditors usually elect a representative who assumes active management of the firm for a long enough period of time to guarantee that the plan will be followed. As soon as the organization is operating smoothly and successfully, the creditors' representative or committee withdraws and allows the original managers to operate without supervision.

If the creditors cannot agree to some type of a voluntary settlement of their claims or if there seems no hope of successful operation, the only alternative is to turn to the courts for help. Such a step can be taken by the insolvent firm, or the creditors may force the issue. In either case, there is a choice between an equity receivership and bankruptcy.

Equity Receiverships. In an equity receivership, the court appoints a *receiver* who operates or liquidates the company in the interests of the creditors. If it is decided to continue the firm, the results may be similar to that of a voluntary agreement on the part of the creditors with the added authority given by the law and, likewise, added costs. The chief advantage is that no single creditor can block the proceedings by refusing to become a party to the agreement. Also, the receiver reports to the court and must make an accounting for all receipts and expenditures. Furthermore, no creditor can bring suit or insist on collection of his claim so long as the receiver is in charge of the business.

If the receiver believes the best plan is to liquidate the firm, he will apply to the court for this permission and, if granted, will proceed to turn the assets into cash and pay creditors in their order of preference. Some debts may be secured by mortgages or other collateral sufficient in sales value to provide adequate funds to discharge these claims in full. Or, if the security is sold for less than the amount owed, the creditor will receive the proceeds and join the unsecured creditors for the balance due him. General creditors will usually receive

only a portion of their claims, as the sale of assets under forced sale conditions does not normally produce enough money to satisfy all claims in full.

Bankruptcy. Equity receiverships may be under the jurisdiction of state courts or Federal courts, depending upon whether the business is local or interstate. However, if a firm goes into bankruptcy, the proceedings will be in a Federal court because the bankruptcy laws are national. The Constitution of the United States provided for a national and uniform bankruptcy law, and at present the Chandler Act of 1938, plus some recent amendments, is the effective law in this field.

An individual or corporation, with certain exceptions such as banks, may file bankruptcy papers by declaring under oath that liabilities owed exceed the value of assets owned. Or, if an act of bankruptcy is committed, such as assigning assets to a particular favored creditor, creditors with claims of $500 or more can file a petition asking that the firm be declared a bankrupt. Unless the organization can refute the charges, the court will declare the debtor a bankrupt.

As in the case of an equity receivership, the court appoints a receiver. In earlier days, it was most common for him to liquidate the assets and pay off the creditors. In this manner, the debtor was legally discharged from his obligations, and the creditors were given impartial treatment according to their legal status. More recently, there has been a determined effort to reorganize the company rather than to carry through a liquidation. If there is good reason to believe that the enterprise could be operated successfully with a revised financial structure, the court may work out a new financial plan.

Section 77b. Impetus to this type of reorganization was given by a 1934 change in the 1898 National Bankruptcy Act, which became widely known as Section 77b. This amendment provided that reorganization plans, formerly available only under equity receiverships or voluntary agreements, could be carried out under the Bankruptcy Act. All creditors would receive fair treatment, but no group or individual could block the proceedings. Also, firms would be kept alive, and the expensive liquidation of properties would be avoided.

Although a great many corporations took advantage of Section 77b, certain flaws in this law were discovered, and in 1938 the Chandler Act was passed, which not only was a sweeping revision of the bankruptcy laws but also included Chapter X, a revision of Section 77b. Among the changes were provisions for the protection of some of the smaller creditors. Chapter X provided, too, that any reorganization plan involving a debt of over $3,000,000 must be reviewed by the Securities and Exchange Commission.

Under Section 77b and Chapter X of the Chandler Act, the court usually appoints a trustee who prepares a plan of reorganization. All interested parties are given a chance to present their plans for special consideration, and various groups such as bondholders and stockholders submit plans. If possible, the trustee works out a final plan that is acceptable to all classes of creditors. If this is approved by the court, it goes into effect.

Reorganization Plans. Reorganization plans usually involve the scaling down of amounts owed or the interest or dividend rates, with more sacrifices being taken by the common stockholders and other unsecured interests. For example, first-mortgage bondholders owning 6 per cent securities might agree to accept 4 per cent bonds in exchange. Second-mortgage bondholders might agree to a reduction in interest rate and also in principal amount. Preferred stockholders might be given lower dividend stock or even common stock. Common stockholders sometimes are eliminated entirely or are given a small amount of new stock in exchange for their previous holdings. The net effect is to reduce the annual fixed charges for interest and debt retirement to the point where normal operations of the business will allow for these charges and still leave a profit margin.

Sometimes, reorganization proceedings are carried through because it would be against the public interest to allow the organization to be liquidated. This is true in the case of some railroads and other public service industries. In many cases, reorganizations have saved to the economic world a good business organization that was inherently sound but could not continue with its existing financial structure.

QUESTIONS

1. Why is it important that the financial structure of a business organization be constructed on a sound basis?
2. What are some factors that would influence a choice between issuing bonds or stocks in order to secure capital funds?
3. Public utilities and railroads have always secured a large part of their capital from the sale of bonds. Why is this sound?
4. If a stockholder owns 100 shares of stock and is entitled to buy 25 more at the par value of $100 although the market price is $110 a share, what is the value of the "rights" that he receives?
5. What factor or factors would cause a firm to call bonds that are outstanding prior to the regular maturity date?
6. Why do most corporations secure part of their permanent capital needs from sources other than common stock?
7. Should corporations distribute all or most of their annual earnings in the form of dividends?
8. It has been said that the "New England method of expansion" forces the stockholder to increase his investment in the particular corporation. Discuss.
9. What is the difference between a stock dividend and a stock split-up?
10. If a well-established company is in financial difficulties, what procedure would probably prove the most satisfactory for an unsecured creditor?
11. Why would a firm prefer to go through an equity receivership rather than to take out bankruptcy papers?
12. What was accomplished by Section 77b and Chapter X of the Chandler Act in amending the National Bankruptcy Act of 1898?

PROBLEMS

1. The XYZ Corporation has been earning $80,000 on its total assets of $1,000,000. These assets were purchased with funds secured from the sale of $750,000 of common stock (par value, $100), $200,000 borrowed from a bank at 5 per cent, and $50,000 in open book accounts. The Corporation expands by selling $500,000 of 3½ per cent bonds and $500,000 of 4½ per cent preferred stock. Part of the proceeds from this sale are used to pay the bank loan.

Assuming that all operating earnings are paid out either for interest or for dividends and that the rate of earnings on total assets remains constant, what dollar dividends per share were available to the common stockholders before and after the expansion? Show calculations.

2. The ABC Manufacturing Company finds itself in financial difficulties. The annual bond interest requirement on a $5,000,000—6 per cent issue has been the cause of an average net loss of $25,000 each year. No dividends have been paid on a $3,000,000—7 per cent noncumulative preferred stock issue nor on the $2,000,000 common stock outstanding.

The Company decides to avail itself of the opportunities of Chapter X of the Chandler Act. A proposal involving the following financial changes is presented to the various classes of security holders: (1) Bondholders are asked to accept $500 in a 3 per cent bond and $500 in a 4 per cent preferred stock certificate in return for each $1,000 bond; (2) the preferred stockholders are asked to exchange their stock for one half of the new preferred stock and one half common stock; and (3) the common stockholders are to agree to donate enough common stock to provide shares for issue to the present preferred stockholders. Each group of security holders voted to accept the new financial plan.

Show the financial structure after this corporate reorganization and, assuming the same earnings, what rate of dividends is now available to the common stockholders?

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CHAPTER 24

RISK AND RISK-BEARING

Business Involves Risks Risk is universal. All business operations are hazardous; some more so than others. To a certain degree, profits are related to the extent of the risk involved. An investment in an old, established, well-known firm will seldom provide as high a rate of return to the capitalist as could be obtained from a newly organized company that happens to succeed. The yield on United States Government bonds is much less than the interest paid by some South American republics on similar securities. Capital is attracted to some venturesome projects because the high risk involved may be rewarded by high returns if the venture is successful.

Although there are some people who enjoy risks, the majority are careful and conservative. The same is true of most business organizations; if it were possible, the owners would be glad to eliminate all risks. Although this cannot be done, it is possible to eliminate or reduce many business hazards or to shift the risk to companies organized for this purpose. This statement suggests that risks are of two kinds—those that must be assumed by the business, and those against which complete or partial protection can be secured.

Risks That Must Be Assumed Business risks that must be assumed usually include certain changes that take place over the years. The following examples suggest the nature of these types of risks.

(1) *Changes in the price level.* During the early thirties, prices went down to depression levels, and many business operations were conducted at a loss. No single businessman or company could do anything to prevent this subnormal price level. An exception to this classification is *hedging*, which was discussed briefly in Chapter 21.

(2) *Changes in the desirability of business locations.* At the time of construction, a store, apartment house, or restau-

rant, to name a few examples, may be located in the heart of the most desirable business or residential district. Subsequent growth of the city may shift these centers with the result that a profit can no longer be earned at the original location.

(3) *Changes in distribution methods.* Perhaps the best illustration of this change is that which has taken place in the grocery business with the advent of the chain store and the supermarket. Many independent, small grocery stores have been forced to close.

(4) *Changes in public opinion or desire.* Some years ago there was a tremendous growth of miniature golf courses. The public soon tired of playing this game and most of these businesses have discontinued operations.

(5) *Changes in laws.* The prohibition law passed in 1918 forced thousands of saloons to go out of business. The same thing happens today when a city, town, or county votes to prohibit liquor sales in that area.

Protection against Risks Partial or complete protection can frequently be secured against other risks by one of three methods. The first is to remove the risk. Safety devices on machines can eliminate, or at least reduce, the hazard of industrial accidents. Constructing a fireproof building practically removes the danger of a serious fire loss.

A second plan is to recognize the risk and prepare in advance to handle it with the company's own resources. This is called *self-insurance.* Unfortunately, such a program can be put into operation only by a large concern. If a corporation owns several factories, warehouses, or retail outlets, the danger from fire is present at each location, but the chances of having several buildings burn down in any one year are remote. By establishing an insurance fund each year, the company can provide a reserve to cover normal fire losses.

The third and most widely used method is to shift the risk to someone else. This is accomplished by means of insurance, and there are many excellent companies that specialize in handling this type of business. Actually, the insurance companies take very few risks. For example, a fire insurance company insures 5,000 store buildings valued at $10,000 each,

which means a total liability of $50,000,000. These buildings are located all over the United States, and within a large city are dispersed in the various business areas. Past experience has shown that about one half of 1 per cent will be destroyed by fire during the year. This means an average annual loss of $250,000 and, if each property owner purchases a policy for which he pays a premium substantially in excess of $50, the company will have enough money to pay the losses and its expenses of operation, and earn a profit. No one knows in advance which buildings will burn, and no owner could afford to gamble that his property would not be included. The losses of a few are paid for by the small contributions of many.

Characteristics of Insurable Risks The preceding example of fire insurance operation suggests most of the conditions under which a risk may become insurable. The characteristics of a risk that can be shifted to a company formed for this purpose are as follows: (1) The total loss must be predictable. The number of people who will die each year or the number of houses that will burn can be predicted with amazing accuracy. (2) The risk must be spread over a wide geographical area. A fire insurance company could not afford to insure all the houses in one city only. A disastrous fire such as occurred in Chicago in 1871 would bankrupt the company. (3) Risks must be selected. No company can afford to insure only people who are seriously ill, have heart trouble, or make their living testing new airplanes. (4) The risks must be numerous enough as a group to make the law of averages work. Insuring one life for a small premium could not be done on a scientific basis, but insuring the lives of 100,000 people can.

The question may well be asked, "How does a policy insuring the hands of a piano player for $100,000 or the nose of a movie actor for a fabulous sum fit into the classification of insurable risks?" The answer is that such policies are not written except by Lloyds of London, an organization that will insure against any risk regardless of its characteristics. Lloyds is not an insurance company but is an institution through which members who wish to underwrite hazards offer policies. Marine insurance, which falls within the classifica-

tion of insurable risks, forms the bulk, though not the spectacular portion, of the underwriting business of Lloyds.

Types of Insurance Coverage Because insurance is a highly specialized business, companies have been forced to handle certain types of risks. There is some overlapping, but a fire insurance company would not be expected to cover losses from accidents, and a life insurance company would not handle fidelity bonds. In general, insurance coverages can be divided into five classes as follows:

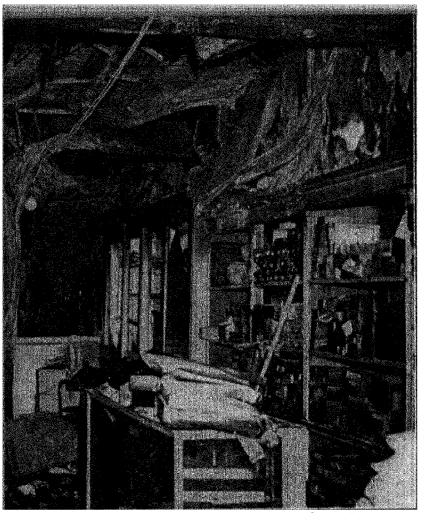
1. Fire and Allied Lines
2. Casualty
3. Marine
4. Fidelity and Surety Bonds
5. Life

The remainder of this chapter will be devoted to a discussion of these various types of coverages.

Fire Insurance One of the most common risks against which insurance is carried is that of fire. Homes, apartment houses, store buildings, factories, and almost every type of building can be insured against loss resulting from fire. The same thing is true of the contents, whether it be furniture, merchandise, machinery, or supplies of any type and description. Policies are sold on a one-, three-, or five-year basis as a general rule. The annual cost is lower if the insured purchases a three-year contract rather than three one-year policies, and even less on the five-year basis.

Premium rates are relatively low but vary considerably in different geographical areas and among types of construction. For example, cities are graded on such items as water supply, fire alarms, building laws, and the efficiency of the fire department. Within the city the location of a building is important as it may stand between two old buildings or at some distance from other structures. Regardless of these factors, if the construction is considered fireproof, the rate will be lower than on frame buildings. The lowest rates are in the neighborhood of 10¢ for each $100 of coverage, and more hazardous risks may cost $2 for each $100.

Coinsurance Clauses. Fire damage to industrial property resulting in complete destruction of all of the property insured



Harold M. Lambert

A Business Loss from Fire

is rare. If it were permissible to buy an insurance policy for one third or one half of the total value of the property owned, the annual savings in insurance premiums would probably more than offset a fire loss in excess of this partial coverage. Insurance companies protect themselves against this reduced premium income by inserting in the policy what is known as a *coinsurance clause*. Such a clause requires that the insured buy coverage up to a stipulated percentage of the value of the property, usually 80 per cent, or personally assume a proportion of each fire loss. Residence property is not subject to coinsurance clause restrictions.

If a factory is properly valued at $100,000 but is insured against fire for only $50,000, the risk is only partially covered because the minimum insurance for full protection against partial losses would have been 80 per cent or $80,000. If a fire occurs with a total damage of $20,000, the insurance company will pay $50,000/$80,000 or five eighths of the loss. This would result in a payment of $12,500 even though the loss was $20,000.

Allied Coverages. Fire insurance companies also handle losses caused by wind, rain, hailstorm, tornado, and water damage. Such coverages can be written in a special policy or can be added to the fire insurance policy by means of a special agreement known as a *rider* or *endorsement*. Rates vary with the extent of the risk. For example, adding a wind-damage clause to a fire insurance policy for an ordinary dwelling costs approximately 10¢ a year for each $100 of coverage.

Casualty Insurance

The number of types of risks that are assumed by casualty insurance companies is much greater than those for other insurance organizations.

No attempt will be made to itemize all of the policies available, but a survey of the more important ones will indicate the field of casualty insurance.

Automobile Insurance. The usual types of automobile coverage include fire and theft, public liability, property damage, and collision insurance. If the policy covers *fire and theft*, the amount paid the insured in case of total loss is the value of the car at the date of the fire or theft. *Public liability insurance* can be taken out for various amounts that will pay the policyholder's legal liability for injury to one person or to a group. If a driver hits a pedestrian or causes injury to persons in another car, the insurance company will pay damages up to the amount of coverage carried. A common policy fixes maximum limits of $5,000 for causing the death or disability of one person, and $10,000 for similar reasons to more than one person. This type of policy is frequently identified by the fraction $5/10$. Higher maximum coverages than $5/10$ can be obtained in amounts such as $15/20$ or $20/40$ by paying a slightly higher premium.

Property damage insurance is stated at a single amount such as $5,000. If the insured car damages another car, or runs into a house, or damages any property not belonging to the insured, the insurance company will settle the claim up to the size of the policy. It will not pay anything for damages to the policyholder's car unless *collision insurance* is carried. Many drivers do not carry collision insurance because of the relatively high cost, although cars purchased on the installment plan are so covered in order to protect the finance company.

Within recent years automobile insurance companies have offered *comprehensive coverage.* This is a contract that covers practically all damage to the insured's automobile except that resulting from collision and upset. For example, claims have been paid for accidental damage to upholstery and for windshields broken by flying stones.

In many states legislation has been enacted that relieves the driver of a car from liability for injury to his passengers arising from an accident. Such "guest laws," as they are termed, were passed to prevent friendly suits against the car

owner with the knowledge that the insurance company would finance the settlement. A *medical payments endorsement* can be purchased that will pay hospital and doctor bills up to a specified maximum for each guest in the insured's car who is injured in an accident.

Theft Insurance. Burglary insurance is another common type of coverage. Any loss that may result from theft can be covered by insurance. Money, jewelry, clothing, merchandise—anything of value that might be stolen—may be included in a policy.

Although residence burglary insurance is the most common type written, the businessman is more interested in other forms. These include mercantile open stock, business safe, office burglary and robbery, and paymaster protection. The small businessman can purchase a storekeeper's burglary and robbery insurance policy, which gives a comprehensive coverage. Merchandise in a store is not protected from theft during the hours the store is open.

Accident and Health Insurance. The oldest form of casualty insurance is accident and health insurance. In case of an accident, the policyholder may receive weekly payments, certain medical expenses will be taken care of, and if the accident results in a serious disability or loss of life, a specified sum is paid. For example, if the insured loses a hand in an accident, he may draw weekly payments for one hundred weeks, or the policy may specify a lump sum payment such as $2,500.

Health insurance merely extends the coverage to loss of income from illness as well as from accidents. Such a policy will pay the insured a specified weekly income while he is unable to draw his regular salary because of ill health.

Many employers have taken out *group accident and health insurance* covering their employees. Such policies frequently provide paying approximately two thirds of the regular salary for a period of twenty-six weeks in case of illness or accident. Sometimes, the employer pays the cost of the policy; in other cases, the employee contributes the cost under a pay-roll deduction plan. Although health and accident coverages are classified as a type of casualty insurance, these policies are sometimes sold by life insurance companies.

Workmen's Compensation. Almost all states have passed laws making it compulsory for employers to carry workmen's compensation insurance. Certain classes of workers, notably farm and domestic laborers, are exempted, and a certain minimum number of employees is usually stated. In some states, the workmen's compensation insurance is a monopoly of the state; in others, private insurance companies compete with state funds; and in still others, private insurance companies handle the business unless the employing company is large enough to warrant approval for self-insurance. The rates are assessed against the pay roll, and they vary with the hazard of the industry.

The purpose of workmen's compensation insurance is to guarantee medical expenses and salary payments to workers who are injured on the job unless it can be shown that the employee's injury or death was willful or caused by intoxication. The usual practice is to specify weekly benefits. These are set at a fraction of the regular wage, such as one half or two thirds, in order to discourage those who might prefer to draw benefits rather than work. A waiting period of from a few days to two weeks is also a common provision of many laws. This means that no benefits can be drawn until the expiration of the waiting period, which eliminates claims for minor accidents. In case of death, weekly payments are made to the dependents for a specified period, frequently eight years.

Originally, business firms were opposed to legislation that required carrying workmen's compensation insurance. However, most organizations have found that the cost has proved well worth while. In addition to insuring the individual worker, the policy also protects the employer against claims for injury and loss of pay resulting from accidents that occur during working hours. Suits for damages, which might be expensive to defend, plus the prejudice of juries for the individual against the corporation, are avoided. Whether the state has a monopoly of the insurance or whether private companies operate in the territory, there is usually a state commissioner who oversees the operation of the compulsory state law.

Aviation Insurance. Aircraft that are registered with the United States Department of Commerce are considered eligible

for insurance. Coverages include fire, theft, windstorm, accidental damage, public liability, and property damage. Some of these risks are insured by fire insurance companies; others, by casualty companies.

In general, if a passenger plane is operating on a scheduled route, it is assumed that the aircraft is a common carrier and the company operating the line is responsible for injuries to the passengers, fatal or otherwise. Airlines carry passenger liability insurance, usually a minimum of $5,000 a person. The same type of coverage is available to owners of planes who sell contract flight trips.

Trip ticket personal accident policies are available to individuals who wish to purchase added protection. These are good only if the flight is made in regularly-scheduled licensed planes flown by licensed pilots. A variation of this type of coverage can be purchased by a company to cover all employees who use planes for travel in behalf of the business. The purpose of this latter type of policy is to encourage the use of travel by airplane by executives of the company purchasing the group policy.

Public Liability Insurance. A great many manufacturers, retailers, service industries, entertainment centers, building operators, and even home owners, buy a public liability insurance policy. The purpose is to protect the policyholder against claims that may be made by the public from real or fancied injuries received while using the facilities or products of the business. For example, the manufacturer of candy bars might be sued by an individual who claimed damage to his dental bridgework caused by a stone in a candy bar. This type of coverage is known as *products liability insurance*, and any such claim would be handled by the insurance company.

Most public liability policies are concerned with injuries that are received on the premises of the insured. Building operators are subject to elevator accident risks, people fall down steps in darkened movie theaters, visitors to industrial plants may be hit by a moving crane, and similar types of risks are present even in private homes. In each case there may be a claim against the owner because he can be held responsible for conditions that permit the accident.

Miscellaneous Casualty Coverages. The number of types of insurance coverage that can be secured from casualty companies is almost endless. Additional common types, which are practically self-explanatory, include plate glass insurance, steam boiler insurance, power plant insurance, use and occupancy losses following shutdowns as a result of an accident, and power interruption insurance.

Marine Insurance There are two general types of marine insurance, ocean and inland. The coverage includes ships of all types as well as their cargoes. The contract covers all perils of shipments by water including all degrees of loss from injury to the vessel and contents up to a complete loss of both as a result of sinking. Fire insurance is usually included as a separate part of the policy.

The term "average" is one that is somewhat peculiar to marine insurance. For example, if part of a cargo must be thrown overboard or part of the ship is destroyed to save the balance, such property is said to be *jettisoned.* Ordinarily such a loss will fall proportionately on all shippers even though the actual goods thrown overboard were part of a single shipment. This is called a *general average loss,* and shippers include protection against this risk as a part of their marine insurance. The insurance company would pay its share of the total loss in a ratio of the value of policies that it has assumed in relation to all insurance carried on the cargo or vessel.

Most marine losses are partial because it is unusual to lose a ship and its cargo. If the loss is not shared by others, as in the case of general average, and if the property is not entirely destroyed, it is called a *particular average.* For example, water getting into the hold might damage the lower portion of merchandise shipped in sacks, for example, sugar. The loss is not complete as to any single sack of sugar but is a partial damage of the contents of each sack.

Marine insurance is sold on a time or voyage basis. In the case of a ship that is on a regular run, it obviously is more satisfactory to carry insurance on a time basis. However, a shipper of merchandise by water will probably prefer a policy that covers his goods from the port of departure to the port of destination. Coverages include risks, such as fire, which

might take place in port as well as at sea. In other words, the goods are covered from the time they are loaded on the ship until the time they are unloaded.

Inland marine insurance might be thought to cover only shipments on lakes, rivers, canals, and other inland waterways. Actually, the policies cover all of these and movement of the goods by freight, express, and motor truck. The most common form includes protection while the goods are in the custody of railroad and express companies, truckers, and inland and coastwise steamers and barges. Since most of these companies are classed as common carriers, and as such are responsible for damage to goods while in their custody, it might seem unnecessary that a shipper buy inland marine insurance. The main reason for such coverage is that common carriers are not liable for safe delivery if prevented from doing so by "an act of God or of the public enemy." Under this heading is included such possibilities as lightning, floods, earthquakes, hurricanes, and risks of war. Protection is provided against such risks as these and also landslides, collisions, collapse of bridges, etc. Furthermore, common carriers usually limit their liability by contract.

Fidelity and Surety Bonds Fidelity and surety companies specialize in guaranteeing policyholders that other individuals, corporations, and agents with whom the insured may have business relations are reliable. In many cases losses might result from such connections, and the business firm is not in a position to investigate the character or financial responsibility of each of the persons or corporations involved. The only way that the company can protect itself against such losses is by carrying the proper insurance protection. In fact, members of a board of directors occupying a position of trust may find themselves personally liable for losses if employees are not properly bonded.

Fidelity bonds are the most common and are usually written to cover an employee occupying a position of trust in which he has jurisdiction over funds. The employer is guaranteed against loss caused by the dishonesty of such employees as the insurance company will reimburse the policyholder for losses up to the amount specified in the policy.

Coverages may be individual, or group, or may name positions. For example, a business firm may secure a fidelity bond on specifically named employees for such varying amounts as the funds to which each has access. Or, the company may secure a policy covering a group of employees in a particular department. Still another possibility is to purchase a policy in which positions and the amounts of coverage are specified, such as Treasurer—$50,000. Whoever is hired for a specified task is bonded for the stated amount.

Surety bonds are similar to fidelity bonds except that the coverage is more extensive, and there are more types of surety bonds. A fidelity bond written to cover an individual employee protects the employer against loss from dishonesty. However, negligence on the part of the employee might also give rise to a loss, and this would be covered by a surety bond. Surety bonds are also written to protect the insured against loss from the nonperformance of a contract, or the nonperformance of any agreed upon act or business transaction.

Another type of underwriting in this general class is *title insurance.* The purpose of a title insurance policy is to guarantee the individual purchaser of property against a loss that might result from discovery of a defect in his ownership rights after the purchase has been completed. Several companies specialize in title insurance and write no other policies.

A type of insurance that borders on but, strictly speaking, is neither fidelity nor surety is *credit insurance.* Under a policy of this type, the insurance company undertakes to relieve the insured from losses caused by the insolvency of debtors to whom merchandise has been sold in the regular course of business. The policy does not cover ordinary losses caused by normal bad debts but does assure the risks of excess losses. Regular policies cover only companies that have a preferred risk rating with an agency such as Dun and Bradstreet, Inc. A higher premium is charged for a combination policy that includes preferred and inferior classifications of debtors.

Life Insurance Regardless of the type of life insurance policy written, the premium charge is related to statistics covering deaths. Until recently the American Experience Table of Mortality was in common use,

although some insurance companies also used other tables. A few years ago the National Association of Insurance Commissioners became dissatisfied with the American Experience Table because the figures were compiled in 1868 and did not reflect the marked improvement in life expectancy that had taken place since that date. Furthermore, this table was based on the expected length of life of 100,000 people beginning at the age of 10 and continuing to the age of 95, and this span of life was inadequate.

In 1941, the state commissioners of insurance approved the Commissioners 1941 Standard Ordinary Mortality Table, and the CSO Table, as it is usually called, is gradually being adopted by all of the states. This means that insurance companies that sell policies in these states must base their rates on the CSO Table. The complete table is shown on pages 486 and 487. Note that it covers the life history of 1,000,000 people beginning at the age of 1 and continuing to the age of 99. For each year there is shown the number living at the beginning of the year, the number who will die during the year, the death rate for the year, and the life expectancy of those still living. For example, at the age of 18 a total of 955,942 young men and women will be living out of the original group of 1,000,000. During the year 2,199 will die, which is a death rate of 2.30 per 1,000 (2,199 ÷ 955,942). A person at age 18 can expect to live 48.32 more years. It should be added that life insurance companies usually choose their risks on the basis of physical examinations and are able to achieve a record even better than the table indicates.

Term Insurance. If life insurance were written on a basis similar to fire and other losses, a glance at the CSO Table would show how this could be worked out. If 1,000,000 children at the age of 1 had their lives insured for $1,000 for one year, the amount the insurance company would pay out would be $5,770,000 to the beneficiaries of the 5,770 children who would die during the year. This means that, if a premium payment of $5.77 were made for each policy, the insurance company would have adequate funds to meet the necessary outlay. Of course, the actual premium would need to be higher in order to meet the expenses of doing business and to make

a reasonable profit. Similarly, at age 60 there would be 677,771 people living at the beginning of the year who would need to share the cost of $18,022,000 that would be paid to the families and estates of the 18,022 who will die during the year from this age group. This would represent a premium charge of $26.59 to each policyholder.

The principle in the preceding paragraph is the basis of term insurance except that most policies run for 5, 10, 15, or 20 years. During this period, the insured pays the same premium each year, which is an average of what he might have paid over the life of the policy based on annual calculations similar to the figures given above. The advantage of this form of life insurance is that it gives the most protection for the least amount of premium payment.

Most term insurance carries a provision permitting a conversion to other forms during the life of the policy. It is also possible to purchase renewable term insurance, usually for the same length of time as the original policy, but at higher rates for each successive series of years. Despite these features, term insurance is not a popular form of life insurance. The cost is high for older people, and most companies will not write term insurance after a man or woman has reached the age of 65.

Term insurance can serve many useful business purposes. For example, Mr. Downing, who has successfully operated a clothing store for many years, takes his son into partnership with him with the thought that the young man will eventually learn the business. At this time an opportunity is presented to buy the store building for $15,000 and of this amount $10,000 is borrowed on a mortgage. Mr. Downing is confident that he can pay off the debt in ten years but is afraid that, if he should die during this period, the mortgage payments might be more than his son could handle. This hazard can be eliminated if Mr. Downing will take out a ten-year term insurance policy for $10,000 payable to his son.

Group Insurance. Within recent years, many companies have insured the lives of their employees under a group plan in which all, or a large percentage, are covered. Such insurance is usually written on a one-year renewable term plan.

Commissioners 1941 Standard Ordinary Mortality Table

AGE	NUMBER LIVING	DEATHS EACH YEAR	DEATH RATE PER 1,000	NUMBER OF YEARS EXPECTATION OF LIFE
1	1,000,000	5,770	5.77	62.76
2	994,230	4,116	4.14	62.12
3	990,114	3,347	3.38	61.37
4	986,767	2,950	2.99	60.58
5	983,817	2,715	2.76	59.76
6	981,102	2,561	2.61	58.92
7	978,541	2,417	2.47	58.08
8	976,124	2,255	2.31	57.22
9	973,869	2,065	2.12	56.35
10	971,804	1,914	1.97	55.47
11	969,890	1,852	1.91	54.58
12	968,038	1,859	1.92	53.68
13	966,179	1,913	1.98	52.78
14	964,266	1,996	2.07	51.89
15	962,270	2,069	2.15	50.99
16	960,201	2,103	2.19	50.10
17	958,098	2,156	2.25	49.21
18	955,942	2,199	2.30	48.32
19	953,743	2,260	2.37	47.43
20	951,483	2,312	2.43	46.54
21	949,171	2,382	2.51	45.66
22	946,789	2,452	2.59	44.77
23	944,337	2,531	2.68	43.88
24	941,806	2,609	2.77	43.00
25	939,197	2,705	2.88	42.12
26	936,492	2,800	2.99	41.24
27	933,692	2,904	3.11	40.36
28	930,788	3,025	3.25	39.49
29	927,763	3,154	3.40	38.61
30	924,609	3,292	3.56	37.74
31	921,317	3,437	3.73	36.88
32	917,880	3,598	3.92	36.01
33	914,282	3,767	4.12	35.15
34	910,515	3,961	4.35	34.29
35	906,554	4,161	4.59	33.44
36	902,393	4,386	4.86	32.59
37	898,007	4,625	5.15	31.75
38	893,382	4,878	5.46	30.91
39	888,504	5,162	5.81	30.08
40	883,342	5,459	6.18	29.25
41	877,883	5,785	6.59	28.43
42	872,098	6,131	7.03	27.62
43	865,967	6,503	7.51	26.81
44	859,464	6,910	8.04	26.01
45	852,554	7,340	8.61	25.21
46	845,214	7,801	9.23	24.43
47	837,413	8,299	9.91	23.65
48	829,114	8,822	10.64	22.88
49	820,292	9,392	11.45	22.12

Commissioners 1941 Standard Ordinary Mortality Table—Concluded

AGE	NUMBER LIVING	DEATHS EACH YEAR	DEATH RATE PER 1,000	NUMBER OF YEARS EXPECTATION OF LIFE
50	810,900	9,990	12.32	21.37
51	800,910	10,628	13.27	20.64
52	790,282	11,301	14.30	19.91
53	778,981	12,020	15.43	19.19
54	766,961	12,770	16.65	18.48
55	754,191	13,560	17.98	17.78
56	740,631	14,390	19.43	17.10
57	726,241	15,251	21.00	16.43
58	710,990	16,147	22.71	15.77
59	694,843	17,072	24.57	15.13
60	677,771	18,022	26.59	14.50
61	659,749	18,988	28.78	13.88
62	640,761	19,979	31.18	13.27
63	620,782	20,958	33.76	12.69
64	599,824	21,942	36.58	12.11
65	577,882	22,907	39.64	11.55
66	554,975	23,842	42.96	11.01
67	531,133	24,730	46.56	10.48
68	506,403	25,553	50.46	9.97
69	480,850	26,302	54.70	9.47
70	454,548	26,955	59.30	8.99
71	427,593	27,481	64.27	8.52
72	400,112	27,872	69.66	8.08
73	372,240	28,104	75.50	7.64
74	344,136	28,154	81.81	7.23
75	315,982	28,009	88.64	6.82
76	287,973	27,651	96.02	6.44
77	260,322	27,071	103.99	6.07
78	233,251	26,262	112.59	5.72
79	206,989	25,224	121.86	5.38
80	181,765	23,966	131.85	5.06
81	157,799	22,502	142.60	4.75
82	135,297	20,857	154.16	4.46
83	114,440	19,062	166.57	4.18
84	95,378	17,157	179.88	3.91
85	78,221	15,185	194.13	3.66
86	63,036	13,198	209.37	3.42
87	49,838	11,245	225.63	3.19
88	38,593	9,378	243.00	2.98
89	29,215	7,638	261.44	2.77
90	21,577	6,063	280.99	2.58
91	15,514	4,681	301.73	2.39
92	10,833	3,506	323.64	2.21
93	7,327	2,540	346.66	2.03
94	4,787	1,776	371.00	1.84
95	3,011	1,193	396.21	1.63
96	1,818	813	447.19	1.37
97	1,005	551	548.26	1.08
98	454	329	724.67	.78
99	125	125	1,000.00	.50

It is distinctive in that no medical examination is required as is true for most other forms of life insurance. This is possible because of the number, as well as the composition, of the group covered. Most employers do not hire workers who are not physically fit.

If the entire cost of the group life insurance is paid by the company, the plan is on a *noncontributory basis.* If the employees pay a portion of the premium, it is called a *co-operative* or *contributory* plan. The employer always pays at least a portion of the premium, which really constitutes a bonus to the employee. Rates are lower than for any form of an individual policy for many reasons. Some of these are that the premiums are paid by the company in one check, which greatly reduces collection costs; there are no medical examination fees; and commissions paid on group insurance sales are lower than on other types.

Ordinary Life. The most popular form of life insurance is ordinary or "straight" life. This is a level premium plan in which the individual pays a standard amount each year up to the time of his death. The premium is determined by the age at which the policy is taken out. For example, a $1,000 policy purchased at age 20 will cost approximately $19 a year, and at age 40 the rate has increased to $33. In both instances the premium payment must be made annually up to the time of death.

The advantage of an ordinary life policy is that maximum protection can be attained for the lowest premium, with the single exception of term insurance, which has objections already noted. Disadvantages include the fact that the insured must die before full payment is made on the policy and also that premiums are due in years after earning capacity has ceased. If a man retires at 65, he must still continue to pay premiums.

The reason that ordinary life premium rates are higher than those charged for term insurance is that each payment contains an element of savings as well as the amount necessary to buy protection. These savings remain with the life insurance company unless the policy is canceled and provide what is known as the *cash surrender value* of the insurance con-

tract. If the policyholder lives a number of years, the cash value increases to a sizeable relationship to the face value. For example, a $1,000 policy taken out at age 20 will have a cash value of approximately $480 by the time the insured reaches the age of 50.

In some instances, it is impossible for an individual to continue annual premium payments on an ordinary life policy. Should this occur, the insured may elect one of three options: (1) He can withdraw the cash value; (2) he can trade his original policy for a smaller one that is paid up for the remainder of his life; or (3) he can retain the original amount of protection for a limited period by exchanging his ordinary life for paid-up, extended term insurance.

AT END OF POLICY YEAR	CASH SURRENDER VALUE LOAN VALUE PER $1,000 INSURANCE	PAID-UP POLICY PER $1,000 INSURANCE	AUTOMATIC EXTENDED INSURANCE	
			YEARS	DAYS
1st	$ 1.27	$ 3.00	—	187
2nd	17.74	45.00	6	258
3rd	34.42	86.00	11	331
4th	46.30	114.00	14	275
5th	58.40	141.00	17	35
6th	70.69	167.00	19	3
7th	83.20	194.00	20	204
8th	95.92	219.00	21	302
9th	108.84	244.00	22	314
10th	121.95	269.00	23	252
11th	135.26	293.00	24	131
12th	148.77	316.00	24	327
13th	162.48	339.00	25	112
14th	176.38	362.00	25	228
15th	190.46	384.00	25	312
16th	204.72	405.00	26	4
17th	219.15	426.00	26	35
18th	233.75	447.00	26	46
19th	248.52	467.00	26	39
20th	263.43	486.00	26	15
25th	340.02	577.00	25	65
30th	418.98	656.00	23	257
35th	498.65	725.00	21	312
40th	577.03	784.00	19	287

The above table, taken from a policy of one of the larger mutual life insurance companies, shows the minimum guaranteed values for each of the options on a policy issued at age 20. For example, Mr. Miller bought a $1,000 policy at the age of 20 and continued payments for twenty years. He is

now 40 and because of ill health cannot earn enough to continue his insurance payments. Because his policy has been in force for twenty years, he has the following choices: (1) He can cancel the policy and receive $263.43 in cash; (2) he can accept a paid-up life insurance policy in the amount of $486; or (3) he can request that a $1,000 term insurance contract be written, which will be effective for 26 years and 15 days.

Limited Payment Policies. The chief difference between ordinary life insurance and the limited payment plan is that premiums are due for only a stated number of years. The most common period of time is twenty years, although almost any number of years can be selected. The whole idea is to pay the necessary premiums in a short period of time, which means, of course, that annual payments are much higher. Cash surrender values are also higher because of the larger sums paid each year. The advantage is that the individual is able to eliminate the drain of payments extending over a lifetime and can concentrate these premiums within the period of his maximum earning capacity. However, much more protection could be secured for the same annual outlay if ordinary life insurance is selected. As in the case of ordinary life, the insurance company does not pay the face value of the policy except at the death of the insured.

Endowment Policies. Endowment insurance emphasizes the savings element in a life insurance contract over the protective features. Because the annual premium is much larger than for ordinary life, the cash surrender value of the policy increases at a faster rate. At the expiration of a stated number of years, which may be an even figure such as thirty or the number of years before the insured reaches 65, the cash value of the policy equals its face. If, at the age of 30, a man takes out a $1,000 endowment policy running for thirty years, he has automatically created an estate of $1,000 by the time he is 60. If he dies within this period, the insurance company will pay the face of the policy. If, however, he lives to the age of 60, the company will pay him the face of the policy at that time, or he may elect to receive annual payments.

This type of policy eliminates the objection to other forms of life insurance in that the insured rather than his heirs can

collect on the policy. On the other hand, it is the most expensive form of insurance, and for the same amount of premium a much greater amount of protection could have been secured at the time of taking out the policy.

The following premiums of an insurance company for selected ages indicate the relative costs of the different types of policies described.

AGE	5-YEAR RENEWABLE TERM	ORDINARY LIFE	TWENTY-PAY LIFE	20-YEAR ENDOWMENT
20	$10.23	$19.21	$29.39	$48.48
30	11.15	24.38	34.76	50.43
40	13.28	33.01	42.79	54.06
50	19.95	48.48	56.17	62.55

Lump Sum Premium Payment. A variation of a limited payment plan is that of a single premium payment either for insurance to be paid at the death of the insured or for an annual income beginning at some specified date. This plan is particularly attractive to individuals who inherit a large sum of money or who are the recipients of a substantial gift. Also, professional athletes, actors, and others whose years of high earnings are frequently short may find this type of insurance advantageous over other forms.

Annuities. Life insurance companies write annuity contracts in addition to policies already described. It is also possible to purchase an annuity on an annual premium plan. In its pure form, however, the annuity follows the pattern of having the individual pay the insurance company a lump sum of money, for which he receives a monthly check for the remainder of his life. If he dies within a few months, the company gains; if he lives to a ripe old age, the company may pay out many times the amount of money deposited.

There are many variations of the pure form of annuity. One of these is a deferred plan under which the monthly payments do not begin for several years after the deposit is made. Some years ago a professional baseball player bought a deferred annuity, which was not to become effective until he had reached the age of 45. Actually, his playing career came to a close when he was about ten years short of that age and he found himself in the embarrassing position of being without funds for ten years until the annuity became effective.

Another variation is a *joint survivorship plan* including husband and wife. In this case, payments are made until both have died. Because the annuity does not end until two persons have died, the monthly payments are less than under a single survivorship annuity. Smaller payments also result if a number of guaranteed payments are requested, for example, twenty years certain. In the event the insured dies, the company continues sending checks to the designated beneficiaries until the expiration of the two hundred and forty monthly payments.

Combination Policies. Many types of combination policies are sold to meet the needs of individuals with various incomes and responsibilities. A man at the age of 22 might find that he required term insurance for ten years because of low earnings and the need for high protection; he might then convert to ordinary life for ten years; and, finally, he might be in a position to handle an endowment policy up to the age of 65. Such a combination, as well as many others, could be worked out. Some combinations are given special names, such as the family-income plan.

Various types of settlements are also possible. When the insured dies, the lump sum payment can be made to his wife, or the amount could be converted into an annuity with any of the options mentioned for monthly payments. A combination of these two plans might be most effective, in that a portion of the policy would be available for funeral expenses and the balance would be paid out in monthly installments.

During the life of a policy, the individual can always borrow from the insurance company up to the cash value. An alternate procedure is to assign the policy to a commercial bank and use the cash surrender value as security for a loan. The borrower will usually find that his commercial bank will extend credit at a lower interest rate if this type of collateral is offered.

The extent to which one form or another of life insurance is in force in the United States is astounding. Over 60 million individuals have one or more policies, and the amount of coverage exceeds 147 billion dollars.

QUESTIONS

1. Name several types of business risks and classify them as to whether or not they can be avoided.
2. What is the distinction between an insurable risk and one that is not insurable?
3. An individual who insures his home may say that he is betting the insurance company that his house will burn down, and the company is betting that it will not. Is this correct?
4. What types of risks will insurance companies assume on property in addition to the hazard of fire?
5. An individual buys an automobile for $75. What types of insurance should he carry on this car?
6. What are the advantages to an employer as well as to an employee when workmen's compensation insurance is in effect?
7. A restaurant owner fears that his patrons may become ill from eating food that has been inadvertently spoiled or tainted. What can he do to protect himself against damage suits that might result?
8. What peculiar circumstances may surround a loss on the high seas not present in other transportation circumstances?
9. If a bonding company has to pay a claim resulting from the dishonesty of an employee, does this always represent a loss to the insurance firm?
10. Why would a property owner wish to secure title insurance?
11. Most life insurance companies have a much more favorable record of deaths than the American Experience Table of Mortality would indicate to be true. Why?
12. If a man aged 24 is married and has two children, why might he be interested in renewable term life insurance?
13. Under the Social Security program, the United States Government provides for old age benefits. Why then should an individual be interested in either an endowment life insurance policy or an annuity?
14. A businessman operates a retail grocery store. He owns the building and makes deliveries. What various types of insurance would enable him to avoid risks connected with his firm?

PROBLEMS

1. A business property is worth $25,000. Assuming that a fire loss occurs and that an 80 per cent coinsurance clause is in effect, how much will be paid the owner by the fire insurance company in each of the following cases:

	FIRE LOSS	INSURANCE COVERAGE
(a)	$25,000	$20,000
(b)	20,000	20,000
(c)	15,000	15,000
(d)	10,000	10,000
(e)	5,000	5,000

2. What would the premium be on a one-year term insurance policy taken out at the age of 25, assuming that the insurance company would need a 20 per cent margin on total premium to cover its expenses and profits? Refer to the Commissioners 1941 Standard Ordinary Mortality Table shown on pages 486 and 487.

3. The Castile Soap Company manufactures a hair shampoo sold through drug and department stores to the general public. The Company owns its factory. Employees number 5,000. Salesmen are furnished company-owned cars. Itemize the various kinds of insurance policies this firm might be expected to carry.

4. Compute the answers to both parts (a) and (b) by referring to the Commissioners 1941 Standard Ordinary Mortality Table shown on pages 486 and 487.

(a) If a child attains a second birthday, how many years will elapse before his chances of dying are greater than they were during the first year of his life?

(b) What minimum age must a person attain before he can expect to live to the age of 65? 70? 75? 80? 85?

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CHAPTER 25

ACCOUNTING

Importance of Accounting The keeping of adequate financial records is necessary for the successful operation of a business establishment. One of the most frequent contributing causes of bankruptcy is the failure to "keep a set of books." Today, the demand of governmental agencies for financial data makes it imperative that satisfactory records be kept. Some departments of the government even have the legal right to specify minimum financial records. A bookkeeping system is a necessity for every business from the smallest single proprietorship to the largest corporation.

Accounting information is primarily a tool of management. Amounts owed to and by the firm, cash balances, inventory records, pay rolls, and many other operating figures are kept up to date by the bookkeeping department. Decisions as to profit distributions, sales prices, points at which operating economies might be possible, merchandise items to be abandoned or to be stressed, and the best answers to many similar questions may rest on the figures produced by the accountant.

In addition to management, many other groups are interested in the figures compiled by the bookkeeping or accounting department. The owners, if divorced from management, rely on published financial data to give them a summary view of the operations of their company. Creditors examine the financial standing of firms as reported directly, or indirectly through credit agencies, to form a basis for judgment as to whether or not to sell on open book accounts. Banks usually require a business organization seeking a loan to submit a financial statement, and in some cases this must be verified by a certified public accountant. If a corporation desires to sell securities or have its stock traded on a national exchange, audited yearly financial statements are required. Potential investors are interested in these reports and also in statements for companies not required to furnish such information to the Securities and Exchange Commission.

Practically every business, regardless of size, finds it necessary to submit income tax returns to the Federal Government, an income tax or sales tax return to the state government, and pay-roll tax and income tax withholding reports to both the state and Federal governments. These returns are subject to audit, which means that proper records must be kept to support the data submitted. During World War II other governmental agencies, such as the Office of Price Administration, requested financial reports for purposes of establishing price ceilings and other reasons. There is no question but that government is an important reason why accounting records are a necessity for modern day business organizations.

Accounting Defined Accounting may be defined as the recording, classifying, summarizing, and interpreting of business transactions. The term "business transaction" means literally any business activity of the firm. Buying a building for $100,000 is an illustration of a business transaction, as is selling an ice cream cone for five cents. Business transactions are recorded either separately, as in the case of purchasing a building, or by means of daily totals for such items as cash sales. Thousands of transactions are recorded and then classified by the most efficient methods possible, with emphasis on labor-saving devices. The systematic procedures used are those prescribed by the accountant. The routine labor of carrying out these principles is the function of the bookkeeper. The distinction between an accountant and a bookkeeper is important, but the terms "accounting" and "bookkeeping" frequently are used interchangeably.

The summaries of the results of business transactions are reflected in the statements. The two principal statements that are prepared at the close of a stated interval of time—such as a year, six months, quarter, or month—are the *balance sheet* and the *income statement.* Because they are the result of, and the reason for, much of the work done by an accounting department, they will be examined in detail.

Balance Sheet The balance sheet lists the assets, liabilities, and the proprietorship rights of the owners of a business. *Assets* consist of the property owned and used in the operation of the firm, such as land, buildings,

merchandise, office equipment, and cash. Some of these assets may have been acquired by buying on open account or by the use of borrowed funds secured from a bank or from the proceeds of a bond issue. Until such time as these debts are repaid, creditors have a claim against the property of the business. The rights, or equities as they are sometimes called, of these creditors in the assets of the business are known as *liabilities*. The remaining equity, or claim against the assets, is the right of the owner or owners in the property and is known as the *proprietorship*.

Because all of the assets of a business are subject to claims by creditors and owners, it follows that the total value of the property owned exactly equals the equities of creditors and owners. For example, Judson Clarke buys a radio business for $8,000. Of this amount he is able to invest $6,500 of his own funds and borrows the remaining $1,500 at his bank. His balance sheet after purchase would show assets, $8,000; liabilities, $1,500; and proprietorship, $6,500. This information can be expressed as an equation, as follows:

Assets	=	Liabilities	+	Proprietorship
$8,000	=	$1,500	+	$6,500

The truism that assets equal liabilities plus proprietorship is known as the *balance sheet equation*. By transposing the liabilities, the equation can be made to read, assets minus liabilities equal proprietorship. Published balance sheets most frequently use the first formula and show equal totals for assets and for liabilities and proprietorship combined. The assets can be listed on the left-hand side of a page and the liabilities and proprietorship on the right-hand side. This is known as the *account form* of balance sheet. If the assets are listed and totaled at the top of a page, followed by the liabilities and proprietorship, which are added together, the resulting balance sheet is known as the *report form*.

On page 498 is shown a report form of balance sheet for a sole proprietor, J. G. Elliott, who owns and operates a retail hardware store. Note that the balance sheet items not only have been grouped according to the three major classifications but also have been broken down into subclassifications. Assets have here been given five subdivisions and liabilities three, although there is no standard practice.

J. G. ELLIOTT

BALANCE SHEET
December 31, 1946

ASSETS

Current Assets:			
Cash		1,475	
Notes Receivable		525	
Accounts Receivable	3,000		
Less Reserve for Bad Debts	250	2,750	
Merchandise Inventory		16,300	
Total Current Assets			21,050
Fixed Assets:			
Office Equipment	1,000		
Less Reserve for Depreciation	400	600	
Buildings	12,500		
Less Reserve for Depreciation	2,000	10,500	
Land		2,500	
Total Fixed Assets			13,600
Deferred Charges to Expense:			
Prepaid Insurance		500	
Office Supplies		200	
Total Deferred Assets			700
Investments:			
Stock in XYZ Company			6,000
Intangible Assets:			
Goodwill			4,000
Total Assets			45,350

LIABILITIES AND PROPRIETORSHIP

Current Liabilities:			
Notes Payable		800	
Interest Payable		50	
Accounts Payable		5,150	
Taxes Payable		200	
Wages Payable		300	
Total Current Liabilities			6,500
Fixed Liabilities:			
Mortgage Payable			5,000
Deferred Credits to Income:			
Unearned Rent			50
Total Liabilities			11,550
Proprietorship:			
J. G. Elliott, Capital, January 1, 1946		29,750	
Net Income in 1946	6,450		
Less Withdrawals in 1946	2,400	4,050	
J. G. Elliott, Capital, December 31, 1946			33,800
Total Liabilities and Proprietorship			45,350

Current Assets. Cash and other assets that will be converted into cash within a short time are known as *current assets.* The maximum length of time for conversion is usually stated at one year, and it is expected that this process will take place in the normal operations of the business. If merchandise is sold on open book account or for notes, it is reasonable to assume that the accounts receivable or notes receivable will be paid in less than one year from the date of the sale.

Fixed Assets. Assets that possess a degree of permanence extending beyond one year and which are intended for use rather than for resale are known as *fixed assets.* Some assets, such as automobiles and trucks, may not last more than from three to five years, while land for a building site may last forever. Although fixed assets are sold when they are no longer useful to the firm, they are not purchased for this purpose.

A fixed asset deteriorates in value with use and the passage of time (land is sometimes an exception). Because it is desirable to show the original cost of the asset as well as its reduced value year by year, two separate figures are required. The reserve for depreciation is increased each year until it may equal the value of the asset from which it is subtracted. At that time, if the estimate of the useful life of the asset was accurate, the balance sheet value will be zero and the asset is discarded. Scrap values are taken into account when warranted.

Deferred Charges to Expense. Assets at the date of the balance sheet that will become items of expense, usually in the next accounting period, are known as *deferred charges to expense.* This classification title is sometimes shortened to *deferred charges* or *deferred assets.* There are two types of assets usually found under this heading. Consumable items, such as office supplies, will be used within a few weeks or months although at the date of the balance sheet it is obvious that pencils, paper, stationery, and stamps are assets. The other type of deferred charge is a prepaid expense item, such as a fire insurance policy that may not expire until three years from the date of purchase. A balance sheet constructed

prior to the maturity of the policy will show the value of the unexpired portion.

Investments. Stocks or bonds of other organizations that are purchased with the intent to hold them for income or for other reasons are known as *investments*. It is unusual for a sole proprietorship such as that owned by J. G. Elliott to have investments, although many corporations acquire assets of this character in order to cement trade relationships or to secure voting control of another corporation.

Intangible Assets. Assets that are not tangible but are of value to a going concern are classified as *intangible assets.* The most common of these is *goodwill,* which is the price paid for a firm over and above the actual physical value because of the good name, trade connections, or earning capacity of an operating business. *Patents* owned by a firm may be valuable for the seventeen years for which they are granted by the United States Patent Office and are classified as intangible assets as are copyrights, which are protected for fourteen years and can be renewed for a like period of time.

Current Liabilities. Debts that are owed and payable within a short time are classified as *current liabilities.* Amounts owed to trade creditors, banks, employees, and other debts of a similar nature are common current liabilities. For example, purchases of merchandise on open book account are due in thirty, sixty, or ninety days depending upon the terms of the transaction. As in the case of current assets, the usual rule is that liabilities that will come due and be payable within one year after the date of the balance sheet should be included under this heading.

Fixed Liabilities. Long-term debts that will not be due for several years are called *fixed liabilities.* Money borrowed by selling bonds, long-term notes, or by assuming a mortgage payable result in liabilities classified in this section of the balance sheet. Because the main reason for creating a fixed liability is to purchase fixed assets, a comparison between these two totals will indicate the extent to which permanent assets were acquired by funds secured in this manner. When-

ever the maturity date of a long-term debt becomes less than one year, this fixed liability becomes a current liability.

Deferred Credits to Income. Liabilities at the date of the balance sheet that will become items of income, usually in the next accounting period, are known as *deferred credits to income.* This classification title is sometimes shortened to *deferred credits* or *deferred liabilities.* If a store owner sublets a second story room on November 1 and requires the down payment of six months' rent, he has earned only two months' rent on December 31. The other four months' rent is a liability on that date because, for example, if the building should burn on December 31, the owner might have a legal obligation to refund the unearned prepaid rent, since he would be unable to furnish the facilities for which he was paid.

Proprietorship. The equity of the owner or owners of a business in the assets is the *proprietorship. Net worth* is a common synonym for proprietorship, and the word "capital" is also used. Although the assets and liabilities of a single proprietorship, partnership, or corporation might be identical, this would not be true of the proprietorship section. By examining the proprietorship information on a balance sheet, it is possible to determine the type of business organization as to ownership.

The proprietorship section of the balance sheet of J. G. Elliott clearly indicates a single proprietorship. Changes that have occurred in his proprietorship interest between the beginning and end of the year have been shown, but this analysis is not absolutely necessary. The section could have been abbreviated to show only the proprietorship equity at the date of the balance sheet as follows:

J. G. Elliott, Capital 33,800

If a business firm is operating under a partnership agreement, the capital interests of the partners are shown in the proprietorship section of the balance sheet. For example, if R. A. Gowan, W. E. Blanchard, and F. R. Morgan own and operate a business under the name of the Rome Music Company, the proprietorship section of the balance sheet for this firm might appear as shown at the top of page 502.

R. A. Gowan, Capital	15,800
W. E. Blanchard, Capital	9,450
F. R. Morgan, Capital	4,100
Total Proprietorship	29,350

In the case of a corporation the individual interest of each stockholder is not shown on the balance sheet. Although the proprietorship section of a corporation can become quite complicated, generally speaking only two items are shown. One is the original investment on the part of the stockholders in the capital stock of the corporation, and the other is the sum of past earnings that have not been distributed to the owners. The proprietorship section of the balance sheet of a small corporation might appear as follows:

Capital Stock	25,000
Surplus	8,385
Total Proprietorship	33,385

Examples of Balance Sheets The statement on page 503 is a simplified balance sheet of the A. E. Staley Manufacturing Company for December 31, 1946. On pages 504 and 505 is a consolidated balance sheet for the Boeing Airplane Company and its Canadian subsidiary for December 31, 1946. The notes accompanying that statement are given at the bottom of page 516.

Income Statement The statement that summarizes the profit and loss activities of a business for a stated period of time is known as the *income statement.* It shows such information as the total merchandise purchased and sold, expenses incurred, and miscellaneous sources of income. Other names given to this statement are *profit and loss statement, operating statement, income summary,* and *income account.*

The income statement is dynamic, whereas the balance sheet is static. This means that the income statement reflects summaries of operations over a period of time such as a year, six months, quarter, or month while the balance sheet is a picture of the business at a given instant of time, usually the close of business on the date of the balance sheet. Both statements are prepared at the same time, and the net income or loss shown on the income statement is reflected in the proprietorship section of the balance sheet.

What We Own and What We Owe

AT DECEMBER 31, 1946

WE OWN:	*Total Amount for the Company*	*Approximate Amount per Employee*
Cash on deposit in various banks needed for the prompt payment of payrolls and purchases	$ 3,237,771	$ 1,263
Due from customers for merchandise delivered to them and from other persons for various charges	4,989,937	1,946
Invested in corn, soybeans, manufacturing supplies and finished products on hand	44,924,956	17,521
PLANTS		
Total original cost of lands, buildings, and equipment	$26,090,177	$10,176
Less the amount that has been deducted for depreciation and reinvested in various assets	14,090,955	5,496
NET BOOK VALUE OF PLANTS	$11,999,222	$ 4,680
Cost of lands and other properties held for possible use or sale	435,220	170
Insurance, supplies and other expense paid in advance	668,088	261
TOTAL VALUE OF THINGS OWNED	$66,255,194	$25,841

WE OWE:		
To employees for wages and salaries, to manufacturers for materials purchased from them, and to customers for amounts paid us in advance	$ 3,325,370	$ 1,297
To government for taxes	5,130,934	2,001
Money Borrowed		
To purchase corn, beans, and materials (short term notes)	$25,590,000	$ 9,981
To provide additional working capital (long term notes)	4,500,000	1,755
Set aside for retirement of employees	126,000	49
TOTAL WE OWE	$38,672,304	$15,083

SAVINGS OF OWNERS:		
The total value owned less the total we owe leaves a balance representing the savings of our 1,852 stockholders invested in our company	$27,582,890	$10,758

BOEING AIRPLANE COMPANY

CONSOLIDATED

December

ASSETS

CURRENT ASSETS:		
Cash (including $502,422 of restricted deposits)		$ 7,017,640
United States Certificates of Indebtedness, at cost		30,362,778
Accounts receivable (including $654,171 due from the United States)		837,612
Estimated Federal excess profits tax refundable under "carry-back" provisions of the Internal Revenue Code ($4,726,126) less reserve for prior years' taxes ($641,919) (Note 1)		4,084,207
Estimated recoverable expenditures and fees under cost-plus-a-fixed-fee contracts with the United States (Note 1)—		
On terminated contracts (including subcontractors' claims of $870,891)	$ 4,663,826	
On current contracts	1,429,014	6,092,840
Advances to suppliers		2,441,176
Work in progress and purchased materials and parts, at the lower of cost or market, (including $23,216,400 on contracts as to which title has passed to the United States)	$34,348,254	
Less—Progress payments	14,923,922	19,424,332
TOTAL CURRENT ASSETS		$70,260,585
INVESTMENTS AND OTHER ASSETS:		
Balances not yet due from the United States on emergency plant facility contracts (assigned to bank)	$ 1,268,849	
Less—Reserve for Federal taxes applicable thereto	913,571	
	$ 355,278	
Investment in and advances to Boeing Aircraft of Canada Limited, a wholly owned subsidiary, not consolidated, at cost (Note 2)	727,805	
Deposits with mutual insurance companies, etc.	99,595	1,182,678
FIXED ASSETS, at cost:		
Land and buildings	$10,597,107	
Machinery, tools and equipment	5,568,145	
	$16,165,252	
Less—Reserves for depreciation and amortization	13,560,625	2,604,627
DEFERRED CHARGES		217,501
		$74,265,391

NOTE: The above consolidated balance

AND SUBSIDIARY COMPANY

BALANCE SHEET

31, 1946

LIABILITIES AND CAPITAL

CURRENT LIABILITIES:		
Accounts payable and estimated subcontractors' termination claims		$ 4,527,138
Accrued wages, taxes, etc.		2,683,712
Unexpended balance of partial payments received from the United States for termination claims of subcontractors		502,422
Advances on commercial contracts		18,940,350
TOTAL CURRENT LIABILITIES		$26,653,622
NOTES PAYABLE TO BANK, payable in installments from reimbursements receivable from the United States under emergency plant facility contracts, the right of the Company to receive such reimbursements having been assigned to the bank		1,268,849
RESERVE for contract adjustments and indeterminate expenses resulting from war-time conditions (Note 1)		8,145,953
CAPITAL STOCK AND SURPLUS:		
Capital stock—		
Authorized—1,250,000 shares of $5 par value		
Issued and outstanding—1,082,454 shares, including 111¾ shares issuable for shares of common stock of United Aircraft & Transport Corporation when presented for exchange	$ 5,412,270	
Paid-in surplus	8,142,064	
Earned surplus	24,642,633	38,196,967
		$74,265,391

sheet is subject to the notes on page 516.

On page 507 is shown an income statement for J. G. Elliott, whose balance sheet has already been illustrated, for the year ended December 31, 1946. Note that the income statement is divided into sections for the grouping of like items. However, the income statement, unlike the balance sheet which totals balances, consists of accumulated totals of the various items, which are added to or subtracted from each other in order to arrive at a final figure of net income.

Income from Sales. Most firms secure the major source of their income from sales of merchandise, and this section heads the income statement. The *gross sales* figure includes the amounts paid by customers or the amounts they have agreed to pay if sales have been made on account. It is a total for the year or for a shorter period of time if statements are prepared more often. From this total must be subtracted the value of the merchandise returned or reductions in price granted following complaints by the customer as to quality or quantity received. The resulting figure is logically called *net sales.*

Cost of Goods Sold. The cost of goods sold represents the purchase price of the identical goods that were sold by the firm during the year. The formula used for arriving at the cost figure is usually the one shown. Merchandise on hand at the beginning of the year plus purchases, adjusted for transportation costs and returns and allowances, gives the total cost of all the goods that might have been sold. Subtracting the inventory figure at the end of the year from this total results in the cost of the goods sold.

The beginning and ending inventories were determined by a physical count of each item in stock and a valuation of these quantities. The purchases of merchandise made during the year can be secured from the books in which have been recorded all of the invoices covering the various shipments received. Transportation charges on these shipments, when paid by the buyer, must be added because the delivered cost is the important one to the merchant who is selling the goods. Returns and allowances follow the same pattern as indicated above for sales.

J. G. ELLIOTT

INCOME STATEMENT
for Year Ended December 31, 1946

Income from Sales:			
Gross Sales		45,250	
Less Sales Returns and Allowances		250	
Net Sales			45,000
Cost of Goods Sold:			
Merchandise Inventory, January 1		17,000	
Purchases	28,000		
Add Freight In	600		
Delivered Cost of Purchases	28,600		
Less Purchase Returns and Allowances	300		
Net Purchases		28,300	
Merchandise Available for Sale		45,300	
Less Merchandise Inventory, December 31		16,300	
Cost of Goods Sold			29,000
Gross Profit on Sales			16,000
Operating Expenses:			
Selling Expenses:			
Salesmen's Salaries	3,500		
Advertising	1,000		
Delivery Expense	400		
Total Selling Expenses		4,900	
Administrative Expenses:			
Office Salaries	2,400		
Bad Debts	90		
Office Supplies Used	110		
Insurance	350		
Taxes	1,200		
Depreciation on Buildings	500		
Depreciation on Office Equipment	100		
Total Administrative Expenses		4,750	
Total Operating Expenses			9,650
Net Profit from Operations			6,350
Other Income:			
Interest Income		50	
Purchases Discount		150	
Rent Income		200	
Total Other Income			400
Gross Income			6,750
Other Expense:			
Interest Expense			300
Net Income			6,450

Gross Profit on Sales. The difference found by subtracting the cost of goods sold from the net sales is termed the *gross profit on sales*. If there were no expenses in connection with

the sales, gross profit would be the amount of profit earned. For example, if a student buys a secondhand textbook for $2.00 and subsequently sells it for $2.50, the gross profit is $.50, and this represents a net gain as no expenses would be incurred in this sale. However, business firms do incur expenses, which must be taken into account before arriving at net profit. For this reason the difference between the selling price and the cost price of goods sold during the period is called the gross profit on sales.

Operating Expenses. Pay rolls for sales clerks and office employees, supplies consumed, depreciation on fixed assets, advertising costs, taxes, and expired insurance are examples of operating expenses. All of the costs that a business firm incurs in its normal operations are grouped under this classification. Individual items are shown so that the owner or owners can note the amount spent for different purposes. If certain expenses appear too large, steps can be taken to correct this situation.

Operating expenses are usually subdivided into selling expenses and general or administrative expenses. *Selling expenses* are those that are incurred as a direct result of the sales activities of the firm. Such items as salaries of sales clerks, advertising, store supplies used, depreciation on store equipment, and delivery costs are examples of selling expenses. The advantage of segregating these from general expenses is that the total for one year compared with the total for another year may be significant. If selling expenses have increased in total, it would then be possible to analyze the individual items to locate the cause or causes.

Office salaries, rent, taxes, insurance, office supplies used, depreciation on buildings and office equipment, and the cost of bad debts resulting from account sales that prove uncollectible are examples of *general expense.* They are costs connected with the general operation of the business. If an expense is difficult to allocate between the selling and general classification, such as fire insurance on merchandise inventory, it is usually assigned to the general expense classification.

Net Profit from Operations. The difference found by subtracting the total of the operating expenses from the gross

profit on sales is known as the *net profit from operations.* If there were no other items of income and expense, this figure would also be the net profit, but most businesses do have nonoperating incomes and costs. In some instances the total operating expenses may exceed the gross profit on sales. Should this occur, the difference between the two amounts would be known as the *net loss from operations.*

Other Income and Other Expenses. Most firms secure some income and incur some expenses of a financial, rather than an operating, character. These are classified as *other income* and *other expenses* and are added to and subtracted from the net profit from operations. Other titles used for these sections of the income statement are *nonoperating income and expense* and *financial income and expense.* The most common items are interest received and paid on notes, mortgages, and bonds, and purchases and sales discounts, which are earned or granted for the payment of amounts owed on open book accounts within the cash discount period.

Net Income. The final figure on an income statement and the one that represents the net profit from all operations of a business, both operating and nonoperating, is called the *net income.* It is, naturally, the most interesting single figure on an income statement. Although the amounts used in arriving at the final result are of interest to those connected with the management of the firm, others are more concerned with the amount of net profit or net loss.

Schedule of Cost of Goods Manufactured

The discussion of the income statement for J. G. Elliott assumed that, as a retail hardware merchant, he purchased all of the merchandise that he sold. Manufacturing firms produce their goods from raw materials purchased. In this event the line titled "Purchases" in the income statement would be replaced with "Cost of Goods Manufactured, Schedule No. 1." An illustration of such a schedule is shown on page 510. Note that inventories of raw materials and of goods in the process of manufacture are shown, and that the nature of the manufacturing expenses is somewhat different from operating expenses.

THE ROLLMAN MANUFACTURING COMPANY

SCHEDULE NO. 1—COST OF GOODS MANUFACTURED

To Accompany Income Statement for Year Ended June 30, 1946

Goods in Process Inventory, July 1, 1945			7,500
Raw Materials Inventory, July 1, 1945		15,000	
Purchases of Raw Materials	46,200		
Freight and Cartage In	1,000		
Delivered Cost of Purchases	47,200		
Less Returns and Allowances	600		
Net Purchases		46,600	
Total Cost of Raw Materials Available for Use.		61,600	
Less Raw Materials Inventory, June 30, 1946		18,000	
Cost of Materials Consumed		43,600	
Direct Labor		37,500	
Manufacturing Expenses:			
Indirect Labor	3,600		
Repairs	3,000		
Heat, Light, and Power	5,000		
Depreciation on Machinery and Equipment	6,500		
Factory Supplies Used	2,500		
Patents Expense	1,700		
Expired Insurance	900		
Total Manufacturing Expenses		23,200	
Total Manufacturing Costs			104,300
Total Goods in Process during Year			111,800
Less Goods in Process Inventory, June 30, 1946			10,000
Cost of Goods Manufactured			101,800

Interpretation of Statements As soon as the balance sheet and income statement are prepared, it is possible to perform the next step in the work of the accountant, that of interpretation. The fact that a business may or may not have been operated at a profit is of vital concern, but this one figure fails to tell the whole story. For example, a bank might be willing to extend a loan to a firm that has a strong financial structure despite recent operating losses. Judicious use of such funds might correct conditions so that future business operations would be profitable.

An automobile may run satisfactorily enough to transport its passengers to destination. However, if certain parts are worn or if the tires are too thin, either the trip is not so efficient or so economical as it might have been, or a breakdown may occur in the near future. In like manner, a busi-

ness may seem to operate successfully although actually it is inefficient. Or, conditions may exist that will eventually result in a breakdown unless corrective steps are taken in time.

By means of ratios, percentages, and other devices, it is possible to analyze the financial status of a company. The directions such an analysis may take are varied and may be extensive in scope. The current balance sheet offers definite possibilities in itself, and comparisons can be made with previous balance sheets and also with the balance sheets of competing companies. The same remarks can be stated concerning the income statement. Furthermore, there are a number of important relationships between the two statements. A few of the most useful and common methods of analysis are described below. The figures used have been taken from the statements of J. G. Elliott, previously illustrated, which means that no attempt has been made to show trends from year to year or to contrast the efficiency of Elliott's firm with any of his competitors.

Current Ratio. The ratio of current assets to current liabilities is known as the *current ratio.* It is found by dividing the current assets by the current liabilities. This ratio is very important to the owners and to short-term creditors because the liquidation of current assets is relied on as a source of funds to pay current liabilities. An acceptable minimum ratio is 2 to 1, which takes into consideration the fact that current assets sometimes shrink in value whereas current liabilities do not.

Reference to the balance sheet of J. G. Elliott shows that on December 31, 1946, his current assets totaled $21,050 and his current liabilities, $6,500. The calculation for his current ratio is as follows:

$$\frac{21{,}050}{6{,}500} = 3.2 \text{ to } 1$$

Working Capital. The excess dollar value of the current assets over the current liabilities is known as the *working capital.* It should be large enough to absorb any shrinkage in the stated value of the current assets while they are in the process of liquidation. In the case of J. G. Elliott the excess of $14,550 ($21,050 — $6,500) should provide more than

adequate protection, and neither the owner nor short-term creditors should have any fear concerning payment of debts.

"Acid-Test" Ratio. The *acid-test or quick ratio* is a refinement of the current ratio in that it determines the ability of a firm to meet its current debt on very short notice. It recognizes the fact that the conversion of merchandise inventory into cash takes more time than is true for other current assets. The formula is to divide the total cash and receivables by the current liabilities, and an acceptable minimum is 1 to 1. If the firm owns marketable securities purchased on a temporary basis, these may be added to the cash and receivables.

In the illustration on page 498 the balance sheet shows that J. G. Elliott owns cash, notes receivable, interest receivable, and accounts receivable totaling $4,750 and that his current liabilities total $6,500. His "acid-test" ratio is computed as follows:

$$\frac{4{,}750}{6{,}500} = .7 \text{ to } 1$$

Whereas the current ratio was considerably in excess of the minimum, the above ratio falls short of the 1 to 1 requirement. This may indicate a situation that should be corrected by a more rapid liquidation of the inventory; otherwise Mr. Elliott may not be able to meet maturities on his current debt.

Turnover of Merchandise Inventory. A retail establishment must always be alert to "turn over" its stock of salable goods as rapidly as possible; in other words, to sell present stock before it loses its maximum value. The frequency with which this move is accomplished is a measure of efficiency, as losses from obsolete stock are reduced and less money is tied up in merchandise.

The best method of determining the turnover of merchandise inventory is to divide the cost of goods sold by the average inventory. In the case of Mr. Elliott only the beginning and ending inventories can be averaged because other inventory figures are not available, although a truer picture could be obtained if monthly inventory amounts could be secured. The information available on page 507 shows a merchandise inventory on January 1 of $17,000 and on December 31 of $16,300.

These two amounts average $16,650, the cost of goods sold is shown as $29,000, and the turnover calculation is as follows:

$$\frac{29,000}{16,650} = 1.7 \text{ turns for } 1946$$

For a retail grocery store this would be a very poor turnover as from 5 to 10 turnovers each year are secured by efficient firms. Mr. J. G. Elliott, however, operates a hardware store, and the figure of 1.7 is satisfactory as most businesses of this type are not able to turn over their stock more than from 1 to 3 times a year.

Ratio of Ownership to Debt. Practically every business is financed by a combination of funds secured from the owners and by borrowed capital. The ratio of ownership to debt shows the relative proportion of capital secured from the two sources. A mark of conservative financing is substantial ownership on the part of the proprietors or stockholders. This means that the ownership equity is large enough to absorb even extensive and continued losses, and there is less danger of insolvency.

The balance sheet of J. G. Elliott shows total liabilities of $11,550 and total proprietorship of $33,800. The ratio is found by dividing the ownership equity by the creditors' equity as follows:

$$\frac{33,800}{11,550} = 2.9 \text{ to } 1$$

This is a very conservative ratio because Mr. Elliott has contributed almost three times as much capital as he has borrowed, and some businesses operate on a ratio much lower. In the case of public utilities and railroads the ratio is sometimes less than 1 to 1.

Rate of Net Income to Proprietorship. The reason an owner invests his own funds in a business is to secure a return on his investment. Because of the risks involved this rate should be higher than an investment in United States Government bonds, for example.

Mr. Elliott's investment in his business for the year was $27,350 ($29,750 minus withdrawals of $2,400) and his net income was $6,450. As shown on the next page, dividing the

return by the investment shows a yield of 23.6 per cent, which should be gratifying to any businessman.

$$\frac{6{,}450}{27{,}350} = .236$$

Percentage of Net Income on Sales. If a business is able to sell a large volume of goods on a small investment, the net return on each dollar's worth of goods sold can be very small, perhaps as low as one cent on the dollar. This is the principle under which chain stores and supermarkets operate. However, if the turnover of total assets (the number of times each dollar value of assets is converted into a sales dollar in one year) is low, then the net return on each sales dollar must be substantial if a satisfactory return is to be secured.

The net sales made by J. G. Elliott in 1946 totaled $45,000, as shown on page 507, and the net income was $6,450. His total assets were $45,350, a figure slightly in excess of the sales. Consequently, it is not surprising to note that this successful firm secured a high rate of net income on sales as follows:

$$\frac{6{,}450}{45{,}000} = .14 \text{ or } 14 \text{ per cent}$$

QUESTIONS

1. Why is it essential for every business to keep a set of books?
2. Name the various groups that are interested in the figures produced by the accounting or bookkeeping department of a firm.
3. What are the four chronological steps included in a definition of accounting?
4. Describe a balance sheet and state the balance sheet equation.
5. What are assets, liabilities, and proprietorship?
6. How may assets, liabilities, and proprietorship be classified?
7. Describe an income statement. How does it differ from a balance sheet?
8. If a firm has a large volume of sales, will it necessarily show a net income? If not, why?
9. If a firm manufactures the products it sells, how do its statements differ from those of a firm that buys the products it sells?
10. What is the purpose of analyzing financial statements?
11. Why should a bank considering making a short-term loan be interested in the current and "acid-test" ratios?

PROBLEMS

1. The following items of information, alphabetically arranged, were taken from the books of O. G. Davidson on December 31, 1947. Prepare a balance sheet, using the statement for J. G. Elliott, illustrated on page 498, for guidance as to form and arrangement.

Accounts Payable	$ 910	Notes Payable	$2,300
Accounts Receivable	830	Notes Receivable	1,380
Cash	655	Office Equipment	1,500
O. G. Davidson, Drawing	300	Office Supplies	300
O. G. Davidson, Capital, 1/1/47	8,800	Prepaid Insurance	200
Delivery Equipment	1,375	Reserve for Bad Debts	50
Merchandise Inventory, 12/31/47	9,200	Reserve for Depreciation of Delivery Equipment	275
Mortgage Payable	1,000	Reserve for Depreciation of Office Equipment	150
Net Income for 1947	2,255		

2. The following items of information were taken from the books of O. G. Davidson on December 31, 1947. Prepare an income statement, using the statement for J. G. Elliott, illustrated on page 507, for guidance as to form and arrangement.

Advertising	$1,340	Merchandise Inventory, 1/1/47	$ 6,900
Bad Debts	50	Merchandise Inventory, 12/31/47	9,200
Delivery Expense	550	Office Expense	60
Depreciation on Delivery Equipment	275	Purchases	27,500
Depreciation on Office Equipment	150	Purchases Discounts	515
Freight In	490	Purchase Returns and Allowances	275
Office Salaries	2,250	Rent Expense	2,400
Heat, Light, and Water	280	Sales	38,630
Insurance	380	Sales Returns and Allowances	215
Interest Expense	50	Salesmen's Commissions	3,500
Interest Income	25		

3. The following figures were taken from the statements of the McCallister Company for the year ended December 31, 1946. Compute the (a) current ratio, (b) working capital, (c) acid-test ratio, (d) inventory turnover, (e) ratio of ownership to debt, (f) rate of net income to proprietorship, and (g) percentage of net income on sales.

Current Assets	$28,000	Current Liabilities	$ 10,000
Total Assets	60,000	Total Liabilities	16,000
Merchandise Inventory, Jan. 1	11,000	Total Proprietorship	44,000
Merchandise Inventory, Dec. 31	17,500	Net Sales	125,000
		Cost of Goods Sold	80,000
		Net Income	6,800

SUGGESTED READINGS

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NOTES TO BOEING CONSOLIDATED BALANCE SHEET

(See pages 504 and 505)

Note 1:

Termination settlements, renegotiation of 1945 profits under the Renegotiation Act, examination of Federal income and excess profits tax returns and other matters relating to the war years have not been completed as of December 31, 1946, and final effect thereof in the accounts of the Company is indeterminate at this time. The balances in the reserves for taxes and for contract adjustments and indeterminate expenses resulting from war-time conditions are believed to be adequate to cover additional liabilities and expenses which may result from these factors.

During the year 1946 the reserve for contract adjustments and indeterminate expenses resulting from war-time conditions has been charged with the net amount of $154,533 in connection with the 1944 renegotiation settlement, and $600,000 has been transferred to the profit and loss account in respect of unrecovered expenses, net of taxes, incurred during the year in reconversion and transformation from war- to peace-time operations.

A transfer to the profit and loss account of the year has been made from the reserve for development of post-war products and markets to cover the cost, net of taxes ($650,000), of a discontinued project, and the balance of the reserve ($7,025,000) has been considered to be no longer necessary and transferred to earned surplus.

Note 2:

The investment in Boeing Aircraft of Canada Limited (a wholly-owned subsidiary, not consolidated) is stated at cost of $727,805. The underlying book value, in Canadian dollars, is $1,463,667 as shown on the separate balance sheet of the subsidiary. The earnings of the subsidiary for the year were $5,199.

CHAPTER 26

STATISTICS

Need for Statistical Information

Business decisions are, or at least should be, based on facts. Intuitive hunches are more likely to result in disaster than they are to produce satisfactory results. The most successful procedure for making a decision is to gather all pertinent facts as a first step, then to weigh these carefully, and finally to decide on the best course of action in light of all that can be learned about the problem. Even then there is a chance for an error, but the executive who relies on factual information can be confident of having a higher percentage of wise decisions to his credit.

Figures produced by the accounting department are an important source of data and are relied on to a considerable extent by management. They are subject to interpretation and analysis, as was noted in the preceding chapter. However, accounting deals almost exclusively with items measurable in terms of dollars and with the business transactions of the individual firm. Many important figures that can be compiled are concerned with quantities, which may or may not have a dollar equivalent, and which frequently are based on information from outside sources. This much larger area in the collection, summarization, presentation, and interpretation of numerical data is the field of *statistics*.

Some business firms maintain their own statistical departments; others rely on outside agencies for providing statistical studies. Use of both sources is very common, particularly by the larger concerns. In this event the normal division of labor would be for the statistical department to study internal data and for the outside agency to make external surveys. Small business firms, unable to maintain a statistician, necessarily must secure needed information from agencies that can be employed to do the work or from published material that is available with or without cost. Sources of printed data are discussed later in the chapter.

Uses of Statistical Information

Statistical information can be very helpful to the management of a business in practically every phase of operations. The following three brief illustrations may clarify this statement. (1) The sales department is asked whether or not it can sell 100,000 units of a new product. A survey of potential customers in a limited area, plus information as to the number of people in the same income group in the United States, may provide a reasonably satisfactory answer. (2) The employment manager is asked to report to the board of directors on the effect of a new bonus system on labor turnover. A study of comparative rates of hiring new employees before and after the system was installed, assuming that other factors are stable, should provide the basis for definite conclusions on this point. (3) The treasurer is faced with a refinancing problem, which can be undertaken now or a few years later. He would be greatly interested in the trend of interest rates.

Facts, properly presented, are also helpful to a company dealing with other parties. For example, the Treasury Department of the United States Government might suggest to the Congress that a tax should be imposed on a particular product. Representatives of this industry would probably be given the opportunity to appear in Washington before the proper committees to argue against the proposal. Their presentation would consist, for the most part, of facts designed to show the detrimental effect, from their viewpoint, of the proposed law. Or, if a corporation is having a labor dispute involving higher wages and can produce evidence to show that the additional cost would make it impossible for its products to be sold in the competitive market, this fact might have an important bearing on the final settlement.

Types of Statistical Measurements

Regardless of the purpose for which statistical material is used, data must be collected and organized in some logical form. There are many possibilities, although the available figures may dictate the most logical choice. As presented in the preceding chapter, *ratios* and *percentages* are a type of statistical measurement to which accounting data can readily be adapted. Other measures that are commonly made of nu-

mercial facts include averages, index numbers, correlations, and time series. The meaning of these terms will indicate which ones are peculiarly appropriate for use in connection with different raw data.

Averages. Everyone uses the term "average," but different meanings of this word frequently are involved. To say that the average college student can swim refers to a different type of average than to say that the average height of the same group is five feet seven inches. In one case, the use refers to the fact that almost all college students can swim, whereas the other is the result of a mathematical computation.

There are three types of averages, or measures of central tendency, which are commonly calculated: the *mode*, the *median*, and the *arithmetic average* or *mean*. Each has its advantages, and one may give a much better picture of the "average" than the other in specific instances. For example, an instructor may grade an hour examination and wish to announce the average grade to his class. The size of the group is twenty seven, and the papers, arranged numerically, show the following marks:

99 ..... Olsen, W.	75 ..... Tennbaummen
93 ..... Dodds	75 ..... Coats
88 ..... Steele	75 ..... Olsen, F.
88 ..... Babcock	73 ..... Sallander
85 ..... Haines	73 ..... Loucks
82 ..... Moore	70 ..... Elton
82 ..... Farnsworth	70 ..... Winter
82 ..... Maines	70 ..... Rader
82 ..... Zybroski	65 ..... Goode
82 ..... Budden	65 ..... Roots
82 ..... Rysinger	50 ..... Hooten
80 ..... Samsen	28 ..... Jacob
80 ..... Klein	12 ..... Nuckels
78 ..... Allson	

This series of grades, or numbers, is known as an *array*, which is simply a list of all of the figures to be used in a statistical computation listed in order of size. The first step in computing an average might be to condense the array by noting the number of students who earned each different grade. This is known as a *frequency distribution* and appears as follows from the above data:

GRADE	NUMBER OF STUDENTS
99	1
93	1
88	2
85	1
82	6
80	2
78	1
75	3
73	2
70	3
65	2
50	1
28	1
12	1
	27

Without further handling of the data, the mode and median can be determined. The *mode* is the number that occurs most frequently in any given series. The grade received by the largest number of students is 82. This is the value that occurs the greatest number of times, by a considerable margin. Sometimes other grades might have been earned by an almost equal number of students, in which case there would be subsidiary modes. Also, each student might have received a different grade on the examination. In such a case, there would be no mode.

The *median* is the number in an array that divides the group in half. Referring again to the illustration, since there are twenty-seven students in this class, the fourteenth student in the list would have thirteen individuals above him and thirteen below him. Counting down from the top or up from the bottom, the fourteenth grade is 78, which is the median. If a class had an even number of students, it would be necessary to interpolate between the grades received by the last individual in the upper one-half of the group and the first individual in the lower one-half of the group, unless both of these students received the same grade.

The *arithmetic average* or *mean* is the most common type of average employed, so much so that it is implied in most requests to furnish an average. It is the result of dividing the total of a series of numbers by the number of units making

up the series. To calculate the mean for the above problem, it is necessary to add all of the grades received and divide by the number of students. This can be done as follows:

GRADE	NUMBER OF STUDENTS	TOTAL GRADE POINTS
99	1	99
93	1	93
88	2	176
85	1	85
82	6	492
80	2	160
78	1	78
75	3	225
73	2	146
70	3	210
65	2	130
50	1	50
28	1	28
12	1	12
	27	1984

$$\frac{1984}{27} = 73.5$$

The arithmetic average of 73.5 is the lowest average of the three computed and is the result of the two or three extremely low grades in the series. This emphasizes a characteristic of the mean, which is that a few high or low figures have a great influence on the result.

In this problem, the mode was the highest average, the median next, and the mean the lowest. Taking a different series of grades, the results might have been exactly opposite. Furthermore, if three or four hundred grades had been used, the averages would normally approximate each other. The example selected was purposefully constructed to show contrasts among the different results that can be secured from the three methods of averaging.

The question might well be asked, "Which is the best method to use?" The answer to this depends a great deal on the circumstances. If a manufacturer of men's hats wanted to specialize in one size, he would want to produce an average hat size, as this would present the maximum sales possibilities. The average selected for this situation would be the mode. In the problem given above, the median is probably the best

average because the arithmetic mean is unduly influenced by the small number of low grades, and the mode includes only a small percentage of the class.

For most business problems, the arithmetic mean is used. If units of 1,000 dresses are sold at prices of $8.00, $9.50, $10.25, $11.00, and $12.00 for each dress in the lot, it would be necessary to determine the arithmetic mean in order to determine the average price for all the dresses sold. Adding the above different sales prices and dividing by five, a figure of $10.15 results. If more dresses had been sold at the $8.00 and $9.50 prices than were disposed of at the higher prices, it would have been necessary to multiply the prices by the units sold in each price group and to add the units sold and the sales prices before dividing to obtain the average sales price.

Index Numbers. An index number is a device for measuring the change that has taken place in a group of related items over a period of time. More use is probably made of index numbers by the business world than of any other kind of statistical measurement. In order to determine whether the cost of living is rising or falling, whether wholesale prices are up or down, the relative activity in the building industry, in stock price movements, and in literally hundreds of other similar items, index numbers are constructed.

The most widely used index number, without much question, is the Index of Wholesale Commodity Prices issued weekly by the United States Bureau of Labor Statistics. Over eight hundred items are used in the computations. This Bureau also issues a cost of living index and a retail food price index. Another widely used index number is that issued by the Board of Governors of the Federal Reserve System, covering industrial production. There are many others issued by governmental and private agencies.

In order to clarify the meaning of index numbers and to illustrate their construction, a cost-of-living index computation is shown below. Only three items have been included instead of the several hundred that would be necessary to present a true picture. This brief and over-simplified illustration provides an opportunity to show the use of *relatives*,

a device that permits the averaging of unlike figures. If it could be assumed that the cost of living consisted of only three items, eggs, cloth, and gasoline, and if it were desired to compare the current year with a base year, say five years earlier, the computation might appear as follows:

	BASE YEAR		CURRENT YEAR	
	PRICE PER UNIT	PERCENTAGE RELATIVE	PRICE PER UNIT	PERCENTAGE RELATIVE
1 dozen eggs	.50	100	.54	108
1 gallon gasoline.	.20	100	.19	95
1 yard cloth	.40	100	.46	115
		3)300		3)318
		100		106

On the basis of the above calculations, the cost-of-living index has risen from 100 in the base year to 106 in the current year. By means of assigning relatives to prices that have gone up or down, it becomes possible to average unlike items and prices, such as eggs, gasoline, and cloth.

In constructing a cost of living index, again assuming that only the three items shown are involved, it is obvious that the same quantities of each commodity would not be used by an average family. They might use fifty dozen eggs in a year, but would buy only twenty-five yards of cloth for one purpose or another in the clothing line. If they own a car, two hundred gallons of gasoline might be purchased. A *weighted index number* takes these amounts into the calculation in order to reflect more accurately the real picture on whether the cost of living has gone up or down. Using the same figures that were shown in the previous example, the calculation for the current year would appear as follows:

	BASE YEAR		CURRENT YEAR	
	PRICE PER UNIT	TOTAL AMOUNT	PRICE PER UNIT	TOTAL AMOUNT
50 dozen eggs	.50	25.00	.54	27.00
200 gallons gasoline.	.20	40.00	.19	38.00
25 yards cloth	.40	10.00	.46	11.50
		75.00		76.50
		$75 = 100		$76.50 = 102

Whereas the unweighted index number showed an increase in the cost of living amounting to six points, the weighted

index number shows only a two point increase over the base year. This indicates the fallacy of conclusions based on incorrect assumptions and also explains why an index number covering a particular subject prepared by the statistical departments of different organizations may show considerable variation. Both the items used and the weights assigned must be determined, and two separate agencies might not agree on these factors. Another variation results from the use of a different base year or base period.

Correlation. If it can be determined that there is a definite relationship between two separate sets of figures, the measurement of the extent of the relationship is known as *correlation*. The methods of computing the correlation between the two series of figures can be complex and will not be elaborated upon. Suffice it to say that, if a high degree of correlation is present and if a time lag is involved, one series can be used to forecast the trend that the other will take. For example, the probable enrollment in the grade and high schools of the country should logically have some connection with the birth rate. If the number of children born in any given year is higher than normal, it is reasonable to forecast that the number of children in the first grade six years later will be higher than normal. Several factors, such as a high degree of infant mortality, might invalidate this conclusion. However, past series of figures have shown a high degree of correlation, and it would be logical to make the first assumption.

Many statisticians try to find series of figures that can be used to predict business changes. Some of these may be coincidences. If vacation travel following extremely hard winters is higher than normal, this might or might not indicate a causal relationship. On the other hand, the index of productivity in the machine tool industry is usually considered a fairly accurate forecast of business conditions in the year ahead. The reason for this is that business must "tool up" before it can produce and, if the machine tool industry is particularly active, this should indicate that business is on the verge of producing in increased quantities.

The Metropolitan Life Insurance Company, in common with other life insurance underwriters, maintains a statistical de-

partment. A press release from this organization, issued after World War II had ended, announced that marriage and active fighting on battlefronts vary inversely. Marriage licenses in the principal cities of the United States jumped eighteen per cent in the six months following the close of hostilities. There is an obvious causal relationship between these facts, and businessmen interested in selling new furniture, for example, would be interested in this correlation.

Time Series. Our economic system is in a constant state of change. The calculation of an average is based on conditions that exist at a certain date. However, before action can be taken on the conclusions drawn from this calculation, conditions might have changed. Static analysis is valuable, but we live in a dynamic world. The various types of time series attempt to analyze changes that take place over a period of time. The most frequent movements that are measured are known as:

1. Secular trends
2. Cyclical fluctuations
3. Seasonal variations
4. Irregular deviations

Secular Trends. Over a long period of time a dominant characteristic of the United States has been growth. The population has increased, industries have grown, production has moved ahead, transportation facilities have been enlarged. Although the growth of population has been an important factor, it is not entirely responsible for other increases. This type of long-term movement is known as a *secular trend.* As this country or others become more mature, there is a tendency for the rate of growth to decrease, and it may be that a downward curve will eventually result.

In general, the secular trend in the United States has meant that business could expand in almost any direction. More people with more money means demands for food, housing, clothing, amusements, and other necessities, conveniences, and luxuries. To apply this logic to a particular industry, however, may prove to be a serious error. In the early days of the twentieth century there was a considerable expansion of the traction lines connecting various cities. With the advent

of the large passenger bus, the traction lines lost so much business, despite an increased population, that many were forced out of business.

Cyclical Fluctuations. Although the general movement in the United States has been upward over many decades, there have been years of prosperity and years of depression. This is true for the business world as a whole, and individual businesses have their ups and downs, which may or may not correspond to the general business picture. Any fluctuation that tends to recur with some measure of regularity and that extends over a period of years rather than months can be called a *cyclical fluctuation.*

Within recent years, a low point in business activity was reached in 1921, which was followed by years of increasing prosperity that reached a peak in 1929. The depression that followed reached a low point in 1933. Many efforts have been made to level out the extreme swings in either direction, but efforts to keep our economy at an equilibrium have not been successful.

Seasonal Variations. Many businesses are subject to regular month-by-month changes during the calendar year. Department stores have an increase in trade around Easter and Christmas. Travel agencies are patronized heavily during the summer months and also have a smaller boom in the mid-winter season. Such changes are known as seasonal variations.

Weather and holidays are reasons for many seasonal variations, but they are not the only factors responsible for month-by-month changes. If a manufacturer of automobiles brings out a new model each year, he can determine his own seasonal variation because of the large number of people who want to own the most up-to-date product and who place orders as soon as the new car is on display.

Irregular Deviations. Sometimes a particular industry or business organization experiences an increase or decrease in the demand for its products for no apparent reason. A restaurant may find that the number of customers it serves daily is suddenly falling off. This condition may continue for a month or two, at which time business again picks up. This would be known as an *irregular deviation.*

Another type of irregular deviation might result from a strike or some other event that would clearly be the cause of an irregular variation in business activity. A strike would cause a decline in production and also in the sales of the product for the idle period. On the other hand, retail establishments in a city that is successful in securing a large convention may experience a short period of increased business because of the large number of visitors.

Presentation of Statistical Material In order to present statistical material in a manner that will be useful for purposes of analysis, two devices are commonly used. These are summary tables and graphic presentation. It is not necessary to use one of these forms, particularly when the data are brief, but they are usually most effective. A statement that production in 1947 reached 10,000 tons, which was an increase of 25 per cent over the 1946 output of 8,000 tons, might well be expressed in this narrative form. If the number of yearly production figures were increased, a summary table or graph would become more effective.

Summary Tables. A considerable amount of statistical material can be presented in a tabular statement. Years, geographical areas, types of products, income groups, and nationalities may be the basis of the comparisons. Some analysis may be incorporated in the statement, such as a percentage distribution, or the facts may be presented for inspection or for further analysis by those interested. A typical table is presented below.

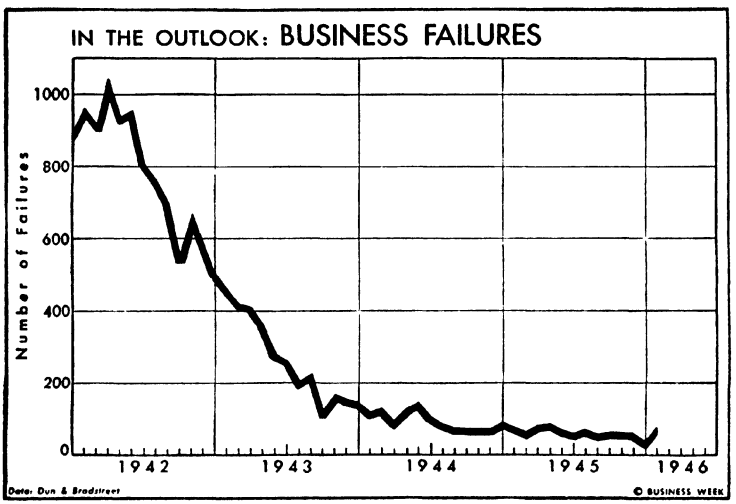
INDUSTRIAL AND COMMERCIAL FAILURES
By Months, 1940 to 1945

YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEPT.	OCT.	NOV.	DEC.
1940	1,237	1,042	1,197	1,291	1,238	1,114	1,175	1,128	976	1,111	1,024	1,086
1941	1,124	1,129	1,211	1,149	1,119	970	908	954	735	809	842	898
1942	962	916	1,048	938	955	804	764	698	556	673	585	506
1943	458	422	410	362	281	265	203	227	124	169	155	145
1944	120	132	96	131	148	110	91	77	75	74	75	93
1945	80	66	85	90	72	61	72	56	64	62	60	42

Source: Statistical Abstract of the United States, 1946.

Graphic Presentation. The pictorial presentation of statistical data has the great advantage of interest to the reader and of presenting a visual analysis of the facts. Several forms are used, some of which are a matter of choice, while others seem particularly well adapted to certain sets of facts.

One of the most common graphic statistical presentations uses a *line* or *curve* to indicate changes or a trend over a period of time. Two or more lines may be used in the same chart to indicate changes in related items.



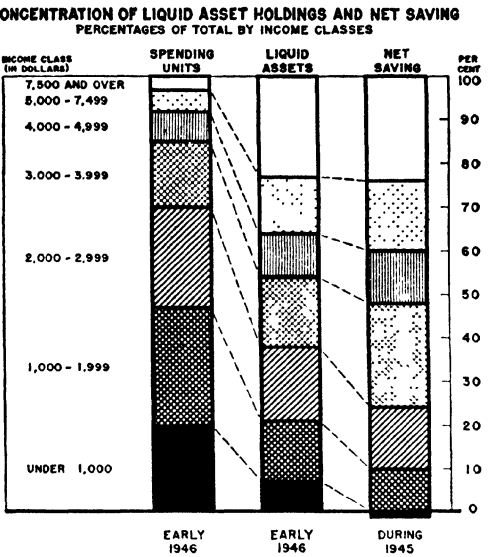
A Line Chart

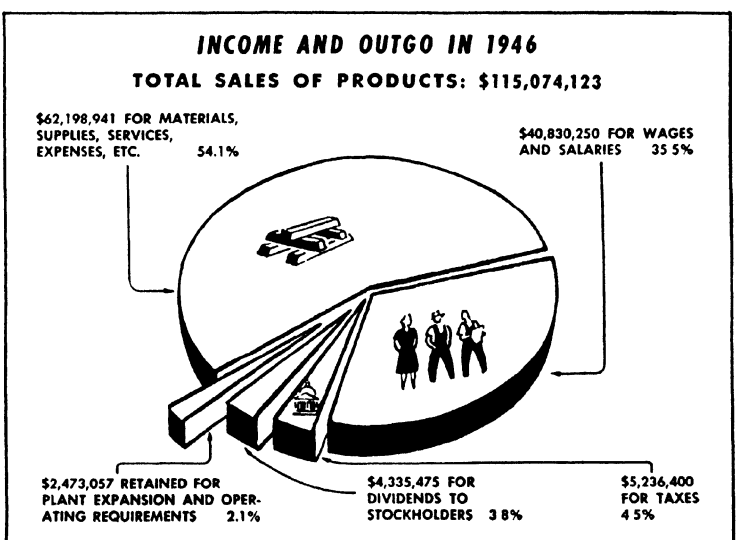
Another common form of graphic presentation is the *bar chart,* which is used for the comparison of figures. The bars in the chart may be horizontal or vertical. When the item represented by a bar includes two or more parts, each part of the bar can be indicated by a different color, shading, or design, as illustrated on page 529.

The *pie diagram* or *circular chart* is particularly useful for explaining financial matters when the unit involved is 100 per cent or one dollar. Many annual reports of corporations make use of the pie diagram in the manner illustrated on page 529.

A Vertical Bar Chart

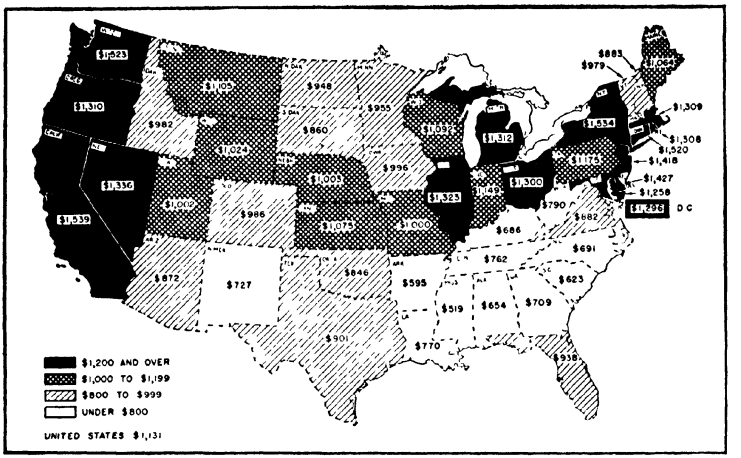
Spending units in the $1,000 to the $1,999 income class accounted for 11 per cent of the net saving, while those having incomes under $1,000 dissaved (spent more than their current incomes) to the amount of 1 per cent of the total.





American Locomotive Company

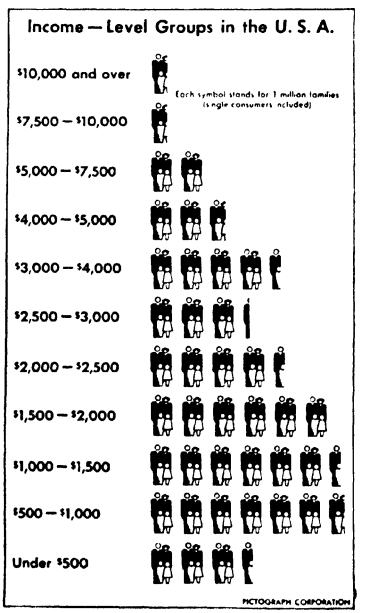
A Pie Diagram or Circular Chart



A Statistical Map—Per Capita Income by States

Statistical maps are commonly used when it is desired to present geographical information. By means of shading, coloring, pins, circles, and other devices, data can be presented for a city, state, the United States, or a larger geographical area. The illustration above is typical of such a presentation.

Within recent years, bar charts particularly have been given added reader attention by the use of a series of small pictures or drawings of the data presented. These graphs are sometimes called *pictographs.* They are effective for comparisons of subject matter that can be presented by a self-explanatory drawing.



A Pictorial Chart or Pictograph

Reproduced from *The World Book Encyclopedia* by special permission of publisher.

Collection of Data Numerical data must be collected before they can be summarized and used. If the figures are concerned with operations of the company, without regard for outside influences, the source for these lies within the records of the particular business. Financial statements, purchase invoices, sales reports, and pay-roll records can supply vital information, which is subject to statistical analysis. As an illustration, a company may show an operating profit in the current year of $325,000 as contrasted with a corresponding figure of $300,000 for the preceding year. If these figures represent the output of a factory and no expansion took place during the current year, the conclusion might be reached that more efficient use was made of the production facilities or that the plant operated more hours. However, an analysis showed that 50,000 units were sold in the current year as contrasted with 60,000 in the preceding year and that the increased operating profit was due entirely to an increase in selling price. In this case, the sales manager rather than the plant superintendent may have deserved commendation.

Another method of securing facts is to get them from primary outside sources. This is usually done by a market research department, which conducts surveys among the actual or potential consumers of the product. Two methods of securing the new data are available, and both are frequently used in conjunction with each other. A *questionnaire* can be prepared and mailed to as many individuals as seems wise, or *personal interviews* can be held by investigators in the employ of the company. Both methods have their advantages and disadvantages, which are known and can be weighed by the directors of the market research program.

If a questionnaire is used, it must be prepared carefully, and the questions must be clear and easy to answer. It should not be too long. Despite such efforts to make the task as easy as possible, only a ten per cent to twenty per cent return can be expected if the mailing list is large or if the questionnaires are sent to people that do not have a vital interest in the subject. One corporation that has made extensive use of the questionnaire is General Motors through its Customer Research Staff. An attempt has been made to find out what the car owner wants in the many details of his automobile.

Sampling Technique Personal interviews are more satisfactory than questionnaires because most people are willing to answer direct questions. The number of people reached will usually be a smaller group than can be solicited by questionnaires because of the greater cost involved. The personal interviews frequently lead to the necessity of a process known as *sampling*. If it is desired to secure an opinion on whether men prefer an aromatic or nonaromatic pipe tobacco, it would be necessary to interview males of all adult ages and those with high and low incomes; attention would need to be given to geographical areas; outdoor versus indoor workers might be an important factor. An attempt to interview everyone would be practically impossible. If it can be ascertained that there are ten times as many men with incomes of $2,500 as there are with incomes of $5,000, that twice as many work outdoors as indoors, and that certain known facts exist about age groups and geographical distribution, it should be possible to curtail sharply the number of interviews and yet arrive at the same conclusion that would be reached if many more were involved.

Some business firms are not large enough to maintain a market research department. In this event, they may find it advantageous to hire an outside agency to make special studies for them. In practically every large city, there are organizations that are willing to collect data for a particular firm. If the company belongs to a trade association, a considerable amount of statistical material covering the industry as a whole will be available to it. Some trade associations maintain research departments for the benefit of their members, such as the American Iron and Steel Institute, which collects and distributes a wealth of statistical material on the steel industry to its members and to the general public.

Not all primary research is conducted for the benefit of individual firms or industries. Polls of public opinion, particularly those that are concerned with election results, are well known to everyone. The agencies that conduct such surveys make extensive use of the sampling procedure and, by taking into account every factor that permits the grouping of our population, have been able to forecast with an amazing degree of accuracy. The Gallup Institute and the Elmo Roper

organization are well-known agencies that specialize in this type of interviewing technique.

Results obtained from questionnaires and interviews must always be interpreted with great care, because the validity of the conclusions is always open to question. Several years ago a national magazine conducted a presidential poll involving the mailing of 35,000,000 postcards to voters. A large percentage of replies was received, but the final results were considerably in error to the extent of picking the wrong candidate by a substantial margin. Apparently the chief difficulty was that telephone books had been used as a basis for mailing lists, which resulted in polling only voters who had sufficient income to pay a monthly telephone rental. The number of votes from lower income groups was sufficiently large, and so overwhelmingly for the victorious candidate, that the survey was invalidated despite the extensive coverage.

Secondary Sources of Business Information A great mass of statistical information is available to all business firms, either without cost or by subscribing to some business service. In general, this material is known as secondary sources of statistical data. The businessman can find many facts which, applied to his particular situation, may result in the determination of the wisest course of action to pursue. The manufacturer of automobile tire chains would be more successful if he spent sales promotion dollars in a geographical area that had a high proportion of dirt roads or a climate favorable to snow and ice than he would if he chose a region in which hard-surfaced roads and warm weather were predominant.

U. S. Government Publications. The most extensive source of external data of value to the businessman is the large number of publications issued by various departments, agencies, and bureaus of the United States Government.

The Bureau of Foreign and Domestic Commerce of the Department of Commerce exists primarily to serve the needs of large and small businesses. Among its publications are the weekly *Commerce Reports*, the monthly *Survey of Current Business*, and monthly and annual reports on foreign trade and commerce.

The Bureau of the Census is another governmental department that makes available important statistical material. In addition to population figures, which are basic to many surveys, this Bureau issues many other publications including the annual *Statistical Abstract of the United States.* The Bureau is responsible for the census of business, which classifies the channels of distribution on a geographical basis, and for the census of manufacturers, which presents important information covering the various types of industries.

One of the most reliable indexes of industrial production is published monthly by the Board of Governors of the Federal Reserve System. The annual reports of this body, as well as the bulletins issued by the individual Federal Reserve Banks, are helpful in the field of banking and finance.

The Bureau of Labor Statistics of the Department of Labor issues the *Monthly Labor Review,* which gives information of price levels, unemployment, and wages. This Bureau is responsible for the Index of Wholesale Commodity Prices, the Index of Retail Prices, and Changes in Cost of Living.

The Department of Agriculture, although primarily concerned with its own field, presents in its Agricultural Yearbook many facts that can be used by the businessman who is concerned with the use of raw materials grown on the farms. Soybean acreage or production, for example, would be of interest to the manufacturer of paints.

Non-Government Sources. Another valuable source of secondary data is the number of publications issued by newspapers and magazines, trade journals, trade associations, private agencies, and institutions.

Barron's, which appears weekly, the semi-weekly *Commercial and Financial Chronicle,* and the *Wall Street Journal* and the *Journal of Commerce,* which are daily papers, are examples of the newspaper and magazine type.

Trade journals include *Business Week* and the more specialized magazines, such as *Plastic Age.*

The publications of the National Retail Dry Goods Association, the Automobile Manufacturers Association, the American Petroleum Institute, and the American Iron and Steel Institute are good examples of those issued by the trade associations.

Private agencies that issue publications and reports include such well-known services as Dun and Bradstreet, Inc. in the credit field and *Moody's Manual of Investments* in the field of finance. In the field of interpretation of Federal laws the Commerce Clearing House, Prentice-Hall, Inc., and the Research Institute of America are outstanding.

Institutional releases include such publications as the *Harvard Business Review* and others issued by bureaus of business research in the various universities, the Brookings Institution, the Twentieth Century Fund, and the National Industrial Conference Board.

QUESTIONS

1. Do accounting and statistics constitute separate fields, or do they overlap?
2. What uses can be made of statistical data?
3. Does the fact that averages can be computed in more than one manner lessen their value to the businessman?
4. Is it better to say that the average American family consists of 4.2 people or that it consists of a husband, wife, and two children?
5. Why do index numbers use a base year or base period?
6. If it could be proved that the demand for new refrigerators varies inversely with the birth rate of Eskimos, would this be an illustration of correlation?
7. What do time series and index numbers have in common?
8. Would a bar chart or pie chart be more helpful in graphic presentation of the number of salesmen employed by a firm this year compared with five years ago?
9. Why are facts from primary sources more reliable than those gathered from secondary sources?
10. What are some of the dangers present in the process known as sampling?
11. Should the United States Government spend the taxpayer's money to collect and publish, without charge, material that business firms would be willing to buy?
12. Is there a possibility that the use of statistical data will permit business in general to avoid peaks of depression and prosperity?
13. A business firm having annual sales of $1,000,000 is considering the employment of a statistician. To hire an experienced man will cost $10,000, and he will need a budget of $5,000 for equipment, supplies, and assistance. Is this a wise expenditure of money?

PROBLEMS

1. Compute the median, mode, and arithmetic mean of the following numbers: 100, 20, 65, 84, 56, 71, 88, 84, 90, 70, 75, 50, 84, 90, 82, 66, 94, 83, 71, 42, 89, 70, 84, 96, 74, 91, 84, 75, 12, 82, 69, 80, and 72. Indicate by an asterisk which average you believe is the best for this series of figures, and state the reasons for your choice.

2. The following table shows the distribution of sales dollar volume in a department store by merchandise divisions. Compute the percentage of each classification to the total sales, and construct a chart to present this information.

DIVISION	SALES VOLUME
Main-floor	$2,623,700
Ready-to-wear	3,472,300
Home-furnishings	1,106,800
Basement	385,200

3. You are asked to make a survey by means of personal interviews of the attitude of students in your school on the best hour for starting the first classes of the day. If the survey is not to include more than 5 per cent of the total student body, how would you select the students to be interviewed?

4. Complete the chart on page 528 to the extent that later figures are available.

SUGGESTED READINGS

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CHAPTER 27

BUDGETS

What Is a Budget? A budget frequently has been likened to the course that a ship's captain plots for his vessel before setting out on a journey. In planning for his trip, the captain takes account of all factors that may conceivably have a bearing on it, such as the tides, the weather, known danger spots, and so on. With all these things in mind he lays his course as accurately and intelligently as he can. Then as the journey gets under way, he checks his progress from time to time and compares it with the plan. As unforeseen circumstances arise, he may alter his planned course in the interest of safety. The process of checking and comparing is continued until the ship arrives safely at its destination.

The analogy is a good one, although it oversimplifies a somewhat complicated practice. A *budget* is a carefully thought-out plan that embodies the considered expectations of the major executives of the business for a stated period of time and that embraces many, if not all, of the principal phases of the firm's operation.

The budget idea goes further than the mere setting forth of a plan; it also involves the establishing of procedures whereby the progress of the various aspects of the business may be recorded and compared with the original plan, with the presumption that deviations will be called to the attention of those responsible and remedial measures instituted. In some cases, it may be wise to effect changes in the original plan, in response to conditions that cannot be overcome.

Thus the resemblance between the budget and the ship's course is complete—the checking and correcting phase is common to both.

The Purpose of Budgets There are really two purposes to the budget idea: (1) to provide an over-all plan for the guidance of a business for the budgetary period, and (2) to force a careful study of all phases of the business

as a preliminary to the establishing of the plan. Budgets should never be undertaken hastily, as those who have tried to do so have learned to their sorrow. Only the most careful and painstaking examination of all factors involved in the conduct of a business will bring forth plans that will have any chance of fulfillment under the stress of the day-to-day problems, vicissitudes, and uncertainties that beset firms engaged in the competitive struggle.

If budgeting had no other purpose than to cause executives to scrutinize their businesses closely, it would be well worth the effort required. However, it does more than that. It brings about the charting of a path, based on past experience and taking into account all foreseeable circumstances, along which the managers of the business hope to guide it during the coming months. Without such a plan—and many firms, particularly small ones, do not have them—a business is bound to drift, and its chances of ultimate, and sometimes preventable, failure are greatly increased. Investigation of several hundred bankrupt companies has revealed that only a negligible few employed budgets.

Generally speaking, human beings will exert greater efforts if goals or incentives are established for them than they will when these are absent. Budgets set forth these goals for all the key personnel of a business, and the budgetary control that follows serves to measure the degree of success that attends their efforts to attain them.

Furthermore, budgeting permits those charged with the conduct of a business to base their actions on something more than mere guesswork. Many phases of managerial activity require the making of commitments for the future—the treasurer must arrange for funds to meet anticipated obligations, the purchasing agent must place orders for future delivery of the many items that the company uses in its productive processes, and the employment manager must arrange to procure the needed personnel for future operations.

Budgeting also provides the means whereby the activities of all of the different departments of the business may be co-ordinated toward a common goal—that of achieving the largest attainable profits. Budgeting furnishes the machinery for evaluating the contribution that each department expects

to make toward the attainment of this objective and for providing the guidance required for the fulfilling of this anticipation. It is an instrument of managerial control of major importance.

Historical Development of Budgets In this country budgets first made their appearance in connection with governmental bodies, where planned income, usually from tax sources, was apportioned among the customary avenues of expenditure. The general theory, if not the practice, was that the budget must be balanced—that the outgo could not exceed the income. In the minds of many people budgets are associated solely with government, although this is an exceedingly narrow view.

Budgeting as a business practice is apparently a phenomenon of the twentieth century, but it received its greatest impetus in the early 1920's when a book by the late J. O. McKinsey set forth some of the details of budgeting procedure and indicated its importance in the intelligent and satisfactory conduct of business enterprises. Since that time an increasing number of firms have adopted budgeting as more or less standard practice until, at the present, it would probably be difficult to find a company of any size or consequence that does not embrace the budget idea to some degree. As its benefits have become known, the budget has also been made a management tool by many small, progressive concerns. There is nothing about budgetary procedure that should prevent its use by small as well as by large companies, and great numbers of the former group have discovered this fact to their benefit.

Budget Preliminaries Once a company has decided to install a budget as the keystone of its operating philosophy and practices, it is important that adequate preparatory steps be taken in order to make certain that this instrument of managerial control will yield the maximum of beneficial results. These preliminary moves are mentioned briefly in the following paragraphs.

(1) Need for Care. It is impossible to overestimate the importance of the exercise of exceptional care in preparing to

install a budget. The executives who are charged with the responsibility of setting forth the various estimates upon which the final budget figures are based must understand the vital part that they are called upon to play in this preparatory process. They should give thoughtful consideration to all factors that can have any possible bearing on their actions and arrive at their final conclusions only after having exercised the utmost care.

(2) Need for Adequate Accounting Methods. While the operation of a budget is far more than an accounting function, the accounting records and methods provide the data upon which the estimates are based and by which the subsequent operating performance is revealed. It is, therefore, necessary that the accounting system be adequate to perform its part in budgeting. In cases where the accounting records do not appear to be adequate, it is wise to postpone the introduction of the budget until this condition has been remedied. The establishing of a budget based on insufficient records may foredoom the whole project and result in the rejection of the budget idea, to the ultimate detriment of the company involved.

(3) Need for Proper Supervision. No budget, however well conceived and planned, is capable of operating itself. Not only during the time of its preparation, but particularly throughout the period of its operation, the need for proper supervision at all executive levels, including the highest, cannot be overemphasized. The history of the development of budgetary control, to its present state of widespread acceptance and acclaim, has been unfortunately marred by the presence of those cases where the budgets were apparently left to run themselves with the almost invariable result that their operation was far from satisfactory.

(4) Need for Establishing Responsibility. For a budgetary project to have a chance of succeeding, the individuals selected to operate it must be made fully responsible for the adequate performance of their assigned tasks. Along with the need for proper supervision, mentioned above, goes this requirement of responsibility that must be fixed by the top management and thoroughly understood by those upon whom it is placed.

(5) Need for Recognizing Limitations of Budgets. The limitations to the budgetary idea are principally those of time and method. It takes time to install a budget. Furthermore, the need for possible revision after the original estimates have been established must be recognized and heeded, particularly in those businesses that are subject to unpredictable fluctuations in sales, purchases, or other important factors. No budget can be stronger than the records upon which it is based, nor the personnel through whom it operates. Too much should not be expected of a newly installed budget system, particularly if the personnel affected have had no previous experience with this procedure in other companies. Lastly, it must always be remembered that the figures set forth in a budget are estimates, nothing more. They may be arrived at after the most painstaking and careful deliberations, based on the best possible records, but they are prophecies; they endeavor to plot what will happen during a certain future period and hence their fallibility must be apparent. This characteristic need not discourage executives from adopting the budget idea, but it should condition their attitudes toward it.

(6) Extent of Budget Adaptation. Before budgetary control is installed, the management must determine the extent to which it is to be put into operation. In a great many, if not most, businesses, all parts can be profitably included; in others, because of certain innate irregularities in their operation, it is sometimes possible to utilize budgeting in only a few departments. It is the rare business, however, that cannot make profitable use of the budget in some phase of its procedures.

(7) Length of the Budget Period. A final important preliminary is that of determining upon the proper length of the budget period. This may be for a year or longer, for as little as a month, or for any desirable intervening period. Such factors as the length of the production period, seasonal influences, rapidity of style changes, and the length of the accounting period, will be determinative in this regard. In some cases only experimentation will reveal the proper length of time to be covered by the budget; in others the answer to this question will be quite apparent to the management.

Organization for Budgetary Control While each department head is customarily responsible for the operation of his departmental budget, many businesses have found it desirable to have a budget officer and a budget committee to administer the over-all company budget.

The Budget Officer. At the outset of budget preparation someone within the company should be named budget officer. Frequently he is the controller, because of his contact and familiarity with the accounting system, although sometimes the president or general manager assumes this position. The direction of budgetary procedure is a task for top management; and, while the budget officer may function as a clearinghouse for the assembly of estimates and the transmission of performance data to and from the operating departments, the policy decisions that are required from time to time must emanate from the top.

The Budget Committee. Many companies set up a budget committee, consisting of the president and the heads of the major departments, whose job is that of reviewing the figures that are collected and of counseling with the budget officer and the president as the program proceeds. This group may or may not possess authority to pass on policy matters that arise, but in either case its decisions will usually be subject to the approval or veto of the president.

Starting a Budget The first step in the preparation of a budget is to determine the most profitable level of operations, taking into consideration the interrelationship of such factors as sales volume in terms of units and prices, productive capacity, financial requirements, and credit policies. After this decision has been reached, based more often than not on the anticipated volume of sales, the next step is that of the preparation of the various departmental budgets.

Kinds of Budgets The procedures involved in establishing the departmental budgets are described in the paragraphs that follow. In the case of the sales budget, two steps are involved: (1) the submitting, by the sales

manager, of the estimated sales volume that he believes his department can attain, and, (2) the possible revision of these by the budget committee and the establishment of the revised figures as goals for the sales budget. All of the other departmental budgets are set up on the basis of their relation to the sales budget and involve only a single step in their preparation, that of compiling and submitting the figures.

Sales Budget. There are in common usage three methods of setting up a sales budget. The first is to require each salesman to submit a detailed estimate of the sales, by items in the line of merchandise he handles, that he believes he can secure from his territory during the coming budget period. For example, salesmen of food lines, such as packaged cookies, know how many grocery stores there are in their territories, what new ones are to be opened, and what old ones are to be closed. They also know about conditions of employment and industrial and commercial activity that will affect the purchase of their products by consumers. They know the competitive picture and how it will probably affect their sales. Accordingly, they are in an excellent position to submit intelligent and attainable estimates of the probable sales of cookies in their areas.

HARRISON MANUFACTURING COMPANY

Sales Budget

Month	Territory				Total
	No. 1	No. 2	No. 3	No. 4	
January	$ 15,000	$ 11,000	$ 17,000	$ 19,000	$ 62,000
February	16,000	12,000	18,000	22,000	68,000
March	18,000	15,000	22,000	27,000	82,000
April	19,000	19,000	24,000	32,000	94,000
May	22,000	24,000	26,000	35,000	107,000
June	24,000	24,000	28,000	37,000	113,000
July	25,000	26,000	30,000	37,000	118,000
August	21,000	19,000	24,000	35,000	99,000
September	21,000	16,000	22,000	29,000	88,000
October	19,000	14,000	20,000	26,000	79,000
November	19,000	12,000	20,000	25,000	76,000
December	17,000	11,000	18,000	20,000	66,000
TOTAL	$236,000	$203,000	$269,000	$344,000	$1,052,000

These estimates are then accumulated by territories and finally for the company as a whole. Where field sales executives exist on a territorial or commodity basis, it is customary for them to summarize and submit these figures as the anticipated sales for their respective divisions. One of the major advantages of this method is that it draws its estimates from the men who will have to make good on their expectations and who know their territories.

A second method is for the home office sales department to set forth an over-all sales total, based on computations developed by its economists or statisticians through a consideration of past sales and a knowledge of general economic trends. This total, which is usually by items, is then broken down for the different sales territories, and these become the estimates for these subdivisions. The various district sales managers are then given the job of dividing these totals among their men. This method has the advantage of a broad view of the company's markets and of taking into account any nationwide influences or tendencies that may appear to be in the offing. It has the disadvantage of a lack of familiarity with the local conditions in each area, which frequently are all-important from the standpoint of the attainment of the regional sales objectives.

The third method is a combination of the first two. The estimates submitted by the salesmen in the field are checked against those developed by the home office, and any differences are adjusted through conferences. In this way the knowledge that the salesmen have of their respective territories and the broader prospective of the home office people can be combined to produce results that will probably be more accurate than either group could produce alone. It likewise preserves the factor of responsibility on the parts of the salesmen, which is important from the standpoint of comparing the estimates with the results, as the budget period progresses.

The final figures that are determined upon are established as the sales budget, upon which the budgets of all of the other departments depend.

Sales Expense Budget. It is frequently considered desirable to set up two budgets that are closely allied to the sales budget.

These are the sales expense budget and the advertising budget. The sales expense budget consists of an estimate regarding the anticipated cost of securing the sales volume that is projected for the coming budgetary period. It includes sales office expense, traveling expense, salesmen's salaries or commissions, and sales supervision expense. It may also include storage costs for finished goods.

Advertising Budget. As a corollary of the sales expense budget, the advertising budget sets forth the expected cost of advertising the product as a means of helping to secure the planned sales. It is made out in great detail and usually embraces all items of publicity and the dates of their scheduled appearance. Unusual advertising plans are presented with a complete explanation of the reasons for them and the sales results that are expected because of the extraordinary expenditure. For example, one company, which manufactures automatic pencils, planned to spend $100,000 on a campaign to introduce their products on the West Coast. In making up his advertising budget, the advertising manager of the firm placed this item together with the required explanation in a section of his budget estimate separate from that in which his regular advertising expenditures were listed. Thus the members of the budget committee were able to note quickly the increased advertising that was planned and to discern the reasons for it.

After the sales, sales expense, and advertising budgets have been drawn up, they are submitted to the budget officer for transmittal to the budget committee, where they are finally validated. This is the crux of the planning procedure, and the estimates adopted here are passed back to the sales and advertising departments as their goals for the period. Before the final figures are issued, careful consideration is given to all possible factors that may affect the actual results, and the plans of the sales executives may be altered.

Once the decision has been made, however, the plans become specific objectives toward which the energies of the entire company personnel are directed. All other budgets depend on the sales budget and none can be established until it is approved. Those that follow are typical of the budgets that are based on the sales figures.

Production Budget. In most companies, the production budget is dependent upon the development of the sales budget, which simply means that planning for sales precedes the planning for production. In some firms, the manufacturing division decides what and how much is to be made, and the sales budget is based on this estimate. This practice, however, is becoming less frequent in recent years. The drawing up of the production budget consists of determining the amounts of all products that will be made during the coming period and setting up the production schedules so that these goals can be attained.

There are occasionally instances where the manufacturing division takes issue with the sales department's budget figures, with the result that changes are made in the latter estimate. This may arise due to the production department's feeling that the sales department is asking it to do the impossible in agreeing to manufacture goods in the quantities asked. Perhaps some major alteration in the plant that will take a sizeable part of the productive facilities out of action for a time is scheduled for the coming period. Or possibly a planned addition to the factory is behind schedule because of material or machine shortages. These or any number of other causes may force a revision of the sales budget to bring it more in line with the productive capacity of the manufacturing division.

Materials Budget. After the production budget has been established, it is necessary to plan for the required materials that go to make up the finished products. This involves the planning of purchases and stores so that the needed materials will always be available to the production department on schedule.

While some kinds of materials are normally readily available on short notice from suppliers, other kinds of a rarer sort may have to be ordered months in advance of their receipt by the purchaser. When the production budget is fixed, the materials that are necessary for its attainment are listed both as to the items and the number required. Reference is then made to the stock on hand and on order. Such differences as may appear between these amounts and those that will be

required for production must be purchased on such a schedule as to assure their presence in the plant when they are needed. The materials budget thus serves as a guide to the activities of the purchasing department.

Labor Budget. The personnel department is charged with the task of providing the workers who will be necessary to make the planned volume of production. It sets up its plans to procure and have on hand the number and types of laborers that will be required for the job.

For example, if a firm that manufactures silverware decides to increase its output, it may require additional die makers, who are very highly skilled artisans. If these operatives cannot be found in the community where the plant is located, the personnel department will have to go farther afield to secure them. If, by any chance, they are unable to locate the number of workers that are required, this fact is reported to the production manager who must find some way out of this difficulty or inform the budget committee of his inability to meet the production budget. This, in turn, will probably result in a downward revision of the company's over-all budget figures.

Manufacturing Expense Budget. The setting up of a manufacturing expense budget is in order when a firm wishes to extend the practice of budgetary control into all parts of its business. It consists of estimating the expenses that will be incurred by the manufacturing division in producing the quantity and types of goods called for in the production budget. A number of rather knotty problems must be solved in establishing the manufacturing expense budget, particularly regarding the distribution of overhead expenses. This is, however, a technical matter that does not require treatment here.

Other Departmental Expense Budgets. In addition to the sales expense, advertising expense, and manufacturing expense budgets already mentioned, it is a common practice to budget the expenses of operating the other major departments of a business. The department heads submit their estimates to the budget committee, where they are approved or amended.

Plant and Equipment Budget. Somewhat apart from the more or less short-term planning that is characteristic of the foregoing budgets is the long-run type of planning to be found in the plant and equipment budget. This involves the long-range projecting of the plant and equipment needs of the company so that future requirements either to maintain or to increase the volume of production may be satisfied as they arise. Included in this category are repairs to plant and equipment as well as replacements and additions.

Financial Budget. Financial planning involves two types of budgetary operation: (1) the cash budget, which takes care of the day-to-day financial needs during any given budget period; and (2) the longer-run financial needs for plant expansion, which may involve the sale of stocks and bonds. The latter of these types is more a matter of company policy to be determined by the board of directors than of short-term budgeting and will not be discussed further here.

Cash Budget. When a firm is setting up a budget to control its selling and manufacturing operations, it is desirable that a cash budget be established also. The purpose of this budget is to make certain that the company has sufficient cash on hand from day to day to meet its current needs as they arise. Bills of all kinds must be paid when due, and money must be available to meet the pay rolls as they occur.

In order to accomplish this objective, estimates of all cash receipts and disbursements must be drawn up for each month (or even on a weekly basis) in the budget period and examined carefully to determine whether the amounts that will be on hand from time to time will be adequate. If, at any time during the period under scrutiny, the supply of cash will not take care of the needs for it, it may be necessary for the company to negotiate a bank loan, or to sell short-term notes. This condition frequently exists in those industries that have year-round production schedules but seasonal sales periods. The toy industry is an excellent example. Toy manufacturers produce throughout the year, but most of their orders, which constitute the source of their cash receipts, are secured during the late spring and summer months. It is necessary,

J. C. MONROE, INC.

Cash Budget

	January	February	⟨	December
Cash on hand-- beginning of month	20,086.50	42,519.20	⟨	12,267.93
Receipts	48,282.50	32,235.00	⟨	46,350.00
Total Cash Available	68,369.00	74,754.20	⟨	58,617.93
Disbursements:			⟨	
Purchases	16,730.00	24,026.00	⟨	10,250.00
Selling Expenses	4,793.00	4,912.00	⟨	11,330.00
Administrative Expenses	4,326.80	3,592.70	⟨	3,871.80
Other Expenses	.....	.....	⟨	2,600.47
Total Disbursements	25,849.80	32,530.70	⟨	28,052.27
Estimated cash at end of month .	42,519.20	42,223.50	⟨	30,565.66

therefore, for many firms in this business to negotiate bank loans to carry them through the months when sales are not being made.

In somewhat the same manner, firms sometimes find that they have surpluses of cash on hand from time to time, which may indicate the desirability of their planning to make short-term investments during the periods when their supply of cash greatly exceeds their current needs. The cash budget is established to provide for such situations as these as well as to assure the presence of sufficient cash at the time that it is needed.

Estimated Statements If all departments of a business are budgeted, it is possible to construct an estimated balance sheet and profit and loss statement, which will show the expected effects on the company's financial standing of the projected budget estimates, provided they are realized in the coming budgetary period. These statements are prepared by the chief financial officer, who may be either the treasurer or the controller, and they complete the planning cycle of the company's activities.

Budgetary Control

The procedures described thus far comprise only one part of the budgetary picture—the planning operation. The second part—control—is equally important although in many respects it is somewhat more routine in nature.

When the estimates for all of the different budgets have been submitted to the budget committee and approved as submitted or with alterations, the resultant figures become goals toward the attaining of which the affected departments assume responsibility. The sales department breaks its figures into quotas for districts and for the individual salesmen. The production department sets up its manufacturing schedules so as to produce the types and quantities of goods specified in its budget. The same sort of thing takes place in all the other departments that are included in the budgetary operation.

The Control Factor. Control is achieved through the establishing of forms that set forth the budget figures and provide space for the recording of the actual performance as it takes place. The comparison between the planned and the actual results indicates how well each department is doing in measuring up to its budgeted figures. These results are constantly brought to the attention of the budget committee and of the chief executive of the company who will, in turn, review them with the department managers concerned. Any deviations from the plans will thus be immediately noted, and remedial action, if required, can be instituted. For example, if sales in a certain territory are running below the budget, the sales manager can get in touch with the salesmen in that area to discover where the trouble lies, and he can do this immediately after the difficulty arises. He may discover that there are good reasons for the lack of sales, such as bad weather, local business conditions, or something of the sort. On the other hand, he may find that the salesmen have been loafing or that some other situation, which he can clear up in a short time, exists.

The important point in this procedure is that the deviation from the budget is brought quickly to the attention of the responsible executive, who is enabled thereby to investigate the matter and do something about it while there is still time for remedial action.

Need for Flexibility. The experience of many companies shows the need for flexibility in the operation of the control phase of budgeting. Referring to the illustration used above, if it turns out that there is a good reason for a drop in sales in the territory in question and that the planned figures will simply not be attained during the budget period, it is wise for the budget committee to adjust the plans for the remainder of the period to allow for this situation. This may require a far-reaching adjustment that will affect every departmental budget in the business; but it is an intelligent step that brings the planned figures into accord with the facts and, as it were, keeps the company's feet on the ground. There is certainly no point to adhering slavishly to goals that cannot possibly be attained.

This element of flexibility should be present in every budget plan that is adopted by any business. By keeping the budget closely geared to the unfoldment of actual conditions as they develop and by making such adjustments as are dictated by the flow of events, a business can establish a managerial tool of great value.

The Budget as an Over-All Control. As the departmental budgets serve as control instruments for those subdivisions of a business to which they are applied, so can the master budget, the aggregate of the lesser ones, serve as a control tool for the over-all operations of a business. Thus the entirety of a business can be brought under budget control with beneficial results at all points.

The budget idea, while somewhat complicated in operation, is basically quite simple. It consists, in essence, of setting forth plans for the future, recording the results as they occur, noting the similarities and, particularly, the differences between the plans and the actualities, and taking such action as experience and good judgment appear to indicate.

Budgeting and the Business Cycle

Underlying all budgetary planning is a recognition that anticipated sales volume will be affected by the stage of the business cycle—whether a period of prosperity or depression is in the offing. If times are to be good, sustained or increased sales

volume may be planned for; if they are to be bad, the opposite may be expected. The degree of impact of these conditions upon different firms varies with the types of business. The heavy industries, making industrial goods or durable consumers' goods, are the ones most affected, with the food and apparel trades somewhat less so.

Whatever the field in which a firm is engaged, it is imperative that the stage of the business cycle be estimated, both when the budget figures are being put together and after the period has begun. All available forecasts should be consulted before the budget estimates are established, and constant reference should be made to current business indexes as the budget period progresses. If the outlook is for good business conditions for the length of the period, the plans may be more optimistic and ambitious than when a depression looms. Likewise, if any change in the anticipated trends appears, as time goes by, the budget committee may wish to revise the budget estimates in accord with these new developments. As budgeting is, at least in part, a planning operation, its administration must be undertaken with a constant awareness of the general business climate in which the firm operates, and changes that either occur or impend must be noted.

QUESTIONS

1. Why is the analogy between business budgets and the charting of a ship's course a valid one?
2. What is the purpose of budgeting?
3. "All businesses, large or small, should budget." State why you agree or disagree.
4. Name the departments of a business to which you think budgeting could not be applied. Give reasons.
5. What factors determine the length of the budget period?
6. What steps should be taken before a budget is set up?
7. Trace the development of the budget in (a) the sales department. (b) the production department.
8. Why are accurate accounting methods necessary to the successful operation of budgetary control?
9. Who should comprise the budget committee?
10. What are the functions of the budget officer?
11. What is meant by the term "flexible budget"? Why is flexibility a desirable attribute of budgets?

12. How does the control phase of budgeting operate?

13. What factors should be considered in establishing a cash budget?

PROBLEMS

1. The following is a condensed income statement for the Shaw Electric Company for the year 1947:

SHAW ELECTRIC COMPANY

INCOME STATEMENT

for the Year Ended December 31, 1947

Sales (30,000 units)		$450,000
Cost of Goods Sold		300,000
Gross Profit		150,000
Selling Expenses	$75,000	
General Expenses	70,000	145,000
Net Profit		$ 5,000

The management is disturbed at the small net profit and has requested the sales force to estimate possible volume for 1948 with the thought that added profits would result from increased sales. The consensus of the salesmen is that a 50 per cent gain in units sold could be attained provided the price of each unit is reduced 20 per cent.

Prepare an estimate of income, expense, and net profit for 1948, taking into account the information given and also the following factors:

(a) Cost of each unit will decrease 20 per cent with increased volume of production.

(b) Selling expenses will increase 40 per cent due to need for advertising campaign and increased sales commissions.

(c) General expenses will increase 5 per cent.

On the basis of your budget, do you think that the management should reduce prices and expand production or that it should look elsewhere for a solution to the problem of a low net profit?

2. During 1948 the budget director of the Kewanee Paper Company estimates that cash must be available each month to meet a pay roll of $85,000, expenses of $10,000, and payments on accounts payable of $25,000. At the end of each quarter, dividend checks totaling $15,000 will be mailed to the stockholders.

The only source of cash receipts is from collections on accounts receivable. It is estimated that 75 per cent of the amount on the books at the beginning of each month will be collected during the month.

On January 1 the balance on hand in the cash account is $100,000, and the amount owed the firm by its customers is $120,000. The estimated balance of the accounts receivable account on the first of each of the other months is as follows: February—$160,000; March —$140,000; April—$180,000; May—$200,000; June—$100,000; July —$128,000; August—$176,000; September—$152,000; October— $168,000; November—$192,000; and December—$216,000.

Prepare a budget of cash receipts and disbursements by months. When necessary, borrow money to meet the needs of the company for cash and repay the loan as rapidly as possible. How many times was it necessary to plan ahead to borrow money, how large was each loan, and what was the estimated cash balance on January 1, 1949?

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CHAPTER 28

BUSINESS PAPERS

Importance of Business Papers In the efficient functioning of present-day business firms, large and small, the extensive use of a variety of business papers is necessary. There may have been a time when a sole proprietor could "carry everything in his head," although it is doubtful that he was an efficient businessman. Today, the many relationships with other firms, the general public, and the various branches of government necessitate a familiarity with, and use of, many types of invoices, checks, notes, and other business papers.

Any written record or supporting evidence of a business transaction can be classified as a *business paper*. Usually printed forms that conserve time in detailing the facts and figures concerning a particular transaction are available. For example, when a customer pays for merchandise purchased by giving his personal check he adds a date, amount, and signature to a printed form designed for this purpose. The use of printed forms also facilitates the preparation of one, two, or more carbon copies when duplicates of the original can serve useful purposes. The common practice of retailers in giving each customer a sales ticket and retaining a copy for their own records illustrates such a need.

Business papers are used in every phase of a firm's activities and are essential in the operation of any system of managerial control. The bookkeeping department would not be able to record transactions without the reports that are routed to its office through the media of checks, deposit slips, sales and purchases invoices, notes, drafts, pay-roll cards, and many other forms and records. The reports issued by accountants and statisticians are prepared after information has been accumulated and organized from raw data consisting of hundreds or thousands of forms that have been filled out to show essential information. Every individual working for the organization, from the president of the firm to the stock room boy, spends some time in making up or using business papers.

Types of Business Papers The types of papers that are used vary with different types of industries and even among firms within a particular classification. Each organization has its own peculiar problems that special forms may help to solve, and this means that the varieties that may be encountered are almost endless. On the other hand, many business papers that are used to facilitate relations with firms or people outside of the organization have become somewhat standardized. Sales invoices, for example, are printed by each firm to its own order, but the same types of information are included and the basic arrangement is, normally, very similar to that used by other firms.

For convenience of examination in some detail, the business papers that will be discussed and illustrated have been grouped under the general headings of cash, sales, purchases, manufacturing, and miscellaneous. No attempt will be made to discuss more than the business papers that are common to most merchandising and manufacturing operations.

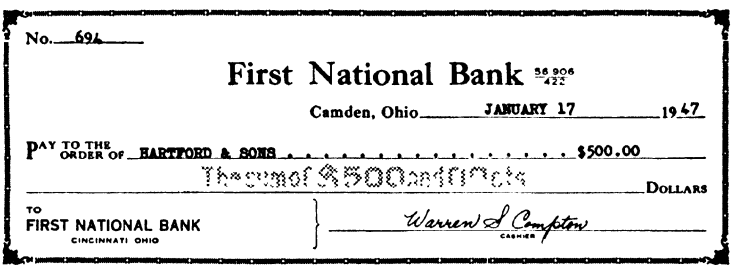
Cash Group of Business Papers The process of receiving and paying out cash is a daily routine in almost every business operation. Some of the transactions involve the use of currency, although the percentage of receipts and disbursements based on coins and the various denominations of bills is small. Most business organizations buy on credit and most of them, other than some cash-and-carry markets, sell on credit, which reduces the volume of transactions involving currency. Business papers substituted for currency, or used to help management to control cash, are described below.

Checks. During any business day, sole proprietorships, partnerships, and corporations receive and issue thousands of checks. Each check is drawn against a balance maintained in a commercial bank by the person or firm issuing this form. A check is signed by the payer or *drawer* of the paper, directing his bank to pay the amount indicated to a named *payee* or his order.

There are also special forms of checks. If a bank writes a check, drawn against itself, this type is known as a *cashier's check* because it is signed by the bank cashier. To the extent

that the bank uses these to pay its own bills, this form could be considered the same as an ordinary check. However, tnere is another use made of cashier's checks. If an individual or business is unknown to the creditor and wishes to pay an invoice by giving a check, he can go to his bank and buy a cashier's check. This will be accepted by a stranger under conditions where a personal check would be refused.

Another similar type of check is a *bank draft,* which was discussed in Chapter 21. It differs from a cashier's check only in that it is drawn against a correspondent bank rather than itself. The use is similar in both cases except that the bank draft might be preferred over a cashier's check for out-of-town payments, particularly in the city where the correspondent bank is located.


No. 694

First National Bank 56-906 422

Camden, Ohio JANUARY 17 1947

PAY TO THE ORDER OF HARTFORD & SONS $500.00

The sum of $500 and 00/100 DOLLARS

TO FIRST NATIONAL BANK CINCINNATI OHIO

Warren L Compton CASHIER

Bank Draft

Money Orders. Many people use money orders for making payments. There are two common forms—*postal money orders* and *express money orders.* The difference between the two is that one form is sold by the United States Post Office and the other by the American Express Company.

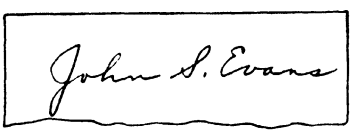
At the time a money order is purchased, it is necessary to fill out a form and pay the amount of the money order and the fee. A receipt is given to the purchaser. The chief advantage of the use of money orders over any form of check is that there is no question about the value of this form of paper. Anyone will accept a money order that is made out in his favor without knowledge of the financial responsibility of the sender.

In recent years, the United States Post Office has issued a new form of remittance paper called *postal notes.* These can

be used for payment of any amount up to a maximum of $10 at a uniform charge of five cents. The cost of a postal note for $5.68, for example, is only five cents, as compared with eleven cents for a postal money order of this size.

Endorsements. In order to convert any of the cash papers mentioned into currency, to add it to the bank balance of the payee, or to transfer it to another party, the instrument must be endorsed. There are various ways in which this can be done, and the choice of method frequently depends on the purpose for which the endorsement is made.

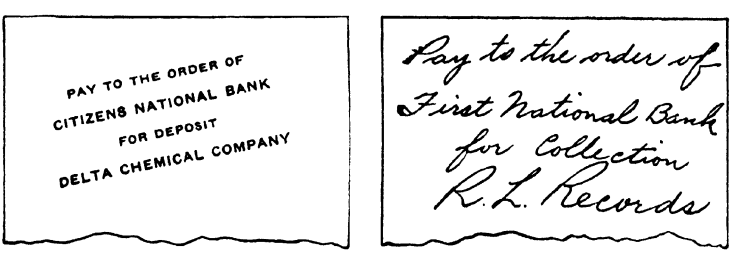
If a payee or subsequent holder of a cash paper, a promissory note, or a time draft (all of which are known as *negotiable instruments*) wants to endorse it to another party, he may do so by merely writing his name on the back of the paper. This is called a *blank endorsement.* The signature of a payee must be exactly as shown on the face of the check, draft, or note. Other endorsers can use their usual signatures.



Blank Endorsement

It is unwise to endorse checks in blank, except at the time of delivery to the next holder, because such a check can be cashed by anyone who affixes his signature.

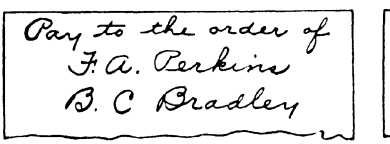
If checks are to be deposited in a bank to the credit of the firm's account, a common endorsement shows the words "For deposit only," or "For deposit to the account of . . ." preceding the name of the firm. This is known as a *restrictive endorsement.* Another form of restrictive endorsement includes the phrase "For collection only." This form of endorsement is



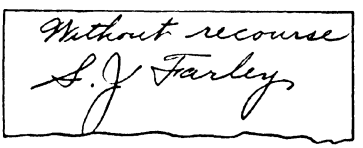
Restrictive Endorsements

used when a business makes use of a bank to collect a note or time draft. A restrictive endorsement may be made by means of a rubber stamp because no one other than the person making the endorsement can benefit from it.

Sometimes checks that have been received are forwarded to another party in full or part payment of a debt. In this event, the intent is to endorse the paper to a specific individual, which requires a *special* or *full endorsement.* This consists of the words "Pay to the order of John Doe" preceding the signature of the endorser. When this type of endorsement is used, the endorsee must sign his name if further negotiation of the instrument is desired.



Special or Full Endorsement



Qualified Endorsement

Every person who endorses a check or any other form of negotiable instrument is liable for the amount shown on the face. If a check receives ten endorsements and is presented to a bank for payment and subsequently it is returned to the bank marked NSF (not sufficient funds), any one of the ten endorsers is liable to the bank that cashed the check. If the bank collects from the person cashing the check, he in turn can collect from any previous endorser, as can any endorser in relation to those whose signatures preceded his. In order to avoid this contingent liability, but still keep the check negotiable, it is possible to give a *qualified endorsement,* using the words "Without recourse." This is not commonly done because most individuals or concerns would not care to accept a negotiable instrument with a qualified endorsement on it.

Post office money orders, unlike other substitutes for cash, have limited negotiability. It is possible for the receiver to endorse a postal money order to another party, but the second party must convert it into cash. This may be done at a post office or at a bank, because the bank's stamp does not constitute an additional endorsement in the eyes of the Post Office Department. Postal notes are not negotiable.

SIGNATURE CARD

Date Jan. 17, 1947 THE MERCHANTS NATIONAL BANK WILL PLEASE RECOGNIZE IN PAYMENT OF FUNDS, OR THE TRANSACTION OF OTHER BUSINESS ON THIS ACCOUNT, THE AUTHORIZED SIGNATURES BELOW

Name of Firm Beyer & Allen, Inc.

By J. L. Stevens, Pres. Signature

By Charles P. Baker, Asst. Treas. Signature

By Signature

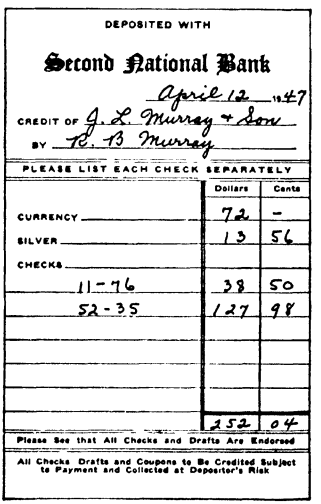
Phone Cherry 3500 135 East Main St. Address

Name to be filled in by Bank

Beyer & Allen, Inc.

Bank Signature Card

Bank Deposit Forms. Practically every business firm maintains a bank account. At the time the account is opened, a *signature card* is placed on file, which provides the bank with a means of identification as checks are written against the account. Only checks signed by the individual or properly designated agent of a business will be honored.



DEPOSITED WITH

Second National Bank

April 12 1947

CREDIT OF J. L. Murray & Son

BY R. B. Murray

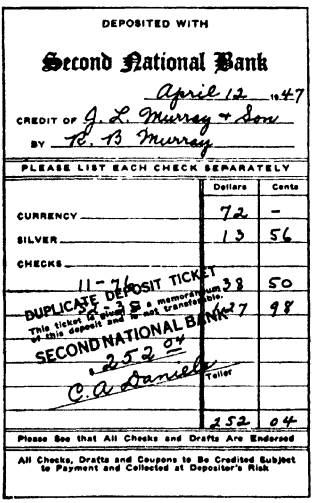
PLEASE LIST EACH CHECK SEPARATELY

	Dollars	Cents
CURRENCY	72	-
SILVER	13	56
CHECKS		
11-76	38	50
52-35	127	98
	252	04

Please See that All Checks and Drafts Are Endorsed

All Checks, Drafts and Coupons to Be Credited Subject to Payment and Collected at Depositor's Risk

Deposit Slip



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PLEASE LIST EACH CHECK SEPARATELY

	Dollars	Cents
CURRENCY	72	-
SILVER	13	56
CHECKS		
11-76	38	50
52-35	127	98
	252	04

DUPLICATE DEPOSIT TICKET
This ticket is given for memorandum purposes only. It is not transferable.
SECOND NATIONAL BANK
252 04
C. A. Daniels Teller

Please See that All Checks and Drafts Are Endorsed

All Checks, Drafts and Coupons to Be Credited Subject to Payment and Collected at Depositor's Risk

Duplicate Deposit Slip

When money is taken to the bank to be added to the account, a *deposit slip* must be filled out, showing in detail the currency and checks involved. A sample slip is shown on page 560. The amount is entered in the *pass book*, which is furnished by the bank to its customer; duplicate deposit slips can also be used. In the latter case, the bank may stamp the duplicate rather than to enter the amount in the pass book.

STATEMENT OF YOUR ACCOUNT WITH

MERCHANTS NATIONAL BANK

Western Appliance Corporation
3198 La Salle Street

REPORT PROMPTLY ANY CHANGE IN YOUR ADDRESS

CHECKS			DEPOSITS	THE LAST AMOUNT IN THIS COLUMN IS YOUR BALANCE	
			BALANCE FORWARD	June 2	1,468.59
95.73			126.56	4	1,499.42
38.00	15.26			5	1,446.16
24.00	38.00	4.70	143.00	7	1,522.46
35.00	172.00		200.83	9	1,516.29
2.68	9.10		302.67	11	1,807.18
113.95	27.84			13	1,665.39
50.00	13.74		105.00	14	1,706.65
132.44	86.85	22.00		16	1,465.36
210.00	19.00	7.96		17	1,228.40
13.10	4.62		99.74	19	1,310.42
5.00	74.75		138.50	21	1,369.17
31.16	195.00	52.00		23	1,091.01
17.20	66.25		325.00	25	1,332.56
6.63	45.73			27	1,280.20
203.00	14.83		245.00	28	1,307.37
145.00			173.92	30	1,336.29

PLEASE EXAMINE AT ONCE AND REPORT ANY DISCREPANCIES OR ERRORS TO OUR AUDITOR WITHIN TEN DAYS

VOUCHERS RETURNED 34

SHEET NUMBER _____

Bank Statement

At the end of each month or some longer period, a *bank statement* and the checks that have been written and that have cleared through banking channels, are delivered to the customer. This statement is very important to the business concern, for it enables the bookkeeper or accounting depart-

BANK STATEMENT RECONCILIATION

CHECKBOOK		BANK STATEMENT		
Balance:	$1,372.00	Balance:		$1,600.00
Deduct charges:		Deduct checks outstanding:		
Service charge made by bank	2.00	#563	$30.00	
	$1,370.00	#587	27.50	
Credits to be added:		#588	77.50	
Deposits made but not recorded in the checkbook	85.00	#589	10.00	145.00
Adjusted checkbook balance	$1,455.00	Adjusted bank statement		$1,455.00

Bank Reconciliation Statement

ment to prepare a *bank reconciliation statement.* Its purpose is to reconcile any differences that may exist between the books of the company and the record kept by the bank covering identical deposits and withdrawals. The bank reconciliation is particularly important if the business follows the accepted practice of depositing all moneys received and of paying all bills by check. The bank statement shows all of the deposits and all of the checks charged against the account.

Petty Cash Vouchers. Almost all firms, particularly those that deposit all receipts in a bank, maintain a small cash fund for the payment of small expense items. For example, the payment of 12 cents for mail returned to sender would not warrant issuing a check. A record of such payments can be kept in a special journal or on petty cash vouchers. A petty cash voucher form is illustrated below.

PETTY CASH VOUCHER

No. 176 Date March 12, 1947

Paid to Cosgrove Wright Co AMOUNT 3 00

For Delivery Service

PAYMENT RECEIVED SHEA, BURNS & COMPANY

B. R. Chaney Approved by J. J. Horton

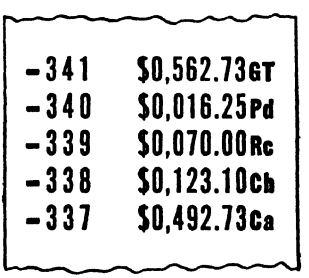
Petty Cash Voucher

Sales Group of Business Papers Sales constitute the usual source of income from which profits are made. The businessman cannot be blamed for being intensely interested in the volume of sales per year, month, week, or even day. He can compare progress this year against a similar period of the year previous. If the concern is departmentalized, he is interested in a further breakdown of the figures. Sales may have increased $10,000 over a similar period of the preceding year, but a departmental analysis may show that Department A has a gain of $12,000 while Department B has a smaller volume by $2,000.

In addition to sales totals, sales papers may provide other valuable information. If merchandise is sold on credit, the details must be known by the accounting department so that proper charges may be made. Adjustments and returns must be recorded from information provided by those responsible for allowing such adjustments. It would be impossible for the modern department store, for example, to function smoothly without a continuous paper record of its numerous daily transactions.

Cash Register Tape. One of the least formal, but nevertheless valuable, business papers in connection with sales records is the cash register tape. Many retail firms "ring up" each transaction on a cash register, whether it be a charge or cash sale. Most registers are fitted with special keys in addition to those that indicate the amount of money involved in the sale. These can be used to indicate sales by departments, returns, charge sales, or cash sales.

The cash register records each transaction on a paper tape known as the detailed audit strip. It also accumulates a total for each type of transaction. At the end of each day the totals are printed on the detailed audit strip by depressing the Total key. In the illustration at the right the symbol **Ca** indicates the total cash sales for the day; **Ch**, the total charge sales; **Rc**, cash received on account; **Pd**, cash paid out; and **GT**, the total cash receipts.



Detailed Audit Strip Showing Totals

Sales Slips. Many stores make out a sales ticket or slip for each sale, regardless of whether it is for cash or on account. At least two copies are prepared, one to be given to the customer and the other used for the records of the firm. Carbon copies are a common method of duplicating this information. Some companies follow the practice of recording the amount on a cash register as well as making out a sales ticket, which permits one total to be checked against the other. If the amount is a charge sale, the duplicates can be filed by name for purposes of keeping a record of the total owed by each customer, or the amount can be posted to a ledger card. The sales slip illustrated at the left contains the information usually found on this type of a business paper.

CASH | CHARGE | C. O. D | WILL CALL

MILLS — ST. LOUIS MISSOURI

DEPT 14 | SOLD BY 12-A | DATE 2/21/47 | DELIVERY NO. 735

SOLD TO: MR J O HELMICK

STREET ADDRESS: 3109 BRAMBLE ROAD

CITY: ST. LOUIS, STATE: MISSOURI

HOW TO SEND | C O D SAL

CASH CHECK NO | TRANSFER NO

CHARGE NAME: MR J. O. HELMICK

CHARGE ADDRESS: 3109 BRAMBLE ROAD

BOUGHT BY: X J. O. Helmick X

CASH | CHARGE | C O D | WILL CALL | AMT REC'D

DEPT 14 | SOLD BY 12-A | DATE 2/21/47

QUAN	ARTICLES	PRICE	AMOUNT
1	MAHOGANY DESK	59.95	59 95
1	END BOOKCASE	25.00	25 00
		TOTAL	84 95

ENCLOSURES

Sales Slip

Sales Invoices. Practically all businesses that do not deal directly with the public use sales invoices rather than sales slips or tickets, although the purpose of the two types of papers is practically identical. If an order is received by a manufacturing firm, a sales invoice is mailed to the customer at the time of shipment. This shows the terms of the sale, the quantities shipped, a description of the goods, prices per unit, and the extensions on the different items. To the total is sometimes added an amount for transportation charges if these are prepaid by the shipper, with the understanding that he will be reimbursed by the purchaser for this added expense.

Statements of Account. In some lines of business the seller expects to receive a separate payment for each sales invoice. This is particularly true for shipments made by manufac-

WESTERN WOOLENS
345 TREMONT STREET
DENVER 4, COLORADO

FOR CUSTOMER'S USE ONLY
Register No. | Voucher No.
P O B Checked
Terms Approved MVH | Price Approved C.H.C.
Calculations Checked R.H.M.
Transportation
Freight Bill No. | Amount
Material Received 6/4 1947 (Date) B.K. Reed (Signature) (Title)
Satisfactory and Approved
Adjustments
Accounting Distribution
Audited | Final Approval J.L.C.

Customer's Order No. & Date 359 - May 31, 1947
Refer to Invoice No. 1859
Requisition No.
Contract No.
Invoice Date June 2, 1947
Vendor's Nos.

SOLD TO J. W. Schneider & Co.
596 Michigan Avenue
Bloomington, Illinois

Shipped to and Destination J. W. Schneider & Co.
Bloomington, Illinois

Date Shipped June 2, 1947 From Denver, Col. Prepaid or Collect? Prepaid
Car Initials and No. F O B
How Shipped and Route Truck - A. A. Moore Trucking Co.
Terms 30 days

QUANTITY	DESCRIPTION	UNIT PRICE	AMOUNT
2 bolts	Wool Rib Crepe	68.40	136.80
2 bolts	Wool Flannel	55.50	111.00
1 bolt	Virgin Wool Coating	87.00	87.00
			334.80

Sales Invoice

turers and wholesalers. However, if payment is delayed or if retail sales are involved, it is customary for the seller to send a statement of account to the customer. This is frequently mailed on the first of the month and shows purchases made during the preceding month plus any older unpaid balance. Large firms usually prepare these statements on posting machines,

PHONE DUNBAR 7000

THE JOHN SHILT CO.
CINCINNATI 2, OHIO

Mrs Harold R Edwards
3581 Monroe Avenue
Cinti 10 Ohio

May 1947

$ _____ AMOUNT PAID

PLEASE RETURN THIS STUB WITH REMITTANCE TO INSURE PROPER CREDIT TO YOUR ACCOUNT

ACCOUNTS ARE DUE AND PAYABLE WITHIN 10 DAYS AFTER RECEIPT OF THIS STATEMENT

CLOSING DATE	PREVIOUS BALANCE	CURRENT PURCHASES	PAYMENTS	RETURNS	BALANCE DUE
MAY 31 47	14.33	2.06	14.33		
		9.98		2.06	
		17.53			27.51 S

THIS BILL INCLUDES ALL TRANSACTIONS THROUGH THE CLOSING DATE. SALES CHECKS AND CREDITS ARE ENCLOSED. THEY SHOULD BE PRESENTED WITH THE BILL IF THERE IS AN INQUIRY ABOUT AN ITEM. PAYMENTS MADE OR MERCHANDISE RETURNED AFTER CLOSING DATE WILL BE CREDITED ON NEXT MONTH'S STATEMENT

THE JOHN SHILT COMPANY

Statement of Account

while small concerns rely on typewritten or handwritten statements of account. The form illustrated was produced by a posting machine.

Debit or Credit Memorandums. Sometimes merchandise that has been sold is returned, or it is necessary for the seller to make an allowance on the original price because the goods failed to equal the quality or condition expected. Returns are normally accepted at full price in the interest of maintaining satisfied customers. If an adjustment in the price is requested, some official or department will be charged with the responsibility of passing on the claim. In either event, if the total of the original sale is reduced, the amount owed is decreased to the extent of the return or allowance. In order that he keep the accounts accurate, the purchaser may send the vendor a debit memorandum or, more commonly, the seller will send a credit memorandum to the customer.

CREDIT MEMORANDUM

MILLER & MILLER

Wholesale Distributors of Leather Goods
331 Murray Street
CLEVELAND 26, OHIO

No. 265 June 14, 1947

O. G. Winston & Son
783 East Fourth Street
Louisville 9, Kentucky

WE CREDIT YOUR ACCOUNT AS FOLLOWS:

1	Sliding Handle Pigskin Case	13.50	13.50
2	Leather Utility Cases	3.89	7.78
			21.28

Credit Memorandum

Purchase Group of Business Papers In a very small business the owner may handle all purchases and, because the control is centered in one individual and may not consist of many items, he can carry many of the details in his head. A larger organization would maintain a purchasing department. The co-ordination between this department and others affected is secured through a series of business papers relating to the purchasing functions.

The papers dealing with buying were discussed in Chapter 6, and the student is referred to this material for a review of the purchase requisition and purchase invoice. It should be noted that a sales invoice in the hands of the seller becomes a purchase invoice in the possession of the buyer, and that a credit memorandum issued by a seller serves the same purpose as a debit memorandum issued by the buyer who returns goods or secures an allowance on the original price.

Manufacturing Group of Business Papers Because each manufacturing enterprise has its peculiar problems, many of the manufacturing forms are designed especially for the firm's particular purposes. There are, however, some common problems usually handled in a standard manner.

Pay-Roll Records. A business employing a large number of people must have a systematic method of determining the number of days and amount of time in each day that have been worked by each individual. Most factories and retailing establishments use a time clock in conjunction with a timecard. When the employee arrives in the morning, he removes his card from the "Out" file, inserts it in the time clock for punching, and transfers it to the "In" file.

On the job, a worker may be requested to keep an account of the amount of time he spends on each job in order that the cost accounting department may be able to charge this cost against a particular order. The individual tickets are collected in order to determine the total amount of time worked and can be checked against the timecards.

PAYROLL NO. 39 | SEX M | POSITION | EMPLOYMENT | S S ACCOUNT NO. 379-62-138

NAME Henry Reynolds

	STATE W T TAX	FED O A B TAX	
AMOUNT TAXABLE	30.63	30.63	PAY ENDING 1/31/47
TAX RATE	1%	1%	TOTAL EARNINGS 30.63
TAX AMOUNT	.31	.31	TOTAL DEDUCTIONS 3.22
			BALANCE DUE 27.41

OTHER DEDUCTIONS Withholding-1 2.60

Form No 851712

	MORNING IN	MORNING OUT	AFTERNOON IN	AFTERNOON OUT	OVERTIME IN	OVERTIME OUT	
M	8[00]	12[00]	12[29]	4[31]			8
T	7[57]	11[51]	12[28]	4[32]			7¾
W	7[59]	12[02]	12[33]	4[31]	5[00]	8[00]	10½
T	7[58]	12[00]	12[26]	4[29]			7¾
F	7[56]	12[03]	12[27]	4[33]			8

		HOURS	RATE	EARNINGS
	REGULAR	39½	.70	27.48
	OVERTIME	3	1.05	3.15
DAYS WORKED 5	TOTAL HOURS	42½	TOTAL EARNINGS	30.63

Timecard

Electric Timecard Clock

Upon arrival, the employee removes his timecard from the "out" rack, inserts it in the timecard clock to record the time, and places it in the "in" rack.

One method of handling the pay-roll problem is to transfer the information from the records kept by each individual to a card that is punched by an operator to indicate all necessary information. Business machines sort the cards by employee number and print the amounts due.

Other Manufacturing Papers. An important manufacturing problem is the control of raw materials, purchased parts, tools, and manufacturing supplies. Records must be kept of the quantities purchased, items removed and returned to the appropriate stock or storage rooms, and the number on hand. Chapter 6 described the business papers used to control materials, and the forms used for purchased parts, supplies, and tools would be almost identical.

Miscellaneous Business Papers The classifications of business papers already itemized include most of the types in frequent use with the exception of notes and time drafts. These were explained and illustrated in Chapter 20. A number of other business papers are worthy of mention even though they are not in day-by-day use. Included in this category are such important documents as insurance policies, deeds to property, licenses, duplicate tax forms, contracts covering agreements to buy or sell, the corporate charter or certificate of co-partnership, and legal documents such as bond indentures or preferred stock contracts. All of these and other similar business papers provide a written record of a business transaction or constitute important supporting evidence.

QUESTIONS

1. To what extent are industry and commerce dependent upon business papers?

2. Which departments of a manufacturing firm make the most use of business papers?

3. When would it be advisable to purchase a cashier's check? a bank draft? What would be the deciding factor between these two types of checks?

4. Why do people buy money orders instead of using checks?

5. If a check is to be mailed to a bank for deposit, what would be the best type of endorsement to use? Why?

6. If the bank balance as reported at the end of the month is not the same as that shown by the check stubs, how may this be accounted for?

7. What information can be drawn from a cash register tape?

8. Under what circumstances would a sales slip be used instead of a sales invoice?

9. What is the difference between a debit memorandum and a credit memorandum?

10. Is a statement of account necessary if merchandise is sold on credit terms?

11. Why are time cards used by many factories and large retailing establishments?

12. In the operation of a small business, such as a retail clothing store, what types and kinds of business papers would be needed?

PROBLEMS

1. Roland Miller gives Charles Hooker a 30-day, 6 per cent note for $100. Hooker transfers the note to Robert Stevens by endorsing it in full. Stevens sells the note to John Grubb for $90 and is permitted to use a qualified endorsement. Grubb, in turn, endorses the note in blank and mails it to Dr. Stanley Cook in payment of a bill for medical services. Dr. Cook holds the note until maturity, at which time he gives it to his bank, The Farmers National Bank, for collection.

On an unruled sheet of paper draw a rectangle the approximate size of a note. Assume that this ruled space is the back of Miller's note, and write the endorsements in the form and order in which they should appear.

2. The Carlos Manufacturing Company of San Antonio, Texas, ships the following items to Ye Olde Gift Shoppe, Kalamazoo, Michigan, on October 18, 1948. The terms are 2 per cent discount for cash within ten days, net thirty days, f.o.b. destination.

1 dozen silver rings at $3.80 each
3 dozen bracelets at $14.40 per dozen

On a blank sheet of paper draw a sales invoice form and enter the above information.

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CHAPTER 29

BUSINESS ORGANIZATION AND ADMINISTRATION

Importance of Organization Plan

The production and distribution of goods for profit are fundamentals of business, as are financing and control mechanisms. These functions are performed by individuals who have different personalities, which means that possibilities of friction among employees are ever-present. If, somehow or other, a business can be so organized that all of its workers "pull together," success is almost assured. On the other hand, if there is a considerable amount of dissatisfaction among the employees, failure may overtake a firm that, from a cold impersonal appraisal of its productive facilities, marketing system, and financial structure, should have been a marked success.

If the morale of most of the men and women working for a particular concern is high, it is said that the *esprit de corps* is excellent. This means that a group of loyal employees are working harmoniously along side of, and in co-operation with, each other. They are anxious to promote the welfare of the firm, and its continuing success is a matter of personal pride to each individual.

It is true that the payment of reasonable wages is an important part of employee morale. However, loyalty and the urge to do a good job cannot be bought by money alone. It is not uncommon to hear someone say, "I wouldn't work for that man if he paid me a million dollars." This exaggeration is an indication of the need for creating conditions under which workers feel happy and comfortable and can labor in harmony with everyone from the highest executive to the office boy.

A proper plan of business organization plays an important part in the solution of the human relations problem in business. This statement does not mean that a good organization structure will automatically solve all of the problems connected with keeping employees well satisfied, nor does it mean that the only reason for an organization plan is to improve morale.

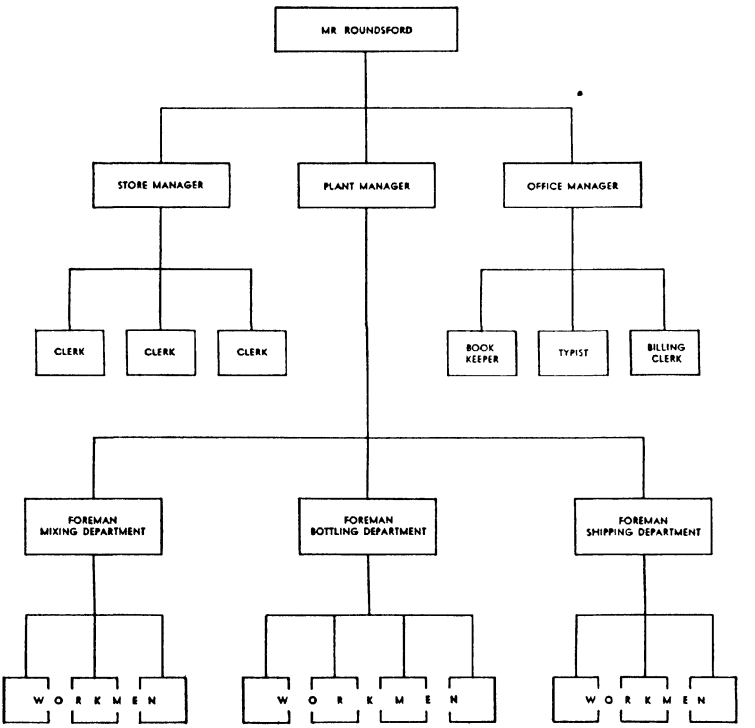
However, unless there is a plan that allows each worker to know what he is supposed to do, to whom he is responsible, and the part he plays in the over-all picture, there is little possibility that workers will remain satisfied. At the same time, an organization plan allows management to control, supervise, delegate and fix responsibilities, and to synchronize the work done by individuals, departments, and divisions.

Illustration of Organization Plan An illustration may clarify some of the points made in the preceding topic. Mr. Roundsford operated a retail drug store. His only employee was a young man who took care of customers during the absence of the proprietor, packaged orders, and otherwise was a handy man around the store. Mr. Roundsford, during his idle time, had compounded a cough syrup that had established a fine local reputation. In time, orders began to arrive from other cities, and it became necessary to establish a small factory to mix, bottle, label, and ship the cough syrup.

Workers were hired to perform the various tasks under the direct supervision of the proprietor. As expansion took place, it became necessary to employ several people in the mixing department, bottling department, and each of the other departments. Furthermore, Mr. Roundsford spent so much time in the factory that he had to hire an extra clerk for his store. Very soon he discovered that everything seemed to be going wrong unless he was around to handle matters. While he was away from the store, the clerks would bicker among themselves as to the amount of work each was doing. If he remained at the store, the factory workers would quarrel, with everyone trying to get out of the heavy or more disagreeable work.

The problem was partially solved when Mr. Roundsford appointed a store manager, and managers of the mixing, bottling, labeling, and shipping departments. These individuals were charged with the responsibility of handling the personnel under them and of reporting directly to Mr. Roundsford. In spite of these appointments, he could not resist the temptation to correct and instruct individual workers whenever he saw something that did not suit him. This led to the complaint on the part of some workers that one boss told them to do things one way and another boss came along and reversed

the previous orders. On top of this, the managers of the various departments blamed each other for delays and other production difficulties. As the plant grew in size, problems multiplied until finally Mr. Roundsford drew up an organization plan, which allowed for a plant manager and an office manager, and abolished the labeling department, as shown below.



Copies of this chart were posted in the store, office, and plant. Orders were given that no one, except the immediate supervisor of an employee, was to take up any matter directly with him. Mr. Roundsford discontinued his former practice of trying to run everything and everybody and dealt exclusively with the store manager, the plant manager, and the office manager. If he observed a poor practice in the shipping

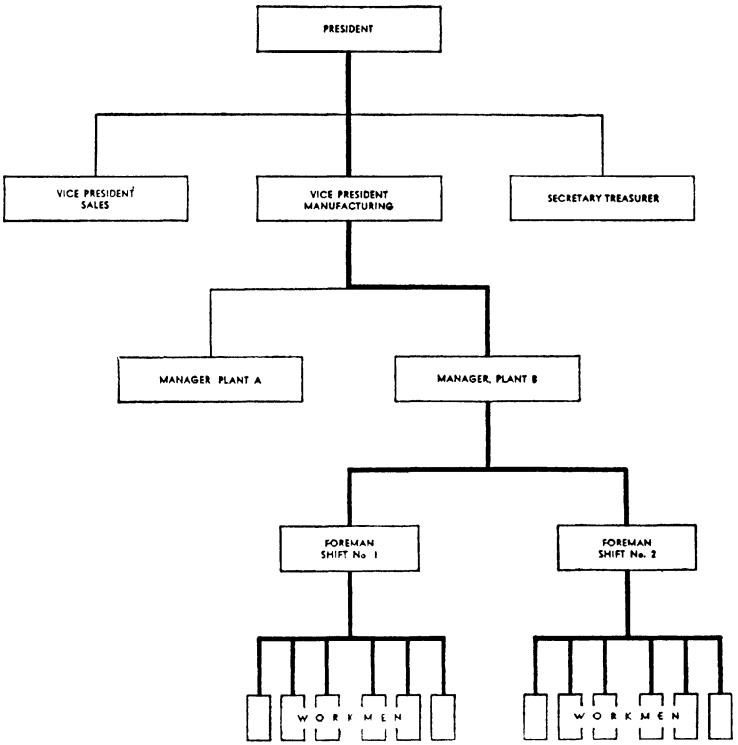
department, he relayed his comments to the plant manager who, in turn, took up the matter with the foreman in charge. Within a short time each worker knew to whom he was responsible, what specific tasks he was supposed to do, and the part he was playing in the entire picture.

The form of organization shown in the above chart would not be adaptable to all business enterprises. In the following pages, different forms will be described, with information concerning the merits and disadvantages of each type.

Types of Organization Structures There are four common classifications of organization structures: (1) line, (2) line-and-staff, (3) functional, and (4) committee. A small firm might adopt exclusively one or another of these types. Larger firms more commonly use one type in some departments or divisions and another for other branches of their operations. Also, there are modifications of the four types that make a definite classification confusing and difficult. However, an examination of the four basic types will present a good picture of the possibilities.

Line Organization. A line organization is sometimes called the military type. Although modern armies have become too complex to rely exclusively on a line organization, they still use the direct chain of command, which is a fundamental characteristic of the line or military type of organization. The private is under the corporal, who is under the sergeant. The sergeant is responsible to a lieutenant, who is subject to orders given by a captain. He, in turn, is under a major, and so on. Each person is directly responsible to an officer higher in rank and is given orders by his immediate superior.

The chart on page 575 shows an illustration of a line organization applied to business. There are many advantages inherent in this form. It is simple and easy to understand. Responsibility is clearly defined and each worker, regardless of his rank, reports to but one individual. This makes discipline easy. Decisions can usually be rendered quickly, and executives must produce or be replaced. As long as each employee carries out the orders of his immediate superior, he is relatively free from criticism, which makes for harmonious working conditions.



Line Organization for Plant B of a Manufacturing Corporation

The details of the organizational structure for the sales department, the secretary-treasurer's office, and plant A have been omitted.

There are, however, many disadvantages of the line type of organization. Each supervisor needs to be a master of many diverse angles to his job. He should be able to handle his men, keep the machines running, invent new processes, recommend pay increases, and train new employees. Frequently he may be outstanding at one or two of his numerous responsibilities and very poor at others. The line organization also has the disadvantage of placing so much final authority and direction at the top that the individual concerned, instead of devoting his attention to working out important matters of

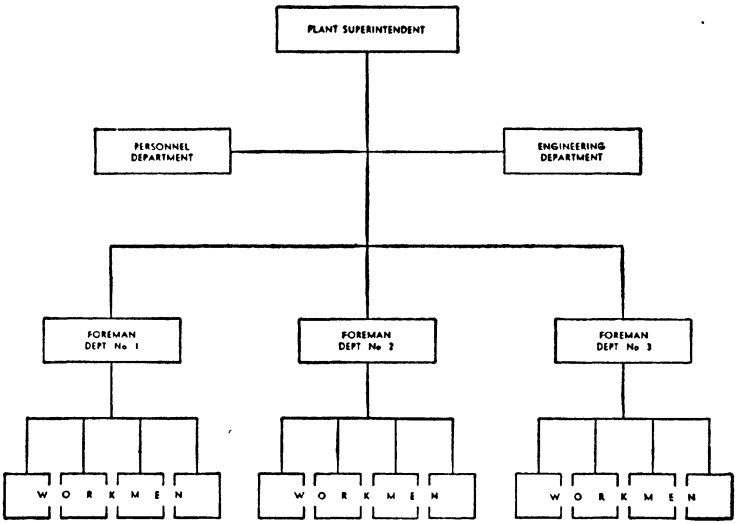
policy and general practices, finds most of his time devoted to reading reports and rendering decisions on operating problems. Co-ordination of the different "lines" is difficult to achieve, particularly in a complex, large-scale industry.

Because of the inflexibility of the line or military organization, it is not used extensively except in small businesses. The line organization is often used in a particular department or division of a large business with success, but it should not be extended beyond the internal organization of the one particular function where it can be operated successfully.

Line-and-Staff Organization. The line-and-staff organization plan is an adaptation of the line organization, which seeks to eliminate the most glaring defect of the line type by making use of specialists. For example, a personnel department will study all salary and wage problems throughout a factory. This does not mean that the foreman is not consulted regarding personnel problems nor that he loses any authority, but advice is available from experts in that particular field. An engineering department will work on new processes and new designs and methods of handling the raw materials. Again, the foreman will probably be consulted and may contribute ideas, but he is not primarily responsible for this important function of the business.

The chart on page 577 shows a line-and-staff organization plan. Note that foremen are not responsible to more than one supervisor, but that specialists are available for specific problems. There is no overlapping of control. The Army in World War II was essentially a line and staff organization in that extensive use was made of specialists in all lines who were attached to the various units, for example, psychologists with every branch of the service.

The many advantages of the line-and-staff plan have made it the most popular form of business organization. It introduces a note of flexibility into the rigid form of the line organization. The use of specialists can be incorporated without departing far enough from the line plan to lose the important advantages already enumerated. It incorporates the principles of division of labor without losing the important combination of authority and responsibility.



Line and Staff Organization for the Manufacturing Operations of a Small Business

Staff functions in this business are performed by the personnel and engineering departments.

On the other hand, the so-called advice given by staff employees may be construed as demands, which can lead to divided authority or serious friction. In some cases, the foremen and supervisors may try to "pass the buck" to staff employees for actions taken on their advice, which do not prove successful. Also, department managers, superintendents, and others in managerial positions may cease to give thought and attention to some of their duties that can be referred to staff members for advice and a recommendation. Thus, it tends to retard the "thinking" formerly regarded by such executives as part of their necessary duties.

Functional Organization. The functional organization in its pure form carries the use of specialists to the extreme in that there is no single line of authority but rather multiple lines of authority affecting each employee. Every worker is responsible to someone of higher rank for each important specific part of his job. The foreman in charge of setting up a job on a machine supervises all workers to this extent. Another

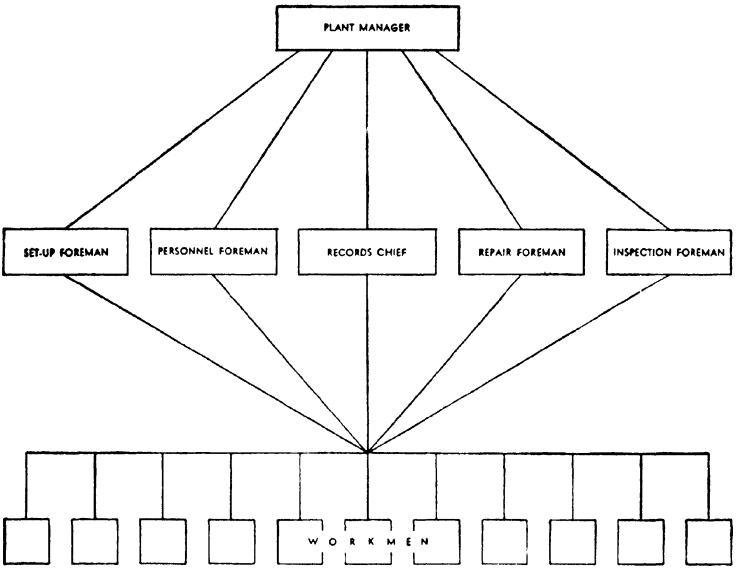
foreman may be in charge of personnel, and all workers report to him concerning problems of wages, hours, and shifts. The man in charge of accounting tells each worker what he shall do regarding filling out time cards and other job cost records. The repair foreman handles this problem for an entire factory and can criticize any employee who carelessly causes damage to machinery and tools.

The functional type has many advantages. It employs the principle of division of labor and of using specialists who can do a more efficient job because they are well versed in their narrow fields. It is very flexible and eliminates some of the dangers that are present when one man is responsible for many things, some of which he is not qualified to handle competently. It provides for co-operation which, if it is harmonious, creates a friendly atmosphere of working together rather than *for* someone. Proponents claim that the directness of line control need not be lost if the distinction between the authority of each specialist is clearly delineated.

All of the above is true—on paper. Actually, it is difficult for any worker to have so many bosses even though each directs only a specific part of his work. Friction and overlapping cannot help but develop unless there is an unusual degree of co-operation and co-ordination. Divided control is not likely to speed up production and may actually retard it because any complex structure is likely to "bog down" in red tape. Discipline is more difficult. In general it is a complicated system, which seems to have merit but which, in actual operation, may not prove effective.

The chart on page 579 shows a diagram explaining the functional organization. Note that each foreman has many more workers under his direction than in other forms of organization. Because he directs only a particular function, he is able to supervise a much larger group.

Committee Organization. The committee organization represents a modification of the line-and-staff organization or functional organization rather than an entirely new form. Its major distinction is the substitution of a committee for an executive in a position above that of foreman. Usually, it is incorporated into the line-and-staff organization by using com-



Functional Organization for a Manufacturing Operation
Note that each workman is responsible to five foremen.

mittees, rather than individuals, in the activities that are carried on by specialists.

It frequently is true that the combined judgment of several men is better than the decision reached by one individual. Furthermore, decisions reached by committees are less personal and therefore less likely to create individual antagonisms. In a committee meeting, everyone can air his views and also secure new ideas. This may result in a degree of cooperation that could not otherwise be obtained.

On the other hand, committee action is usually slower. Important problems that should be settled can be held up in committees. Much time is consumed that might be devoted to action rather than to argument. Frequently committee decisions are compromises when the only hope of success would be vigorous prosecution of one viewpoint or the other. Also, the chances of securing action on a committee report are less than when one executive is interested in seeing his own ideas placed into operation.

Factors in Organization Planning

Regardless of whether the decision is to adopt a line, line-and-staff, functional, or committee type of organization, there are several basic factors that must be considered if the plan is to be successful. It is perfectly possible that, instead of removing causes of friction and making it possible for the business to operate smoothly, an organization plan not adapted to the needs of a specific firm might aggravate unsatisfactory conditions. Some of the points to be considered follow:

(1) Classification of Business Activities. Every business can classify many of its functions into common categories such as buying, selling, financing, and accounting and statistical controls. Manufacturing concerns would add production to their lists of activities. These classifications may provide the basis for the construction of an organization plan although two or more functions may be combined under one executive or in one department. An illustration of such a grouping is found in the common practice of designating a financial officer who is also in charge of accounts. Furthermore, larger firms may add departments that are considered to be of equal rank with those already enumerated. A personnel department or research department are examples of possible additional major divisions.

In brief, although the classification of business activities is not the exclusive factor in determining the form of internal organization, it is fundamental and serves as a basic starting point. Referring again to the problem of Mr. Roundsford, note that the problem of wholesale sales has been neglected. If he assumes this task, no change in the chart is necessary, nor would there be any substantial shift if the store manager were responsible for sales to outside sources as well as to local trade. On the other hand, if a new man is employed to handle these sales of the cough syrup, it would be necessary to expand the organization to include a sales manager who would normally hold a position comparable in rank to that of the store, plant, and office managers.

(2) Specialization. One of the characteristics of business in this country is specialization, which includes the work em-

ployees do as well as the products produced. An organization plan should allow for the advantages to be gained from having people perform jobs for which they are best suited. The suggestion was made earlier that personnel problems might be handled by a separate department. If this plan is adopted, it automatically follows that a line organization plan cannot be used. The personnel department will certainly aid in the selection of new employees, and this fact alone means that either a line and staff or functional organization plan will be necessary.

(3) Delegation of Authority. While it is true that the final authority for all decisions rests with the top man or men in any organization plan, it is not possible to allow every decision to reach up to the owner, president, or board of directors. If an employee is to be fired for insubordination, it may well be that this should be the prerogative of his foreman. Every employee who is placed in charge of the work of others expects to be held responsible for their productivity on the job and must be allowed to exercise some measure of authority over his subordinates.

Authority and responsibility naturally go together and should be clearly understood by every person in a supervisory capacity. There should also be a distribution of authority so that no one man has so many decisions to make that he cannot discharge his duties promptly and, at the same time, with good judgment based on careful consideration of the facts. If an appeal is to be permitted, there should be no question about this possibility and to whom the dispute would be referred.

(4) Checks and Balances. If the organization plan attempts to provide for a system of checks and balances, the groups that check on each other should not be in the same line of authority. For example, the sales department may wish to ship a large order to a willing purchaser, but the credit department has decided that he is a poor financial risk. If the credit manager is under the sales manager, his decision can be overruled by his superior. However, if he is located under the line of authority established in the general field of finance,

the question of whether the sale is to go through would be decided by someone who has authority over both of these major divisions.

In most factories, the problem of inspection is in the hands of a department that is directly responsible to an operating executive. If a foreman had authority over employees engaged in inspecting procedures and if his efficiency were measured by the volume of units produced, he might order inspectors to approve work of an inferior quality.

(5) Clearly Defined Duties. The job every employee is expected to do should be clearly defined to the point that it is different from that expected of others and does not overlap duties assigned to other workers. Unless this is done, there is bound to be friction among employees at all levels. If it is the job of the repair department to keep all machines in good operating order, the foreman in the production department should not be blamed for a slowdown in production based on mechanical breakdowns. On the other hand, if it is the duty of the foreman to see that his machines are kept in operating order, he should not be allowed to "pass the buck." A stenographer who is supposed to take dictation from the assistant sales manager cannot be expected to type reports for the treasurer unless she was assigned to both jobs and unless it was understood that one of the executives had first call on her services in case both jobs could not be handled in the time available.

(6) Subdivisions of Supervisory Authority. In preparing an organization plan, it is necessary to decide the extent to which duties are to be subdivided and the proper sequence of authority. In a small firm, the treasurer may be the chief accountant, auditor, controller, and credit manager, whereas a larger organization would have department heads for each of these divisions. However, even in a large firm, the type of work and the skill of the workers would play an important part. If a machine shop employed only highly skilled workers, the chances would be that each would know his job so well that very little supervision would be needed. In this case, a single foreman might have a large number of employees under

him without the need for any intermediate supervision. The same situation would be true if a large number of unskilled workers were hired to do a simple task requiring very little direction. On the other hand, if it is necessary to hire untrained help to perform tasks requiring a fair amount of skill, no single supervisor can direct the work of more than a handful of people.

(7) Flexibility. As a final point, and one that seems to contradict all of the others, any organization plan that unduly hampers the ability of the employee to express his individuality and initiative robs the organization of one of the most valuable assets to our type of economic society. A certain amount of regimentation is desirable but, when it stifles the worker to the place where he is just a cog in a machine, the firm loses rather than gains. There will always be exceptions to every plan, and some executives spend much of their time handling variations from the routine that has been established. Even though a foreman may have the right to discharge an employee in his department, that man might be a valuable employee under a different boss or in another line of work and should not necessarily be dismissed from the pay roll. Another idea, which has gained great popularity during the last ten years, is that of encouraging employees to submit ideas for improving their work or the operation of the firm. Suggestion boxes are frequently provided, and prizes awarded for the proposals that are workable and of value.

The heading of flexibility also suggests that no plan can be expected to prove satisfactory permanently. Changes will be necessary, and only a constant reworking of the organization plan will make it possible to achieve the objectives desired.

Organization and Administration No amount of organization planning will answer all of the problems of operation. There is a need for administration all along the line from the bottom to the top, and particularly at the higher levels. Sometimes an effort is made to distinguish between management and administration with one or the other term referring to the higher executives as contrasted with the carrying out of orders by those in lesser authority. Since so much confusion

exists on this point, the term *top management* will be used here to denote such officials as the owner, partners, chairman of the board of directors, president, vice-presidents, secretaries, and treasurers. In large organizations, a few other officials including the director of public relations, legal counselor, and director of labor relations, might well be added to the class of top management.

The problems of this group include the ultimate responsibility for all phases of operations, but the details should be delegated to subordinates. If the firm is to prosper, these men should be freed from the making of routine decisions in order to allow time for more important work. Three important problems face top management.

(1) Policies. Decisions regarding the best course of future action to follow, or policies, as the term is used in a business sense, must be made by the highest ranking executives. These policies may or may not need approval by the board of directors, depending upon the frequency with which the board may meet and upon the legal requirement of board action. A few illustrations will make this point clear, although the variety of decisions to be made is almost endless. (a) Assume that a plant is working one shift but that more production is needed. Should an additional plant be built or should a two- or three-shift operation be installed? (b) A retail store has had a policy of selling for cash only. Would it be more profitable to allow credit sales? (c) A manufacturing firm has been selling its products to wholesalers exclusively. Should sales be made directly to retailers and thus eliminate a middleman, or should both avenues of distribution be used?

The importance of policy determination cannot be overestimated. A change in policy may bring ruin to a concern formerly prosperous, and yet refusing to change may also be disastrous. The Procter and Gamble Company established a reputation years ago for the manufacture of soap. Later, a vegetable shortening was produced and more recently a line of toilet articles, such as shampoos and a liquid dentifrice, has been added to their production. The Company has been prosperous, but the situation might have been different if it had continued to restrict production to one product.

(2) Planning. The formation of policies is a type of planning, but all planning is not concerned with policy formation. It is necessary that someone or some group in any organization look ahead to anticipate changes that may be necessary. If prices are on the increase, it may be a good time to stock up on raw materials. If interest rates are declining, it may be advantageous to refund a bond issue that is outstanding. There is also the matter of internal planning. Reorganizations of departments and divisions may improve the functioning of the business if someone has thought out a scheme that will work better than the one in present operation.

(3) Co-ordination. Another important task of top management is the co-ordination of all activities of the business. Divergent views and decisions must be harmonized to the best extent possible. The executive in charge of production wants to buy $500,000 worth of new machinery, but the financial department insists that the money is not available and that the cost of securing it would be more than the savings brought about by the new machinery. When specialists are employed, it is natural that each sees his own task as the most important. As long as their paths do not cross, all goes well. When their paths do cross, it is time for top management to co-ordinate the various phases of operations.

Types of Management

The complex form that some of the giants of industry have taken has brought about problems of organization and administration that are not found in the small enterprise. The United States Steel Corporation, for example, is composed of over one hundred operating subsidiaries. Two of the problems this situation would create are absentee management and centralized or decentralized control.

Absentee Management. In practically all of the large industries, such as steel, oil, tobacco, foods, rubber, and automobiles, the actual operations of any particular firm may take place in numerous locations in the United States as well as abroad. It would be impossible for the higher ranking executives to supervise personally the activity of these units spread over a wide area. Consequently, offices are maintained in some cen-

tral location, frequently New York City, and this gives rise to a condition known as *absentee management.*

The American Telephone and Telegraph Company provides an illustration of the need for absentee management. This company operates long distance lines from coast to coast and telephone exchanges in every state in the Union, and owns several manufacturing plants. The officers must delegate a large share of the responsibility to operating executives located in strategic centers. At the same time, theirs is the final responsibility and this cannot be delegated.

In these circumstances, it becomes necessary to rely on numerous reports and on a staff of experts who can be sent to various locations to secure information or to settle problems that have arisen. On the pay roll at the home office will be lawyers, market research experts, labor relations specialists, engineers, accountants, statisticians, and even doctors. These people study the reports that are received or make independent investigations. On the basis of the accumulated knowledge, top management can form an accurate picture of conditions throughout their industrial empire.

Centralized versus Decentralized Management. If a business operates in one locality only, the chances are that the management will be centralized. If another unit is added, probably in a different geographical area, a decision would need to be reached as to whether one central management will supervise both operating units, or whether each will have its own complete organization. Chain grocery stores, for example, frequently operate with centralized management even though stores may be located in many cities. Buying, warehousing, price policies, advertising, and accounting, are done in one office for all of the units. The local manager does have a few functions that he performs, such as hiring and paying the clerks but, with the exception of a limited field of activity, the central office directs the activities.

As a contrast, the General Motors Corporation operates the Chevrolet, Buick, Oldsmobile, Pontiac, Cadillac, Frigidaire, Delco, and other units on a decentralized basis. Each has its own personnel for all activities including advertising, sales, production, and labor policies. In the automobile field, there

is some overlapping in the various price classes and a dealer for one General Motors car may compete for business against a dealer for another car of the same company.

In decentralized control there are some centralized features, and co-ordination is always needed. Again using the General Motors Corporation as an example, the Fisher Body unit supplies automobile bodies for all of the makes and models of cars that are produced. Only by working together can the best results be achieved. Some executives welcome decentralized control as the only feasible plan, while others fear to place so much power in the managers of the separate units. Most large businesses use a combination of the two methods.

QUESTIONS

1. What are some of the merits of an organization plan?
2. What is the main distinction between a line and line-and-staff organization structure?
3. Does the functional plan more closely approximate the line or line-and-staff structure?
4. Which of the first three types of organization plans discussed can best be modified to incorporate the committee plan of organization?
5. Discuss some of the factors that must be taken into consideration in constructing an organization plan.
6. What is the distinction between organization and administration?
7. What is commonly meant by "top management"?
8. Name some problems that might call for policy determination by top management other than the ones suggested in this chapter.
9. The president of a corporation spends his winters in Florida and his summers in Michigan. Is this absentee management?
10. If a factory located in Connecticut decides to open another factory in California, what factors will determine whether centralized or decentralized control should be used?
11. Assume that a worker is observed by his foreman to be unusually willing and able? Who should recommend the deserved raise in pay and who should have the power to grant it?
12. If a sales executive believes a cheaper model of a product would be easy to sell but the production manager says he cannot produce it at the necessary low cost, who should decide this question?

PROBLEMS

1. The Vance Manufacturing Company is a small concern producing bottle caps. Mr. Vance, the president, started the business and is very active in all of its operations. The personnel of the organization consists of thirty employees as follows: salesmen—2, one of these carries title of vice-president; office force—4, one man's title is secretary-treasurer, and the other three are a bookkeeper, a stenographer, and a girl who does general office work; production force—22, consisting of 15 men operating machines, 2 stockroom boys, 2 men in the shipping department, 2 repair men, and a hand truck operator; janitor—1; night watchman—1.

Using this information, diagram an organization structure of the line type. Any reasonable assumptions necessary to delineate authority may be made.

2. Using the facts contained in Problem 1, construct an organization chart for the Vance Manufacturing Company using a line-and-staff organization structure.

3. Construct an organization chart showing the administration of your college. Secure the necessary data from the school catalog.

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CHAPTER 30

BUSINESS LAW

Legal Knowledge Necessary in Business

Although the businessman need not have an extensive knowledge of business law, he should possess such legal information as will keep him out of trouble and permit him to exercise his lawful rights. The driver of an automobile entering the outskirts of a city knows that, if he exceeds a reasonable speed limit—possibly thirty miles an hour, he may be arrested for speeding. A businessman, in like manner, should realize that, if he makes an offer to sell merchandise and this offer is accepted within a reasonable time, he must deliver the goods or he may be sued for damages.

Almost all business transactions have legal implications. If a particularly important business matter is involved, it is usually wise to employ a lawyer to assist in drawing up the necessary papers. If an appearance in court is necessary, either as a plaintiff or as a defendant, there is no question but that legal talent should be employed. For everyday purposes, however, an understanding of the legal system and a rudimentary knowledge of business law should be adequate.

Legal Systems

There are essentially two legal systems in operation throughout the world, common law and civil law. In the United States, with a few exceptions, the *common law system* prevails. It has come into being by a long series of court decisions. If a decision is rendered by the higher courts, such as the Supreme Court of the United States or of a state, other courts, particularly at the lower levels, are inclined to follow that decision in deciding similar cases. When laws are passed by a legislative body, they are usually general and cannot anticipate every contingency that may arise. Courts find it necessary to interpret the meaning of the statute, and more precedents are established.

Civil law is based on codes. Ancient Roman law was codified by one of the emperors, and the Code Napoleon is another

example of civil law. In countries using civil law, courts interpret the code. The legal system of many European countries is based on civil law and the state of Louisiana, long under the domination of France, still uses some civil law. Other states use the common law system, which came to us from England. It is more flexible because, when changing economic conditions require the settlement of a dispute about which no legislation has been passed, a court will decide what, in its opinion, is fair and equitable. Under civil law, government would have to pass a law covering the issue before a court could render a decision.

One of the interesting developments of common law of particular importance to business arose in England between the thirteenth and seventeenth centuries. The common law judges, basing all decisions on precedent, frequently were unable to extend justice to an aggrieved person because no similar previous case had ever arisen. The only course of action available was to petition the king, who referred most of these cases to his chancellor. The decision rendered was an attempt to remedy the injustice in an equitable manner. So many cases of this type arose that a system of *chancery courts*, or *courts of equity*, came into being and these gradually assumed at least equal importance with the common law courts.

In this country actions at law or in equity are administered by the same courts. If the injured party cannot secure redress in an action at law, he may bring a suit in equity. Ordinarily, juries are not used in the latter type of case but are in the former. In equity actions the judge has more freedom of action because he is not bound by the rigid wording of a particular law.

Legal Procedures If a businessman believes he has been wronged, either because another party has broken a law or has taken unfair advantage of him, he may initiate an action at law or a suit in equity. He is called the *plaintiff* or *complainant*, and the other party is known as the *defendant* or *respondent*. The plaintiff's attorney files a complaint with the proper court and a *summons* is issued, which requires the defendant to appear in court to answer the charges. His lawyer may answer that the court has no juris-

diction or that the plaintiff has no case. Assuming that these defenses do not prevail, the next step is to file a *plea* or an *answer*. The plaintiff can question the reply, but finally the *pleadings*, as they are called, lay the foundation of the dispute and permit the case to come to trial.

If the case involves a point of law, it will be tried before a jury, unless both parties waive this privilege. If the case is in equity, a jury is not impaneled in most states. Assuming that a jury does hear the facts as presented by witnesses for both parties, it renders a decision in favor of the plaintiff or defendant. If a jury does not hear the case, the decision is rendered by the presiding judge.

Types of Courts In the United States there is a system of Federal courts and also of state courts. The lower courts in each case are known as *courts of original jurisdiction*. These are the ones in which the trials referred to above are held. If the loser believes a principle of law has been violated, he may carry this issue into an *appellate court*. If this court believes the case was improperly tried in the first instance, it may dismiss the decision or refer it back to the original court for a retrial. The Supreme Court of the United States is the highest appellate court for matters under Federal jurisdiction, and the supreme court of a state is the highest court for disputes having no federal implications.

Area of Business Law The subject matter of law may be divided between criminal law, that is, offenses against the state, and the legal relations between people. Business law is little concerned with the first and with only a portion of the second; it usually deals with the topics of contracts, sales, agencies, property, bailments, negotiable instruments, partnerships, corporations, insurance, bankruptcy, and guaranty and suretyship. The legal meaning of these terms, with the exception of those that have been discussed in previous chapters, will be explained in this chapter. A brief study of these topics will illustrate the value of a system of law by which business procedures are regularized and principles established for settling disputes. Such an examination will also suggest the types of legal information that the average businessman needs to understand as he goes about his daily work.

Contracts A *contract* is a voluntary agreement between two or more competent persons by which, for a consideration, one party acquires the right to have the other party do or not do some lawful act. In a general way, the entire field of business law is one of contracts because agreements between parties are essential to practically all business transactions. This subject is not discussed as something apart from other applications of business law but rather as a fundamental background.

Voluntary Agreement. The essence of an agreement is an offer and an acceptance. The offer must be communicated in precise terms and with the intent to create a contract, and the acceptance must be indicated within a reasonable time or before the offer is withdrawn. Any means of communication may be used and, if the mail or telegraph is involved, the contract is in force just as soon as the acceptance is deposited with the post office or telegraph company. A reply that fails to conform to the exact terms of the offer, known as a *counterproposal*, does not constitute an acceptance because there would then be no mutual agreement or common understanding of the subject matter of the contract.

Mr. Clark, who runs a clothing store, wishes to buy the building that he is renting. He writes his landlord, who lives in a distant city, stating that he is willing to pay $12,000 for the property. The owner replies that he accepts the offer if Mr. Clark will pay the back taxes that are owed. In the meantime, Mr. Clark has discovered that the building is infested with termites and decides that he does not want to buy. Under the conditions mentioned, he is free to withdraw the offer because the acceptance was not on the same terms as the offer. If the landlord had written or wired an acceptance of the $12,000, Clark could not have withdrawn because a contract would have been in force.

On the other hand, if Mr. Clark places a suit in his display window and accidentally places on it a $5 price tag, which was intended for a hat, and a customer walks in and says he will take the suit for $5, a contract is not in force because the placing of merchandise for display is not an offer but merely a form of advertisement.

Contracts must also involve agreements in which both parties act in good faith and of their own free will. The term *voluntary* is used in the sense that there has been no fraud, deceit, or undue influence brought to bear on one or the other party. Tricking someone into signing a written contract or threatening a person at the point of a gun to agree to a contract will provide grounds for relief. Even some mutual mistakes, such as agreeing to sell a building that burned down the night before, unknown to either party, will void the contract.

Competent Persons. Most people are legally competent to enter into a contract, but there are a few classes that are either wholly or partially disqualified. Insane persons are without the capacity to make a contract. In most states persons under twenty-one years of age are classed as *minors* and cannot make enforceable contracts except for necessities; other contracts can be voided any time up to the age of twenty-one. If an automobile dealer sells a car on the installment plan to a minor who, because he has wrecked the vehicle, refuses to make further payments, the dealer cannot collect from the minor. Other persons not having full capacity to make contracts include intoxicated persons, corporations that are limited by their charters, and, in some states, married women.

Consideration. A good or valuable consideration is essential to every contract. What constitutes consideration is difficult to judge. If Mr. Green pays Mr. Black $50 for an option to purchase property at a certain price within thirty days, the payment of the $50 is the consideration for this contract. Also, any possible gain to one party or loss to another will serve as satisfactory consideration. For example, a wealthy uncle agrees to pay $1,000 to his nephew if he does not smoke until he is twenty-one years of age. The fact that the young man gives up a legal right provides adequate consideration. An offer to sell merchandise at a stated price, followed by an acceptance, includes adequate consideration on the basis of possible gain to one party or loss to another unless the contract is fulfilled.

Many written contracts contain the words "for $1 in hand paid and other consideration" but in most cases the $1 is not

paid, and it is doubtful if this wording guarantees adequate consideration for the contract.

Lawful Acts. The subject matter of a contract must involve lawful acts. A contract made with a person in which a promise is made to burn down a building illegally is not enforceable, nor is one with the intent to restrain trade unduly. Other contracts that are against public policy or that would violate specific laws are not enforceable. For example, most states have laws against gambling, and promises to pay gambling debts, whether written or oral, are not enforceable. Likewise, if a lender attempts to collect interest in excess of the legal rate permitted in the state, as a general rule he forfeits the right to collect any interest, although the debt is still owed.

Forms of Contracts. Contracts may be either written or oral. Most contracts do not need to be written and are fully enforceable although there may be some difficulty in providing proof of the facts. Many states have enacted a Statute of Frauds under which certain types of contracts must either be in writing or have some written memorandum of the agreement available. These include contracts not to be performed within one year, sales of personal property in excess of a stated figure (usually $500), and sales of land and buildings.

If two men are sitting in an office and one agrees to buy forty tons of coal at $10 a ton from the other, a contract is in force. On the other hand, if the agreement is to buy forty tons of coal a month for a period of eighteen months, there is no contract unless these terms are written and signed.

Performance, Discharge, and Remedies. Most contracts are discharged by full performance on the part of both parties. However, some contracts are not completed, and this condition may or may not give rise to a court action. The parties may agree not to perform the contract or they may come to a new agreement before the old one has expired. Otherwise, the injured party may sue for damages. In some instances, the defendant may be excused under the operation of a law such as bankruptcy; or, if special conditions have arisen, such as illness in a personal service contract, the courts may excuse performance.

When a contract has been broken the remedy is to obtain from a court an order that requires the payment of damages or, in a few instances, compliance with the terms of the contract. If damages are in order, the court issues a *judgment* in favor of the plaintiff, which can be executed against the defendant. If necessary, a sheriff will sell enough property of the debtor to satisfy the judgment.

Of interest to many businessmen is the situation in which a person, against whom a judgment has been rendered, has no real or personal property that can be sold to satisfy the claim. If this person is a wage earner, it is possible in most states to force the employer to pay the amount owed by withholding a portion of the wage usually paid to the employee. This is known as *garnishment*. Operators of business establishments may find it desirable to garnishee the wages of individuals who owe them money, and also may be served with an order to impose a garnishment on one or more of their own employees.

Sales

A *sale* is an exchange of goods or property between two parties, known as the buyer and the seller, for money paid immediately or to be paid in the future. It involves a contract, and most of the foregoing comments on contracts are applicable to sales. Because sales are so essential to almost every form of business activity, the legal backgrounds of exchanges of goods are particularly important to businessmen.

Many of the special rules applicable to sales can be found in the Uniform Sales Act and the Uniform Conditional Sales Act that have been passed by many state legislatures. These acts, and others that will be mentioned, were drafted by the National Conference of Commissioners on Uniform State Laws. Each state appoints representatives and the Conference promotes uniformity in state laws on all subjects where uniformity would be desirable. To date, the efforts of the Conference have been only partially successful as state legislatures are not always willing to pass the recommended measures, or if they do so, are prone to add amendments. Furthermore, state courts have not always interpreted the intent of the acts in a uniform manner.

When Does Title Pass? One of the problems involved in a sale is the answer to the question, "When does title pass?" This is important because of the losses that occur and that must be borne by one party or the other. If a customer walks into a store and buys a gallon of vinegar bottled in a glass container, which he drops and breaks on his way out, who assumes this loss? The general answer is that title passes immediately in a cash transaction and the purchaser in this illustration is the loser.

Goods in a deliverable state ordinarily become the property of the buyer as soon as the contract is closed regardless of whether payment is made immediately. A buyer who agrees to buy and move a dining room suite displayed on the floor of a furniture store obtains immediate ownership and a loss that may take place before removal, such as a fire, is his responsibility. If goods are ordered by mail, title usually passes when the goods are delivered to a common carrier. This rule would not apply, however, if the goods were shipped f.o.b. destination.

Sometimes wholesalers and manufacturers wish to sell their products through dealers whose credit standing is not adequate. In this case, goods can be sent on *consignment*, which means that title remains in the hands of the shipper, known as the *consignor*, until such time as sold by the retailer, who is known as the *consignee*. This fact is important to the retailer because he need not insure the goods against loss nor need he pay personal property taxes on such merchandise. For like reasons, the ownership is important to the wholesaler or manufacturer and, in addition, the consignor has the right to repossess the goods should the retailer become bankrupt while the goods are still in his possession.

Warranties. Warranties may be express or implied. An *express warranty* is a statement on the part of the seller that the goods have certain characteristics, such as quality, which are used to induce the buyer to make the purchase. If an antique dealer states that a chest of drawers is over one hundred years old and if it is subsequently discovered that ten years is a more accurate estimate, the dealer can be sued for damages. An *implied warranty* covers title and quality. The

buyer has a right to assume that he receives a clear title to the goods and that they agree with a sample or description and are usable for the purposes for which they were sold. All purchasers of stolen goods must return them to the original owner, but they would have a right of action against the seller because there was an implied warranty of clear title.

Conditional Sales. Merchants who sell goods on long term credit can make a contract under which title does not pass to the buyer until all of the purchase price is paid. This is known as a *conditional sale* and is used in connection with installment sales of radios, refrigerators, automobiles, furniture, and other durable consumer goods. It permits possession of the goods by the user while title remains with the seller. The main purpose is to permit the repossession of the goods in case the monthly or weekly payments are not continued as scheduled.

Agency

An *agent* is one who is authorized to deal with third persons in behalf of his employer, who is known as a *principal.* Many businessmen find it necessary to appoint agents to act for them in either a general or specific capacity, and it is important that there is a complete understanding of the exact relationship. A *servant,* on the other hand, is an employee who does not have authority to act for his employer in contract situations.

A principal is liable for all acts of his agent within the actual or apparent scope of the authority vested in the agent. For example, the manager of a chain store held a contract that permitted him to operate the store at his discretion but with a limitation that all cash was to be deposited in a specified bank to the credit of the principal. On several occasions he endorsed checks on hand and cashed them at the bank in order to obtain change for the store. The principal did not object until one day the manager endorsed several days' accumulation of checks and disappeared. On the basis of the earlier endorsements the bank had the right to assume that the manager was an agent with authority to cash the firm's checks.

Agents are bound to follow instructions, serve loyally, render proper accounts, and use intelligence and due care in the

acts that they perform. A banker who loans money for a trust fund would be personally liable if he did not exercise due care and diligence in the investments that he might make. An agent must be careful to act within his instructions, for if he exceeds his authority he may become personally liable and, instead of acting for his principal, he may be incurring obligations in his own name.

Property Ownership of, or an interest in, anything subject to ownership is known as *property*. A businessman is vitally concerned with the laws on this subject because his daily transactions and the place in which they are carried on directly or indirectly involve rights and interests in property. If he sells merchandise and the contract is completed, title passes to the purchaser; if he improves a building on which he has a lease, such improvements may become the property of the owner when the lease expires.

Property may be given several classifications, but the most important distinction from a business viewpoint is that of real property and personal property. *Real property*, or *realty*, normally refers to land and buildings or, in a general way, to things immovable. *Personal property*, or *personalty*, refers to things owned that are movable. This classification may be further subdivided into *tangibles* and *intangibles*, the former referring to merchandise in stock, fixtures, machinery and equipment, etc., and the latter to stocks and bonds, notes and checks, bank accounts, and accounts receivable. The businessman is interested in all of these classifications because, if for no other reason, he may be required to pay taxes at different rates on each grouping.

Ownership. If a person has every possible right that can be attached to ownership, it is known as absolute ownership. In the case of real property, this common form is known as an *estate in fee simple*. Aside from the various types of restrictions that may be imposed by government, the owner may make such use of his property as he wishes. He can sell it, give it away, leave it to his heirs by drawing up a will to this effect, lease or rent it, or use it as security to borrow money. A customer who owns a fair amount of property usually has

a satisfactory credit standing, but the businessman will do well to remember the rights of this individual concerning the property that has been used as a basis for granting credit. If given away or used as security for a loan, it would no longer be available to satisfy claims of general creditors.

Ownership rights in real property that fall short of the extent of absolute ownership are usually for a fixed period of time, and the common application is the relation of landlord to tenant. If a proprietor leases a store building for a period of ten years, he as tenant has a right in the property as long as he pays the stipulated rent. Unless there is a specific agreement to the contrary, he may sublet his lease, and repairs and improvements that he may make will revert to the owner at the conclusion of the ten years.

Security for Loans. One of the frequent uses made of property is to use it as security for borrowing money. If realty is involved, the customary procedure would be to execute an obligation known as a *real-estate mortgage.* If personal property is used as security in a similar manner, a *chattel mortgage* would result. Either form should be recorded, usually in the county court house. When the loan is repaid the mortgages should be canceled and the legal record cleared. If the loan is not paid in accordance with the terms, *foreclosure* usually follows and title is transferred to the creditor. Intangible personalty is also used as security for loans but, because of its nature, a mortgage is not necessary. The bonds or stock, for example, can be deposited with the lender.

Bailments A *bailment* is a contract by which one party, known as the *bailor*, leaves property with another, known as the *bailee*, for a certain purpose with the understanding that the goods will be returned or delivered to the bailor or to someone else after the purpose is fulfilled. There is no passage of title, which means that a bailment is not a sale although consignment sales are a form of bailment. Leaving a watch at a jeweler's for repairs or with a pawnbroker as security for a loan are examples of bailments.

Bailments are sometimes classed as those for mutual benefit, those for the sole benefit of the bailor, and those for the

sole benefit of the bailee. In the first case, ordinary and reasonable care must be exercised by the bailee in relation to the subject matter of the bailment, and for the other cases slight and great care are in order. Practically all bailments for business purposes are for mutual benefit because a payment is made in connection with the bailment. Use of a safe deposit box or a public warehouse involves a fee. In the dry cleaning and pressing business, the clothes received must be handled with reasonable care and the proprietor will be liable for damage resulting from negligence because he is being paid for this service. Under common law an innkeeper was liable for loss or injury to the goods of his guest, without exception, but most states have now modified this form of bailment to requiring a safe to be available for valuable articles and relieving the hotel from room responsibilities. If the guest deposits money or jewelry with the management and a robbery takes place, the innkeeper is liable for the full value of the articles deposited; otherwise no claim can be supported.

The most common business use of bailments involves warehousing, which has been explained in previous chapters. The next most frequent use of bailments by businessmen involves shipping merchandise by common carriers. Although this act is of mutual benefit to the shipper and the common carrier, the railroad or other form of carrier must pay for loss or damage to the goods in transit for any cause except acts of God, acts of a public enemy, acts of public authority, acts of the shipper, and the inherent nature of the goods. Lightning, seizure by either the enemy or the military in case of war, or poor crating on the part of the shipper may excuse the common carrier. If goods such as fruits or vegetables are shipped in other than refrigerated cars, spoilage would not be chargeable to the railroad. These rules are most important to retail establishments because, if they own title to the goods while in transit, claims for damaged merchandise received are their responsibility.

Negotiable Instruments A *negotiable instrument* is a form of business paper that, by endorsement, can be completely transferred, including title and the amount of money shown on its face, from one party to another. It is a

contract that has the distinctive characteristics of negotiability, and adequate consideration is taken for granted. All negotiable instruments can be classified as either bills of exchange, which include checks, or promissory notes.

Many of the common forms of negotiable instruments, as well as the various forms of endorsements, have been explained in Chapters 20 and 28. However, only casual reference has been made to the Uniform Negotiable Instruments Act, which has been enacted with some modifications by all of the forty-eight states. The fact that this Act was formulated as early as 1896 gives some evidence of the need for uniform and clearly defined legal procedures for handling negotiable commercial paper.

In order that an instrument may be negotiable, it must conform to all of the following requirements: (1) it must be in writing and signed by the maker or drawer; (2) it must contain an unconditional promise or order to pay a sum certain in money; (3) it must be payable on demand, or at a fixed or determinable future time; (4) it must be payable "to order" or "to bearer"; and (5) where the instrument is addressed to a drawee or payee, he must be named or otherwise indicated with reasonable certainty. These rules indicate that there is nothing uncertain about a negotiable instrument, which is the reason why they are able to take the place of actual money in a vast majority of business transactions.

An *I.O.U.* is not negotiable because it is not an unconditional promise to pay, does not contain the words "order" or "bearer," and no time is stated. A promise to pay the amount due on an open account lacks the provisions of a sum certain because the amount is not shown on the written document. A note payable "after the marriage of my daughter" would not be negotiable because there may never be a fixed or determinable future time, but a note payable "after death" would be negotiable. These illustrations do not mean that such documents are not enforceable as ordinary contracts, but the papers would not be negotiable.

Any person may receive a negotiable instrument if it has been properly endorsed. Such individuals are known as *holders in due course* if the instrument is complete and regular on its face, if it is acquired before it is overdue, if it was

taken in good faith and for value, and if there was available at the time of negotiation no knowledge of any infirmity in the instrument or defects in the title of the person from whom it was received. For example, if a merchant accepts a check from a student who has received it from his father, the merchant would be a holder in due course if the check was presented within a reasonable time, possibly ten days. If the check were over six months old or bore signs of an erasure, there might well be some doubt as to whether or not the merchant was a holder in due course.

When a negotiable instrument comes due, it must be presented for payment in accordance with the terms appearing on its face if the last holder wishes to hold the person primarily liable and all endorsers. In the case of demand paper there is no definite rule although some banks specify four months. When the instrument is not payable on demand, presentment must be made on the day it falls due. If it is not paid, *notice of dishonor* must be given to the drawer and to each endorser, and any omitted are excused from liability. This notice can be either written or oral; foreign bills of exchange require a formal protest. A *formal protest* involves a statement sworn to before a notary public that is mailed to all parties concerned within twenty-four hours. Unless the negotiable paper specifically states "No Protest," the businessman will usually find it advantageous to follow the formal procedure even though such notice of dishonor is usually not necessary.

Practically all of the thousands of negotiable instruments that are handled by sole proprietorships, partnerships, and corporations are perfectly regular and are paid when due. A few are not, and holders of these should be aware of their rights and responsibilities in order to avoid losses.

Bankruptcy Bankruptcy is a subject of Federal legislation, and the Chandler Act, passed by the Congress in 1938, codified all previous laws and court decisions. This Act consists of fifteen chapters, one of which, Chapter X, on corporate reorganizations, was mentioned in Chapter 23. The Act is involved and comprehensive, dealing with such subjects as voluntary and involuntary bankruptcy,

acts of bankruptcy, and procedures for the administration of a bankrupt estate.

A few items will suggest some of the many features of the Chandler Act. Banks, incorporated cities, insurance companies, railroads, and building and loan associations may not become bankrupts. Wage earners whose annual income is less than $1,500 and farmers cannot be forced into bankruptcy. Other persons, partnerships, or corporations can become a bankrupt on either a voluntary or involuntary basis if debts of $1,000 or more are owed.

The usual procedure following the filing of a bankruptcy petition is for a trustee to be appointed by the court, and this individual works with the referee who is a court officer. Assets are sold, and resulting funds are distributed to the creditors on the basis of an established order of priority of claims as follows:

(1) the actual and necessary cost of preserving the estate subsequent to the filing of the petition;
(2) filing fees paid by creditors in involuntary cases, and the reasonable expense of recovery of transferred or concealed assets for the benefit of the estate;
(3) costs of administration including witness fees and attorney's fees as allowed by the court;
(4) reasonable expenses of creditors in opposing confirmation of compositions, where confirmation is refused or set aside;
(5) wages due to workmen, clerks, traveling or city salesmen, or servants that have been earned within three months prior to bankruptcy, not to exceed $600 to each claimant;
(6) taxes due the United States or any state, county, district, or municipality;
(7) debts owed to any person who by the laws of the state or the United States is entitled to priority.

Another feature of the law is the ability to "set off" mutual debts between the estate of a bankrupt and a creditor. For example, if a painter who is owed $100 for work done for a grocery store also owes that store a grocery bill of $60, the one amount can be offset against the other in case the proprietor becomes bankrupt. Otherwise the painter would owe $60 and, if the total funds available were not sufficient to pay even the seven preferred groups listed above, he would not receive any part of the $100 owed to him.

Guaranty and Suretyship

Guaranty refers to a contract under which a person, known as a *guarantor*, undertakes to perform a contract or to fulfill an obligation for another provided the individual who was primarily responsible for discharging the contract is unable to do so. *Suretyship* is a contract by one person to be answerable for the payment of a debt or performance of some act or duty in case another person fails to meet his obligation. The main distinction between the two is that guaranty is a secondary liability whereas suretyship involves primary responsibility coextensive with that of the debtor. In one case, the guarantor must discharge the obligation if the principal *cannot*, while the surety agrees to pay the debt or discharge the obligation if the principal *does not*.

A good illustration of the responsibilities of a guarantor or surety is afforded by the contrast between an accommodation endorser and the comaker of a note. If an individual merely endorses a note in which he has no personal interest, the holder at the due date must first look to the maker for payment, and only after the maker has failed to pay can the holder collect from an endorser. On the other hand, the cosigner of a note is equally liable with the debtor who originated the instrument. Guarantors must be notified if the debtor defaults, while a surety need not be notified because the obligation to pay at maturity is just as direct on him as on the other party.

QUESTIONS

1. What is the distinction between common law and civil law? Why do we have a common law heritage in the United States?

2. What is the difference between an action at law and a suit in equity? Would a different court be used for the two types of legal procedure?

3. What types of courts are conducted in the United States? What factors would decide which one to use?

4. Why is the law of contracts fundamental to an understanding of practically all legal features of business?

5. What are the essential and necessary features of a valid contract?

6. If a contract is not performed, what can the injured party do about this condition?

7. Why is it important to know when title passes in a sales contract? In general, when does this take place?

8. What is the distinction between an express and an implied warranty?

9. A wholesaler has several representatives in various geographical areas. Should he maintain an employer-employee relationship or appoint these men as agents?

10. Can a person who has an absolute ownership title in property use such property in any manner he may see fit?

11. What is wrong with the following note, as to negotiability? "I promise to pay Mr. Jones 10,000 bushels of wheat provided he has a crop failure next spring. (Signed) R. A. Clark."

12. If employees are working for an individual whose financial status is most uncertain, what precautions should they take in order not to lose money, assuming that some pay-roll dates have not been met?

13. Why would anyone willingly undertake the obligations of a guarantor or surety?

14. Should a businessman employ a lawyer on a more or less permanent basis, or should he expect to be able to handle most of his legal problems without such professional assistance?

PROBLEMS

1. Mr. Adams, a manufacturer, sends a prospective buyer, Mr. Borden, a sample of a black rainproof cloth quoting a price of $.60 per square yard. B mails in an order for 1,000 yards provided the color is red and the quality is the same as the sample. A ships 1,000 yards of the black cloth. B cuts the cloth and uses it but writes A that he will pay only one half of the price because it was the wrong color and also was not of the same quality as the sample. Discuss some of the legal features of the controversy that may develop between A and B.

2. Mr. Durreli has owned and operated a small haberdashery business. A new store has taken away most of his business and, after operating several months at a loss, he cannot pay his debts.

At his request the court declares him a bankrupt and at that date his assets and liabilities are as follows:

ASSETS		LIABILITIES	
Cash	$ 50	Wages Payable	$ 500
Merchandise	800	Taxes Payable	700
Fixtures	1,200	Accounts Payable	7,000
Building	6,000	Mortgage Payable	4,500
	$8,050		$12,700

Under the direction of the court the merchandise was sold for $500, the fixtures for $600, and the building for $4,800. Costs of the sale, lawyer's fees, and court costs amounted to $750.

Compute the percentage of payment in terms of cents-on-the-dollar that was paid to the trade creditors.

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CHAPTER 31

STATE AND LOCAL GOVERNMENT RELATIONS

Legal Powers of State and Local Government

In 1787 when the Constitution of the United States was drafted, delegates from the states were reluctant to relinquish existing state and local powers to a central government. To make sure that the Federal Government could not assume any more rights than those specifically granted to it by the Constitution, the Tenth Amendment was enacted by the Congress and ratified by the necessary number of states in 1791. It read as follows: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people."

It is clear from the wording of the amendment that the intention of the citizens of the first thirteen states was to retain considerable power in the states and their political subdivisions. All of the forty-eight states have adopted state constitutions and these specify the authority of the state and of its political parts, such as counties, municipalities, townships, and school districts. As long as the provisions of such constitutions are not in conflict with the Constitution of the United States, a state can assume any power that its citizens are willing to entrust to it.

It is generally agreed that it is a duty as well as right of state and local governmental units to enact legislation to promote the health, morals, and welfare of the people residing under such jurisdictions. Numerous laws passed have affected business and businessmen. At present the supervision, control, and regulation of business by the Federal Government is more far-reaching than that exerted by states, counties, municipalities, and other local governmental subdivisions. Nevertheless, many businessmen, particularly the owners and operators of small business units, are more likely to be affected by state or local laws.

Laws affecting business passed by the forty-eight states and the thousands of smaller political subdivisions have been numerous and varied. Although it is difficult to classify such legislation, most of these laws fall under the general headings of taxes, licenses, and the use of the police power. These three classifications will be used in the following description of the relations between business and state and/or local government.

Taxes Financial support is necessary for the maintenance of any governmental unit. Necessary funds are derived, for the most part, from taxes levied on numerous taxpayer groups such as property owners, consumers, corporations, other business units, and employers. All taxes affect business either directly or indirectly. For example, a tax on the value of a building used for a restaurant will be paid by the operator of the eating establishment directly if he owns the property or indirectly if he rents the building.

The problem of enacting a suitable program of taxation is most difficult. The total revenue secured should be adequate to meet necessary current expenditures. The burden should be distributed on an equitable basis. The tax law must be reasonably simple and the funds easy to collect. In some instances it may be desirable to use the tax as a means of regulation as well as revenue. Liquor and tobacco taxes furnish an example of this point. States derive large amounts of income from such taxes and, at the same time, the resulting higher prices tend to discourage the consumption of these items.

If a tax rate is uniform on all taxpayers affected, it is called a *proportional tax.* In a particular locality, for example, the same tax rate on the appraised value of real estate is used for determining the tax to be paid by every property owner. Many fiscal experts believe that taxes should be based on the ability to pay, which calls for a system of *progressive* taxation. Income taxes and inheritance and estate taxes are usually graduated with higher rates applying to the upper brackets of income or to large estates or bequests. The opposite of a progressive tax is a *regressive* tax, which places proportionally a heavier burden on those less able to pay. A sales tax

on food and other necessities takes away a larger percentage of the income of a poor family than of a rich family. At the same time, if it were not for this tax, the lower income groups would make little, if any, direct contribution to the maintenance of their government.

From the businessman's point of view, the *impact* and *incidence* of taxes are important. *Impact* refers to the person who is liable for the tax and who keeps the necessary records and mails out a check in payment of the amount due. In many instances it is possible, through a process known as shifting, to pass the tax on to others, usually the final consumer. The place at which the ultimate burden falls is known as the *incidence*. A gasoline tax of 4 cents a gallon may be paid by the man who owns the service station but, if he is able to add this tax to the purchase price paid by the customer, he is merely serving as a collection agency for a governmental unit. If the tax cannot be shifted, the businessman must absorb the amount. If the incidence can be made to fall elsewhere, the tax, aside from the burden of record keeping, does not affect his operations to a great extent.

Businessmen are also interested in taxes from the standpoint of the total burden, which seems to be growing year by year. For example, a manufacturing firm may plan to erect a new plant. It may be advantageous to build it in what is now a cornfield in order to avoid the real estate tax rate assessed within the corporate limits of a city. Or, it may be desirable to locate in an entirely different state because of the differences in taxes. It should not be inferred that the final decision would be made on the basis of this one factor, but tax differentials may loom as an important consideration.

The following partial list of the taxes that are most frequently levied by the several states and their various political units will indicate the nature as well as the seriousness of this relationship between business and government.

Real Estate Taxes. Counties, cities, villages, and school districts rely on real estate taxes as their major source of revenue, and some states also secure income from this source. Local assessors value the land and buildings, and a rate is applied against the appraised value. This rate is determined

each year for all political subdivisions. The total might be computed at $24.62 a $1,000 of assessed valuation. This would mean that a factory building and land valued at $100,000 for tax purposes would have to pay an annual real estate tax of $2,462.

Tangible Personal Property Taxes. Taxes are also levied against tangible personal property. From the business standpoint, this usually includes machinery, stocks of raw materials, goods in process, finished merchandise, and office, store and factory appurtenances. Some localities assess the values of these tangibles in the same manner as real estate, and the same rates apply. In other localities the cost minus depreciation is used as a basis for valuation, and special rates having no relationship to real estate taxes are levied.

Intangible Personal Property Taxes. This is the weakest form of the general property tax in that it is easy to conceal assets of this type. Generally speaking, intangibles include stocks, bonds, mortgages, and notes. Some states have laws that apply special rates to such values; others include them in the same rates applicable to real estate.

Income Taxes. Thirty-two states and the District of Columbia have enacted personal and corporation income taxes, which are levied either on gross income or net income—normally the latter. This source of revenue has become the major item in many state budgets. All profits made within the state are taxable regardless of whether the individual or corporation owns property or has any offices in the state.

Within very recent years a few cities have enacted income taxes to provide a source of revenue for the municipality. An illustration is the 1946 law of the City of Toledo, Ohio, that imposed a one per cent tax on: (a) wages, salaries, and commissions of Toledo residents, and, to the extent earned in Toledo, of nonresidents; (b) profits of all businesses and professions conducted by Toledo residents, and local profits of nonresidents and corporations.

General Sales Taxes. Taxes on the sale of merchandise are levied by states and by a few large cities. Usually certain

items, such as food, are exempted. The rates vary. In Ohio, for example, sales up to 40¢ are taxed 1¢ with an exclusion made for sales up to 9¢; from 41¢ to 70¢, the tax is 2¢; and between 71¢ and $1.00, the tax is 3¢. The rate above $1.00 is 3 per cent except for fractional parts of a dollar, and these amounts are taxed as indicated.

Pay-Roll Taxes. There are two types of pay-roll taxes that may be paid by employers into the state treasury. Unemployment insurance levies are universal, and workmen's compensation payments are required by many states. Unemployment insurance taxes amounting to 3 per cent of the pay roll (up to $3,000 for each employee) were required under the Social Security Act of 1935, from employers of eight or more persons. This measure, which was passed by the Federal Government, provided that all states that enacted a satisfactory complementary law could retain 90 per cent of the 3 per cent. All of the forty-eight states passed satisfactory laws and collect 2.7 per cent from employers. Otherwise, the entire 3 per cent would have been collected by the Federal Government.

The main provision of the state laws permits a worker who has been laid off and who cannot find another satisfactory position to draw a definite sum of money for a specified number of weeks. Both the amount of money and the length of time vary with the different states. Benefits may be calculated on the basis of the previous weekly wage, usually one half of that amount up to a maximum of $15. The number of weeks runs from ten to fourteen with a three-week waiting period before payments start.

Employers in most states can secure a reduction in the amount of this tax under what are called *merit rating plans.* This is a device to recognize the stability of working conditions in some plants and establishments as compared with seasonal hiring and firing, which is not uncommon in some industries.

Workmen's compensation is a form of compulsory accident insurance that is required of most employers in the states where this type of a law is in effect. The cost is paid by the employer with rates varying according to the hazard of the industry. A contractor who builds bridges and skyscrapers would be charged a higher rate than a retail merchant.

Organization and Entrance Taxes. *Organization taxes* refer to the amount charged a corporation at the time it secures a charter. *Entrance taxes* are similar except that they refer to foreign corporations that wish to do business within the state. Most of the organization taxes are based on the amount of stock authorized, and some states place their entrance taxes on the same base. Usually, however, the entrance taxes are a fixed amount. A fee of $100 is quite common.

Annual Capital Stock Taxes. In addition to organization or entrance taxes, states levy an annual capital stock tax. In the case of domestic corporations, this is normally based on the amount of stock either outstanding or authorized. For foreign corporations the base may be the amount of stock owned by residents of the state, the value of the assets located within the state, or some combination of these two values. For domestic corporations, this tax is frequently referred to as a *franchise tax*, and this same term, or *privilege tax*, is used for foreign organizations.

Occupation Taxes. Some states, particularly in the south, levy occupational taxes. These are usually restricted to such industries as the manufacture and wholesale distribution of malted drinks, bottling companies, and the manufacture and wholesale distribution of tobacco products. A few states have license taxes applying to all manufacturers, wholesalers, and retailers. If the amounts merely cover the cost of registration, they are known as licenses only but, if the amount is in excess of this figure, the net result is a special tax. Chain-store taxes are an example of a special occupational tax.

Special Sales Taxes. A tax on the manufacture or distribution of commodities in domestic commerce is known as an *excise tax*. The most common excise taxes charged by states are on cigarettes and liquor. The number of states that assess a special tax on the sale of cigarettes has been growing in recent years. The rates are usually from 1 cent to 3 cents a package. Liquor taxes are also an excellent source of revenue for the states. In some, this business is a state monopoly, and the profits provide income either in lieu of or in conjunction with a special sales tax. In Ohio, a tax of $1 a gallon is

levied even though the profit from the operation of state-owned liquor stores is also paid into the state treasury.

Special Business Taxes. Many of the states have enacted special business taxes that are levied against the income of selected industries. The most common ones chosen for these special taxes are insurance companies, railroads, public utilities, and banks. Less frequently, taxes in this classification are levied against railroad terminals, express companies, mining companies, lumber producers, grain elevators, etc.

The customary method of taxing insurance companies is to levy a gross premium assessment of approximately 2 per cent. All premiums collected within the state are subject to this rate regardless of whether the company is organized under the laws of the state or of another state, although some laws favor domestic corporations. Before a company can sell policies within the state, it must be licensed and agree to pay the tax applicable. Sometimes the amount is payable to the county, village, or city, although most states provide for central collection.

Banks, both state and federal, are usually taxed on a basis of net income.

Railroads, whether interstate or intrastate, are frequently taxed on the regular real estate basis. This means that the value of the property in each state must be determined, which is a difficult problem. In order to lessen these complications, some states tax the railroads on the basis of the gross earnings. Even this method is cumbersome, because it becomes necessary to apportion the earnings among the several states in which any particular railroad may operate.

Public utilities are usually taxed on the basis of gross earnings. Many utilities confine their operations within the borders of a particular state, which eliminates the problems faced in the taxation of most railroads. For those that cross state lines, the problems of allocation reappear. The taxes may be determined on the basis of volume of business in the state or by calculating the pro rata share of assets owned in the state.

Inheritance and Estate Taxes. Both estate and inheritance taxes are levies against the wealth passed on to heirs by a

deceased person. They are frequently called *death duties.* The difference between the two is that *estate taxes* are assessed against the entire net value of the holdings formerly belonging to the deceased, while *inheritance taxes* are based upon the separate bequests made to individual heirs. Inheritance tax rates usually vary depending upon the directness of descent; for example, widows and children pay a lower rate than nephews and grandchildren.

All states except one levy inheritance and/or estate taxes. Because the rates vary in the several states, businessmen have sometimes found it advantageous to transfer their holdings and legal residences to a more favorable state prior to the time at which they might expect to die.

Gasoline Taxes. Although a state tax on gasoline might well be classified as a special sales tax, the importance of this source of revenue justifies separate consideration. All states levy such a tax with rates ranging from 3 cents to 7 cents a gallon. Large revenues are derived and, in general, these funds are used for building and improving highways, roads, and streets. Payments are made to the state, but a proportion of the amount collected is returned to the county, township, city, or village on the basis of collections originating in the various political subdivisions. The gasoline tax is a good example of assessing the cost of a government activity against those who use the facilities provided at government expense.

The large amounts collected from gasoline taxes and the ease of adding to this tax burden have induced some state legislatures to enact laws diverting gasoline tax collections to purposes other than the improvement and maintenance of highways, roads, and streets. Unemployment relief and weak school districts are examples of beneficiaries that have participated in such diverted funds.

Severance Taxes. A severance tax is a fee levied upon the owner of timber land or mineral deposits whenever the timber is cut or the minerals are removed from the ground. It is the fairest way of taxing these two items. If a real estate tax is assessed against timber lands on which trees are being allowed to mature, there is a pressure brought on the

owner to conduct logging operations in order to raise enough money to pay the taxes. This is contrary to good rules of conservation. If the severance tax replaces the real estate tax, the owner can pay the state a fair amount in the years in which profits should be available.

Special Assessments. Special assessments are purely a local problem and, furthermore, should not be classed as a tax. However, the general effect is the same as a tax except that the assessment is for services presumed to be of direct benefit to the property owner involved. Ordinary real estate taxes usually support the fire department, police, schools, parks, and other municipal functions, whereas a special assessment is made for building a sidewalk, highway, or sewer system available to a particular property owner. This type of improvement is supposed to add to the value of the property, which is the justification for taxing those who benefit from the improvement.

Summary. Before leaving the subject of taxes, it might be well to point out some of the burdens the various types of levies entail. A large corporation that conducts operations in all of the forty-eight states must be familiar with the laws in each area, must submit such types and varieties of reports as are required, and must pay numerous tax bills to the states and sometimes to the political subdivisions. The administrative cost is enormous. For a railroad or public utility to compute the distribution of its gross income over several states or the value of its property within each state border is a difficult and expensive job.

Furthermore, many taxes cannot be shifted and must be absorbed by the business. If a state exempts domestic corporations or businesses from certain taxes or favors them in any tax rate, the ability of a foreign concern to compete with the local firm is based upon its willingness to absorb the tax differential. Business establishments located in border cities must compete with concerns located in another state with, perhaps, a more favorable tax rate. Only a mile or so may separate two towns but, if the gasoline tax in one state is 3 cents a gallon and in the other state, 7 cents, the bulk of the

business will go to the filling station located in the state with the lower tax.

Another issue of interest to local business is the amount of tax money that is retained by the city or county or is rebated to it by the state. For purposes of collection, many taxes are paid to a central agency and subsequently are prorated in whole or in part to local taxing units. The major source of income in some towns is revenue returned to it from gasoline, inheritance, and other forms of taxation. The owner of a fleet of taxicabs has less objection to a high gasoline tax if a large share of such revenue is spent on the city streets over which his vehicles operate.

Licenses All taxes are supposed to be levied for purposes of revenue; their regulatory features, if any, are more or less incidental. Licenses, on the contrary, are definitely regulatory, and the fee charged is primarily for the purpose of covering the cost of administration of the law. Sometimes this classification hardly seems to be valid, notably in the case of motor vehicles.

The number of types of licenses required in one state, or by one city or village, runs into the thousands. For this reason, only a few of the more general types will be discussed.

Motor Vehicles and Drivers. Every state requires the owner of most types of motor vehicles that use the highways to purchase an annual license. The cost of these licenses is usually high enough to produce a sizeable revenue that augments the gasoline tax. However, states charging more than a minimum license fee normally exclude the value of automobiles and trucks from personal property taxes. License fees vary for different vehicles depending upon the rated horsepower or the tonnage in the case of trucks.

Many cities also license motor vehicles that are owned by individuals residing within the corporate limits. The fee is usually lower than the state charge, and funds collected are spent on street improvement and maintenance.

Drivers' licenses are required in many states in order to protect the public against automobile drivers who are unfit physically or mentally to handle a car. A test is required of

new applicants, and the license can be revoked for good cause. The fee is usually nominal. Chauffeurs, taxicab drivers, and truck drivers secure a special license.

Professions. The practices of medicine, law, accounting, dentistry, and other similar professions are usually regulated in that the individual concerned must secure a license from the state before he can offer his services to the public. An annual fee is charged each registrant. Frequently state boards are created to supervise the granting of licenses on the basis of examinations or other measures of proficiency.

Trades. Brokers, real estate salesmen, barbers, insurance salesmen, and many other workers in occupations not classed as a profession must also secure a license from the state. The fee charged may be as low as $1, and an annual payment is customary.

Sports. Hunters and fishermen in practically every state must secure licenses before they can engage in such sports. This requirement aids in the conservation of game and fish, and frequently the revenue from this source is high enough to finance fish hatcheries, breeding farms for game fowl, and other similar activities.

Peddlers. Of particular interest to established retail firms are the various licenses required of itinerant peddlers, who may "skim the cream" from a local market although they do not invest any capital in the neighborhood or provide a continuing service. Most of these fees are charged by municipalities and, if the amount is substantial, it discourages or eliminates possible competition from this source. Farmers usually are exempted.

Liquor Sales. Stores that sell liquor in bottles, other than those that may be operated by a state, are required to secure a special license. Also, hotels, inns, taverns, and other places where liquor is sold for consumption on the premises are licensed. The cost varies with the types of liquor sold and with the nature of the establishment. Night clubs, for example, usually pay a fee higher than that paid by any other type of

bar or saloon, and the cost of a license to sell beer only is less than one that permits the sale of whiskey as well. Because some of these fees are so high, it might be questioned whether the charge is a tax or license fee. The intent, however, is certainly one of regulation and the fee, if excessive, is merely for the purpose of reducing the number of places where liquor can be purchased.

Miscellaneous Licenses. There are several other businesses that are commonly required to secure a license. Included in this group are restaurants, hotels, amusement places, pool halls, and bowling alleys. These licenses are usually required by the county or city rather than by the state.

Police Power The police power of the states has long been recognized by the courts to include laws necessary to protect the lives, safety, health, property, and morals of their citizens. Under such broad classifications, the various state legislatures and local governing units have enacted numerous laws of vital interest to business. Working conditions and hours of labor, price fixing, wage standards, various types of health and sanitation inspections, usury laws, and zoning ordinances have been considered as fit subjects to come under the jurisdiction of the law enforcing agencies of states and their political subdivisions.

Working Conditions and Hours of Labor. State laws covering necessary minimum standards for working conditions and hours of work have long been recognized as a valid field for legislation. Buildings must be fireproof or have proper safeguards. Each worker is entitled to a certain amount of space. Adequate washrooms and other sanitary facilities must be available. Safety devices must be installed where the occupational hazard is excessive; for example, mines must have ventilating devices, emergency exits, and proper shafts. If women are employed, additional safeguards usually are required.

Hours of work have been most frequently specified for women and children. In some occupations, a woman may not work more than eight hours a day and must be given a certain amount of time for lunch. Children cannot be employed

before a specified hour in the morning or later than a specified hour in the evening.

Prices. Normally, states have not attempted to enact legislation fixing minimum or maximum prices for ordinary business transactions. In 1933 the State of New York fixed a price of 9 cents a quart for milk sold in retail stores. A Mr. Nebbia, who owned a grocery store in Rochester, sold two quarts of milk and a five cent loaf of bread for 18 cents and claimed that the law was unconstitutional. This case reached the Supreme Court of the United States, which upheld the power of the legislature of New York to pass such legislation.

Wages. Wage minimums for women and children were also the subject of efforts on the part of the state to make sure that high enough rates were paid to guarantee a subsistence salary. Some of these laws were held to be unconstitutional, but in 1937 the United States Supreme Court upheld the minimum wage law of the State of Washington and, since that date, most states have passed similar laws.

Health and Sanitation Laws. Reference has already been made to the application of laws of this type to proper working conditions. There are numerous other directions such regulations may take that affect businessmen. For example, a restaurant is usually subject to a periodic inspection and, if certain minimum standards of cleanliness are not maintained, the owner's license to operate can be withdrawn. His food handlers may be subject to annual health examinations.

Highways. States have the right to insist on proper use of the highways within their borders. Rulings frequently include the size and weight of trucks, and proper safety devices. This condition creates a possible state barrier to the free flow of interstate commerce, as out-of-state trucks may not meet the requirements of all states through which they need to travel on certain trips. Ports of entry are no longer an uncommon sight at state borders. In addition to regulating size, shape, weight, and equipment, various types of registration fees and mileage taxes are assessed.

A Possible Barrier to Interstate Commerce

At this port of entry a state trooper records the license number and checks the weight, size, and equipment of each truck before permitting it to cross the state line

Ports of entry are also used as quarantine stations, although most efforts to halt the movement of shrubs and plants that might carry plant diseases are conducted by the United States Department of Agriculture rather than by similar state departments. It is legal for the authorities to confiscate the goods against which the quarantine has been imposed.

Usury Laws. Many people find it necessary to borrow money, and those who have little or no credit standing should expect to pay a higher rate of interest. In the past, some unscrupulous money lenders charged such a high rate, or added service fees, that the modest weekly payments the borrower could make failed to reduce his indebtedness. After paying for months, or even years, he might find that he owed more than at the time of the original loan. Usury laws passed by most states specify maximum rates that can be charged on different types of loans.

Zoning Ordinances and Building Codes. Most people who build a home do not want their residential area invaded by hot dog stands, pool halls, and other similar types of business enterprises. Laws establishing areas that are available for business sites and others that are restricted to homes are known as *zoning ordinances.* Such laws are passed by village, town, or city councils. They interfere with the right of a property owner to use his land in any manner that he may desire; this interference is in the better interest of his neighbors.

Closely related to zoning laws are the building codes, which are local or state. Plans for a new building or extensive repairs must be drawn with the inspector in mind. If the completed work does not follow specifications provided by law, the work will have to be done over. For example, the code may provide that electric wires must be laid within a pipe or cable. If this is not done, the inspector will not give his approval, and the utility company providing the electricity will not be permitted to turn on the current.

Aids to Business It might be inferred from the preceding discussion of the relations of states and municipalities with business that all the laws and regulations are for the purpose of restraining what businessmen would like to do if they were not oppressed. There is some truth in this inference, but the regulations are mostly for those who would be willing to sacrifice the best interests of others for their own selfish aims. States and cities want prosperous business conditions because their interests and those of the successful businessman are mutual in many respects.

Businessmen in general rely on their government for many services and realize that they must help pay the bills. A manufacturer who runs a clean, well-lighted, sanitary factory is glad that his finished goods do not have to compete with others produced under sweatshop conditions. The owner of a building does not want a fire trap constructed next door. Supervision of insurance companies gives the businessman a partial guarantee that his policy will not prove worthless just when the protection is most needed.

States and local government units aid business in many other ways. One of the most interesting in recent years has been the advertisements that have appeared in magazines read from coast to coast. Some of these have been directed at the tourist trade in the knowledge that the millions of dollars spent by vacationers can bring prosperity to the residents of the area patronized. Other advertisements have listed the advantages of locating factories and business establishments in the state with the thought that resulting pay-roll income, property values, and job opportunities would improve the economic status of the local citizens.

States and municipalities also build roads, airports, municipal auditoriums, stadia, and recreation centers in order to attract visitors. State and municipal universities provide research facilities. Usually a Department of Commerce and a Department of Labor are available at the state capital to help business with special problems. Business complains about governmental interference but prefers present-day conditions to those that would exist without supervision and control by governmental units willing and able to force compliance with laws passed for the public good by elected representatives of the people.

QUESTIONS

1. Under what rights do states and local governmental units enact legislation affecting business?
2. Are proportional taxes always regressive in nature?
3. Give an example of a tax that can be shifted and an example of a tax that cannot be shifted.
4. Why is it easier to collect a tax on real estate and tangible personal property than on intangible personal property?
5. If a state is deciding between enacting an income tax or a general sales tax, which would be the more logical and satisfactory?
6. Would it be possible to organize a small business in such a manner that no tax or license would be due to a state or subdivision thereof?
7. What is the difference between inheritance and estate taxes?
8. Is a poll tax an example of a proportional type of tax? Is it progressive or regressive?
9. What is the difference between a tax and a license?
10. If factories located within the city limits are pouring from their chimneys smoke that creates an unhealthy atmosphere, should the city have the right to force the factories to take steps to correct this situation?
11. If a man owns property, why should he not have the right to use it in any manner he deems fit?
12. Should states be allowed to regulate interstate commerce that passes through its borders?
13. A city passes a law eliminating all signs that hang over the streets. Would such a law be enforceable?
14. Should cities and states extend their regulation of business, or should they spend more time and money boosting the products and industries within their territories?

PROBLEMS

1. Five men form a corporation to manufacture a metal container that has been patented by one of their number. The company buys an abandoned factory building and hires a labor force of fifty men. It is planned to sell the product in several states. The size of the container is such that it will be most efficient to make deliveries in company-owned trucks.

Itemize the various state and local taxes that may be incurred by this corporation.

2. Mr. Colson invests his savings in a new building in an incorporated village. He installs several pool and billiard tables, and a food counter with stools. As a side line, he plans to operate a motor scooter, selling ice-cream bars throughout the village.

(a) Itemize the various types of licenses Mr. Colson may need to purchase.

(b) What types of business regulation may the state enforce against Mr. Colson in the exercise of its police power?

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CHAPTER 32

FEDERAL REVENUES AND EXPENDITURES

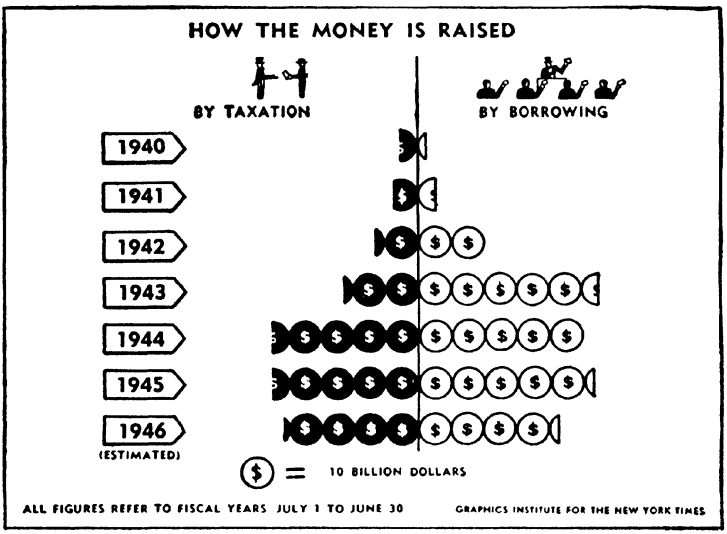
Federal Revenues and Expenditures Affect Business

Strong and vigorous central governments have been a characteristic of the twentieth century. In some countries totalitarian forms of government have arisen; in the United States, by democratic processes, the power of the Federal Government has been substantially increased. More activity results in higher costs, and in recent years the Federal Government has been spending many billions of dollars annually. These funds are secured from current revenues or by borrowing.

The businessman is vitally interested in both Federal revenues and expenditures. Taxes provide the chief source of revenue and the size and allocation of this tax burden affect sales possibilities, expenses, and the net profits that can be retained or paid to the owners. High taxes affect the entire economy and to the extent that certain industries, such as tobacco, are singled out for special taxes, business interests are even more concerned. If government borrowing is necessary to secure additional funds, businessmen are interested in such factors as the size of the national debt, its inflationary possibilities, the burden of annual interest charges, and the potential purchasing power of individual savings invested in government bonds.

Expenditures are just as important as revenues although the benefits are less noticeable to business in comparison to the burden of paying taxes. Payments to old-age pensioners, veterans, and those on relief add purchasing power to these groups. Subsidies paid to certain industries interest a particular segment of business as do contracts for public works and projects such as national highways, dams, and public buildings. Many of the annual expenditures of the Federal Government find their way either directly or indirectly into the tills of business, large and small.

Because Federal revenues and expenditures constitute a major relationship between the businessman and his govern-



ment, this chapter will be devoted to a study of the Federal taxing system and the purposes for which these funds are raised. Other relationships between business and the National Government will be discussed in subsequent chapters.

FEDERAL REVENUES

Power to Tax One of the specific powers granted by the Constitution of the United States to the Federal Government is the right to levy taxes. The first paragraph of Article I, Section 8 reads as follows: "The Congress shall have power to lay and collect taxes, duties, imposts, and excises to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States." Because there was some doubt about the legality of taxes on incomes, the Sixteenth Amendment was passed in 1913. It reads as follows: "The Congress shall have power to lay and collect taxes on incomes, from whatever sources derived, without apportionment among the several States, and without regard to any census or enumeration."

Under this constitutional authority Congress enacts necessary revenue legislation. Although the major sources of income are more or less stabilized, each new revenue act contains some modifications over those enacted previously. Rates, particularly, are subject to change and those that will be given in this chapter are cited only to illustrate and clarify the various types of Federal taxes. Current charges can be found by reference to the text of the latest revenue act.

Income Taxes The largest single source of revenue for the Federal Government is derived from income taxes levied on individuals and on corporations. In 1944 this type of taxation resulted in receipts in excess of 34 billion dollars. Approximately one half of this huge sum was paid by individuals and one half by corporations. The rates and methods of computation vary considerably between individuals and corporations.

Personal Income Tax. Every person in the United States who has an annual income in excess of a prescribed amount ($500 in 1946) may be liable for income taxes. This income includes receipts from such sources as wages, dividends, interest, sale of property, and the net profit from a business or profession. Sole proprietorships and partnerships that are engaged in any form of business have their net income taxed on the basis of such profits forming part or all of the income of the individuals concerned. Partnerships are required to make out a special return, but this is merely for information, and the actual tax is levied on the share that accrues to the benefit of each partner.

All individuals are entitled to a personal exemption and are also allowed to deduct certain nonbusiness expenses such as interest, charitable contributions, most state and local taxes, and excessive medical expenses. A taxpayer is also allowed an exemption for each dependent who is closely related to him and who receives more than one half of his support from the taxpayer. In 1946 the personal exemption and also the exemption for each dependent amounted to $500 a person. This meant that a married man with three young children was entitled to $2,500 in exemptions alone.

One of the merits of the personal income tax is the application of the principle of "ability to pay." This is accomplished by levying a flat rate, called the *normal tax*, and also a progressive rate, called the *surtax*, on all taxable income. In 1946 the normal tax was 3 per cent and the surtax rates were graduated from 17 per cent to 88 per cent. These were combined in the computation of taxes so that the rate on the first $2,000 of taxable income was 20 per cent; the rate on the next $2,000, called a tax bracket, was 22 per cent; and similar increases continued to a maximum rate of 91 per cent on taxable incomes in excess of $200,000. After the total tax was computed, a reduction of 5 per cent was permitted for incomes earned in 1946. The net effect of this reduction was to lower the minimum rate on the first $2,000 of taxable income to 19 per cent.

An illustration of the actual tax calculations of a businessman will show the application of 1946 rates. Mr. Jonathan Burgess operates a retail drugstore, and also owns a one-third interest in an apartment house that was built by a partnership. The profit and loss statement for the store showed a net income of $28,246.50, and the partnership return showed that his share of the net profit on that enterprise was $4,683. In addition, he received dividends and interest amounting to $9,375. These items constituted his entire income. Mr. Burgess is married and has one daughter who is attending college.

Income from business		$28,246.50
Profit from partnership		4,683.00
Dividends and interest		9,375.00
Total Income		$42,304.50
Exemption for self, wife, and daughter	$1,500.00	
Deductions for contributions, etc.	500.00	
Total Exemptions and Deductions		2,000.00
Taxable Income		$40,304.50
Computation of Tax:		
Normal and surtax on $38,000		$18,360.00
Excess over $38,000 ($2,304.50 at 69%)		1,590.11
		19,950.11
Less 5%		997.51
Total Income Tax		$18,952.60

Beginning in 1943, all personal income taxes were placed on a "pay-as-you-go" plan. This means that Mr. Burgess and

other businessmen are required to anticipate their profits and incomes and to make quarterly payments on the estimated amount of total tax. Payments are due on March 15, June 15, September 15, and January 15 of the following year. If operations during the year do not correspond with the original estimate, an amended declaration can be made on any of the dates mentioned. In the case of wage earners whose income is from salaries, the employer is required to withhold a portion of each salary payment and he remits these deductions to the local Collector of Internal Revenue.

Corporation Income Taxes. Ordinary corporations engaged in an industry or trade are also subject to normal taxes and surtaxes, and during World War II they were subject to excess profits taxes in many instances. For purposes of the normal tax, according to the 1946 rates, corporations are divided into three classes based on net taxable income, as follows:

(1) Corporations with normal-tax net incomes of not more than $25,000.

First $5,000 ..... 15%
Next $15,000 ..... 17%
Next $5,000 ..... 19%

(2) Corporations with normal-tax net incomes of more than $25,000 but not more than $50,000.

31% of the amount in excess of $25,000 plus $4,250.

(3) Corporations with normal-tax net incomes of more than $50,000.

24% of their entire normal-tax net income.

Surtax rates are also divided into three classes, as follows:

(1) Surtax net income under $25,000—6%.

(2) Surtax net income between $25,000 and $50,000—$2,500 plus 22% of surtax net income in excess of $25,000.

(3) Surtax net income over $50,000—14%.

Without going into the technicalities of determining normal-tax net income and surtax net income, these amounts may be identical with the net income as shown by a corporation on its profit and loss statement. Assuming this to be the case, a corporation with an income of $100,000 would pay at 1946 rates 24 per cent as a normal tax and 14 per cent as a surtax, making a total of $38,000.

During World War II corporations were subject to excess profits taxes in addition to normal taxes and surtaxes. The purpose was to "take the profit out of war" and furnished an interesting example of government regulation of business through use of the taxing power. Some corporations paid as much as 80 per cent of their net income to the Federal Government during war years.

Income taxes on corporations are a determining factor in many decisions reached by management. A small corporation with only a few stockholders might well consider the possible tax-saving advantage of changing the form into a partnership. Or, if additional capital is needed, the advantage of selling bonds over stock from a tax standpoint may resolve this question. Interest on bonds is a legitimate business expense, whereas dividends on stock are considered a distribution of profits. Policies on depreciation rates used to amortize the cost of fixed assets, the write-off of worthless trade accounts receivable, and the possible sale of investments are examples of other business practices on which management cannot afford to ignore the existence of the income tax.

The preceding paragraphs devoted to the corporation income tax have referred to profit-making domestic organizations. Many types of corporations do not pay a tax. Examples include labor organizations; fraternal societies; religious, charitable, scientific, literary, or educational corporations; farmers' co-operative associations; and other corporations that are operated on a nonprofit basis. If profits are earned, these may not be distributed to individual shareholders, or to members if the corporation has not issued stock. Some of these organizations are now required to file an information return, but no tax can be collected unless the Congress decides to change the present law.

Other corporations have been singled out to be taxed at special rates. Corporations that accumulate surplus improperly, that is, do not declare a fair share of their earnings in the form of dividends, pay a special surtax of 27.5 per cent of the first $100,000 of undistributed net income and 38.5 per cent of amounts in excess of this figure. Personal holding companies such as are formed by movie and radio stars are assessed an extra surtax of 75 per cent of the first $2,000 of

undistributed net income, and 85 per cent of amounts over $2,000. In this case, the purpose is obviously to prevent a means of tax avoidance. A wealthy individual could transfer securities and income-producing properties or assign his annual earnings to a corporation formed for this purpose and, by restricting dividends to the amount of income needed by the one stockholder, who owns practically all of the shares of stock, his total taxes, both corporate and personal, would be materially reduced.

Social Security Taxes The Social Security Act of 1935 provided that employers should pay the Federal Government 1 per cent of their pay rolls, up to a maximum base of $3,000 for any one individual, and that employees should pay 1 per cent on the same basis, for the purpose of old-age retirement benefits. In addition, 3 per cent was to be paid by the employer for unemployment insurance although, as explained in the preceding chapter, all states took advantage of a 90 per cent credit allowed on this tax for payments to the state. The remaining 10 per cent, amounting to three tenths of 1 per cent, is paid to the Federal Government. This Federal levy of a total of 1.3 per cent on pay rolls became a direct burden on business, and furthermore there is an additional cost of record keeping in withholding the employee's 1 per cent from his pay roll and of remitting the amounts withheld.

It might be argued that this is not a tax but rather a donation on the part of the employer to a pension plan. The net effect in either case is the same and, although the United States Government invests in Government bonds the funds not currently needed, the income provides a source of expendable funds just as surely as receipts from other sources. At the time the law was enacted, the plan was to increase the rate gradually from 1 to 3 per cent by 1949 for both employers and employees. However, the Congress has continued to enact legislation each year holding the contribution at the original rate of 1 per cent.

Many persons are not now covered by the social security laws. These include agricultural and domestic workers and civil service and other employees of the United States Gov-

ernment, the states, or political subdivisions thereof. Students working for a school or employed by a local chapter of a college fraternity, sorority, or club are not subject to the social security taxes. When the law was first enacted, railroad employees were also exempted because a special Railroad Retirement Act was ready for passage—it became a law fifteen days after the Federal Social Security Act was signed on August 14, 1935. The purpose of the two laws was similar, but the Railroad Retirement Act prescribed an initial rate of 2¾ per cent and provided for increases to 3¾ per cent in 1949.

Liquor and Tobacco Taxes Taxes on the production of liquor and tobacco products are illustrations of Federal excise taxes on special products. They have been segregated here because the revenue from these two taxes constitutes an important source of Federal income amounting to well over a billion dollars annually. In 1945, 5 cents of every tax dollar received by the Federal Government came from alcoholic beverages and 2 cents from tobacco taxes. These taxes might also be classed as stamp taxes, as the method of showing that the tax has been paid is usually to affix the required value of stamps on the manufactured product. Nearly everyone is familiar with the blue stamp that seals a package of cigarettes, but many individuals do not realize that the cost of that stamp is 7 cents. This means that from one third to one half of the retail price is in payment of the Federal tax on the product. The rates on spirituous liquors vary with the alcoholic content; the rate for products containing over 24 per cent of alcohol is usually from $1.00 to $1.25 a quart.

Although it would appear that taxes on liquor and tobacco are shifted to the consumer, the effect of these and other excise taxes cannot be dismissed as having no effect on the manufacturing concerns engaged in those industries. On the contrary, one of the purposes of such excise taxes is to raise the price of the finished goods to a point that discourages consumption of the products. The higher prices, which result from shifting the tax to the consumer, lower the volume of business that would be available if the tax were removed. To this extent, the taxes are regulatory as well as revenue measures.

Estate and Gift Taxes The Federal Government did not enter the field of estate taxation until 1926, and the first gift tax law was enacted in 1934. These recent laws complement each other in that it is no longer possible to avoid estate taxes by gifts made prior to death. Despite the fact that there is an exemption of $30,000 for gift tax purposes, plus $3,000 each year to any number of donees, and an exemption of $60,000 for estates, these two taxes produce a sizeable amount of revenue each year.

Assume that Samuel Whitacre has amassed a fortune amounting to $3,000,000 during his lifetime. His wife has died, and he desires to leave everything to his only child, Samuel Whitacre, Jr. If he makes a gift of his fortune, the tax amounts to $934,282.50. On the other hand, if he retains control of the entire amount until his death, the tax on the estate that will be due the Federal Government will approximate $1,231,400. Rates in both cases vary with the size of the taxable gift or taxable estate. Gift rates start as low as 2¼ per cent and rise to a maximum of 59¾ per cent for gifts in excess of $10,000,000. Estate tax rates begin at 3 per cent, and the highest rate is 77 per cent for estates valued at more than $10,000,000.

The effect of estate and gift taxes with rates as high as those indicated is to make it impossible for large concentrations of wealth to remain in the hands of one individual. In England, where it was traditional for the eldest son to inherit the bulk of any property owned by a family, conditions existed that raised a real question as to the social desirability of allowing such unequal distribution of wealth. Death duties in that country, as well as here, tend to eliminate excessive amounts of wealth owned by an individual. Also, income taxes at the present rates reduce the possibilities of acquiring great wealth during a person's lifetime.

Customs Duties Customs duties are a tax levied on the importation of foreign goods. All importations of merchandise from sources outside the United States are either on the free list or subject to duties. Goods of the types that are not grown, mined, or made in this country are frequently permitted to enter the country tax free.

Coffee is a good illustration of a commodity on the free list. Other goods that compete with American-made products are charged a fee, which discourages imports or at least affords protection to local producers against the foreign goods. The import rate of 14 cents a pound on butter is obviously protective in nature.

During the early history of the United States, the receipts from customs duties were a major source of income to the Government. More recently, newer forms of tax legislation have overshadowed the receipts from this source. Furthermore, under the plan of working out reciprocal tariff agreements with many foreign countries, the tendency has been to lower the duties in order to promote more world trade. The subject of tariffs, including levies for protection and for revenue, was discussed in Chapter 18.

Occupational Taxes The Federal Government, as well as many states, requires the payment of an occupational tax or license fee as a condition precedent to engaging in certain businesses. Failure to pay these special taxes subjects the offender to a fine or imprisonment. A listing of the occupations that have been singled out by the Federal Government is rather interesting. Agricultural groups have been responsible for a tax on manufacturers, wholesalers, and dealers of and in oleomargarine, adulterated and processed or renovated butter, and filled cheese. Annual rates on producers and handlers of oleomargarine require manufacturers to pay $600; wholesalers pay either $200 or $480, and retailers pay $6 or $48, depending upon whether they handle white or colored margarine.

Producers and distributors of liquor, narcotics, marihuana, and firearms are also required to pay an occupational tax. The purpose of including this selection is doubtless connected with the need for control and regulation. In the case of narcotics, the importer, manufacturer, or producer pays a $24 tax per annum, a wholesale dealer $12, a retail dealer $3, and physicians, dentists, veterinary surgeons, and persons engaged in research pay a fee of $1. All must keep accurate records of receipts, uses, and stocks on hand, which are subject to examination by the Treasury Department.

Operators of bowling alleys, billiard and pool halls, and other amusement places where coin-operated devices are permitted, pay an annual tax based on the number of units installed. Each alley or table is subject to a tax of $10 a year, and each coin-operated machine requires a payment of $10 or $100, depending upon the type. Music and amusement devices require the smaller fee, while so-called "slot machines" are taxed at the higher amount.

Manufacturers' Excise Taxes In a broad sense, a Federal excise tax is an inland customs duty levied not only on goods but also on facilities. Manufacturers' excise taxes are very similar to sales taxes with the distinction that only selected products are subject to the tax. This limited number of articles is the extent to which the Congress has yielded to pressure from some groups for a general sales tax.

A list of some of the manufacturers' excise taxes and the 1946 rates will indicate the direction such taxation has taken and also the burden of such taxes:

Tires—5¢ a pound
Inner Tubes—9¢ a pound
Automobiles—Manufacturer's Sales Price
  Passenger cars—7%
  Trucks and Busses—5%
  Tractors—5%
  Motorcycles—7%
  Parts and accessories—5%
Radios—10%
Phonographs—10%
Phonograph Records—10%
Musical Instruments—10%
Mechanical Refrigerators—10%
Sporting Goods—10%
Luggage—10%
Electrical, Gas or Oil Appliances—10%
Photographic Apparatus—10%
Business and Store Machines—10%
Electric Light Bulbs and Tubes—5%
Firearms, Shells and Cartridges—11%
Electrical Energy—3⅓% on sales for domestic or commercial consumption
Gasoline—1½¢ per gallon
Lubricating Oil—6¢ per gallon

Retailers' Excise Taxes Although most Federal sales taxes are levied against the manufacturer, a few must be collected by the retailer. These include taxes on jewelry, furs, and toilet preparations. During World War II the rate in each case was 20 per cent, and in addition all types of luggage were removed from the manufacturers' list and transferred to the retail classification with a tax of 20 per cent.

Admissions and Dues Another form of revenue has been a tax levied against admissions to public events and a tax on dues and initiation fees to various types of clubs and organizations. During World War II these rates were 20 per cent of membership fees, night club and cabaret checks, tickets to events, and 1 cent for each 5 cents or fraction thereof for admission to movie theaters, and similar amusement places. Peace-time rates were 11 per cent for dues and tickets, 5 per cent for roof gardens, cabarets, and the like, and 1 cent for each ten cents or fraction thereof on admissions.

Communications and Travel Railroad tickets and Pullman reservations are subject to a tax of 10 per cent, which was increased to 15 per cent during World War II. Telephone and telegraph charges are also subject to a tax paid by the user of the service. Local telephone tax rates were raised from 10 to 15 per cent and long-distance charges from 20 to 25 per cent during the war years. Telegraph charges were similarly increased from a tax rate of 15 per cent to 25 per cent.

Stamp Taxes Another form of an excise tax is one that is levied by means of selling stamps that are affixed to the product. Such taxes could be included under the heading of sales taxes, in some instances. For example, a stamp must be attached to each deck of playing cards that is manufactured. Tobacco and liquor taxes are also levied in this manner. On the other hand, a transfer of stocks, bonds, or mortgages must also have stamps affixed to the documents in order to make such a transfer legal.

Taxes on the manufacture of narcotics, marihuana, white phosphorus matches, oleomargarine, adulterated butter, processed or renovated butter, and filled cheese are also assessed

by means of stamps. In many ways, these are similar to a manufacturers' excise tax except in the method of payment. Oleomargarine, for example, is subject to a tax of one fourth of 1 cent per pound if uncolored, but the rate is 10 cents a pound if the Commissioner holds it to be yellow in color.

Regulatory Taxes Most taxes are levied with revenue primarily in mind, and regulatory features are at least secondary. There have been a few instances of taxes that were assessed for the sole purpose of regulation. One of the best examples, although it has been repealed, was the Undistributed Profits Tax of 1936. Congress felt that many corporations were not declaring dividends in relationship to earnings and were thus allowing the stockholders to avoid the high surtaxes that would have been assessed against them as individuals following dividend receipts. The tax was levied against the amount of current earnings of corporations that were not paid out as dividends. Rates were graduated so that the more earnings that were retained, the higher was the tax against these larger amounts. The result was an effort on the part of most corporations to pay out all of their current earnings as dividends in order to avoid the tax. In fact, the success of this tax was measured by the lack of revenue secured from it as would be true of all fully regulatory taxes. There were many arguments advanced against the tax, and it proved so unpopular that it was soon repealed.

A good example of a regulatory tax still in force is that on the manufacture of opium for smoking purposes. The rate is $300 a pound. In addition any manufacturer must file a bond with the Collector of Internal Revenue of the district in which he is located of not less than $100,000. The tax on white phosphorus matches of 2 cents per hundred matches is also so high that it practically prohibits the manufacture of this product, thereby eliminating the health hazard to workers in this industry. Another regulatory tax is the excise fee of 27½ per cent on the transfer of stocks or securities to foreign corporations with the intent to avoid income taxes. The tax on the circulation of bank notes issued by other than national banks is a further excellent example of the use of the taxing power for purposes of regulation.

Miscellaneous Taxes In searching for suitable sources of revenue, the Federal Government has taxed many products, services, facilities, and occupations. The problem of securing adequate funds is difficult in view of the level of Federal expenditures and the desirability of reducing the national debt. At the present time, for example, there is a tax on the annual cost of renting a safe-deposit box from a bank. This is mentioned as an illustration of the extent to which the Federal Government does go in selecting items suitable for taxation. In seeking to maintain a high level of annual tax receipts, particularly in light of the political expediency of reducing income taxes, future revenue acts may well include more types of miscellaneous taxes than has been true in the past.

FEDERAL EXPENDITURES

Increases in Federal Expenditures Prior to World War I, the annual expenditures of the Federal Government were less than one billion dollars annually, and the national debt was a little over this figure. The picture changed materially during the period from 1917 to 1919, but soon after World War I was over expenditures dropped to less than four billion dollars annually and the debt, which had risen to over 26 billion dollars, was reduced to 16 billion dollars by 1932. The budget was balanced each year with enough left over to pay off a portion of the indebtedness.

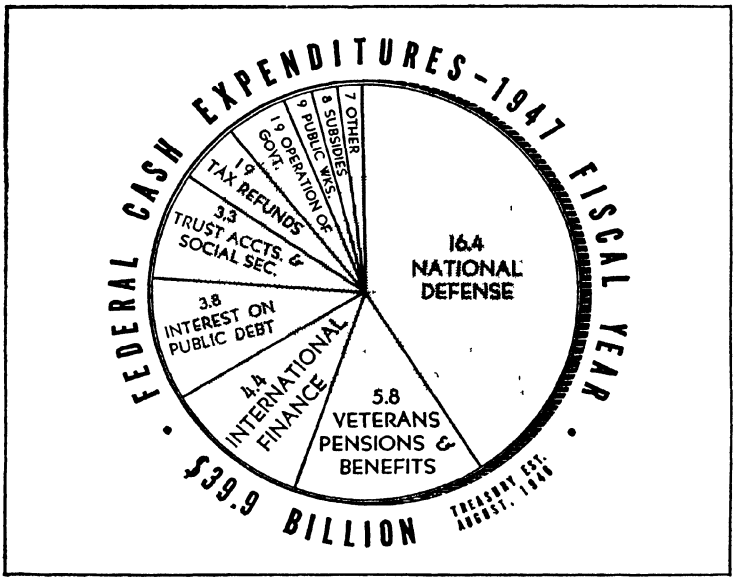
Beginning in 1932 public expenditures increased in a desire to assist in recovery from the most serious depression this country had ever experienced. Tax collections were at a new low, and the extra expenditures caused a rise in the national debt of over 30 billion dollars by 1940. With the advent of World War II, this proved to be a minor matter, considering the fact that the debt rose to over $278,000,000,000 during the fiscal year ending June 30, 1946. Assuming that the Federal Government can borrow money at an average rate of approximately 2 per cent, the annual interest owed at that time was about five billion dollars, which is considerably more than all Federal expenditures annually prior to 1933, except for the abnormal period from 1918 to 1921.

During World War II annual disbursements reached a peak of 100 billion dollars for the fiscal year ending June 30, 1945. With the coming of peace, the rate declined drastically, but it is doubtful if the level of postwar expenditures will fall below approximately twenty billion dollars annually. In addition to the interest burden mentioned above, the maintenance of a large army and navy plus the care and benefits paid to veterans can be expected to keep expenditures high. Furthermore, Governmental functions have increased and no appreciable reduction is in sight for the near future.

Types of Expenditures The disbursement of public funds affects business in different ways, depending upon the direction such expenditures take. As a general proposition, all payments to individuals, be they veterans or public officeholders, provide incomes that will be spent. This was the theory of the "pump priming" experiments of the thirties when direct and work-relief payments were made through such agencies as the Public Works Administration and the Works Progress Administration. However, the production of useful goods and the receipt of pay for this endeavor would be more beneficial to the public at large than payments made to public servants. Everyone should be concerned with efficiency in government as well as in private endeavor.

Some disbursements are particularly valuable to certain business groups. Subsidies paid to ship-building concerns, air-mail contractors, and producers of certain products, notably along agricultural lines, assist these groups but are not welcomed by other business interests. Aids to states to build highways may relieve local taxation, which would not be detrimental, at least. Projects, such as the proposed Missouri Valley Authority, are more likely to aid citizens located in that area than those living elsewhere although all taxpayers will have to help pay the bill.

Despite the desire of citizens of the United States for peace, it can be safely assumed that this country will maintain a much larger army and navy than was the case before World War II. Suppliers of military equipment will benefit from Government expenditures for an expanded peacetime national defense program. Another direct result of World War II will



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be a sizeable increase in expenditures for veterans, including disability compensation and educational benefits.

In 1945 The Brookings Institution, an independent research organization, prepared an estimate of Federal cash expenditures for 1949 in comparison with 1940. These figures, shown on page 640, show the sizeable increase then expected in expenditures and also the items for which Federal funds are expended. Omitted from this table is a further estimated expenditure of $1,955,000,000 for social security against which receipts of $3,864,000,000 from social security taxes would leave an excess of $1,909,000,000.

There is no question but that annual expenditures of the Federal Government will continue at levels greatly in excess of those prevailing before World War II. Unless a high rate of national income can be maintained, which means high production and prosperity, it is going to be difficult to bear the necessary tax burden. Of course, borrowing can provide more funds but, unless the budget is balanced in most years, there is little hope for a stable price level and economy.

Federal Cash Expenditures

ESTIMATES FOR THE FISCAL YEAR 1949 COMPARED WITH 1940
(In millions of dollars)

PURPOSE OF EXPENDITURE	1940	1949		
		MINIMUM	MAXIMUM	PROBABLE
Military Functions	2,090	9,176	12,323	10,611
National defense	1,546	6,939	8,711	7,802
Veterans' benefits	544	2,237	3,612	2,809
Regulation and Protection	132	169	188	177
Law enforcement and public safety	89	115	128	120
Regulation of commerce and industry	43	54	60	57
Promotion of Economic Development	1,957	3,580	4,416	4,097
Transportation	340	780	900	858
Commerce and industry	14	17	23	20
Labor interests	15	20	25	22
Agriculture	1,266	2,289	2,810	2,602
Other natural resources	322	474	658	595
Promotion of Social Welfare	2,674	1,004	1,520	1,262
Education	34	120	175	147
Public health and sanitation	38	90	110	100
Recreation	22	35	45	40
Public assistance	2,502	589	940	765
Social security administration	74	95	125	110
Housing	4	75	125	100
Interest on Public Debt	882	4,177	6,101	5,099
General Government	339	423	486	451
Legislative, judicial, executive	315	378	426	401
Foreign relations	24	45	60	50
Miscellaneous	95	133	306	215
Liquidation of special war agencies		35	65	50
Indian affairs	50	51	60	55
Government life insurance (net)	36	85	177	132
Government employees' retirement (net)	24	−25	−15	−20
Undistributed grants	6	7	9	8
Other	−21	−20	10	−10
Governmental Business Enterprises (net)	300	200	500	400
Total	8,469	18,862	25,840	22,312

Source: The Brookings Institution, *Postwar Fiscal Requirements*, 1945, p. 9.

QUESTIONS

1. Is it necessary for a sole proprietor to pay an income tax on the profits of his business even though he does not withdraw these amounts from the business?

2. Do partnerships pay income taxes on the profits earned?

3. Mr. Anatharius operates a restaurant, and last year the business showed a net profit of $3,000. He is married and has two children in grade school, one in high school, and another is attending college. Will Mr. Anatharius owe a Federal income tax, assuming an exemption of $500 a person?

4. If a corporation pays out all of its earnings in the form of dividends, does it pay an income tax?

5. What pay-roll taxes do most employers have to pay to the Federal Government and what are the rates?

6. Why have the liquor and tobacco industries been singled out for high rates of tax with corresponding high yields? Is this desirable?

7. Estate and gift taxes have a tendency to redistribute the wealth of the country. Is this socially desirable or will it have a tendency to discourage individual initiative and enterprise?

8. Explain the difference between a manufacturers' excise tax and a retailers' excise tax. Give some illustrations of each.

9. Many Federal taxes are "hidden" in the sense that the consumer ultimately pays them but is not aware of this fact. Name some taxes in which this is the case and others in which the consumer is directly concerned.

10. Why are businessmen interested in the expenditures that are made by the Federal Government?

11. During World War II business conditions were prosperous despite the fact that large sums of money were borrowed by the Federal Government. Does this mean that there is no need for balancing the budget?

12. Why is it impossible to reduce annual Federal expenditures to the four billion dollar level that prevailed from 1919 to 1929 or to the eight billion dollar average from 1931 to 1940?

PROBLEMS

1. During the current year Mr. Arthur Woodstock made a net profit of $18,000 from his furniture store. In addition he received $800 in dividends on stocks owned, and a salary of $400 as clerk of the school board.

Mr. Woodstock is married and has five children. He also supports his mother-in-law who makes her home with the Woodstock family.

Assuming a $500 exemption for each person and a $500 deduction for charitable contributions, taxes paid, and other similar allowable items, how much tax will Mr. Woodstock owe the Federal Government, taking into account the fact that he has already paid $3,700 on the pay-as-you-go basis.

Use the appropriate rate from the ones listed below.

TAXABLE INCOME						AMOUNT OF TAX						
Over	$12,000	but	not	over	$14,000	$3,400	plus	43%	of	excess	over	$12,000
"	$14,000	"	"	"	$16,000	$4,260	"	47%	"	"	"	$14,000
"	$16,000	"	"	"	$18,000	$5,200	"	50%	"	"	"	$16,000
"	$18,000	"	"	"	$20,000	$6,200	"	53%	"	"	"	$18,000

Use the form on page 627 as a model, unless instructed otherwise.

2. The Jordan Manufacturing Company manufactures portable radio receivers. All parts are produced in the factory and some of the raw materials used are imported. The labor force consists of about 600 employees. The finished sets are distributed throughout the United States.

Itemize the different types of Federal taxes this firm would be likely to incur.

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CHAPTER 33

COMBINATION AND CO-OPERATION

Combinations in Restraint of Trade

In 1776 Adam Smith, writing in his *Wealth of Nations*, said: "People of the same trade seldom meet together even in merriment and diversion but the conversation ends in a conspiracy against the public, or on some contrivance to raise prices." This statement indicates the somewhat natural desire of businessmen to secure higher prices for their products. It also suggests that some devices, which might prove successful for this purpose, are a form of conspiracy against the public. One of the bulwarks of our form of economic society is price competition. On the other hand, "cutthroat" price competition may prove injurious to the public in the long run.

In this country, prior to 1880, the problems of combination and co-operation were not serious. It had already been recognized that competition was not desirable in a few industries, such as telephone, gas, and electric service, and these had been classed as public utilities subject to control by the state in which they operated. In other fields the dominant characteristic was a large number of small enterprises in each of the various fields of economic endeavor. Price competition was the rule rather than the exception.

During the period from 1879 to 1890 a number of "trusts" were formed for the primary purpose of eliminating price competition. The most famous of these were the Standard Oil Trust (1879), the Whiskey Trust (1887), the Sugar Trust (1887), and the Tobacco Trust (1890). At the time these were formed it was generally recognized that they were illegal because undue restraint of trade was contrary to common law. However, no specific legislation had been passed to prevent the formation of such organizations which assumed a practical monopoly in the area of business in which they were engaged.

Legal Action against Trusts. In 1890 the Congress of the United States passed the Sherman Anti-Trust Act, which de-

cleared that combinations in restraint of trade were illegal. On the basis of this legislation, actions were brought against the trusts that had been formed, and most of them were broken up into competing units. However, numerous other devices were available for securing all or some of the same objectives. For example, the State of New Jersey in 1890 passed a law that permitted corporations to hold the stock of other corporations, a condition that had previously been regarded as illegal. This gave rise to similar legislation in other states and offered an opportunity for the holding company, which proved to be one of the more popular forms of combination and co-operation, to develop.

When business units first grew in size, there was a general fear that large organizations were automatically detrimental to the best interests of the public. Bigness and badness were considered as synonyms. T. N. Carver in his *Essays in Social Justice* published in 1925 made the following remarks about the large corporation:

> The larger the corporation, the greater is its power for good or evil, and that makes it especially important that its power is under control. . . . If I may use a homely illustration, I will take the common house cat, whose diminutive size makes her a safe inmate of our household in spite of her playful disposition and her liking for animal food. If, without the slightest change of character or disposition, she were suddenly enlarged to the dimensions of a tiger, we should at least want her muzzled and to have her claws trimmed whereas, if she were to assume the dimensions of a mastodon, I doubt if any of us would want to live in the same house with her. And it would be useless to argue that her nature had not changed, that she was as amiable as ever, and no more carnivorous than she had always been. Nor would it convince us to be told that her productivity had greatly increased and that she could now catch more mice in a minute than she formerly could in a week. We should be afraid lest, in a playful mood, she might set a paw upon us, to the detriment of our epidermis, or that in her large-scale mouse-catching she might not always discriminate between us and mice.

In 1914 the Clayton Anti-Trust Act was passed, as was the Federal Trade Commission Act. These laws, which will be explained in some detail in the following chapter, furnished further protection to the public against detrimental corporate or large-scale industry practices. Then, too, the country was

growing, and business units that had seemed too large in earlier days no longer loomed as ogres so terrifying as to frighten off the organization of competing companies. This was recognized by several decisions rendered by the Supreme Court in anti-trust suits in which the "rule of reason" was introduced, which made a distinction between good and bad combinations.

The Rule of Reason. The Sherman Act had also prohibited all contracts in restraint of trade. The rule of reason applied the test of reasonableness to contracts that might be construed as restraining. Under this line of argument, the Tobacco Trust was dissolved while the decision in the case of the United States Steel Corporation, which was not rendered until 1920, was in favor of this company. It was decided that, while the joining of several steel companies into one organization had a restraining influence on competition, it was not unreasonable as there were other companies not in the trust that could compete with the United States Steel Corporation.

Today there is no longer any fear of size if this is the only factor involved. In the automobile field, General Motors, Ford, and Chrysler are all large and, in addition to competition among themselves, are subject to competition from such firms as Studebaker, Packard, and Nash. There are several smaller tire manufacturing companies that do not hesitate to sell in competition with Goodyear, Firestone, Goodrich, and the United States Rubber Company. Once a business is large enough to gain the advantages of mass production, mass purchasing, and extensive distribution outlets, there seems to be little advantage, if any, to a further increase in size.

The preceding paragraph should not be construed to mean that the problems of illegal combination and co-operation are no longer important. Anti-trust suits have been introduced regularly by the Attorney General's office against specific companies or against a number of related companies that have taken what appears to be group action. Businessmen are ever interested in securing higher prices and less competition, and only watchful vigilance on the part of governmental authorities can prevent practices that are detrimental to the general public.

Types of Combinations There are a considerable number of methods of forming combinations, and this fact explains, in part, why it is difficult to maintain proper competitive conditions. A description of several of the most common types of combinations will give some idea of the magnitude of the problem. It should be remembered, however, that many of these methods are perfectly legal and even desirable under proper circumstances.

Trusts. This is an illegal form as has already been noted, although it should be added that the term was applied at one time to all large combinations regardless of whether they used the trustee device. Strictly speaking, a trust results when stockholders of several competing concerns transfer their stock interests in the various concerns to a group of men who give them, in return, trustee certificates. This group, known as *trustees*, have complete control over the separate companies and can operate them in any manner they see fit. Their purposes would normally be to gain some of the advantages of large-scale production and to stifle price competition.

A special type of this form of combination is a *voting trust.* The difference between this and the more general trust form is that the stockholders of the separate firms merely transfer their voting rights to the trustees, retaining all other rights and responsibilities of stockholders. There are some legitimate purposes to which a voting trust could be put, but inherent in the form is the possibility of eliminating competition among like companies.

Mergers. When a merger takes place between two or more companies, the dominant one absorbs the smaller units, and they disappear as separate entities. If Company A makes an offer to Company B to purchase its assets and liabilities and the offer is accepted, Company B ceases to exist as a separate organization and Company A is then a larger concern. The payment to Company B can be made in cash, cash and stock of Company A, or entirely by Company A stock. The stock of Company B, if it was a corporation, is canceled.

The process of a large concern buying out a smaller competitor is a common, everyday occurrence. Purchases of

small-town drugstores, movie theaters, and grocery stores by chain organizations are not unusual. Large industries frequently purchase the business of smaller manufacturers who have been furnishing necessary parts. Many of the large companies of the present have grown by means of mergers rather than by internal expansion.

Amalgamations. The difference between a merger and an amalgamation is that a new company is formed in the process of combining two or more existing organizations. If Company A and Company B decide to combine, instead of merging one into the other, a Company C is formed, which buys up the assets and liabilities of Companies A and B. In this case, both of the old companies disappear and a new one is born.

One of the best-known illustrations of an amalgamation in recent years is Standard Brands, Inc. This company was formed to purchase the Royal Baking Powder Company, Chase and Sanborn, Inc., and the Fleischmann Company. The old organizations disappeared as separate companies despite the opposite inference that might be made from their individual radio programs.

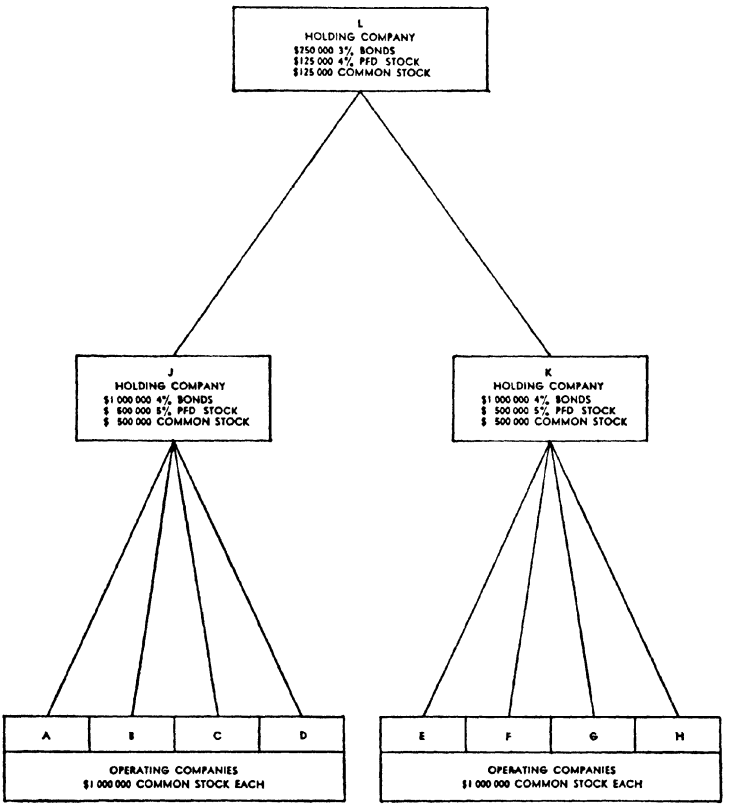
Holding Companies. The most popular device for combining a number of concerns is the holding company. In its pure form, a holding company is organized for the sole purpose of buying enough of the voting stock in other companies, called subsidiaries, to ensure control. Theoretically, this should be approximately 51 per cent, but in actual practice some holding companies own all of the stock of their subsidiaries and in other cases much less than one half which, under the system of management-secured proxies, is adequate for effective control. Also, in actual practice, many holding companies conduct operations in their own name as well as functioning as a holding company.

It would be difficult to mention the name of a well-known corporation that is not also a holding company to some extent. The American Telephone and Telegraph Company, the Pennsylvania Railroad, the United States Steel Corporation, E. I. duPont de Nemours and Company, and a host of others are holding companies for one or more other organizations. The subsidiary components of the American Telephone and Tele-

graph Company are listed below, together with the extent of the stockholding in each of the separate companies.

SUBSIDIARIES	PERCENTAGE OF STOCK OWNERSHIP
New England Telephone and Telegraph Company	68.92
New York Telephone Company	100.00
New Jersey Bell Telephone Company	100.00
Bell Telephone Company of Pennsylvania	100.00
Diamond State Telephone Company	100.00
Chesapeake and Potomac Telephone Companies	100.00
Southern Bell Telephone and Telegraph Company	100.00
Ohio Bell Telephone Company	99.99
Michigan Bell Telephone Company	99.99
Indiana Bell Telephone Company	99.99
Illinois Bell Telephone Company	100.00
Northwestern Bell Telephone Company	99.31
Southwestern Bell Telephone Company	100.00
Mountain States Telephone and Telegraph Company	73.23
Pacific Telephone and Telegraph Company (common)	89.34
Bell Telephone Laboratories, Inc.	50.00
Western Electric Company	99.46
195 Broadway Corporation	100.00
Eastern Telephone and Telegraph Company (Canada)	100.00
OTHER COMPANIES	
Southern New England Telephone Company	33.34
Cincinnati and Suburban Bell Telephone Company	29.73
Bell Telephone Company of Canada	22.03
Cuban American Telephone and Telegraph Company (common)	50.00

The holding company device has many advantages and legitimate purposes. By buying enough voting stock to assure control, which may run as low as 10 per cent, the management of the holding company can mesh the operations of several companies. If these are in the same or related field, some of the economies of large-scale production can be brought to the units that were previously independent. Buying orders can be grouped, engineering and research services can be of a higher order at less cost, and factories can produce more of the one or two items for which they are peculiarly adapted. In the case of public utilities producing electricity, the plants located in a restricted geographical area can be joined, which might eliminate excess facilities required when different peak loads are involved. The holding company can usually borrow money at a lower rate than the small operating company and can make such funds available to its subsidiaries at a saving in interest. These are called *downstream loans.*



The financial and control possibilities of the holding company device are apparent from the illustration shown above. Eight operating companies (Companies A to H inclusive) are purchased by two holding companies, J and K. Each of the operating companies has outstanding $1,000,000 in common stock with voting rights. Company J buys 50 per cent of the stock of Companies A, B, C, and D; and Company K does the same for Companies E, F, G, and H. Each of the holding companies needs $2,000,000 in order to buy $500,000 worth of stock in each of four operating companies. This sum is raised by selling bonds, preferred stock, and common stock.

Another holding company, Company L, now enters the picture and purchases 50 per cent of the common stock of Companies J and K. It needs $500,000 to buy one half of the voting stock of the two subsidiary holding companies, and funds are raised by the same methods as used by Companies J and K. Because it seems to offer a greater degree of security, with earnings from eight operating companies indirectly available, Company L is able to sell both bonds and preferred stock that carry lower yields.

This is an illustration of a pyramided holding company organization, and the chart shows clearly the source of this name. Further pyramiding is possible. One of the best examples of the length to which this device was used is furnished by the Mid-West Utilities Corporation, which flourished in the 20's under the guidance of Samuel Insull of Chicago. Its structure became so complicated, with various operating and holding companies owning part of each other and loaning each other money, that it took lawyers and accountants months to unravel the mystery. It collapsed, as others have, when earnings of the operating companies fell so low that they were unable to pay annual dividends to the holding companies. As a result the holding company could not pay the bond interest due and the bonds went into default.

There are two main reasons why holding companies are popular from the viewpoint of the stockholder. In the first place, a small holding can control vast resources. In the illustration, the owner of one half of the common stock of Company L would need to invest $62,500. This amount would give him control of the entire structure including the assets of the eight operating companies. It can be safely assumed that each of these is at least twice as large as its common stock issue, which means total assets of around $16,000,000 are controlled by an investment of less than one half of 1 per cent.

The other advantage to the stockholder is the possibility of securing a high rate of return on his stock. In the illustration it is assumed that the operating companies pay annual dividends at the rate of 6 per cent. By using the principle of trading on the equity, these 6 per cent dividends ultimately make it possible for the stockholders of Company L to receive dividends amounting to 34 per cent.

The calculations back of this statement are as follows:

Operating Companies pay 6 per cent dividends		
Eight corporations at $60,000 each		$480,000
J and K receive one half of above		$240,000
Bond Interest, J and K	$80,000	
Preferred Stock Dividends, J and K	50,000	130,000
Available for Common Stock Dividends, J and K		$110,000
Company L receives one half of J and K dividends		55,000
Bond Interest, L	7,500	
Preferred Stock Dividends, L	5,000	12,500
Available for Common Stock Dividends, L		$ 42,500
34 per cent on common stock of Company L		$ 42,500

Lease. One of the least expensive methods of controlling the operations of other units is to lease the businesses involved. The arrangement may be as simple as an agreement to pay a monthly rental, and it is conceivable that the profits of the leased unit may be more than adequate to cover the rentals. A drugstore owner could expand into a chain by leasing existing stores in several locations in the same city or in nearby towns. A railroad could, and commonly does, lease small lines that serve as "feeder" connections.

Most leases require a down payment as well as a monthly rental. This condition would require some capital but not nearly so much as outright purchase. The drugstore owner who wishes to secure an additional outlet might be asked for a down payment of $10,000 and a monthly rental of $500 in order to secure a ten-year lease on a business that has been averaging profits of $7,500 a year. The writing off of $1,000 of the lease each year, plus $6,000 annual rental, plus the cost of borrowing the $10,000, will use approximately all of the profits that past experience has shown can be earned. However, if he is a shrewd operator and can effect economies by running two stores, the leased outlet may be expected to produce more earnings in the future than it has in the past.

Consolidations. All of the forms of combination described to this point are known by the broad term "consolidation." There is no distinct system that can be classed as a combination by consolidation. Businessmen speak of consolidation by

lease and consolidation by stock ownership. However, there are a number of other methods of combination that are not consolidations. They are usually less formal than types already described, but the noticeable results may be identical with those secured under other methods.

Interlocking Directorates. If the majority membership of the board of directors of two corporations is composed of the same individuals, these men can direct the operations of the two organizations in such a manner that their activities will be co-ordinated in just as effective a fashion as though the organizations were consolidated. If the firms involved are in the same business and should be in competition with each other, such a board might be illegal under the Clayton Anti-Trust Act. If the firms are not competing, interlocking directorates are legal and may promote harmonious working relations between the two corporations.

The question might be raised as to how it would be possible to have the same men on two boards of directors if the stock ownership were not common. The plain truth is that stockholders in large corporations rarely have anything to say about the selection of the board members who serve them. The board members decide on their successors or the man who is needed to fill a vacancy, and under the proxy system of securing votes there is rarely any difficulty in electing the chosen individual or individuals.

Community of Interests. Two or more corporations may have complete or large stockholding interests in the hands of the same parties. Each company has its own board of directors, but the stockholders who own a dominant interest in the two or more organizations are responsible for placing and keeping them in their positions. This means that the actions of the board members can be controlled in the long run.

The oil trust, which was dissolved by the Supreme Court of the United States in 1911, broke up into 19 companies. The Standard Oil Company of Ohio, the parent company, no longer was connected with the Standard Oil Company of Indiana, the Standard Oil Company of New Jersey, the Standard Oil Company of New York, etc. However, because of the dominant

holding of the Rockefeller family, these companies operated in areas that did not conflict with each other. Of course, it should be added that, even though these organizations did not compete, the numerous other oil companies provided plenty of opportunity for competition.

Pools. Pools are of both historical and modern interest. Originally, they provided another method, in addition to the trusts, of eliminating competition. In this capacity they were declared unconstitutional by the Supreme Court. In a famous case involving the Addyston Pipe and Steel Company and others, the arrangement by which this manufacturer, together with several more who produced steel pipe, conspired to fix prices was declared illegal.

Pools are usually written agreements among several companies covering one or more phases of operations such as territories, prices or profits, output, or patents. The Addyston Pipe and Steel Company case involved a *territorial pool.* The companies agreed that each member was to have the exclusive right to sell in certain cities or small areas. In other regions the companies might bid among themselves for the business. This was known as a restrictive territory as opposed to the cities reserved for one company. Still other areas were free territory in which each company could seek business on a normal competitive basis.

Price and profit pools are based on an agreement to charge certain prices or to share profits on a certain percentage in relationship to the entire membership of the pool. For example, if Company A is a member of a profits pool and it has been determined that A shall receive 13 per cent of the total profits of all of the members, it will either pay in or draw out of the pool, depending on whether A's own operations are more or less successful than those of other members of the pool.

When the agreement covers the total production of any item that the pool has decided shall be manufactured, this is known as an *output pool.* If Company A is allotted 20 per cent of the total amount of cast iron sewer pipe to be manufactured, this percentage of the total decided output is all it can manufacture regardless of its production facilities or abilities or desires.

If several firms that own important patents decide to share the use of these patents, such an agreement would constitute a *patent pool.* A few years ago the General Electric Company and the Radio Corporation of America were required to divorce themselves of their mutual interest in a number of radio patents. The glass manufacturing and automobile industries have used patent pools extensively.

Cartels. A *cartel* is an association of enterprises in the same line of business that, while retaining their legal independence, contract to do or not to do certain things specified in the agreement. They can be classed as national or international and also as production, price, or territorial cartels. In the United States national cartels are illegal, but this has not been the case in some South American countries and many European nations. In fact, the word "cartel" as used in this country refers to an international group or to a national group in a country that encourages such organizations. This is the essential distinction between a pool and a cartel.

In the United States some producers of export goods were placed at a disadvantage in the world markets because they were forbidden under the anti-trust laws to combine in any manner that would restrain trade. In 1918 this condition was remedied by the passage of the Webb-Pomerene Act, which permitted manufacturers to join international cartels just so long as such united effort was not extended into local markets. Protected by this law, many producers and users of zinc, tin, rubber, machine wire, copper, etc., joined the international cartels that had been formed in these industries by producers in other countries.

Exclusive Selling Agencies. If a number of producers form a single agency to market their products, this is known as an *exclusive selling agency.* The best known examples are the co-operative marketing associations, such as the California Fruit Growers' Exchange. The Clayton Act contained the provision that "nothing in the anti-trust laws shall be construed to forbid the existence and operation of . . . agricultural or horticultural organizations, instituted for the purposes of mutual help, and not having capital stock or conducted for profit. . . ."

In 1933 an organization called the Appalachian Coals, Inc. was alleged to be in restraint of interstate commerce in bituminous coal. One hundred and thirty-seven producers had joined to form this exclusive selling agency. In view of the deplorable conditions in the coal business, plus the fact that no efforts were made to restrict production, the agency was held to be legal. This decision seemed to approve selling agencies as long as restraint of trade was not clearly shown.

Patent Licensing. Holders of exclusive patent rights have the opportunity, through restrictive licensing to a limited number of manufacturers or through restrictive use of the patented product, of controlling the output and other uses of such patents. This differs from a patent pool only to the extent that one company allows others to use its patents or the patented product, whereas in the pool each company in the group contributes its patents for the use of the others.

In 1940 the Ethyl Gasoline Corporation was forced to discontinue many of its practices because the courts held that, in contracts made with refiners, it restrained competition and virtually forced the maintenance of established prices. It manufactured an anti-knock fluid, which was sold only to gasoline refineries that agreed to maintain certain price standards.

Tying Contracts. One form of restraint of trade that was practiced by the holders of patents on certain types of machinery was to insist that users of those machines also had to buy all of their supplies from the company owning the patent. Agreements in which such restrictions are enforced are known as *tying contracts.* At one time the United Shoe Machinery Company owned practically all of the patents on machinery for producing shoes. These machines were leased to other companies if they would agree to purchase leather and other basic materials from the United Shoe Machinery Company. Action was brought against this Company but, before a decision was reached, the tying contracts were voluntarily dropped from the lease agreements.

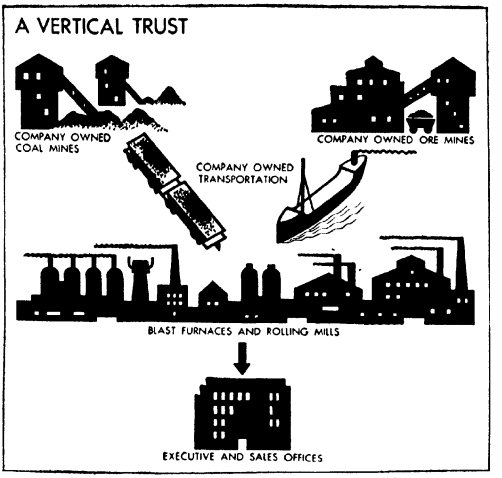
Collusive Bidding. Government agencies and other business organizations frequently allocate their purchase orders

on the basis of bids received. In some cases, identical bids have been received from all companies interested, indicating collusive bidding. In other cases, there has been some evidence that one company submitted the lowest bid after agreeing with other so-called competitors that they would submit higher bids. It may be difficult to prove collusive bidding, but sometimes the facts point strongly in this direction.

Gentlemen's Agreements. If representatives of several competing concerns get together for a conference and agree that it would be advantageous to raise prices and if such a price increase does take place, this would be called a *gentlemen's agreement.* The most famous operation of this informal method of combination was the Gary dinners, which were held between 1906 and 1909. Judge Elbert Gary, then head of the United States Steel Corporation, would invite executives of other steel companies to a dinner. At these affairs he spoke on conditions in the industry and indicated what the United States Steel Corporation was going to do in the future in regard to output, prices, etc. There was nothing secret about these meetings, and newspaper reporters were usually present. No discussion took place that would indicate that other companies were in agreement with the pronouncements of Judge Gary, but the result was that all steel companies followed the leader, and there was essentially no competition in the steel business.

Combination Structures In addition to the preceding classification of combinations, there is a distinction among them as to structure or the purpose for which they are organized. Whereas they all hope to secure larger profits through the reduction of competition or through the benefits of large-scale operation, the purpose under discussion refers to the kinds of companies that are combined. The result may be classed as a vertical, horizontal, circular, or complementary combination.

Vertical Combinations. A combination that groups two or more companies at different but related levels in the production or distribution of a product would be known as a *vertical combination.* If a mining company combines with a large com-

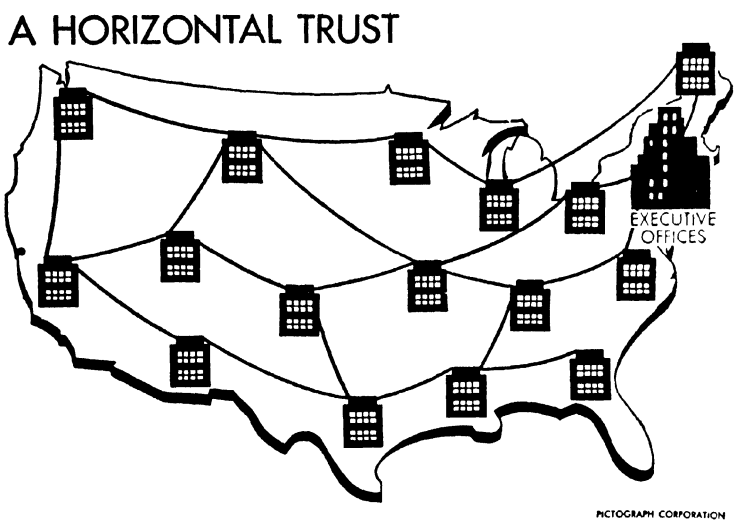


Pictograph Corporation

pany that hauls ore, or if a motion picture distributing concern buys a chain of movie theaters, such integration would be of the vertical type. A completely organized vertical combination would bring under one management producers of raw materials, transportation facilities, manufacturing corporations, and selling organizations. The Ford Motor Company provides a fairly good example of a vertical combination that controls most of the stages from raw materials to consumers. It owns mines, rubber plantations, lake boats, a railroad, foundries, a glass factory, a tire-producing concern, and manufacturing plants in Detroit; and it licenses dealers throughout the country. Although it does buy many parts from other producers, it is not dependent entirely on other business units for any essential goods or services.

The advantages of vertical combinations include assurance of a continuous supply of materials, which means a reduction in the total inventory that needs to be on hand at any stage in the manufacture and distribution of the article. Selling costs and profits at intermediate stages can be eliminated. Manufacturing processes can be co-ordinated among different producing units. However, vertical combinations also mean that everything depends on the ability to market the end product. During periods of lessened demand, some of the units may not be able to operate at full capacity, which means idle equipment and loss of economies that can be obtained from large-scale operations.

Horizontal Combinations. If many companies doing exactly the same type of business are combined, this would be a *hori-*



zontal combination. These could be mines, transportation companies, manufacturing plants, or selling organizations. The General Motors Corporation is an example of a horizontal combination, although it also includes some features of other forms. To the extent that the Buick Motor Company, Chevrolet Motor Company, Cadillac Motor Company, and so forth, were combined under one corporation, an illustration of a horizontal combination is provided. A chain of drugstores, restaurants, or lumber yards also illustrates this type of a combination.

Some of the economies available to horizontal combinations are the elimination of certain types of costs, crosshauling in many instances, and the general advantage of the best utilization of the entire capacity. On the other hand, there is a limit to possible economies where the units must be locally operated or where the products are so varied as to require separate promotional efforts. For the most part, the gains are reflected in the efficiency with which expert knowledge of only one problem can be applied on a large scale.

Circular Combinations. The association of different types of companies that are more or less in allied lines is known as a

circular combination. The different businesses may seem to bear no relationship to others, but there is usually some logical association. The Canadian Pacific Railway Company operates hotels, steamship lines, and a railroad. Standard Brands, Inc., mentioned previously in this chapter, combined coffee, baking powder, yeast, and other diverse food products.

Because so many different products may be involved in a circular combination, some of the usual economies are not available to such groups. Financing, advertising, engineering, distribution, accounting, and research centralization may all or partially be conducted on a more efficient scale than if the combination had not been organized.

Complementary Combinations. Sometimes two or more business operations that may seem diverse actually complement each other to the extent that they form a rather natural combination. For example, ice and coal businesses are frequently found under one management, although the two industries bear no particular relationship to each other. A great many undertakers operate furniture stores. Either the seasonal nature of the business or the amount of time devoted to one activity seems to allow for adding a second business that complements the first.

Large-scale complementary combinations frequently involve acquiring or organizing companies to dispose of by-products. Coke companies can sell gas, and vice versa. Meat packers have gone into the fertilizer business. In a few instances, the sale of by-products has become more important than the original article.

Types of Co-operation Combinations, whether formal or informal, are not the only means by which businessmen can get together for their mutual good. There are many common problems either in the same locality or in the same line of endeavor. Associations that aid businessmen need not result in any decrease in competition. On the contrary, agreements that may be reached often help to preserve fair competitive conditions. For example, many localities maintain a Retail Merchants Association. If this group decides that all retail stores shall be closed on Wednesday after-

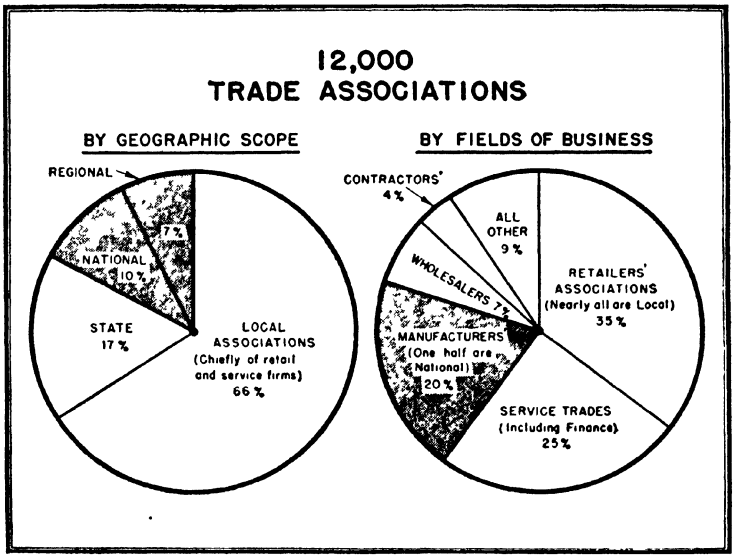
noon during the summer months, such a decision promotes equal competitive conditions, which could not be attained under individual action. "Dollar days" are also sponsored by this type of organization.

Chambers of Commerce. The Chamber of Commerce organizations, which flourish in most cities, are deserving of special mention. Members of a local organization are usually business and professional men who pay dues in order to support a secretary and his staff. This office engages in many activities to promote the community welfare and prosperity. It urges civic improvements and advertises the merits of its locality. Efforts are made to induce new business units to build factories in its area.

Local chambers of commerce and individual members form state organizations, which in turn support the United States Chamber of Commerce. Through research and lobbying activities, the interests of businessmen are presented to state legislatures and to the Congress. This organization, together with the National Association of Manufacturers, is generally recognized as the voice of business and industry. Considering the existence of other "pressure blocs" it is well that some organization can speak with authority for business.

Trade Associations. The most common example of worthwhile co-operation among businessmen engaged in similar industries or occupations is the trade association. These flourish in every conceivable field of business activity, and the total number runs well into the hundreds. Some are relatively small, but many have thousands of members and maintain a central headquarters and a sizeable staff. In all cases, the purposes are to promote the best interests of the members of a particular trade or industry through co-operative effort.

Trade associations are a form of combination as well as co-operation and, if the result of their joint activities might be construed as a conspiracy in restraint of trade, the offending association would be declared illegal. The American Hardwood Manufacturers' Association was indicted on a charge that it was engaged in illegal activities. Frequent meetings of the members were held at which prices and



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production were discussed and recommendations made for future conduct. This was called an Open Competition Plan, but the Supreme Court held that the association, by concerted action, curtailed production and increased prices, which lessened competition and restrained interstate commerce. However, the Maple Flooring Manufacturers' Association was given a clean bill of health on somewhat similar activities. This group, controlling 70 per cent of the finished maple flooring, distributed information on freight rates, and published statistics on production, inventories, and factors influencing production. Since these figures were available to everyone, and because no discussion of future production or prices took place at the meetings, the Supreme Court held that the Association was merely trying to help its members conduct their individual businesses in an intelligent manner.

These cases established a general pattern for the legal activities of trade associations, although other cases have also reached the courts. Activities now conducted by many trade associations include the following:

Arbitration
Cost Accounting
Credits and Collections
Education—Trade and Consumer
Employment Relations
Exhibitions
Foreign Trade
Insurance
Legal Aid
Legislation
Patents Cross Licensing
Public Relations
Publications and Periodicals
Publicity
Research—Market and Technical
Standards—Products and Business Practice
Statistics
Taxation
Trade Promotion
Traffic Bureau
Trade Relations

A few of the above are worthy of special comment. Legislative activities in Congress and in the state assemblies are important in protecting the interests of the members and in promoting laws to aid the industry or trade. The National Lumberman's Association, for example, would be interested in fighting building codes that would exclude the use of lumber and in promoting legislation to aid forest fire prevention.

Uniform accounting systems and other financial data are frequently supplied to members. The National Retail Hardware Dealers' Association publishes operating statistics on a composite basis. A member dealer can determine whether his office salaries, advertising expense, or other items are out of line with the average for the industry. Similar figures are available from most other associations.

Recently trade association activities have extended into the field of labor relations. Many members are not large enough to employ experts who have been trained in such subjects as collective bargaining, writing labor contracts, and settling labor disputes. One man in the employ of the association can serve the many members by giving advice, by circulating model union agreements, and by his presence at labor-management conferences.

Trade associations are an excellent example of what can be done to promote harmony and good feeling among the members of a particular trade or industry. Intelligent and decent competition is best for the public in the long run, and trade associations have done much to create such conditions. As long as joint action does not affect production or prices, trade associations should be encouraged in their activities.

QUESTIONS

1. What is the distinction between trusts in the broad sense of the term and in the more technical definition?
2. Why were bigness and badness linked so closely in the public mind, and what happened to change this attitude?
3. What is the difference between a merger and an amalgamation?
4. Since holding companies do not produce anything, why should they be allowed to exist?
5. Why is it possible for companies having interlocking directorates or community of stock interests to gain the advantages of a more formal method of combination?
6. Before World War II, Germany promoted the existence of cartels. Why are they illegal in the United States?
7. In many communities the price charged for a gallon of standard grade gasoline is identical at all stations. How do you account for this situation?
8. Which types of combinations as to purpose would seem to have the most economic justification?
9. Is it fair to allow chambers of commerce to pursue lobbying activities in state legislatures and in the Congress?
10. Trade association activities attempt to secure group action from their members. Is this not a restriction on the freedom of individual enterprise?
11. Would our economic system contain more competition if all forms of combination and co-operation were declared illegal?
12. Assuming that all forms of combination and co-operation were illegal, would prices to consumers be lower?

PROBLEMS

1. Company A dominates the field in the manufacture of product X, although Companies B and C also are engaged exclusively in turning out the same article. Officials of the three companies agree to combine and begin to explore all possible methods of unified action. At this point the largest stockholder of Company A, who holds the office of president of the corporation, refuses to consider any plan that will eliminate the corporate identity of his company or that will place it in a secondary position.

List (a) the types of combination as to form that cannot be used in light of the facts given, and (b) the types of combination as to form that would be acceptable to the president of Company A.

2. Assuming facts as given, and that all operating earnings are paid out as interest or dividends, what dividend rate will be paid to stockholders of Company H?

Company H has a capitalization of $400,000 in 3% bonds, $300,000 in 4½% preferred stock, and $300,000 in common stock. Assets consist of one half of the common stock of Companies L and M.

Company L has a capitalization of $2,500,000 in 4% bonds, $2,000,000 in 5% preferred stock, and $1,500,000 in common stock. Assets consist of one half of the common stock of Companies A, B, and C.

Company M has a capitalization of $1,000,000 in 4% bonds, $750,000 in 5% preferred stock, and $500,000 in common stock. Assets consist of one half of the common stock of Companies X and Y.

Companies A, B, and C each have a capitalization of $4,000,000 in 4½% bonds, $4,000,000 in 5½% preferred stock, and $2,000,000 in common stock. In the current year Company A earned $600,000, Company B $700,000, and Company C $800,000.

Companies X and Y each have a capitalization of $3,000,000 in 4½% bonds, $3,500,000 in 5½% preferred stock, and $2,250,000 in common stock. In the current year Company X earned $900,000 and Company Y $400,000.

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CHAPTER 34

FEDERAL REGULATION AND COMPETITION

Early Attitudes Originally, the attitude of government toward business was one of general indifference except for a few efforts toward support and encouragement. Usually it was consistent with the *laissez faire* philosophy—let business alone and it will function for the best interests of everyone concerned. Some steps were taken in the direction of encouraging investors to risk capital in new ventures. One of the earliest of these actions was the granting of patent rights for a period of seventeen years that, in some instances, practically guaranteed a monopoly for that period of time. Customs duties levied against importations prevented foreign goods from providing such stiff competition that infant industries would die before attaining maturity. In the case of railroads, outright grants of public lands and public money were made to companies willing to build extensions into sparsely settled areas.

This picture of the relations between government and business continued for practically one hundred years following the adoption of the Constitution. The United States was growing in territory and population, natural resources of raw materials were abundant, business units were small with a few exceptions, and there was plenty of room and opportunity for all. Government was content to limit its relations with business to promotional aids because increased business activity meant increased prosperity for this new nation.

Railroad Regulation One of the first industries to attain a vantage ground that was inimical to the public interest was the railroad. Encouraged by government aid, so many lines had been constructed in some areas that there was considerable competition for the available business. This meant that large shippers were able to secure lower rates, rebates, special allocations of cars, and other favors. In

order to make up revenues lost in the competitive territory, railroads charged all the traffic would bear in regions where one line provided the only means of transportation.

About 1870, the farmers of the Middle West became so incensed concerning the high rates generally effective for grain shipments that they organized the Granger Movement and insisted in their state legislatures that commissions be created to deal with the railroad problem. However, state commissions could regulate only intrastate transportation and the operations of railroads were chiefly interstate. The Federal Government is the only body authorized by law to control interstate commerce. The passage of the Interstate Commerce Act in 1887 was a recognition of the need for regulating some forms of business enterprise.

The 1887 law created the Interstate Commerce Commission and gave it the right to end rate discriminations, stated that rates were to be just and reasonable, and required schedules of rates and fares to be published. It also included a "long-and-short-haul" clause, which made it illegal for a railroad to charge a higher rate for a short haul than for a long haul under substantially similar conditions. Some railroads had been charging a low competitive rate between two points served by another line, but between cities not served by another carrier it was possible to charge a high monopoly rate. Although the Commission was not given the necessary authority to enforce the provisions of the 1887 Act and several adverse court decisions further weakened the law, it proved to be an important step in the Federal regulation of business.

The early recognition of the public utility character of the railroads and of the need for extensive regulation of common carriers in interstate commerce has continued to the present day. Important legislation concerning the powers and duties of the Interstate Commerce Commission was passed in 1903, 1906, 1910, 1913, 1920, 1933, and 1940. These acts, plus minor amendments, have given the Commission extensive control over every phase of railroad operation. Rates, service, valuation, security issues, consolidations, safety appliances, accounting, and many other phases of this industry are controlled by the seven commissioners, aided by a large staff of experts in many fields.

American Airlines, Inc

Air Transportation Is Subject to Federal Regulation

Other Transportation Regulations. Public interest in means of interstate transportation has been extended to pipelines and water, highway, and air transport. As early as 1906, the Interstate Commerce Commission was given jurisdiction over the interstate shipment of oil by pipelines. More recently, in 1938, natural gas mains that crossed state boundaries were placed under the control of the Federal Power Commission. Water transportation between states was placed under the control of the I.C.C. in 1940, although this Commission had always had the authority to fix rates involving joint water-rail interstate transportation.

The regulation of interstate busses and trucks was first recognized as a duty of the Federal Government with the passage of the Motor Transport Act of 1935. Previous to this time only state governments had regulated motor carriers, but so many interstate problems had arisen that the addition of some measure of Federal control became desirable. Under this Act, the Interstate Commerce Commission assumes power

over interstate motor transport carriers very similar to the extensive supervision that already existed for railroads. Under provisions of a "grandfather clause" all lines already in existence were to be allowed to continue, but new routes could not be opened until a "certificate of convenience and necessity" was secured. The extent of control varies for common, contract, and private carriers. *Common carriers* operate on regular schedules and offer service to the general public. *Contract carriers* hire their services for special hauls such as moving household goods from one state to another. Trucks and busses used by the firm owning them are known as *private carriers.*

Air transport is under the control of the Civil Aeronautics Board of the Department of Commerce. By the terms of the Civil Aeronautics Act of 1938, this board has the right to prescribe reasonable rates, to remove discriminations, to fix fair and reasonable rates for air mail, to register all aircraft, to license pilots, and to prescribe numerous safety regulations. Although regulation in this field is not yet equal to that effective for railroads, the great impetus given by World War II to air transportation will doubtless result in further legislation governing common carriers in the field of air transport.

Anti-Trust Legislation

At about the same time the railroads were becoming so powerful as to constitute a menace to the public, there arose a few big business units which, by means of combinations, attained similar monopoly positions. The approach to a solution of this problem provides an interesting contrast to that outlined for rail transport. As has been noted, the decision was reached to allow railroad monopolies to continue in business under governmental regulation. In the case of other industries, such as oil, sugar, whiskey, tobacco, and steel, the decision was to dissolve the combinations and to insist on a return to competitive conditions. Recognition of this distinction is fundamental to an understanding of all legislation regulating business. If it is in the public interest to allow a monopoly, rate and service regulation under governmental supervision inevitably follow. If the business is not considered a public utility in the broad sense of the term, then the legislative regulatory efforts are directed toward enforcing proper competitive conditions.

Sherman Anti-Trust Act. Public concern over the objectionable practices of trusts resulted in the enactment in 1890 of the Sherman Anti-Trust Law. The extent of opinion favorable to such a measure can be judged by the fact that the Act was passed by both houses of Congress with only one dissenting vote. It provided that "every contract, combination . . . or conspiracy in restraint of trade or commerce among the several states . . . is hereby declared to be illegal," and that "every person who shall monopolize or . . . combine or conspire to monopolize . . . shall be deemed guilty of a misdemeanor."

Although the Sherman Act was and is an important piece of legislation, it did not prove to be the complete answer to the problem of eliminating monopolistic practices in private industries. In the first place, some of the decisions of the Supreme Court of the United States weakened the effectiveness of the law. For example, in the E. C. Knight Company decision rendered in 1895, it was ruled that manufacturing was not commerce. This case had been prosecuted by the Attorney General in an effort to break up the sugar trust and the action was to prevent a proposed exchange of stock among the American Sugar Company, the E. C. Knight Company, and three other independent sugar refineries.

Another weakness was that ways were discovered to accomplish the same objectionable practices that had formerly been restricted to trusts and other forms of monopolistic organizations. The Gary dinners, for example, were not contracts or conspiracies in restraint of trade, and yet the effect of this form of a gentlemen's agreement was that steel prices were anything but competitive. Many other questionable practices were discovered by a Bureau of Corporations, which was created in 1903 by the Congress. This Bureau was chiefly a research organization and in this capacity performed a real service in uncovering unfair business dealings.

Clayton Anti-Trust Act. The Clayton Act was passed in 1914 to bolster the Sherman Act and to clarify its meaning. It was specific, whereas the former law had been indefinite. The Act stated that it was unlawful for persons engaged in interstate commerce "to discriminate in price between dif-

ferent purchasers of commodities . . . where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce." Exceptions could be made where such discrimination took into account differences in grade, quality, quantity, or cost, or where such discrimination was made in good faith to meet *bona fide* competition. The law also prohibited exclusive agreements "for the sale of goods, wares, merchandise, machinery, supplies, or other commodities . . . for use, consumption, or resale within the United States," if the result of such an agreement "may be to substantially lessen competition or tend to create a monopoly in any line of commerce."

Other provisions made interlocking directorates unlawful under specified conditions and prevented the purchase by one corporation of another corporation's stock if the effect of either of these practices was substantially to lessen competition or tend to create a monopoly. Individual officers of a corporation were to be deemed guilty along with the corporation in anti-trust suits successfully prosecuted. Also, labor unions and agricultural organizations were specifically exempted from the provisions of the anti-trust laws.

Federal Trade Commission Act. The Act that created the Federal Trade Commission was passed on September 26, 1914. The Clayton Act, described in the preceding paragraphs, became law on October 15, 1914, and the enforcement of many of its provisions was added to the powers already delegated to the F.T.C. It is interesting to note that the Congress was so determined to take action against monopolies and unfair trade practices that two very important laws on the subject were passed within a very short time.

The Federal Trade Commission Act provided that "unfair methods of competition in commerce, are hereby declared unlawful," and the five members of the Commission were empowered and directed to prevent business concerns from using such unfair methods. When, in the opinion of the Commission, the interests of the public would be served, it could issue a "cease and desist" order against the person, partnership, or corporation engaged in the unfair method of competition. Unless hearings before the Commission showed that the

complaint was not justified, the offender had to obey the order of the Commission or seek relief in the courts.

The Federal Trade Commission has sometimes been called the "policeman of the business world." In this capacity it probably functions effectively as a deterrent to many unfair actions that might take place if no one were around to catch the culprits. It also attempts to clean up conditions in an industry that is progressing into the trouble stage. By means of industry conferences, unfair trade practices can be discussed with representatives of all of the leading companies engaged in a particular business. Frequently these are called at the request of the industry, and the result is a voluntary agreement on the part of all to abandon past unfair trade practices. Individual conferences are also held with officials of companies against whom complaints have been made or who are engaged in practices that the investigators of the F.T.C. have referred to the commissioners. In many instances these organizations voluntarily agree to discontinue the acts for which they have been criticized, and no formal action becomes necessary.

Wheeler-Lea Amendment. Although the F.T.C. does try to settle disputes peacefully, whenever necessary it is willing to use legal force to ensure obedience to its rulings. The procedure for enforcing its cease and desist orders was greatly improved under the Wheeler-Lea Act of 1938, which amended the original Act of 1914. Under that amendment, such an order becomes final sixty days after being served on the offender unless he wishes to petition the Circuit Court of Appeals. If this is not done and the order is not obeyed, there is a fine of not more than $5,000 for each violation.

The Wheeler-Lea Act also added other important duties and powers to the Commission. The original Act stated that unfair methods of competition in commerce were unlawful. This part of the law was changed to read, "Unfair methods of competition in commerce, and *unfair or deceptive acts or practices in commerce* are hereby declared unlawful." In the first instance, it was necessary for the Commission to prove that the objectionable practices were related to competition. As the law now reads, any practice that may injure the public

is under the jurisdiction of the Commission. Furthermore, the false advertisement of food, drugs, cosmetics, and devices that might be injurious to health was specifically stated to be an unfair or deceptive act or practice.

Unfair Trade Practices. As matters now stand, the Federal Trade Commission derives most of its powers from the Federal Trade Commission Act as amended and the Clayton Act as amended. The main goal of the Federal Trade Commission Act and its amendments is the prevention and elimination of unfair trade practices. A few illustrations may indicate the direction such activities take. The Commission has ruled that it is unlawful to use the term "Irish lace" and "Irish crochet" on lace not made in Ireland, or to sell ready-made clothing as "tailor-made." It has also stopped concerns from falsely representing that their products are endorsed by the United States Government or any of its branches, or using a name containing the words "manufacturing company" when no production operation was undertaken. Secret commissions, lotteries, circulating false rumors about a competitor, and stating that the products of a competitor are injurious to health are all listed as unfair selling methods. These examples show the great care and detail exercised by the Commission in its effort to maintain a business world in which fair-minded and honest men and women can compete on equal terms.

The latest addition to possible unfair or deceptive trade practices is contained in the Wool Products Labeling Act passed in 1940. Under this law, every woolen garment must be stamped to show the total fiber weight of the wool; whether it is new, processed, or reused; the percentage of nonwool filling; and the name of the manufacturer. This Act is commonly called the "truth in fabrics law."

Anti-Monopoly Powers. The power derived from the Clayton Act as amended covers practices that have the nature, capacity, or tendency to create monopolistic conditions. One of the most important of these is *price discrimination* between buyers of like quantities or at the same level of distribution. The Robinson-Patman Act, which was passed in 1936 to amend the Clayton Act, dealt with this subject and has been described in Chapter 14. It was aimed at the chain stores who were

being favored by certain manufacturers with such low prices that other retail units were unable to compete on a price basis. Other methods of co-operation and combination, which have been described in some detail in the previous chapter, are also subject to scrutiny by the F.T.C. A constant watch is kept to see that all forms of "getting together" on the part of competitors do not cross the rather indefinite boundary line between legal and illegal territory.

One practice formerly considered illegal by the Commission now has sanction by law. Some manufacturers formerly attempted to control the retail sales price of their products by contracts or by such devices as "blacklists" of firms that did not maintain the desired retail price. These methods were illegal until the Miller-Tydings Act amended the Sherman Anti-Trust Act to exempt contracts for resale price maintenance in states that passed so-called fair trade laws. Chapter 14 dealt in part with this problem.

Pure Food and Drug Act. As early as 1906, the Federal Government found it desirable to enact legislation singling out the food and drug industries for special regulation. The Pure Food and Drug Act prohibited the shipment in interstate commerce of any food or drug that was adulterated or misbranded. The enforcement of this law was placed in the hands of a Pure Food and Drug Administration, which is now a part of the Federal Security Agency. In 1938, the Copeland Act was passed, amending the original law in many respects, including the addition of cosmetics and therapeutic devices.

Powers of the Administration include insistence on sanitary methods of manufacture, purity of content, and proper labeling. The package must show the accurate weight, ingredients in proportion, and whether coloratives or preservatives have been used. Drugs must be labeled as to use and, if the drug is habit-forming, a statement to this effect must be included. New drugs cannot be distributed until they have been proved safe to use. Heavy penalties are provided with a limit of a fine of $1,000 and/or imprisonment for one year for a mere infraction of the law, and maximums of $10,000 and imprisonment for three years for deliberate intent to defraud or mislead.

Other legislation has given the Food and Drug Administration the power to control adulteration of insecticides, labeling of caustic poisons for household use, and maintenance of standards for imported tea and silk. It might be added that food products are also subject to some other forms of regulation by different agencies. For example, the Federal Alcohol Administration requires special labeling of alcoholic beverages, and the Bureau of Animal Husbandry of the Department of Agriculture inspects meats. The Bureau's purple stamp indicating the proper grading of many cuts of meat is familiar to housewives everywhere.

National Industrial Recovery Act

In 1933, the United States was experiencing the depths of a serious depression. At that time the Congress passed two laws designed to aid recovery: the National Industrial Recovery Act for business, and the Agricultural Adjustment Act for agriculture. Both were subsequently declared unconstitutional by the Supreme Court of the United States, the N.I.R.A. in 1935 and the A.A.A. in 1936. However, an examination of the National Industrial Recovery Act and its application for a period of approximately two years is rewarding to the student of business.

The N.R.A., as it was called, provided for *codes of fair competition* to be written for each trade or industry, subject to the approval of the President. The anti-trust laws were not to apply to such united action despite agreement to sell at a markup over cost and to eliminate all forms of cutthroat competition. Industry, in return for these privileges, had to include in each code "that employees shall have the right to organize and bargain collectively," and "that employers shall comply with the maximum hours of labor, minimum rates of pay, and other conditions of employment, approved or prescribed by the President." Once a code was adopted for a particular industry, a fine of $500 a day was prescribed for offenders. Goods produced under a code were identified by a "blue eagle," which played a prominent part in all publicity released by the N.R.A.

The codes were not particularly successful, and it is generally agreed that the law would have been repealed if it had

not been declared unconstitutional. The individual was forced to yield to group action, frequently dominated by the large units in the industry. Hours of operation, production quotas, price policies, and labor relations were removed from the sphere of individual treatment. Competition, instead of being fostered by codes of fair competition, practically ceased to exist.

New Deal Legislation Following the decision on the part of the Supreme Court that the National Industrial Recovery Act constituted an improper delegation of legislative power to the President, numerous laws that sought to secure some of the broad objectives originally contained in the codes were introduced and passed. Other objectives were also sought by various legislative enactments. Encouraged by a change in membership and attitude of the Supreme Court, the Congress passed and the courts upheld an extensive list of acts affecting business. Some of the more important laws covered many phases of labor, finance, and specific industries.

Labor. It will be remembered that the N.R.A. specifically required in the codes of fair competition provisions favoring collective bargaining, maximum hours, and minimum rates of pay, and other rights for the laboring group. Important New Deal labor legislation includes the following laws.

(1) National Labor Relations Act (1935). This law guarantees labor the right to organize and bargain collectively and defines unfair labor practices. The provisions of the Act are enforced by the National Labor Relations Board. See Chapter 10 for a discussion of the Act.

(2) Social Security Act (1935). There are three important parts to the Social Security Act as it was passed in 1935 and amended in 1939. The best known provision is that of old-age pensions to retired employees, based on contributions that they and their employers have made. A nation-wide system of unemployment insurance was provided, but the carrying out of this provision is left in the hands of the forty-eight states. Chapters 32 and 33 discussed the rates for pensions and unemployment insurance. A third feature of the Act is

Federal subsidies and grants-in-aid to the states for crippled and dependent children and other forms of child welfare, vocational rehabilitation, aid to the blind, and public health generally.

(3) Walsh-Healy Public Contracts Act (1936). This law provides that a person contracting to sell goods to the Federal Government and its branches totaling over $10,000 must specify that he has not hired any person for more than 40 hours a week or 8 hours a day, that he has paid the prevailing wage in the industry, and that he has not employed males under sixteen years of age and females under eighteen years of age. Since the Government is one of the best customers of thousands of industries, this law has been quite effective in securing certain reforms in the field of labor that had not been possible through other legislation.

(4) Fair Labor Standards Act (1938). The Wages and Hours Bill, as this Act is popularly known, provides maximum hours of employment and minimum rates of hourly pay for all workers of private industries whose products enter into interstate commerce. Minimum rates of pay advanced from 25 cents an hour to 40 cents an hour over a period of seven years, and maximum hours of work dropped from 44 a week to 40 a week within three years. Overtime is permitted as long as it is paid for at one and one-half times the regular rate. Provisions for child labor are also included, which prohibits the employment of children under fourteen and limits the occupations at which children from fourteen to sixteen and sixteen to eighteen may work.

(5) Miscellaneous. The Byrnes Anti-Strikebreaker Act passed in 1938 prohibits the interstate shipment of strikebreakers. The Motors Carrier Act of 1935 authorizes the I.C.C. to determine maximum hours of work for truck and bus drivers engaged in interstate commerce. The Selective Service Act of 1940 provides that employers must rehire veterans of World War II who entered military service, if such a request be made within forty days after discharge. The veteran is to be restored to his old job or one equal to it and is to regain a seniority status equal to that which he would have acquired if he had remained on the job.

Finance. The right and duty of the Federal Government to provide a stable and safe currency system was recognized at the time the Constitution was written. In performance of this obligation the Federal Government has also taken steps to control abuses that have crept into the financial system to the detriment of the general public.

(1) Federal Deposit Insurance Corporation Act (1933). This law provides for the insuring of deposits up to $5,000 for each depositor in any bank that joins the Federal Deposit Insurance Corporation. Chapter 21 discussed this plan.

(2) Banking Acts of 1933 and 1935. One of the features in these Acts is the provision that member banks of the Federal Reserve System are forbidden to have investment affiliates or to participate in the underwriting of new securities other than United States Government issues. This eliminates the evils inherent in having both commercial and investment banking interests combined in one company. For example, the investment advice given to customers by officers of the bank would always be colored if the bank also had securities available for sale.

(3) Securities Act of 1933. The main purpose of this law is to make available to prospective investors accurate and complete information about the financial affairs of the company whose securities are to be available for purchase. See Chapter 22 for a discussion of this Act.

(4) Securities Exchange Act of 1934. The regulation of organized exchanges and control over credit used for speculative purposes are the main features of the Securities Exchange Act. This law is discussed in Chapter 22.

(5) Wagner-Lea Law (1940). This law provides that the Securities and Exchange Commission can regulate investment trusts and also provides a partial control over investment counselors and advisory services. Abuses that have crept into this field are prohibited. These include payment of dividends out of capital without stating the source, restrictions on managerial fees and commissions, and intercompany dealings in securities.

Specific Industries. The interest of the Federal Government in conservation has led to establishment of special regulatory provisions over the coal and oil industries.

(1) Bituminous Coal Act of 1937. Because the coal business was in such a demoralized state, an effort was made in 1935 to obtain the protection of codes of fair trade, which had been available under the N.R.A. However, the Bituminous Coal Conservation Act was declared unconstitutional within a year. In 1937 another similar law was enacted, and this Act was upheld by the Supreme Court. It provided for minimum and maximum prices and marketing rules for members of the industry who agreed to code provisions.

The enforcement of this law is in the hands of a Coal Division, which is assigned to the Department of the Interior. Most of the work of this Division has been to determine costs of various grades of bituminous coal at member mines and to fix prices. Some progress has also been made in promoting co-operative marketing agencies and in listing unfair methods of competition.

(2) Connally Act of 1935. Practically all of the regulations for the conservation of oil have come from the states. These laws, in general, provide for restricted production. The primary reason for this is to conserve the oil, although the matter of supply and prices has also been present. One of the difficulties encountered by the states in enforcing their measures was the lack of control over the oil once it found its way beyond state borders. The Connally Act of 1935 prohibits interstate commerce in oil produced in excess of state production quotas. It is generally known as the "Hot Oil" act because this is the term applied to oil that is withdrawn from wells in excess of predetermined quotas. The Act is administered by a Federal Petroleum Agency and a Federal Tender Board.

World War II With the outbreak of World War II in Europe, the Federal Government undertook various measures to aid in the national defense program. At first industry and the public were asked to co-operate, which they did most willingly. The Selective Service and

Training Act of 1940 was passed, and this law gave the President the right to buy without regard for the usual competitive bids, to force any industry to accept a Government order, and to commandeer or rent plants that might be needed. After December 7, 1941, over five hundred laws were enacted on an emergency basis that placed a measure of power in the hands of the President, and in the various agencies that were created, to an extent never before equaled. Worthy of special mention are the First War Powers Act dated December 18, 1941, the Second War Powers Act approved March 27, 1942, and the Emergency Price Control Act of 1942. A complete listing of the enabling acts and of the boards created would be confusing because of the many changes that took place. In general, the Government's control over business may be summarized as follows:

(1) Production. Under a system of allocation of raw materials, all business was regimented for maximum war production. Although a great deal of voluntary compliance was requested and received, actually the need for fundamental raw materials was so widespread that very few manufacturing operations could be conducted except along lines approved by Governmental authorities.

(2) Labor. Many workers were "frozen" in their existing occupations by the requirement that workers previously employed could not change jobs without getting a referral card from the United States Employment Service. This agency could control the conditions under which such cards would be granted.

(3) Prices and Rationing. The Office of Price Administration was given the authority to establish "ceiling" prices and to ration food, gasoline, tires, and shoes. Although there were some exempt items, every person and practically every business felt the impact of the O.P.A. rules and regulations. Price competition ceased to exist in most lines of business, and rationing was necessary in certain fields to distribute available goods to all of the people.

(4) Profits. Despite the fact that high excess profits taxes were levied on corporations and high surtaxes on individual

incomes, the Government reduced the profits of manufacturing corporations through renegotiation of war contracts. If the original price per unit of an airplane motor, for example, had been contracted for at $50,000 and it was later discovered that mass production so reduced the cost that a price of $30,000 would have been more reasonable, the original contract was renegotiated to the lower figure.

Wartime controls were justified during the time actual fighting was in progress, and most businessmen did not question the authority of the Federal Government to impose as many and varied restrictions and regulations as furthered the war effort. It was generally agreed that these should be relinquished just as soon as feasible, and this policy has been in effect. In order to avoid disastrous inflation it was necessary to continue price controls, sugar rationing, and some production controls for several months following the cessation of hostilities.

Competition The Federal Government has always been a competitor of private business in certain areas through the ownership and operation of facilities. The postal service was provided for in the Constitution and competes with other forms of transporting goods and messages. Its parcel post service, money order and postal note sales, and postal savings particularly are in competition with private businesses engaged in the same type of activities. The fact that it operates at a loss means that private agencies must compete against a Government department that is subsidized to the extent of such losses.

The United States owns at least two railroads. One of these, The Alaska Railroad, was built to aid in the development of this territory because private capital was not willing to undertake a venture that showed little or no signs of becoming profitable. The Panama Railroad was acquired at the time the Canal Zone was purchased and, unlike The Alaska Railroad, has been very profitable. This railroad also owns the Panama Steamship Line, which has continued in business on a modest basis.

The Canal Zone proper is an interesting territory in that all business units are owned and operated by either the rail-

road or the canal administration, or by both. Dock facilities, apartments, restaurants, grocery stores, farms, and public utility services are all under the direction of Government employees. In general, operations have been very successful and satisfactory to the consumers. The lack of competition in fields normally regarded as private business has not been a deterrent to good service at low prices.

The Inland Waterways Corporation was organized in 1924 to operate barges on the Mississippi and Warrior Rivers. It has not been profitable but has affected the railroad rates for hauls between points that can be reached by land or water. Another form of water transportation has been the ships built by the Maritime Commission, as it is now called, which are operated in part by the Federal Government. Many of the ships built were sold and others leased, but the Commission has never been able to dispose of all of the ships owned. Operations have never proved profitable, but the amount of money lost has probably been a wise investment in building up a merchant marine flying the flag of the United States and in keeping shipyards busy.

There are many other government-owned industries that compete with private business, and examples could be cited into the hundreds. The Government Printing Office in Washington, D. C., is called the largest printing plant in the world. The mints and the Bureau of Engraving perform a function that private business could handle. The operation of feeding and housing facilities in the national parks places the Federal Government in the recreation and travel business. The United States Army has always owned and operated a few arsenals, and the United States Navy owns and operates some shipbuilding and repair facilities.

Competition in the field of finance was discussed in Chapter 21. It is probably a safe conclusion that in this field and in all of the others there is no marked tendency to extend the amount of competition afforded by the Federal Government. Although there are some people who would like to see government ownership and operation extended into many industries, the chances are that private business will continue to be the dominant factor in our industrial and economic life. The ownership of hydro-electric plants may be an exception.

Federal Assistance to Business Not all of the activities of the Federal Government as related to business are directed at regulating or restraining industry. Many aids are available. The existence of patent, copyright, and trade-mark laws and regulations are very helpful to business units. The first two protect inventors, authors, and the industries that use the fruits of their labors; the last allows companies to enjoy the advantages of names, such as Nabisco and Kodak, which have been built up through advertising. Customs duties have protected many industries against foreign competition that, in some cases, would have been injurious. The Export-Import Bank has assisted in foreign trade, as has the Department of Commerce in co-operation with the State Department.

The Bureau of Mines, the Coast and Geodetic Survey, the Bureau of Fisheries, the Weather Bureau, and the Bureau of Standards are a few illustrations of departments of the Federal Government that render valuable services to business. The Bureau of Standards is particularly valuable in the field of weights and measures, and standardization of products. The number of milk bottle sizes, for example, has been reduced from forty-nine to nine by voluntary acceptance on the part of producers following recommendations made by the Bureau.

Statistical information is also available from numerous Government agencies, as was noted in Chapter 26. Despite the adverse feeling on the part of many businessmen, the Federal Government is interested in helping to maintain the private enterprise system at a high level of performance. At various times regulation of competition may prove to be unwarranted in certain fields, but even the most rugged individualist would not want to see all forms of control removed.

QUESTIONS

1. To what extent does the Interstate Commerce Commission regulate the railroads?

2. What other forms of transportation are regulated by the Federal Government, to what extent, and by which agency?

3. What were the main purposes and chief provisions of the Sherman Anti-Trust Act?

4. Why was it necessary to enact a second anti-trust law?

5. From what laws does the Federal Trade Commission derive its powers?

6. Give some examples of business practices that the F.T.C. might rule to be unfair or deceptive.

7. Should meat packers be subject to inspection by the Federal Government? If so, why?

8. What were the main objectives in the several laws covering labor passed between 1935 and 1938? Was such legislation desirable or necessary?

9. What conditions existed in the financial world that caused the Congress to enact regulatory measures in this field in recent years? Was such legislation desirable or necessary?

10. During World War II production and consumption reached new high levels. Does this mean that a regimented economy is superior to the free enterprise system? Why?

11. Should the Government compete with private business through public ownership of various types of enterprises?

12. Do you believe that Government operation is more efficient or less efficient than private management of commercial ventures?

13. Viewing the picture from all angles, would you say that governmental regulation is helpful or harmful to business activity?

14. Most government aids to business are free or rendered at a very low cost. Should business concerns be charged reasonable fees for services requested?

PROBLEMS

1. Mr. Guy Altermann, a farmer, has made such a fine local reputation selling sausage, hickory-cured hams, and other smoked meats, that he decides to expand his operations to several adjacent states. He buys some trucks to haul his produce and secures some dealers in several cities. Each one is forced to promise that he will sell the meat furnished at a standard price to be established by Mr. Altermann.

An advertising campaign is undertaken featuring a statement that the Altermann products had received the approval of the United States Army, as sales had been made to this source during the war. Orders pour in and it becomes necessary to mix soybean mash into the sausage and to cure hams by means other than hickory smoke in order to meet the demand.

What Federal laws may affect Mr. Altermann on the basis of the facts given?

2. Each of the following industries is subject to some degree of control by a Federal commission, bureau, division, board, administration, or agency, if interstate commerce is involved. Indicate in each case the name of the Federal body that would have jurisdiction.

(a) Railroads
(b) Drug manufacturing
(c) Meat
(d) Advertising
(e) Highway transport
(f) Natural gas
(g) Air transport
(h) Wool garments manufacturing
(i) Bituminous coal
(j) Water transport
(k) Alcohol
(l) Oil production

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CHAPTER 35

PUBLIC UTILITIES

Nature of Public Utilities No one is prepared to say exactly what is and what is not a public utility. Generally speaking, gas, water, telephone, and electric service companies plus street railways or busses comprise the industries classed today as public utilities. Railroads are also public utilities in the broad sense of the term, but they are usually given a separate classification. Other present-day businesses sometimes included in the public-utility classification are telegraph, cold storage, steam heating, radio, and sewage disposal companies.

At various times other industries have been subject to governmental regulation of the rates that they were permitted to charge for their services, which is one of the signs that an industry is considered to be a public utility. In a very famous legal case, Munn et al. versus Illinois, the Supreme Court of the United States upheld an Illinois law that regulated the charges that could be made by grain elevator operators in Chicago. This decision was handed down in 1877, and the opinion cited many other instances when private property had become affected with the public interest. These included the regulation of rates of wharfage at private wharves, the sweeping of chimneys, and the weight and quality of bread. None of these businesses are now considered as belonging to the public-utility field.

Characteristics of Public Utilities An examination of some of the chief characteristics of public-utility companies will explain, in part, why they are placed in a separate category. These characteristics provide the justification for a state or the Federal Government to regulate a private industry to the extent of establishing the prices it may receive for its services and to prescribe the quality and quantity of such service.

Natural Monopoly. One of the fundamentals of our economic system is a reliance on competition to determine prices

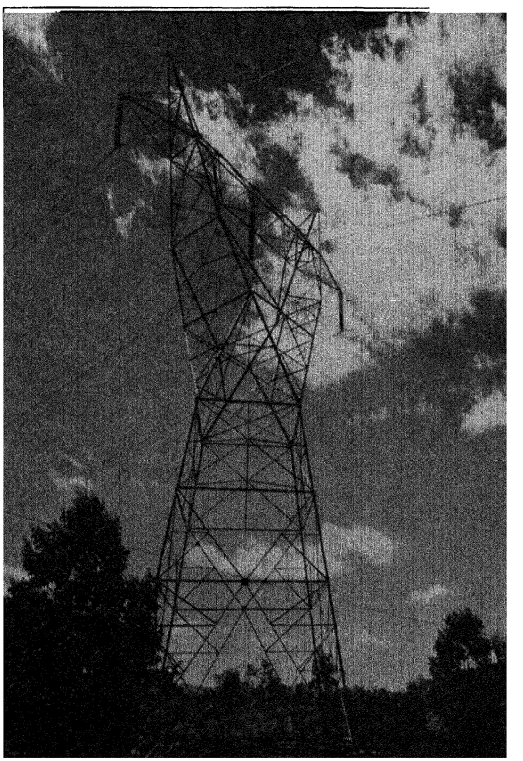
Public utilities are characterized by the need for large-scale operations in order to operate efficiently. Electric current produced by water power can be very cheap, but there would be no incentive to build a hydroelectric plant unless a large volume of business could be secured. A telephone company cannot afford to erect a line one mile long to serve a single customer but can for ten or fifteen outlets.

Large Investment. Most public utilities require a large investment in plant and equipment before any operations can begin. The cost of building a dam to secure hydroelectric power or of installing tracks and trolleys and of buying cars and repairing equipment for a street railway is tremendous. It would not be economical to duplicate such facilities in any one area unless the volume of business available was exceedingly high.

The amount of capital invested in public-utility operating companies has been estimated at more than 22 billion dollars. The consolidated assets of the American Telephone and Telegraph Company alone approximate five billion dollars.

Steel Tower for Transmission Lines

The large investment in equipment that is required by an electric service company makes it uneconomical for more than one producer to serve the same area.



Large Overhead. As a direct result of a large investment in plant, equipment, and other fixed assets, public-utility operations are characterized by a large overhead. Much of this is in the form of depreciation on the fixed assets owned, plus repairs and upkeep. Labor costs and other out-of-pocket expenditures are frequently low, as it takes, for example, only a few employees to handle the controls of an electric generating plant. This means that utility operating costs are predominantly fixed rather than variable and, if consumers are to enjoy low rates, a large volume of business is necessary.

An oversimplified example may clarify this overhead problem. If a water service company has an investment of $10,000,000 in fixed assets on which an average depreciation rate of 3 per cent is effective, the overhead burden for this item is $300,000 annually. If the cost can be spread over a 300,000,000 gallon output, one mill per gallon will absorb the depreciation charge. However, if sales are only 30,000,000 gallons, the amount of this item of overhead will remain the same, but one cent a gallon will enter into production costs.

Special Privileges. Another characteristic of many public utilities is the right to secure special privileges from governmental units. These usually take the form of franchises or the right of eminent domain. A franchise will be granted by the elected officials to a gas company, for example, giving it the exclusive right to lay pipes under the city streets and to serve the community for a specified number of years without any threat of competition. When the franchise expires, negotiations are conducted for its renewal. Frequently, there is no competing company available, and public ownership would be the only alternative to a renewal.

The right of *eminent domain* is the power of a government to take private property by the payment of a fair price that, if necessary, will be determined by a court. This privilege may be extended to telephone, telegraph, gas, electric service, and other quasi-public companies. For example, many of the long-distance electric transmission lines run overland on a straight line between two points and make use of private property for the erection of support towers regardless of whether or not such use of the land is agreeable to the owner.

Regulation of Public Utilities As noted in the last two chapters, monopolies in most fields of business are illegal. If this were not the case, the public would suffer from resulting high prices and low standards of service. When it is decided that the public can be best served by a monopoly, as is the case with public utilities, a method must be devised to protect the consumer against the practices that are available to monopolies. This has taken the form of regulation by some governmental unit. Part of the price that a public-utility industry must pay for special privileges, including monopoly rights, is to be subject to regulation much more extensive than can be legally imposed on a private industry.

Because of the local nature of many public-utility services, it is natural that municipalities and states were the first governmental units to create rules under which operations had to be conducted. Although the Federal Government has now entered the field, such action is of recent origin. Most of the regulation is now done by the states rather than by municipalities, because cities were unable to cope with the problem. The only method available to cities was to incorporate specifications into the franchise, and this did not prove satisfactory in light of conditions that frequently changed during the life of the franchise.

A result of having forty-eight states enact legislation on this subject is a wide variety of laws. However, the general pattern is to create by legislative enactment a public utility commission, and to invest it with certain powers over the public utilities that operate within the state boundaries. The extent and direction such supervision may take varies among the states as does the activity of the Commission in asserting its rights. The most common subjects of concern are service and rates.

Service Regulation. Several features of the problem of service might not be apparent to a casual observer. The public takes most of these for granted without recognizing that its best interests are being protected by the commission. Some of the directions that service regulations may take follow.

Entry into Public-Utility Field. A public-utility company cannot enter the field in any locality without first of all

securing permission from the commission. This usually takes the form of a *certificate of convenience and necessity.* If a company is formed to operate a bus route between City A and City B, a distance of fifty miles, it would need to secure a certificate from the state regulatory body before operations could begin. If the bus were to operate on the city streets of a municipality, it would also be necessary to secure a franchise from the local authorities.

There are good reasons why it is desirable to control entry into the public-utility field. If a company is serving the territory adequately, a competitor would eliminate the advantages the monopoly formerly possessed. In the long run, the public would suffer from the inefficiencies of competitive rather than single, large-scale operations.

Extension and Abandonment. A public utility usually may not extend or contract the service it renders in any particular territory without first securing approval from the state commission. In the case of extension, problems similar to those mentioned above in the matter of entry might be created. It is interesting to note that some commissions have the right to order an extension of service where such a move would be economically sound and of benefit to the public served. An electric-service company, for example, might be ordered to extend its lines into a rural area if enough customers were available for profitable operation of this addition.

Partial or complete abandonment of service is also restricted by the commission. If a company is losing money, it can, of course, liquidate. If it is losing money on one of its operations or on a particular extension of its service but is earning an over-all profit, it may not abandon the losing service without commission approval.

Service without Discrimination. A public-utility company cannot choose its customers or render different classes of service to like users. Every person whose residence is on a street that carries gas, telephone, and electrical connections has a right to demand the use of these services. Furthermore, he is entitled to the same service and rates as exist for other like users of the services. If a utility is granted the exclusive right to serve a certain area, it must do so without discrimination.

This feature of service is subject to a considerable amount of interpretation by state commissions. If a resident rents a telephone and does not pay his bill, the utility company has the right to remove the instrument and discontinue the service. If a water main has already been tapped up to the limit of its capacity to serve the connected outlets, the utility would not be ordered to render a service that it could not do except by installing a new or duplicating main. In other words, the utility must render equal service within limits of reasonableness.

Standards of Service. Most public-utility commissions have the right to insist on certain minimum standards of service. A bus route must maintain regular schedules, which means that equipment and drivers must be available to meet published timetables. The heating value of gas furnished to homes cannot be allowed to fall below established minimums. Water must be pure, and the pressure must be maintained in order to insure protection against fire losses.

Other types of standards are also required. The utility must be safe for the user. Busses and street railways must be equipped with proper safety devices, for example. Meters for gas, water, and electricity must be accurate, and the customer can usually secure an inspection by the commission if he is willing to pay a small fee. Complaints must be handled promptly. If a service has been suspended, even for a good reason such as a storm, it must be restored just as soon as practicable.

Rate Regulation. Of prime importance to the public utility and to the public that uses its services are the rates charged. Because these companies are monopolies, it would be possible, without rate regulation, for the utility to charge exorbitant rates for services rendered. Whether or not this practice would produce maximum profits might be open to question due to the probable reduction in demand for many services if prices were high. Regardless of the logic of low prices to secure a high volume output, the fact remains that all states but one consider it necessary and desirable to regulate the rates that public utilities under their jurisdiction may charge for their services.

As a general working principle, commissions have tried to establish rate structures that would permit each public-utility company to earn a fair return on a fair value of its property. This follows a line of argument adopted by the Supreme Court of the United States in a decision that read, in part, as follows: "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties."

Percentage of Yield. It is extremely difficult, if not impossible, to determine what is a fair rate of return. Various utility commissions have found it necessary to state a definite percentage, and this has usually varied from 5 to 9 per cent. A 6 per cent rate has probably been used more than any other, although in recent years the tendency has been toward an even lower figure.

Of course, once a rate of return is established, there is no guarantee that the return will equal exactly the rate because of fluctuations in business conditions, and other changing and variable factors. If operations produce a loss or a very low rate of return, the company can apply for an adjustment in rates. If the commission should refuse to grant such a request, the courts on an appeal would probably decide that the allowed rates were too low. On the other hand, if operations result in a high rate of return, the public will soon bring pressure to bear on the commission to reduce the charges.

It has been charged, and with some truth, that there is no incentive for efficient management of public utilities. If a particular company finds many ways to economize without decreasing the scope of its operations, the result should be a higher profit. As soon as the commission notes the increased earnings, lower rates may be ordered. On the other hand, inefficient operation may produce such a low yield on value that the company feels justified in asking for an increase in rates.

The solution to the above dilemma has been partially worked out by the requirement of most state commissions that uni-

form accounts be kept and that reports be made at periodic intervals. If one company seems to be spending more for certain items than other similar organizations, the commission can disallow the added expense when it considers rate revisions. Excessive salaries paid to officers, high depreciation charges, the writing off of capital expenditures, and payments made to other companies in the same holding company are examples of expenses subject to close scrutiny.

Fair Value. Assuming that a fair rate of return has been determined, it must also be decided what is a fair value of the public-utility property, which is used and useful for the public good. This involves placing a price tag on every item owned by the company that can reasonably be said to be essential. For example, an electric-service company frequently owns more production facilities than are normally used. Such "stand-by" equipment, as it is called, is available should an unusual peak load be created at any time. Obviously, this is necessary and desirable. On the other hand, if a public utility owns and operates a vacation resort for its employees, a question might be raised as to whether the cost of such facilities was necessary and should be included in the fair value of the utility properties.

Disputes involve not only the items to be valued, but the method of arriving at this value. Two experts, both perfectly sincere, may arrive at fair-value figures that are as far apart as $100,000,000 and $200,000,000. Usually, the commission is supporting the claim that the lower figure is correct, and the experts representing the company have agreed upon the higher amount. If a return of 6 per cent is involved, the company has good reason to fight the commission and take its case to the courts.

The reason for these wide variations in value is the lack of agreement as to the method that should be used for arriving at the true value. Some of the methods used, all of which have been approved by courts under one condition or another, are as follows:

(1) Original Cost Less Depreciation. This method makes use of book values, assuming that the actual cost of the

properties now in use has been properly recorded and that depreciation has been charged on a consistent basis in accord with generally accepted accounting principles. It is the value that private corporations place on fixed assets according to their published statements.

When this method is used, depreciation rates have an important bearing on the net value of the older utilities. A variation of 1 per cent or less could amount to millions of dollars over a long period of time. This means that the depreciation rates used need to be determined just as accurately as is humanly possible.

(2) Prudent Historical Cost. A question can be raised about whether or not the public should suffer from a poor purchase made by a particular utility. For example, an electric-service company bought a local installation because it wished to add this operation to its network of lines. Considerable resistance was encountered in making this purchase, which was finally overcome by offering twice what the local plant really was worth. Under the prudent historical cost theory, the utility would not be allowed to include more than the fair value of its purchased property regardless of the amount actually paid.

Depreciation is charged against original values as measured by the prudent historical cost in exactly the same way as against original cost. The only difference would be the base against which the rate is figured.

(3) Reproduction Cost New, Less Depreciation. In a period of rising prices the utilities try to bring reproduction cost new, less depreciation, into the picture. The method used is to value all of the assets now in use at their current purchase prices, and to substitute these values for the actual costs. The argument for this system is not without some justification. Why should Area A enjoy lower rates than Area B simply because a utility was organized in A at a time when prices were low, and in B at a time when prices were high?

It should be added that in computing reproduction cost new, less depreciation, no utility wants to lose whatever value it has been able to establish as goodwill as an original or prudent historical cost. This and any other values that may be attached to a company as a "going concern" are extremely

difficult to determine as a reproduction cost with any degree of accuracy.

(4) Cost of Reproducing the Service. This method is similar to reproduction cost new, less depreciation. It differs in that technical improvements that have taken place over the years are considered so that, instead of reproducing the original installation, costs are figured on a modern plant that would be capable of rendering exactly the same service. This method has much to be said in its favor from the standpoint of the public, but it is not usually given much consideration by the courts because it does not attempt to measure the value of the assets actually owned.

(5) Value of Securities. One of the easiest methods of arriving at the value of a public utility is to determine, on any given day, the market value of all securities outstanding. Assuming that bonds, preferred stocks, and common stocks are all listed on exchanges, it would not take anyone very long to determine the value of the utility as measured by the prices investors were willing to pay for its securities.

There are several objections to this method. Although control over security issues is more complete now than in earlier years, this does not help matters for utilities that have been in existence for a long time. In many instances, for example, stocks were given for promotional services, which means that no measurable assets were received when the stock was issued. Also, the market prices of securities may fluctuate widely between one month or year and another, and it would be difficult to decide on a date to be used for valuing the public utility by this method that would be fair to the utility and to the public.

Rate Differentials. As should be obvious from the foregoing discussion, the determination of the proper charges that a public utility should be allowed to make is an extremely difficult task. Despite all of the many complications, the fact is that commissions have struggled with the problem and have come to definite answers. Quite frequently it has been necessary to carry a dispute between the company and the commission into the courts, and the many legal decisions rendered

have helped to establish policies and precedents for use in future disputes.

One of the special problems that arise in determining fair rates is that all customers of a particular public utility cannot be charged the same rates. In a given locality, like users of the street railways, water service, electric service, and telephone service do pay the same amount. However, rates may vary between two communities located some distance apart even though they are served by the same company. This condition may result from negotiating franchises in different years or under other diverse circumstances. Of even more importance is the difference between rates charged to classes of consumers, such as the home owner and a manufacturing company. The kilowatt-hour rate charged for electricity in the case of the individual who uses a small amount of current is much higher than that charged to the manufacturer who purchases much larger quantities.

There is a sound economic reason for lower rates to large users of gas, water, and electricity. Once the investment in plant and equipment is made, it costs very little to increase the output. The public-utility company is anxious to sell the added volume of business available from large companies. Unless the rate is favorable, a manufacturing company can install its own system, which introduces a competitive situation not usually encountered by utilities. Commissions recognize the general desirability of volume sales and allow rate variations just so long as there is no discrimination among users in the same category. This means that all large users must be given the same schedule of lower rates. The principle of volume sales also explains the lower unit cost applicable to the higher consumption brackets that is generally effective for domestic consumption of electricity.

In general the rates that public utilities have been permitted to charge have resulted in profitable operations for most companies. With the exception of many street railways and interurban lines, which have been faced with competition from busses and privately owned automobiles, the public-utility companies have been moderately prosperous. Over the years they have been able to earn a fair return on a fair value.

Federal Regulation of Public Utilities

The operations of industries that have been classed in this chapter as public utilities are primarily intrastate as opposed to the interstate character of the railroads. For this reason, until recently the Federal Government did not attempt regulation of utilities, in sharp contrast to the extensive control over railroads that has been exercised by the Interstate Commerce Commission for more than sixty years. Only after conditions that could not be handled by the state commissions arose was action taken by the Congress of the United States.

The chief difficulty encountered by the state commissions in discharging their duties arose in connection with the tremendous increase in public-utility holding companies, which took place in the period from 1920 to 1935. Usually, the holding company was incorporated under the laws of a state in which it conducted no business, and its operating subsidiaries were located in several states. If these were integrated into a single system, many interstate relationships developed. It became exceedingly difficult for the state commissions to control matters that had been removed from their direct jurisdiction.

There were many evils in the holding company promotions that took place during the period indicated. Of prime concern to the state commissions was the effect on rates of two common practices that came into being. One of these was the interstate sale of gas or electricity from one subsidiary to another. For example, a holding company would purchase the controlling stock interest of a gas company in Illinois, which had been producing its own product. Shortly thereafter, the production equipment of the Illinois utility would be dismantled and its distribution mains connected to a natural gas line originating in Kentucky and also owned by the holding company. The rate charged for this natural gas would naturally have an important effect on the operating cost of the Illinois gas company, but the Illinois Commission had no direct jurisdiction over this interstate transaction.

Another practice that arose was the establishment of a management firm by the holding company that rendered engineering, financing, sales, accounting, and other expert services to the local subsidiary. The fees charged might be exorbitant

and yet the state commission had very little, if anything, to say on the subject; and these higher costs of operations frequently resulted in a request for higher rates. Sometimes the commissions were strong enough to resist such pressures, and in some cases the courts upheld the right of the commission to control the interstate charges by indirection, but it was almost axiomatic that, as soon as a holding company purchased control of a local utility, a request would be presented for higher rates.

A fundamental objection to many public-utility holding companies organized prior to 1935 was that they were incorporated for purely financial reasons without any thought of rendering more or better service, or of producing at a lower cost. In fact, quite the opposite was true. As has been indicated, the holding company manipulated the operating company in every possible manner to secure more earnings for itself at the expense of the consumers. Even such a simple economy as downstream loans was sometimes perverted by *upstream loans* in which the subsidiary furnished funds to the parent company. The many objectionable practices of public-utility holding companies led directly to the enactment by Congress of the Public Utility Holding Company Act in 1935.

Public Utility Holding Company Act of 1935. The main purpose of this Act was to eliminate the evils that had grown out of the holding company device, as applied to public utilities. It required that all such companies had to register with the Securities and Exchange Commission and that this Commission, after examining the financial structure, could order the liquidation of such holding companies as were not economically sound. In general, only those that combined companies in a like business located in a reasonably small geographical area could continue. Holding companies more than "once removed" from the operating subsidiary were not to continue in existence. This was known as the "death sentence" feature of the Act.

As a means of forcing the holding companies to register, the law provided that unregistered companies were forbidden to use the mails. Registered companies were also forbidden to use the mails if they followed any of a number of specific

practices that were outlawed. These included loans from operating companies to holding companies, excessive dividends, and lobbying activities; and it was specified that sales, service, and construction contracts between the holding company and the operating subsidiary must be approved by the Commission.

The above features were contained in Title I of the Act. Title II was also extremely important from the standpoint of rate regulation. It gave to the Federal Power Commission the right to regulate interstate electric rates at the wholesale level. This eliminated one of the problems that had vexed the state utility commissions and provided complete control over charges for electric service through the creation of joint boards of Federal and state commissions. Title II also gives the Federal Power Commission direction to co-ordinate and interconnect the transmission lines in the United States, and to control security sales and purchases of companies transmitting electricity in interstate commerce.

The Federal Power Commission was not a new Government agency. Originally created in 1920 to be composed of members of the President's cabinet, it was reorganized in 1930 with five full-time commissioners. The original purpose had been to license the use of waters for power purposes to private companies, with the proviso that they could be purchased by the Federal Government. The licenses were to be in the public interest, and about all the Commission had been able to do until 1935 was to require such reports from the licensees as would demonstrate proper use of the permit and to make studies of the hydroelectric power problem.

Natural Gas Act of 1938. As in the case of electric service, the Natural Gas Act of 1938 gave the Federal Power Commission jurisdiction over the rates charged by companies engaged in the interstate transmission of natural gas. The reason that manufactured gas was not included is that almost all gas so produced is consumed in the city in which it is manufactured or in nearby areas and does not, normally, enter into interstate commerce. This Act added to the jurisdiction of the Federal Power Commission another important interstate public-utility operation.

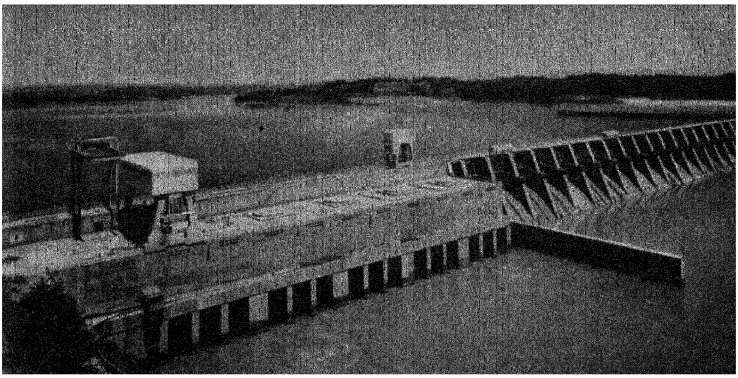
Communications Act of 1934. Prior to 1934, the interstate regulation of telephone and telegraph service had been in the hands of the Interstate Commerce Commission. This body devoted most of its time to railroad problems and did not have time or adequate power to deal effectively with the problems of rates charged by interstate companies engaged in these two fields. The Communications Act created a Communications Commission and gave it the power to regulate rates and services. Charges must be just and reasonable and rates filed with the Commission cannot be varied except on notice and agreement by the Commission. Discrimination among users is prohibited.

The Act also gave the Communications Commission all of the powers that existed at that time in the field of radio, and added others. Although radio may or may not be classed as a public utility, the control over it by the Federal Government is particularly strong. Licenses are issued for a one-year period and, if the broadcasting company is refused a renewal of its permit, there is nothing that it can do but go out of business. For this reason there is no need for control over rates, service, and other features because malpractices could result in losing a license, and without this the company has no right to use the air for broadcasts.

Government Ownership and Competition

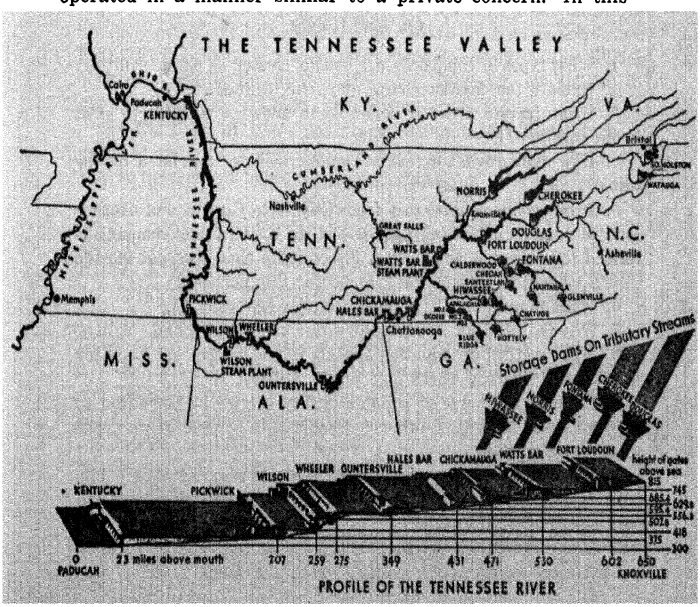
Another factor in the public-utility picture is the widespread government ownership of some types of public utilities and the competition of some of these with those operated by private capital. Many municipalities own and operate the water system, street railways and busses, and electric plant. In some instances, particularly in the case of electric service companies, the municipal installation competes with the private company for local business. If public ownership has not been the rule in the past, there is always a constant threat to the utility seeking a renewal of its franchise that, unless its terms are favorable, public operations will be started.

The most famous example of government ownership and competition is furnished by the Tennessee Valley Authority. The T.V.A., as it is generally known, was created in 1933 to make use of the Muscle Shoals properties located on the



Watts Bar Dam—Part of T.V.A.

Tennessee River, which had been acquired by the United States Government during World War I. A Government corporation was created that had, among numerous powers, the right to sell the surplus power that might be generated in the system of dams planned or already constructed. The Government corporation was to pay taxes, charge depreciation, and be operated in a manner similar to a private concern. In this



way, it was felt that a "yardstick" would be created by which it would be possible to judge the reasonableness of rates charged by privately owned public utilities.

Without much question, the T.V.A. has been a successful operation, and it is a fact that electric rates in the area served are much lower than they are for the country as a whole. Whether or not it is serving as an accurate yardstick of the costs of generating power has been a subject of bitter debate. The T.V.A. is a multiple operation involving flood control, navigation of waters, soil conservation, and fertilizer production. It is very difficult to allocate costs of facilities to one factor because of necessary intermingling. There have also been criticisms of the rates of depreciation used and of the disparity between carrying charges for capital secured from the Federal Government in the case of the T.V.A. and from private sources for ordinary public utilities.

QUESTIONS

1. What types of companies are usually classed as public utilities?
2. Explain the characteristics of public utilities.
3. What factors make it desirable to allow monopolies to exist in our economy?
4. How and to what extent are public utilities regulated by the states?
5. A bus company operates from City A to City B, and another concern runs a route from City B to City C. If a new company is formed to connect A and C by a direct route that does not include City B, should permission be granted for this purpose?
6. What is meant by "a fair return on a fair value?"
7. Why is it difficult to decide on a fair value for a public utility?
8. What method of valuation appeals to you as the best basis for determining the true worth of a public utility? Why?
9. Should some users of a public utility service be permitted to enjoy cheaper rates than others? Should this be true of all types of utility services?
10. The Federal Government did not begin to regulate most public utilities until 1935. Would the country be better off if all regulation were restricted to the states?
11. Is the "yardstick" method of comparing the rates of publicly and privately owned public utilities sound and fair?

PROBLEMS

1. The City Railway Company operates a system of street cars under a municipal franchise. Its investment in rails, trolleys, cars, and other necessary equipment is $10,000,000. The average annual depreciation rate on these fixed assets is 4 per cent. Operating expenses, including salaries, electricity, taxes, and other similar items, will amount to $584,000 for the coming year, according to estimates. On the basis of past experience, it is assumed that approximately 15,000,000 fares will be collected during the year.

What single fare price will be necessary, rounded to the nearest cent, if the City Railway Company is to earn a 6 per cent return on its investment? Show calculations.

2. Prior to 1935 a locally owned electric light company was producing its own current at an average cost of 1.2 cents a kilowatt hour based on an output of 1,000,000 kilowatt hours a month. This was being sold at an average price of 2 cents a kilowatt hour, and the monthly bill of the average domestic consumer was $4.80.

A public-utility holding company purchased the local company, abandoned the local producing plant, and connected the city distribution system with long distance transmission lines owned by another subsidiary. Current was purchased at 2 cents a kilowatt hour. Furthermore, a management concern owned by the holding company charges the local utility unit $10,000 a month for its engineering, sales, research, and accounting services.

On the basis of these facts, and assuming the same profit in cents on the sale of each kilowatt hour, what increase was necessary in the monthly bill of the average consumer? Show calculations.

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CHAPTER 36

ECONOMIC PLANNING

What Is Economic Planning? The term "economic planning" is one that is applied to the efforts of businessmen and/or government to achieve some measure of economic stability through an attempt to foresee future business conditions and to plan for them. This definition might be reworded slightly to say that economic planning also involves the attempt to control future conditions through the setting up of a projected course of action that is expected to have a stabilizing effect on the business climate, and then following out this design.

There is a strong parallel between economic planning for the nation as a whole and budgeting by an individual company. With a considerable measure of truth, it might be said that economic planning is budgeting applied to the whole economy.

Why Economic Planning? The reasons for economic planning are to be found (1) in the losses and wastes that appear to be inherent in a free, competitive, capitalistic system, (a) where the rewards go to the more efficient operators, and the less able ones either fail and go out of business or receive very meager returns for their efforts and (b) where there is needless duplication of retail and service outlets, and of advertising and sales promotional effort; (2) in the periodic depressions that our economy has experienced, which appear to grow more severe with each recurrence and which appear to be due—at least in part—to the lack of over-all planning of production and consumption in the economic system, with resultant dislocation of the supply-demand equation. These two factors will be examined more minutely in the paragraphs that follow.

Competition. In a free competitive economy, as has been stated in an earlier chapter, men go into business for the purpose of securing profits. Those who are engaged in the same

lines of business compete with each other for the favor of the buyers in their fields. This competition is expressed in a number of ways, but price is the dominant one in many lines. This means that the more efficient producers are able to attract customers through the device of offering their goods and services at lower prices than their less able, and higher-cost, competitors. The result of this situation, which comes into being in most trades, is that the less efficient firms are either forced to leave the field or to be satisfied with relatively small profits.

When a company fails, there are losses sustained by all concerned. The owners lose their investment and, in cases of sole proprietorships and partnerships, their personal holdings may be jeopardized. Employees lose their jobs and must seek new ones, often at lower wages and in different industries. Vendors, who have sold goods to the bankrupt firms, must sometimes accept less than the full value of the goods involved. Customers of the unfortunate companies must find new sources of supply for their needs. Each of these involves economic loss, and there have been those who have felt that planned competition, which would be somewhat less disastrous than the type just described, might be more advantageous to business houses than the unplanned, unrestricted sort.

Depressions. The recent history of capitalism in this country has been that of a series of booms and depressions, of which the latter have appeared to be of progressively increasing severity. The depression that began in the fall of 1929 resulted in widespread unemployment and business reverses and failures. Prices dropped abruptly, farm and home mortgages were foreclosed, and the period was one of great economic and human misery.

Almost countless explanations have been offered to explain why depressions occur, and as many remedies have been suggested either to prevent or to control them in the future. Among the more prominent of these remedies have been several whose common basic theme is that of controlling production so that the phenomenon of so-called "overproduction," which has been such an outstanding characteristic of depression times, would either disappear or be diminished in its importance. One of the significant things about periods of

depression has been the presence of large inventories of goods in manufacturers' warehouses and on wholesalers' and retailers' shelves, for which little demand appeared to exist at the time, and which could be moved only through large price reductions, which entailed sizeable losses for all concerned. Following this, producers became reluctant to produce more goods, fearing that they would have to take further losses, and wholesalers and retailers reduced the volume of their purchases for the same reason. Consumers, for their parts, reduced their purchases both because they anticipated still lower prices and because many of them had had their incomes reduced, if not cut off completely.

This situation became a vicious cycle, with businessmen reducing the scope of their operations because consumers curtailed their buying and, in turn, the consumers acting as they did because of the actions of business. This condition would be altered only when business became convinced that the bottom had been reached and that a demand had been built up for goods which would result in a resumption of trade if and when the merchandise again became available. Following this belief, certain courageous manufacturers resumed production, employing more workers whose earnings enabled them to buy more. This, in turn, had a favorable effect on the whole business community and set in motion a beneficent cycle, which was the reverse of the one just described. As more and more producers resumed the making of goods and as an increasing number of workers were re-employed, prices rose and a boom was under way. The race on the part of business firms to achieve greater sales and profits led to an even greater volume of production until, somewhere in the process, businessmen began to fear that more goods were being produced, and at higher prices, than could be profitably disposed of. As a result, they began to curtail their production and to cut their prices for the purpose of moving their present inventories with as little loss as possible. As this belief spread throughout the business community, the downward spiral of business activity was accelerated and a depression was under way.

The foregoing is not intended to be a complete explanation of the business cycle, which involves a large number of other economic factors, but it does present a brief description of one

of the more prominent parts of this phenomenon and one to the alleviation or altering of which no small amount of planning effort has been directed. The details of this planning are given later in the chapter.

Historical Development of Economic Planning Until somewhere around 1880 or until large and powerful business units began to appear on the economic scene, there was little evidence of planning of any sort, on anything other than a purely intracompany basis. Reliance was placed, instead, on the more or less automatic operation of profits and prices to provide whatever corrective action might be required whenever the economic system became unbalanced in any way. This was the age of *laissez faire*, a term that describes a situation in which business operated with a minimum of governmental regulation and contact. It was a time of small business units, when the effects of competition and depressions, while undoubtedly severe, could be overcome rather quickly by the individuals affected, through the opportunities that a growing country afforded and the comparatively low capital requirements for entering or re-entering the business picture. Displaced entrepreneurs or employees found relatively little difficulty in re-establishing themselves after any economic misfortune.

With the emergence, around 1880, of the large corporations in many fields, the first evidences of planning for the purpose of circumventing the rigors of unrestricted competition began to appear. These took the form of so-called trusts, pools, and gentlemen's agreements, which consisted, basically, of concerted action among the members of certain trades, designed to lessen the severity of competition between the firms concerned. Such arrangements were possible because of the potential threat of ruinous competition, possessed by the stronger members of the trade, against the weaker ones, thereby securing the agreement of the smaller firms to the proposals of the more powerful ones that prices be stabilized, territories restricted and mutually respected, and that other measures be instituted to curb competition; or it may have come about through the mutual agreement of the members of the trade to "live and let live" with the same practices just

noted. The merger of many small units into one large company likewise served to lessen competition and its results in the fields affected. The creation of the United States Steel Corporation in 1901 is a good example of this latter method.

Trade Associations. The Sherman Anti-Trust Act in 1890 was designed to curb the effectiveness of these agreements and mergers, and probably achieved this end to some degree. However, mutual action among firms that would otherwise have been competitors has continued with a fair degree of persistence and has embraced forms and methods that are quite varied, in both substance and effectiveness. Among these has been the trade association, which has functioned for the mutual exchange of information between the members. At one time, the so-called Open Price Association operated to collect and disseminate price information among the association members, with the result that prices tended to be stabilized at the highest level reported by individual members. This form of trade association was declared illegal by the United States Supreme Court.

The present methods of group action to avoid the rigors of competition consist of trade association activity and such legislation as the so-called Fair Trade Laws discussed in another chapter and the so-called Unfair Trade Practices Acts, which were designed to prevent price cutting by prohibiting merchants from pricing their goods at less than their costs plus specified markups.

Planning Since 1929. All that has been presented thus far in this section has dealt with group planning to escape competition. The historical phase of the second type of economic planning, that of trying to overcome depressions through stabilizing the economy, is rather brief and dates back only to the depression that began in 1929. As this movement of the business cycle lengthened and the promised "around the corner" prosperity failed to materialize, proposals for planning, both in and out of government, began to appear. All of this probably culminated in the bank holiday of early 1933 and in the various enactments of the national administration that came into being shortly thereafter.

Planning without Government Control

The most conspicuous example of economic planning on a broad scale, without government control, was the Committee for Economic Development, known as the C.E.D., which was formed during World War II by a group of prominent businessmen. Its avowed purpose was to plan for the postwar period, and it endeavored to implement this purpose by enlisting the aid of firms throughout the country and asking them to make elaborate plans for the postwar period. These firms were asked, among other things, to estimate their probable output and especially the number of workers that they expected to employ. The C.E.D. executed and published a number of statistical studies based on postwar plans and also prepared a number of booklets advising returning veterans regarding some of the fields that they might wish to enter.

The effectiveness of the C.E.D. is not entirely clear. It is quite probable, however, that the committee accomplished much more than is readily apparent in inducing businessmen to plan actively for the postwar period, and that the relative speed with which many companies undertook reconversion was due in no small measure to their efforts.

Another example of private planning is the National Planning Association, which was formed in 1934 by a group of forward-looking business and professional men for the purpose of combating the depression that then had the country in its grip. This group undertook to bring together in a common cause—that of planning for a more prosperous future—leaders from all phases of our economic life who would discuss their problems and formulate plans for the years ahead. Before and during World War II this association engaged in research in various economic fields and published several studies as the result of their efforts. They also published a number of pamphlets dealing with planning.

Formed near the end of hostilities were a considerable number of local planning groups, whose purpose was to speed reconversion in their local communities and assist the veterans in finding jobs, thus helping to prevent a period of postwar depression. These groups were sometimes affiliated with local chambers of commerce and occasionally with the city governments.

The principal drawback to nongovernmental planning arises from the fact that this sort of thing lacks any authority. With the constant necessity of making certain that no violation of the anti-trust laws occurs, competitors, or trade associations composed of firms that are normally competitors, find the scope of their activities greatly curtailed, and they must rely on the good intentions and co-operation of the members to implement such moves as they may legally make. For these reasons, economic planning without government control appears to be of relatively slight consequence as a means of combating the evils of depression.

Planning with Government Control

This topic is divided into two phases, (1) those controls that were created to curb the depression of the 1930's, and (2) those controls born of World War II.

Depression Planning. Beginning with the National Industrial Recovery Act and the Agricultural Adjustment Act of 1933, the Federal Government has engaged in economic planning to a considerable degree. Those measures were instituted as means of attempting to counteract the depression of the early 1930's. The fact that the N.R.A. and the A.A.A. were declared unconstitutional by the United States Supreme Court did little to impede the trend toward planning under Governmental auspices. The Tennessee Valley Authority (T.V.A.) was established to plan and direct the economic life of certain Southern states in regard to the supply and distribution of electric power.

The Federal Communications Commission was set up to bring about an orderly development of radio broadcasting and, in effect, it is a planning body for that industry through its power to issue or withhold licenses, without which no broadcasting station can operate. The Interstate Commerce Commission, which is a much older body, serves to a considerable degree as a planning agency for the transportation industry.

The Federal Government's agricultural planning program operates through soil conservation, crop control, and the curtailment of farm acreage.

In each of these instances, as well as in the other fields where government planning exists, the end in view is to bring about a more or less stabilized situation in each industry, which is presumed to contribute to its prosperity. By regulating the number of radio stations that are permitted to broadcast and the wave lengths and kilocycle frequencies that they may use, the Government contributes to an orderliness that benefits both the broadcasters and the listening public. In its agricultural aspects, the planning of the Government is designed to prevent the farmers from raising more crops than can be sold profitably and to avoid the accumulation of large surpluses, which in the past have depressed prices to the point where they represent losses to the growers. It also aimed at halting the wasting of our soil resources, thereby planning for the fertility of our fields many years hence.

The National Resources Committee, which was formed by Executive Order in 1935, was commissioned to co-ordinate all of the planning efforts of the Government and particularly to become interested in the "planned development and use of land, water, and other national resources."

World War II Planning. During World War II this country was subjected to a greater degree of planning by and through government agencies. This was necessary because all of the resources of the nation, material as well as personal, had to be mobilized to support the war effort and also because of the need for conserving certain items that were in short supply. The nation was mobilized for war and almost all of its activities were planned for and controlled.

The Office of Price Administration, through its price-fixing powers, operated both to prevent the inflationary price rises that would have resulted from the war-born maladjustment of supply and demand and to bring about the desired movement of certain goods into channels that would aid the war effort, an example of which was to be found in the rubber industry where rubber intended for the use of the armed services was freed from price control, while that destined for civilian use was subjected to rigid control. It was thus made much more profitable for the producers to manufacture for the Army or Navy than for civilians. Through its rationing

powers, the O.P.A. planned the amount of food that the nation should eat, the quantity of gasoline and fuel oil it could obtain, the number of pairs of shoes it could wear, and the number of tires and tubes it could secure. Furthermore, the O.P.A. determined, in the case of gasoline and tires, what classes of users would be eligible to obtain these items and the quantities to which they were entitled.

The War Production Board undertook a planning job in allocating industrial materials and in prohibiting the manufacture of certain goods and limiting the production of others. This was accomplished through the use of priorities, the Controlled Materials Plan, and the orders to limit or stop production that were issued.

The War Food Administration planned for the distribution of the available food supply. The Petroleum Administration for War virtually controlled the petroleum industry and planned most of its activities. Selective Service planned the availability and entrance of needed personnel into the armed services. The War Manpower Commission planned for the utilization of the civilian personnel in the war effort. These are some of the more important planning groups that came into being during World War II. All of these agencies, with the exception of the O.P.A., passed out of existence soon after the end of World War II.

The so-called Full Employment Bill, enacted into law in 1946, represents a form of postwar economic planning that endeavors to establish certain policies and practices designed to take care of the involuntarily unemployed during any period when it appears that unemployment will become a serious problem.

The Planned Economy

The planning methods enumerated thus far, both within and without the framework of government, have all had one characteristic in common—they have all attacked small segments of our economy. While the combined war agencies came very close to controlling and planning for the entirety of our economic life, their efforts were not co-ordinated by any single over-all planning body, whose task was that of planning for the whole economy. Thus the idea of a planned economy—that would operate on

a stabilized basis with the peaks and valleys of the business cycle eliminated, with no overproduction nor underconsumption, with no unemployment and few business failures, and with some sort of a master planning board at the controls—exists only in the minds of those who believe that such an arrangement offers the only eventual solution to the problem of recurrent depressions.

The *modus operandi* of a planned economy would probably be that of a group of governmental bodies, similar to the war agencies, each charged with the responsibility of planning for and controlling some one or more segments of the economy and reporting to and being controlled, in turn, by a master group vested with the responsibility of operating the entire economic system. Between these groups the production and consumption of practically everything would be planned, and the plans would be implemented by the authority to allocate materials, determine manufacturing quotas and see that they were followed, to set prices, fix wages, allocate manpower where needed, control credit, regulate inventories, and, in short, dictate the tempo and method of our economic life. It should, of course, be recognized that the powers to compel adherence to the plans must go along with the authority to make them. Otherwise, the plans would mean very little and the planning operation would have little chance of attaining its objectives.

In this more or less fanciful picture, it would be most important that consumption be planned for and controlled. During World War II this was done to a considerable degree. The armed forces consumed the wide variety of war materials that were produced in a much more orderly and controlled fashion than is the case with the consumption of civilian goods in peace times. Likewise, the rationing program specified rather rigidly the consumption pattern of the rationed goods, both as to what and when they were to be used.

In a planned economy in time of peace it is equally necessary that consumption be regulated so that the goods which result from the planned production are certain to be taken off the market. How far this would have to go, regarding planning and controlling the purchases of the individual consumer, cannot be foretold in advance of its being attempted.

But it should be obvious, for example, that if the production quota of Ford automobiles for a given year should be set at one million cars, one million consumers must buy Fords that year, and that if only 750,000 buyers really want Fords, an additional 250,000 must be found and compelled to buy the remainder of the production quota. It might be possible to avoid the compulsory phase of this matter to some extent by securing commitments from consumers in advance of establishing the quotas and starting production. The important point, however, is that the cars must be taken off the market by the consumers. If this is not done, the planning mechanism will falter in this segment of the economy and, if the same condition should prevail for shoes, radios, hats, cosmetics, houses, proprietary medicines, and snow shovels, to mention only a few items, the entire planning structure might collapse.

A planned economy, therefore, is a regulated economy if the planning procedure is to have a chance of success. Possibly some arrangement short of complete regulation would serve to lessen the effects of the downswings of the business cycle, and perhaps some small segments of the economy such as certain luxuries could be left out of the planning orbit, if complete regulation should eventually be adopted. Only time will supply the answers to these speculations. The fact remains, however, that there is a discernible trend in our thinking toward governmental planning, which may experience a marked acceleration if and when another major depression threatens.

Arguments for Planning The following arguments for planning apply to economic planning both with and without the institution of a completely planned economy, depending largely on the objectives to be sought and the means required. Despite the objections to the planned economy that must be apparent in a statement of its probable operating procedures, there are a number of powerful arguments to be found in its favor. They are given briefly below.

(1) Elimination of Depressions. Easily the foremost argument in favor of planning is that it would tend to eliminate depressions and all of their attendant misery and loss. Dur-

ing the years that Hitler and the Nazis were in power in Germany—one of the most complete examples of a planned economy that has been seen—there was no depression and little unemployment in that country. It is true that the people were completely regimented and that much of their economic endeavor went into preparations for war, but their economy was moderately well stabilized during the period of Nazi rule. It has been argued that the same thing could be done here, with the economy employed for peace rather than war, with equally beneficial results as far as the elimination of depressions is concerned.

(2) Elimination of Unemployment. Not only would planning serve to eliminate depressions, but the ordered operation of the economic system would involve planning for full employment. Through the controlled economy all workers presumably would be provided with adequate employment.

(3) Effective Use of Productive Facilities. Under a system of economic planning it is expected that a more effective utilization of our productive facilities would result. The very essence of planning would involve the use of all productive equipment at the most economical rate. This is to be compared with the alternate periods of frenzied activity and complete or relative idleness that characterize considerable parts of our productive machinery.

(4) Conservation of Natural Resources. Unfortunately, the development of our economic system has been marred by a rather wasteful exploitation of many of our natural resources, notably lumber. Planning, in providing not only for the immediate but also for the more remote future, would bring into being practices designed to conserve our natural resources and to avoid the wastes of the unplanned use of them.

(5) Elimination of Wasteful Competition. That much competition is wasteful is admitted by even the most ardent supporters of capitalism, as it has existed in this country. The needless duplication of gas stations, restaurants, grocery stores, and urban milk delivery routes are but a few examples

of this form of waste. Planning would presumably eliminate this wasteful competition through the determination of the exact number of each of these units that would be required to serve a given community and by not permitting any additional units to operate. It should be understood, of course, that planning involves the regulating not only of production and manufacturing units but of the distributive process as well.

There are other evidences of wasteful competition, not the least obvious of which is to be found in those situations where extensive advertising does not result in greater total sales, but merely in the shifting of business from one competitor to another. Exaggerated or untruthful advertising would be eliminated under a planned economy, if indeed all advertising would not be confined purely to informing consumers of the availability of goods and of the details of their use.

Arguments against Total Planning

The arguments that are discussed here apply mainly to total planning or the planned economy insofar as its conditions can be approximated from the experience of the country under wartime controls, which come the closest to those of a planned economy of any that have been experienced so far. There are relatively few objections to planning, as such, because it is an activity in which all businessmen should indulge, and economic planning without the compulsions that appear to be implicit in the planned economy may go far to achieve the results that are so desirable. Total economic planning, however, introduces controls, methods, and procedures to which grave objections have been raised. These are discussed briefly in the paragraphs that follow.

(1) Regimentation of the People. One of the major results of economic planning, as a governmental function, would be the regimentation of the people, at least as far as their economic life is concerned. As already pointed out, planning must be accompanied by control in order to be effective, and control means regimentation. Producers and consumers alike would have to do as they were told, make and use the goods that the plans called for, at the times and in the quantities

that would be specified. Freedom of choice, so dear to the hearts of makers and users alike, would largely vanish from the American economic scene.

Producers could not produce what they chose but would be required to make what the plans indicated. Similarly, consumers would be required to buy the things that were available, whether they liked them or not, and at specified times. Research into the likes, dislikes, needs, wants, and preferences of consumers, prior to the determination of production schedules of what should be made and how many, might result in the manufacture of goods that closely approximated the needs of the consumers. If so, the element of compulsion might be greatly softened through the fact that the goods offered were actually what most of them wanted. However, the tendency of consumers to change their minds, with or without adequate cause, would tend to make this a somewhat uncertain basis upon which to assume that the planned products would all be taken off the market without some measure of compulsion. For example, if research should indicate a preference among women consumers for red hats of a certain type, and the hat makers should be authorized to produce a certain number of these hats, it is quite possible that a substantial number of these consumers might have changed their minds to a preference for green or blue hats by the time the red ones arrived on the market. Under these circumstances it would be only under compulsion, or supersalesmanship, that the red hats would be sold.

(2) Destruction of Individualism. The regimentation of the people just discussed would be bound to lead to the eventual destruction of individualism for large numbers of the population. In the immediate postwar period evidences of this sort of thing on the part of labor leaders, and to some extent of the rank and file of union members, were present. These people had come to rely on government agencies during World War II to assist in solving their problems, and they found it difficult to rely on their own resources once the war was over. There were other instances that show quite clearly the numbing effect on individualistic thinking and endeavor that is produced by governmental regulation.

(3) Destruction of Competition. It is difficult to see how competition, in any real sense, could survive in a planned economy. There was very little competition among the producers of war materials during the war, and a peacetime planning operation would produce the same effect.

(4) Destruction of Capitalism. With freedom of choice eliminated, individualism suppressed, and competition destroyed, about the only vestiges of capitalism that would be left would be the private ownership of economic facilities and goods and the right to receive profits. This would be a rather pallid substitute for the robust capitalism upon which the country attained greatness. There is nothing essentially sacred about capitalism, but no better system of meeting human needs has been devised, and it is probable that none could be, unless human nature should undergo a radical change.

(5) Possibility of Government Dictatorship. It is an open question whether or not our democratic form of government could survive the destruction of capitalism. Depriving the people of the right to act freely in an economic manner would probably result in weakening their interest in, and enthusiasm for, political democracy. This would make the transition of the government from a democracy to a dictatorship a relatively easy matter, should personally ambitious and unscrupulous men happen to acquire the government controls. This has been the story in Germany, Italy, and Russia, where the government undertook to plan for all of the people, and "it could happen here."

(6) Man's Inability to Plan Successfully. Quite apart from the drawbacks just listed, which are potential rather than actual at the moment, is the very real and present fact that no man, or group of men, possesses the knowledge and ability to plan successfully for the country as a whole. The experience of the O.P.A. during and after World War II should be sufficient evidence of the truth of this statement. With the highest motives and best intentions in the world, it would not be possible for the most gifted citizens of the country to

design and execute a plan that would have a chance of operating successfully in as complicated and far-flung an economy as ours, even if it were assumed that the people would give such a project their complete approval and support, which is highly improbable, with our background of rugged individualism. The complex interrelationships and interactions among the various factors of our economy are far beyond the power of any group either to understand or to control intelligently.

What about Planning in the Future? While the prophesying of human actions is always risky, it appears probable that we shall continue our piecemeal planning, particularly in those areas where trouble appears. Among these will be unemployment, housing in slum areas, crop curtailment or diversification, and conservation of some of our dwindling material resources. If another war should come, we would, of course, switch quickly to a planned economy, probably even more completely than in the last war.

The big question mark looms in connection with what would happen if and when another major depression should set in. If this should take place and if minor palliative measures—such as relief work, subsidies, and so on—should fail, it is possible that we might decide to have a try at over-all economic planning, as an evil somewhat less in severity to a repetition of the misery and suffering of 1929-1933. In that event we might find it difficult to return to anything remotely resembling capitalism after the depression had passed. On the other hand, such an experience with a planned economy in time of peace might turn us completely against such a program.

QUESTIONS

1. What are the principal reasons for economic planning?
2. How would planning operate to overcome depressions, the accompanying unemployment, and other economic losses?
3. Can competition exist without causing losses to some competitors?
4. Do the gains that competition brings to the economy outweigh the losses inherent in it?

5. Can planning without government control ever be successful, except in small areas?

6. Do you agree that this control must extend to consumers, or can it be confined to producers?

7. What commodities or services do you think might be included in the scope of national planning?

8. Could political democracy survive in a country where a planned economy was in force?

9. Is relief from depressions worth the price of the loss of freedom that total planning would entail?

10. Do you agree with the statement that an economic system is too complicated and extensive for man to be able to plan successfully its operation and control?

PROBLEMS

1. "It is possible for competing business firms to engage in effective industry-wide planning without violating the Sherman Antitrust Act." Do you agree or disagree? Write a brief statement of the reasons for your answer.

2. Each depression seems to be more severe than the preceding one. Do you think that the reason for this is inherent in our capitalistic system? If you do, identify the cause and state what you think can be done to mitigate the effect of depressions without destroying our system of free enterprise.

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