THE BOARD OF DIRECTORS
IN AGRICULTURAL MARKETING BUSINESSES

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COOPERATIVE EXTENSION SERVICE
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Publisher's Statement

This publication was written in 1963 by Dr. Leon Garoian, now a professor at the University of California, Davis, and the late Arnold F. Haseley, who was killed in an automobile accident shortly after completion of the manuscript. The Oregon State University Extension Service continues to make this publication available as a service to those in the profession who continue to find the material useful. No attempt has been made to change the original publication or to revise it in any fashion. The eighth printing is available through the Extension Business Office, Oregon State University, Corvallis, Or. 97331.

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THE BOARD OF DIRECTORS

IN AGRICULTURAL MARKETING BUSINESSES

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". . . Nevertheless the greatest weaknesses and shortcomings in the selection of directors, in our opinion, are those which arise out of heedlessness, shortsightedness, and a lack of comprehension of the part which directors properly should play in the management of a corporation. If this conclusion is correct, the major task involved in securing more competent directors is an educational one."

THE BOARD OF DIRECTORS AND BUSINESS MANAGEMENT
Melvin T. Copeland and Andrew R. Towl

Foreword

This manual has been developed to help directors understand the board's role in managing business corporations. Recognizing responsibilities is but one of the necessary ingredients for improving board performance. We have included in this manual another necessary ingredient: a consistent framework of knowledge for board of director action. We believe that a thorough understanding of the concepts of management and of business competition must logically precede intelligent action.

We have not attempted to make the materials in this manual universally applicable to every company, board, or situation. Nor have we attempted to reduce the concepts and principles to check list form. That is an individual board's responsibility.

The over-all objectives of a director training program are to help the director:

. Understand the board's role in management

. Improve board effectiveness

. Understand board-executive relationships

. Establish effective objectives, goals, policies

. Appraise plans

. Establish adequate controls

. Identify sources of relevant information

. Achieve company growth through long-range planning

This manual can serve as a guide and a stimulator for action. The reader may not agree with the presentation of materials in the manual. In fact, some may violently disagree on specific issues. But, if we have stimulated interest and a desire for more knowledge, this manual will have served its purpose.

The materials have been tested through a series of test schools to determine their applicability and usefulness. The materials and resulting directorate educational program were made possible by a contract between the Federal Extension Service, U. S. Department of Agriculture, and Oregon State University Cooperative Extension Service. It is a companion program to earlier contract publications sponsored by the Federal Extension Service. These include the North Carolina State College's manual on Management for Agricultural Marketing Firms, and Purdue University's manual on Long Range Planning. These manuals were aimed at the executive management group, while this program is aimed at the board of directors.

We have incorporated much of the valuable assistance and advice received from the following consultants to this contract: George Abshier, Extension Economist, Oklahoma State University; Wendell C. Binkley, Associate Professor in Agricultural Economics, University of Kentucky; Kenneth Naden, Executive Vice-President, National Council of Farmer Cooperatives; Homer J. Preston, Director, Purchasing Division, Farmer Cooperative Service, U.S.D.A.; and Kenneth Stern, President, American Institute of Cooperation. Paul O. Mohn, Economist, Marketing Firm Management, Division of Marketing and Utilization Services, Federal Extension Service, served ably as project coordinator. We appreciate the assistance from these consultants. However, the authors assume the ultimate responsibility for whatever inconsistencies and shortcomings may be found in this manual.

In addition we found the comments and editorial assistance of Curtis Reid, Head, Audio-Visual Services; Dwight Fairbanks, Extension Visual Instruction Specialist; and Ralph Salisbury, Extension Publications Specialist, all of Oregon State University, of tremendous value. We appreciate the fact that during critical periods we were "protected" from becoming involved with other important matters by J. W. Scheel, Assistant Director, Cooperative Extension Service, OSU.

Finally we wish to express our appreciation to Miss Irva Tidd, who patiently typed through numerous revisions of this manuscript.

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Arnold F. Haseley

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Cooperative Extension Service

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THE BOARD OF DIRECTORS IN THE BUSINESS ORGANIZATION.

The board of directors faces a two-fold challenge: 1) It represents stockholders or members of the business, and 2) it is vested by law with the duty to reasonably conduct the affairs of the company. This dual relationship for boards of directors results from logical bases. Since the corporation, by law, is a legal "person" comprising an artificial "being" representing a group of owners, there must be real persons who are responsible for managing the affairs of the corporation.

The board is charged by law for the welfare of the corporation. It represents the heart of what makes a corporation a useful and workable organization. Owners of the corporation expect the board to manage the affairs of the business with a broad perspective and with the long run in mind. The time factor, or the long-run, is one of the important features of a corporation; as a legal entity, it may have perpetual existence beyond the life span of the founders. The board of directors is responsible for the long-term guidance of the corporation.

The board has legal, social, and ethical responsibilities in representing stockholders or members of the corporation. Generally the authority of the board includes those responsibilities delegated to it by members or stockholders in the corporate papers (articles and bylaws) except limitations imposed by law. In concept, the board stands in the place of the real owners of the business. It is not the legal agent of the stockholders, but rather the elected representatives of the owners. Like the stockholders, the board of directors acts as a body, and membership on the board gives an individual authority to act only as a part of the group. Individually, a director is no different from any other stockholder or member. Together as a board, directors serve a trusteeship for the members.

While the board of directors is charged by law with the duty of managing the affairs of a business, this responsibility should not be interpreted as meaning the board should manage the day-to-day operating details of the company. This type of managing is delegated to the top executive, who is held accountable to the board for his decisions and performance. The board is responsible for directing the executive in conducting the company's affairs. Some of the distinctions between directing and managing are identified in Chapter 5; others will be developed in detail in this chapter.

Legal Responsibilities

Basically, directors have a legal obligation which is recognized as being personal and individual. They are expected to exercise good faith, undivided loyalty, reasonable care, and complete integrity in the performance of their position of trust. If they do not, they may be held personally and individually liable for losses sustained or damages done. This means that individual directors cannot abdicate their responsibilities for the management or trusteeship of stockholders' or members' interests by failure to direct. Put simply, the board is required to direct, and is held accountable to members and the public for its performance.

STOCKHOLDERS

BOARD

EXECUTIVE

Generally accepted legal responsibilities of the board of directors include the following:

1. Directors cannot abdicate their responsibility to direct.

2. They must manage the business along lines imposed through articles of incorporation and bylaws.

3. They are responsible for appointing officers and delegating authority to them for carrying out the functions of the corporation.

4. Directors must be knowledgeable of corporate affairs, to enable them to perform their duties effectively.

5. Directors must act in good faith and with reasonable care in handling the affairs of the business.

6. They are considered in law as representing a trusteeship to stockholders or members.

7. They must attend board meetings on a regular basis. Absence from board meetings does not constitute freedom of a board member from responsibility of decisions by the board.

8. Directors may be held financially responsible for losses incurred by the corporation under certain specific circumstances, principally gross negligence.

While the board of directors has full authority to conduct and manage the affairs of the company, there are state statutes which reserve certain corporate acts to stockholders or members. Therefore, the board of directors does not have full reign over the company. It enjoys those powers delegated by the members to the board and those which are not specifically denied to it by law.

Many state laws require that members must determine whether to dispose of the entire assets of the corporation. Thus owners or members, not the board, must make the decision to dissolve the corporation. Likewise, while some state statutes permit the board of directors to adopt the initial bylaws of a cooperative, the power to alter, amend, or repeal the bylaws and articles is often vested in the membership. Likewise, the board is not permitted to bring about a merger or consolidation without the approval of members or stockholders.

Boards derive their authority from the membership or stockholders who elect them. The corporate papers and state statutes specify what powers may be delegated to the board, and which must be retained by the members. The delegation of authority to the board is found in the corporation's bylaws, which outline decision-making areas where the board may take action without referral to the members or stockholders. Therefore, each director should thoroughly understand the bylaw provisions and state statutes affecting his duties. Each director's objective should be to represent the business more effectively as well as to avoid legal proceedings due to negligence.

Although directors may be considered trustees in a legal sense, their responsibilities go much beyond that imposed by legal considerations. They must take an active part by providing direction for the business. However, their role is not to make decisions on day-to-day operations. The board's power is derived from specific authority granted by stockholders, but it can delegate much of this to the top executive. Decision making on short and intermediate range programs is delegated to operating executives. However, directors cannot abdicate their responsibility to others; each director may, under certain circumstances, be held fully responsible for failure of the board to exercise its obligations to stockholders or members.

Although legal liabilities exist, directors are not often subjected to any great legal hazards in performing their duties. Nor can it be said that these

liabilities interfere to any great extent, in practice, with the performance of directors, except in cases of outright fraud or negligence. The common law applicable to directors recognizes that a board must make business decisions and should be allowed to take reasonable risks, make reasonable mistakes, and exercise relatively free judgment. The law does not place directors in strait jackets.

Any act by a board of directors affecting the interest of the corporation must be made with due care and undivided loyalty. This legal requirement may also be an ethical consideration, since certain possible actions, while legal, may be questionable from the standpoint of the organization's welfare. For instance, a director should not benefit, gainfully, from his activities in performing his job as a director beyond the normal compensation of directors. Even questionable in the eyes of the courts may be the sale of property of a director to the company, the giving of a mortgage on company property to a director, or any transaction in which the personal interests of the director would be adverse to those of the corporation.

Finally, it should be recognized that although the law may grant boards considerable power, an effective organization is not attained by heedless use of such power. Teamwork - the willing cooperation and coordination of all people in the company - is required for effective organization. Thus the legal powers of a board are subject to practical limitations.

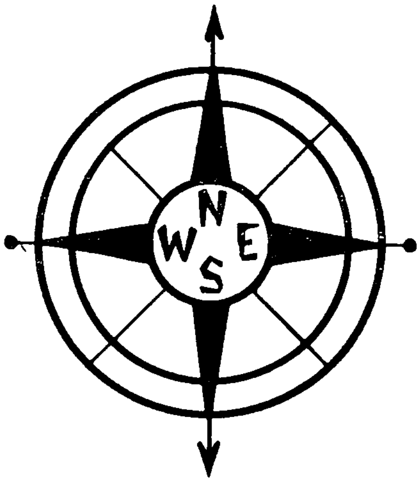
Traditional Generalized Responsibilities

Much has been written and spoken on the responsibilities of directors. There is little reason, if any, for seasoned directors to be in doubt as to their responsibilities. As previously stated, directors cannot abdicate these responsibilities, or delegate their ultimate accountability. We will briefly reconsider the traditional generalized responsibilities of directors at this time to provide a framework for discussion and review. The following are generally recognized responsibilities of directors.

1. Establishing basic objectives and broad policies

If it were not impractical to assemble the entire membership or stockholders to develop company objectives, this group would resolve fundamental company issues. Because it is, boards of directors are elected by stockholders to exercise those rights delegated to directors. Thus, boards are responsible for developing statements on broad company objectives and policies.

Not all policies are developed by the board. Those policies pertaining to the day-to-day operations of the business,



called operating level policies, are developed by the top executive and his management team. These policies are, however, often approved or sanctioned by the board. This is often a point of confusion, and many directors do not distinguish between approval and development. This prompts statements such as one expressed to us by a general manager: "One of my biggest problems is keeping directors from interfering in the operating decisions of the business."

To avoid such confusion, both managers and boards should distinguish between levels of policies. (See page 39.) Directors cannot be expected to be well enough informed of the operating levels in the business nor on the details of operations to develop policies at these levels. Directors should, however, have knowledge of the broad programs, objectives, and goals of the company.

2. <u>Maintaining and enforcing corporate papers</u>

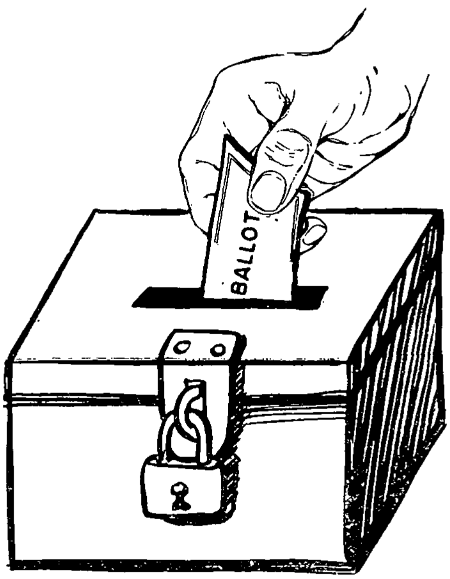
As a trustee, the board is expected to maintain and enforce the articles and bylaws of the company consistent with the law. The board must be certain that policies are consistent with the articles and bylaws, and that operations are consistent with these corporate papers.

The board is in a strategic position to visualize changing demands on the company resulting from a changing economy and industry. They are expected to interpret these changes to the membership. This allows members or stockholders to adopt amendments to articles or bylaws whenever necessary to adjust the basic purposes of the company. Executives who perceive these changes should point out such needs to the board of directors, which makes the decision or refers it to members or stockholders.

3. <u>Electing board officers to provide leadership and organization</u>

In directing a corporation, one of the main tasks of the board is to assure the continued existence of the business. The election of board officers and the selection of an executive is often a first step. Board officers should be in a position to provide the executive with leadership, by symbolizing the characteristics considered desirable for the management team. Board officers, as well as other directors, must distinguish between director-management responsibilities, and avoid engaging in management's area of activities.

Boards that assume responsibility for decisions at operating levels cannot evaluate executive performance nor exer-



cise effective controls. Operating decisions will be a conglomeration of board and executive decisions and it is not possible to determine just who is responsible for poor performance. For the board to guide effectively the destiny of the business, it is not enough for it to set objectives, goals, and policies. The board must exercise the proper degree of managerial control. It is not possible to measure the performance of executives unless there is a clear-cut division of responsibility and authority that is respected by both groups.

4. Approving appointment of key personnel

The board of directors is responsible for selection of the general manager or top operating executive of the company. In turn, the general manager is responsible for selecting key personnel. However, the board may reserve the right to approve all appointments of key personnel. Each key manager may have a chance of becoming general manager in the future, and approval provides a mechanism for boards to keep informed of executive development. The appointment of men who would not be compatible or qualified in the minds of the board members can thus be checked prior to that event.

5. Approving important financial matters

Most decisions by the board have a bearing on the financial position and continuity of the business. Certainly the board is responsible for the financial structure of the organization. Short-sighted and overly conservative financial decisions may restrict growth. On the other hand, the status-seeking "big spender" board may indulge in expansion which may threaten the life of the entire organization.

To be effective in financial decision-making, all directors need to be thoroughly acquainted with conventional accounting reports. They must understand the workings of the balance sheet and income statement, the concept of depreciation, and how to use the funds and cash flow statements. Directors should understand the more important financial ratios, including tests of profitability, liquidity and solvency. Directors who understand and use these tools will be more effective in performing their responsibilities. These are discussed more fully in Appendix A.

6. Safeguarding and approving changes in assets

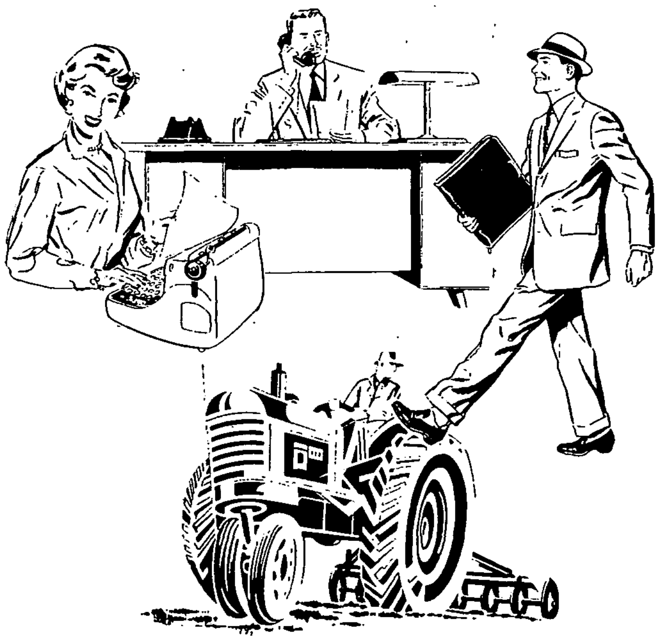
One of the greatest expectations of members and stockholders is for the board to maintain or increase the value of owners' investments by prudent guidance of the corporation. Directors are elected as trustees of the corporation's assets and are responsible for their safeguarding.

Issuance of securities is a typical occasion when the board must exercise sound judgment. Unwise issues of securities may cause a reduction in the value of stockholders' or members' equity. The board should study the effects of new stock issues, retained earnings, and long term debt when questions of financing expansion arise.

The board is accountable for pledges of assets and the possible effects on existing capital obligations to stockholders and members. This responsibility cannot be delegated to executives; it must be reckoned with by the board. Pledging assets to secure capital for poorly planned programs can rapidly erode stockholders' or members' equity.

Declaration of dividends is another financial responsibility of the board. The extent of dividends and how they are declared may determine the confidence of stockholders or members in the business. It may also affect the acceptance of new issues of securities.

A cooperative board must decide the time periods for pools, amount and timing of advances to be made prior to final settlement, determination of the amount of capital to be retained, and the time period for revolving members' equity capital.



7. Harmonizing diverse interests of stockholders or members

A corporation is a complex, living group of special interests, including members, stockholders, executives, and employees. The board must serve in such a manner as to promote harmony among these diverse interests.

Some stockholders of proprietary corporations are interested in acquiring stock as a means of obtaining control over the corporation. Others are interested in the income from stock ownership in the form of dividends. Still others are interested in growth or capital gains, and current dividends are not considered too important. It is obvious that individuals have a scale of preferences for financial and other decisions. This scale of preferences is related to what economists call "utility." Utility is the satisfaction one derives from the consumption or possession of various goods or services. A decision has utility to the extent that it satisfies wants, and thus serves as a basis for individual decision making. It is of importance to the board since each individual stockholder has his own set of utility preferences, and it is difficult to bring about a complete harmony. Nonetheless, the board must recognize the different values of stockholders when making financial and other decisions.

An example of possible conflicts among members of marketing cooperatives may be in the settlement and timing of pools. A single pool operation may provide the board and executives considerable flexibility in pool settlement for each crop marketed. A higher return may be given to some commodities in which the cooperative desires to increase members' production. This may require reducing returns to growers of certain other crops. This poses no problems as long as each member has equal production of all crops in question. However, this is not often the case. Thus conflicts may arise among producers of certain crops, and the board must deal with such conflicts in such a way as to maintain harmony.

Finally, diverse interests of executives, stockholders, and members may exist regardless of the type of corporation. Owners may desire a stable, conservative organization, while executives may be primarily interested in building an expanding organization. Conflicts such as these provide challenges to the board to bring about a reasonable degree of harmony in the business.

8. Perpetuating a sound board and election of officers

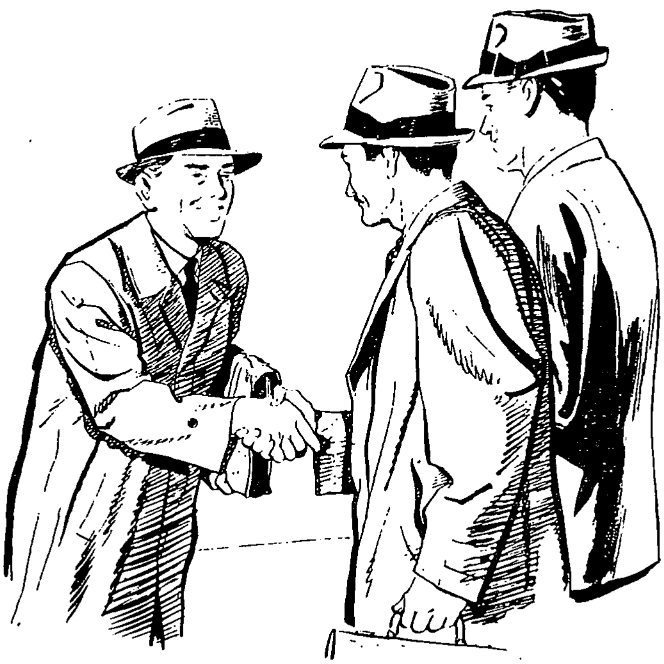
The basic objective of earning sufficient profits is to assure the continuation of the business organization over time. The board can influence the continuation in varied ways. One way is for directors to provide for the perpetuation of a sound board of directors. It should be clear that the responsibility of directors is not necessarily to perpetuate their own continuation as board members, but to perpetuate a group of people who would be capable directors.

In some farmer cooperatives, past directors constitute an advisory council.

They are used as a sounding board by executives and the board. In others, there may be an auxiliary board whose purpose is mainly to educate members. Such boards acquaint a large number with the workings of the business and serve as a pool of knowledgeable people who can be effective as future directors.

Obtaining capable directors involves two different types of education. First, owners should be informed as to the types of directors needed by the firm, and the special requirements of directors. Too often, elections of directors are based on popularity. Sometimes directors are elected as a means of bestowing honor. Neither assures stockholders that such directors are able to serve as effective trustees. Therefore, members need to be informed of directors' responsibilities and of the qualifications required.

Secondly, the board is responsible for the orientation and education of new board members. Proper education and reporting will help new directors be more effective in a shorter period of time. The board should determine that all new directors receive and understand the contents of a director's manual. This should include organizational charts, articles and bylaws, position descriptions for directors and the general manager, organizational structure of the board and board committees, and current financial statements.



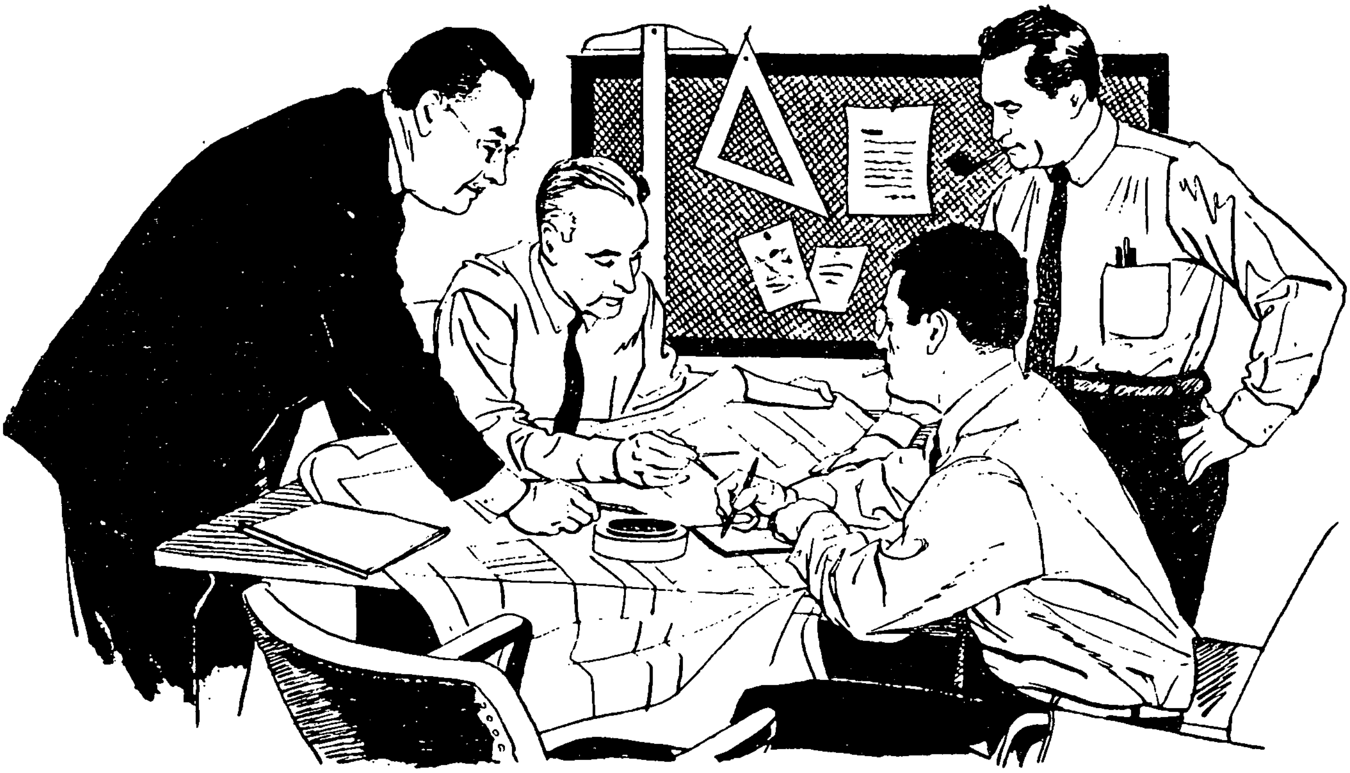
In addition, the orientation should include visits to each department where the major activities are pointed out, and how these contribute to the effectiveness of the business; introductions to department managers; and a special understanding of procurement and marketing environments of the corporation.

The authors believe it is the responsibility of the board to bring about the proper degree of understanding in each of these areas of education.

9. <u>Providing for sound planning</u>

The foundation of any business, in addition to qualified personnel, depends upon the objectives, goals, and policies established by the board. A board of directors does not just pull out of the air some objectives and policies for the business, nor do they adopt those of other firms. These are individual matters which must be tailored to the specific needs of the corporation. Some writers imply that board planning literally means that the board will plan all activities of the business. We do not hold to this opinion. The board must actively engage in planning certain matters, but delegates most of the planning to operating management levels. The board is accountable for the plans developed by subordinates and must approve, reject, or modify these as required.

We believe the board is accountable for planning objectives, goals, and policies, and should have a major role



in their development. Although accountable, the board will most frequently delegate to executives the planning of major facilities, services, resources, and many other matters. The board has final authority and responsibility, and this responsibility cannot be delegated.

Directors may have many interests and limited time, and their primary value to the firm is in providing the broad viewpoint and guidance to executives. As a practical matter, directors often cannot devote the necessary time and resources to development of detailed operating plans; however, their widespread interests and knowledge of firm and industry matters place them in a unique position to evaluate operating plans.

10. Coordinating short-term decisions with long-range objectives

There are at least two considerations which affect the role of the board of directors in planning. First, there are different time-periods in planning, and second, there are interrelations among plans.

Time is an important part of planning. Normally we distinguish between short and long period plans. But in actual operations there is another - the immediate time period.

Time Periods for Planning

1. Immediate
2. Short range
3. Long range

Let's consider the immediate situation first. Some call this emergency planning, and sometimes it is. However, there probably are more occasions when it may be "crisis" planning. And with some firms, it is planning from one crisis to another. "Crisis" planning is not really planning. Planning, as done by executives and the board should be "thoughtful determination and systematic arrangement of all the factors required to achieve the goals and objectives of the business. It is getting ready to do the work." "Crisis" planning is often merely the reaction of the executive body to an unexpected situation. Most of these crises could be prevented by proper development of policies and objectives, or through actual planning.

Short-range planning is usually concerned with situations anticipated or expected during a one-year period. Actually the time element is quite flexible. The short range is the time period in which the company cannot make adjustments in operations. For example, if weather conditions hasten the maturity of a crop being processed, a processor cannot increase his operating capacity by installing additional equipment or adding more floor space to compensate for larger tonnage being delivered by farmers. Another feature of this type of planning is that as one goes from lower to higher levels in the organization, there is less emphasis on planning of current activities. The board is primarily concerned with long-range planning, while supervisors or foremen are concerned with current planning.

Long-range planning is really a function for the board and the executive. It is that planning period in which the firm is able to vary or adjust its operations in line with stated objectives. It can add equipment, buildings, and personnel as needed. Long-range plans may be projections made five to ten years in advance. They are kept five to ten years in advance by annual reviews by the board.

A second consideration is that all plans should be interrelated, from short-range to long-range. Two considerations are apparent here. First, there should be consistency in plans and programs to avoid conflicts. What the company does in the short-run should lead it in the proper direction to achieve its long-run objectives. Here the importance of goals and objectives as benchmarks and targets is evident. These are discussed in Chapter 4.

Second, there is a link between one decision or plan and another, and planning cannot be viewed in isolation, apart from other activities. This chain effect between plans is really a matter of a sequence of plans, whereby one plan leads to a certain goal, which leads to additional planning, and so forth. Plans must be considered from the standpoint of: 1) their costs; 2) effects if the plans are not followed; 3) expected results from carrying out the plans; 4) what reactions may be expected from competitors if plans are achieved, and 5) what future plans are required as a result of achieving current plans.

This sequence of planning decisions is a recognition that there are many changing factors entering into the formulation of a plan, rather than a fixed set of circumstances to be reckoned with in a once-and-for-all manner.

Planning has in recent years taken on a scientific framework, and many successful businesses are utilizing modern techniques to help in making plans. More attention will be given this subject in chapter 6.

11. Communicating with members or stockholders

As representatives of stockholders' or members' interests, the board of directors has a special responsibility to see that effective channels of communication exist between the board and management and stockholders or members. This communication must be effective in both directions. Farmer cooperatives, in particular, must maintain close understanding between members' interests and that of the cooperative.

Boards of cooperatives may consider a monthly newsletter and annual meetings as effective means of maintaining communications. Often, these should be considered minimum efforts, supplemented by other devices such as special letters and local meetings. Professional assistance is often available to assist boards in measuring effectiveness of communication activities.

Board Responsibilities for Adapting to Change

The environment in which a business functions is constantly changing. Also the personality of a business is subject to change over time, either consciously or unconsciously by the manner of performance and behavior. The board has an important role in either perpetuating or changing the personality or public image of the business. Likewise, as the needs of the business change over time, the responsibilities of the board are likely to be affected. In many corporations, the board and executives share responsibility for handling relationships with government, the industry, and the general public. Examples include participating in trade associations, industry study or research groups, and coordinating with government commodity programs. Increasingly, changes in government relations with business, as well as social changes, are bringing about a need for clarification of the role of the board of directors.

Social and Public Responsibilities

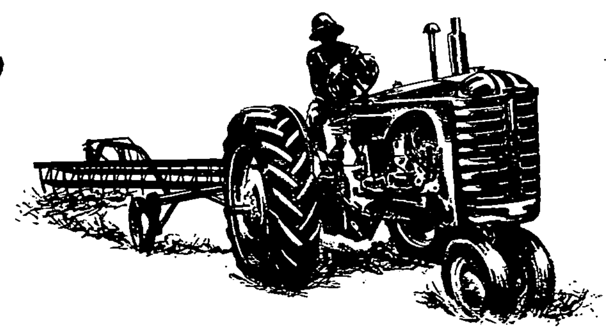
The board of directors is limited in its authority by members, stockholders, the law, and public opinion. If the board arbitrarily follows a course of action, it may encounter considerable criticism. This may come from competitors, from the press, and from the rank and file of the community.

Furthermore, a corporation gets its ultimate sanction from its usefulness to society. While it receives its legal documents from administrative agencies, its ultimate purposes must be compatible with standards established by society. Directors must be sensitive to the ever-changing standards of the public. The board assumes a great deal of social responsibility and must consider the effects of its decisions on others in the community.

Business Morals and Ethics

Modern business ethics no longer require that the "buyer beware." A remarkably high degree of business ethics is a part of American business today. Some of these ethical standards have grown out of business practices. In other cases they have evolved from government persuasion (i.e., the 1962 steel price situation) or from trade associations.

Integrity of the corporation to society is only part of the picture. Direc-



tors' integrity toward their company and its owners is also very important. Each director ought to promote a balanced welfare of the company, rather than only serving partisan interests. This includes directors who believe they represent special commodity or geographic interests. When directors attempt to protect or favor their constituents, the result may be internal conflict detrimental to the company's health.

The board must give consideration to the demands and interests of all groups in the organization. Effective boards develop a nonpartisan point of view. Also, an atmosphere of good faith and integrity must prevail within a board if there is to be good will. With distrust and suspicion, internal difficulties will plague the company, along with those from outside sources. Modern conditions require that directors possess and practice absolute integrity in all their responsibilities.

Government Relations

Today, the influence of government permeates practically every business organization. Governments may provide business opportunities, and they often set restrictions on what business organizations may do.

Recognizing the influence of government, many businesses increasingly find that they must be active in the political-economic field to safeguard their interests. Legislatures are constantly being pressured in two ways: 1) by foes of an industry proposing legislation to curb certain industry activities, and 2) by industry groups desiring special or self-interest legislation. In the modern political-economic arena, there will be more calls for direct intervention by boards in legislative proceedings. Directors can no longer hesitate to enter this controversial field, since opponents will be active.

Director responsibilities are in a constant state of transition. They are being asked to consider a broader scope of business activities than ever before. The effectiveness of directors may be dependent upon their willingness to view business conduct from society's standpoint as well as from the owners'.

Chapter 2.

FUNCTIONS OF THE BOARD OF DIRECTORS

In this chapter we introduce the functions of the board of directors. These are:

1. Supreme decision center
2. Advisory
3. Trustee
4. Perpetuating
5. Symbolic

The broad classification of the special purposes or functions of the board establishes the general field for board action. How the board carries out these functions is the subject of the remainder of this manual. Therefore, this chapter introduces the concepts connected with each function.

Supreme Decision Center Function

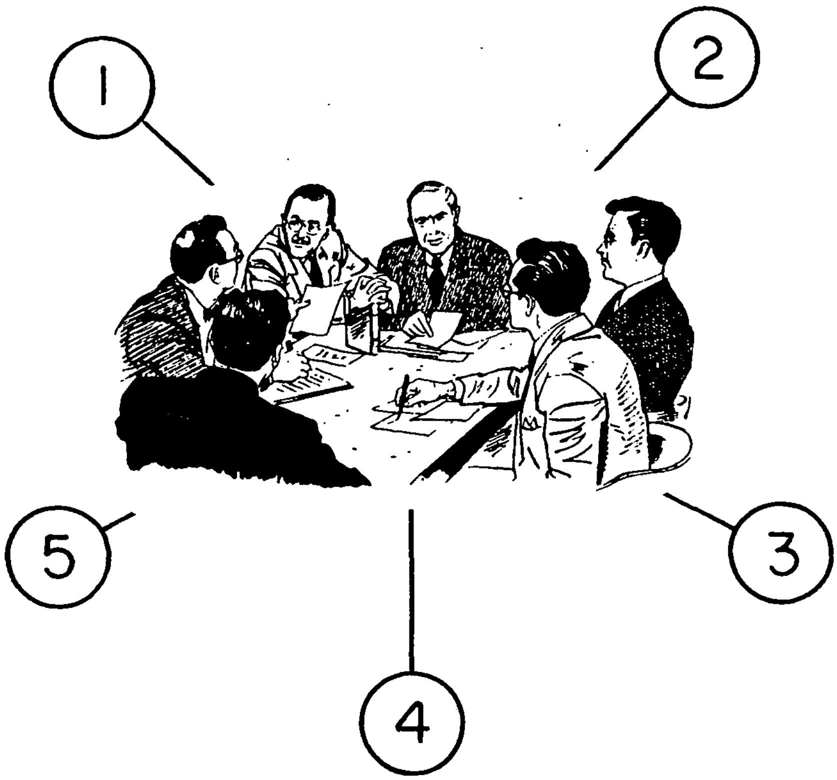
The concept of the board as the supreme decision center recognizes the fact that a corporation must have one decision center for coordinating the whole enterprise. In a large organization there are multiple decision centers and the board is the one which is central and superior to all others. Issues requiring decisions will flow upward to the supreme decision center if the capacity for resolving the issue does not exist at any lower level. Once the supreme center makes a decision on a broad issue, it will move downward and be translated into more specific terms at each lower decision center.

The board is primarily concerned with decisions on the broad course of action to be followed rather than decisions concerning the means for carrying out a course of action. Board decisions determining the over-all course of action are equivalent to defining the field in which all operations at lower levels take place.

Day-to-day decisions are something like those a football coach makes on whether to use the Single-Wing or T-formation next season. These types of decisions are made by executives. They specify how the broad course of action - playing football - will be carried out by the players. A decision by a college faculty to drop football as an intercollegiate sport is something like those decisions made by the board of directors. Such a decision calls for completely redefining the field of athletic operations and must be made by the supreme decision center.

The board of directors functions as the supreme decision center by: establishing objectives; formulating, approving, and adopting policies; approving goals, programs, and plans; and by selecting the chief executive, and approving and controlling his actions.

The most significant role of the supreme decision center is to serve as an organ of growth and change. The board is a vital part of the corporation's organizational structure and is a source of initiative for changing the structure if it is not functioning effectively. The board should not have responsibility for specialized operating activities, for two broad reasons: 1) It must be free to bring about necessary changes in the organization, and even in itself; and 2) it must appraise and evaluate over-all performance, and cannot do this objectively if it has assumed responsibility for operating decisions. Thus,



1. **Supreme Decision Center**
2. **Advisory**
3. **Trustee**
4. **Perpetuating**
5. **Symbolic**

the board's power of decision is a major link between organizational structure and directorate functions.

Advisory Function

The board of directors performs an advisory function for executives and for stockholders.

The board advises stockholders of changes requiring their action or sanction. These may be changes that will enable the corporation to perform more effectively in a changing environment or changes required by law and statute. The board's advisory function to stockholders is closely related to their function as trustees.

The board's role in advising the chief executive is more difficult to specify. In areas where the broad course of action is being determined, the board has a definite responsibility to advise, and sometimes to take the initiative. Alert executives will seek the advice of the board when formulating operating policies and when implementing broad policies and programs. Executives will also often seek the advice of directors on possible solutions to operating problems. Directors must remember that in the area of operations or on any responsibility delegated to the executive, it is the executive who initiates the action seeking advice or counsel. It is also the executive's prerogative to accept or reject advice on these matters.

Boards of directors can render extremely valuable advice on a vast variety of problems confronting executives. It is important that both directors and executives recognize their specific responsibilities for rendering advice and how each can work most effectively in an advisory role.

Trustee Function

The board functions as a trustee for members, stockholders, creditors, and the general public by assuming responsibility for the effective management of the corporation. Basically, the trustee function is the controlling of all corporation assets in such a manner as to protect each investor's capital within the general interest of society. Chapter 1 described the legal responsibilities of directors which form the basis for the board's trustee function.

The board carries out its trustee function by auditing and appraising the executive's stewardship over resources committed to the corporation. The board often employs outsiders to audit both the financial affairs and the managerial practices of the corporation. This provides the board with an independent check on the soundness of the corporation's business practices.

The trusteeship function is extensive at the board level and fundamental to the board's reason for existence. It should not be taken lightly or narrowly interpreted.

Perpetuating Function

The fundamental task of the board is to provide for the continuity of the corporation. The board accomplishes this by: 1) making certain that capable executives are continually available to the corporation; 2) selecting effective executives; 3) guiding these executives; and 4) making certain a capable and effective board always exists to direct the corporation's affairs. In essence, the board's ability to provide for continuity boils down to its own ability to remain a vital force over time. Its vitality must transcend the lives of stockholders, executives, and directors.

The board has two primary tasks in this regard: 1) To specify an ideal for the functioning of the board, and 2) to maintain a board at this ideal level of performance by transferring knowledge, skills, and attitudes to new board members. Broadly interpreted, the ideal for board performance encompasses all aspects of the board's job that enable it to perpetuate the enterprise. This again gives emphasis to the board's role as a stabilizing and adaptive organ for the enterprise. The board keeps the organization tuned to its current and future environment. This does not mean board members perpetuate their own continuance on the board, but rather, does require a critical periodic appraisal of the board's performance, outlining requirements for improvement.

Symbolic Function

An inescapable and difficult function of directors and the board is the symbolic one of leadership. Leadership maintains the power system through which an individual or organization promotes the power to act. By the very nature of the position, directors are considered symbols of strength and leadership, and capable of motivating people toward achievement of goals. An important aspect of communication between the board and executive is the extent to which symbolic behavior can be substituted for force in maintaining the power system. Persuasion takes the place of coercion, even though the board has authority to take more drastic action. The board can effectively change attitudes and expectations through the proper use of the power symbols associated with its position.

The symbolic function goes beyond the corporation. It permeates the community, industry, and institutions with which the business deals. Directors have a tradition and duty to uphold the corporation in all private and public contracts. A directorship is truly a position of honor, responsibility, and trust. It is a position reserved for leaders. Directors cannot escape the symbolic function associated with their position and must learn to perform it effectively.

In this chapter we have considered five basic special purposes or functions of the board of directors. Each of these functions is an inherent part of the board's job, and collectively they broadly constitute the task of directing as carried out by boards of directors.

Chapter 3.

THE TOTAL MANAGEMENT CONCEPT

Management refers to the guidance, leadership, and control of a group effort to achieve common goals. The term "management" refers to the processes an executive carries on in conducting the affairs of a business, the action phase. Or it may refer to the people involved in running the business, or the "who" phase.

In this text the term "management" refers to the processes followed in managing, rather than the people who manage the business. (Occasionally we will refer to a group or level of people as the "top management team.") "Directors" refer to individual members of the board. The "board" refers to the legal body authorized to act for the corporation. "Executive" refers to the highest level of manager, while "manager" refers to those personnel involved in managing, including, for example, division managers, department heads, etc.

The process of management can be clearly visualized by defining the functions that managers perform. These include Planning, Organizing, Directing, Coordinating, and Controlling.

The process of directing by the board refers to the board's responsibilities in the five functions of management. These are the same management functions which apply to executives and managers, but at these levels, the scope of application of PODCC is progressively narrowed. Therefore, the contrast between directing and managing is between how the functions are applied by the board and by executives. The board's responsibility for directing the business organization should not be confused with the management function of directing, which is but one of the five functions required for performing its job.

Because an understanding of management functions is essential to effective directing, the remainder of this chapter is an explanation of management functions and processes as applied to executives.

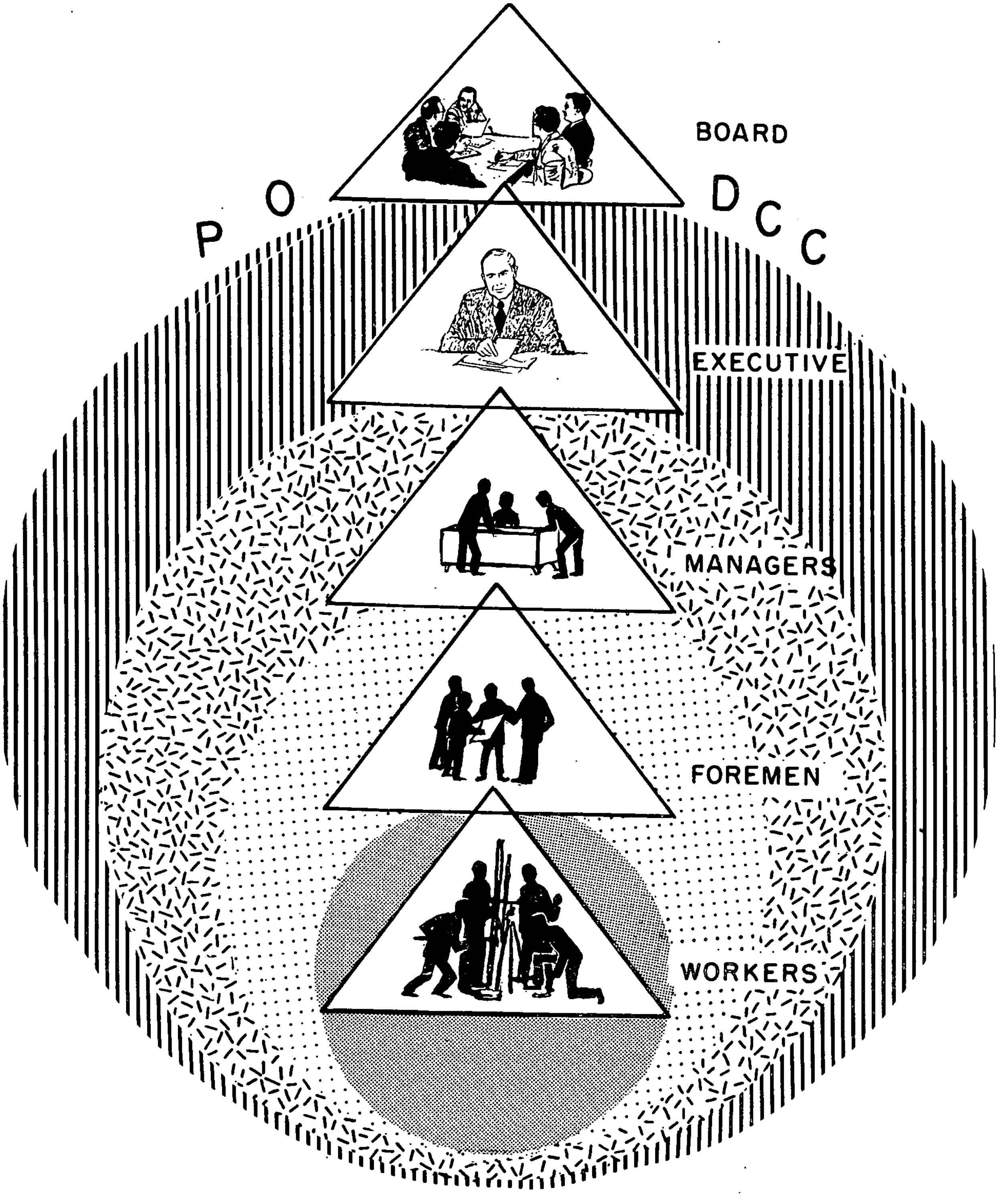
<u>Management Functions</u>

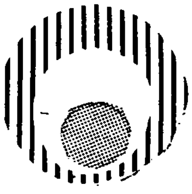
Earlier we referred to management as being the process of guiding, leading, and controlling the efforts of a group to achieve common goals. Some identify management as the "science or the art of combining ideas, facilities, processes, materials, and people to produce and market a worthy product or service profitably." Both descriptions are accurate, but we must do more if we are to describe precisely how managers go about their job of managing.

We first consider the role of managers in terms of functions they perform, providing an opportunity to understand the difficult job of managing. The five generally accepted functions of management are: Planning, Organizing, Directing, Coordinating, and Controlling.

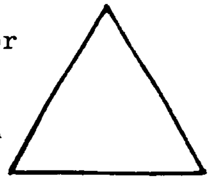
A manager is concerned with one or more of these functions when he performs his duties. They are the broad categories by which managers combine people, resources, etc., into a successful business.

The proportion of time spent on the five functions varies with individuals and organizations. This is expected, since problems, resources, opportunities, training and abilities of managers vary among businesses. However, for a business to remain successful it is necessary that adequate balance be maintained





Decisions and Policies by the board, executive, managers or foremen which prescribe and define the scope of subordinates' role at lower levels than at their immediate command.



Decisions and Policies, set by one level of management, which prescribe the role of an immediate subordinate or the roles of all subordinates in its command.

in the functional areas. With this brief background, we now turn to a summary of the functions of management.

Planning is deciding in advance what is to be done, when, and by whom. It is a process requiring thoughtful consideration of all factors necessary to achieve the objectives of the business. Viewed in this manner, planning is preparing for action, not actually carrying out the work.

There must be recognition of a need for action before any actual planning can be done. Planning needs to be coordinated with the objectives of the business to avoid later conflicts or waste of finances and resources. A good plan is based on investigation and analysis of the possible alternative courses of action.

A good plan is based on objectives and goals. It will be the result of an analysis describing what is to be done, why it should be done, and by whom and how the action will be carried out. Likewise, a good plan will include a satisfactory basis for control, and a means of evaluating or measuring results. Without the latter, it will be difficult, if not impossible, to determine later whether the plan produced satisfactory results.

Planning is based on skills which can be learned by managers. But planning requires more than mere use of skills and principles: It also requires judgment.

Plans are made at various levels in the business organization. In general, plans should be made at the lowest possible level in the organization. This means that managers at different levels prepare plans on matters delegated to them. The board, also, has a responsibility in the planning function. However, these responsibilities are different from those of executives and managers. Planning by directors is an issue requiring clarification. We will devote considerable attention to it in chapter 6.

Organizing is the grouping of activities necessary to 1) organize work units, and 2) define the relationships among the executive, managers, and workers in such units. The objective of organizing is to group activities, people, and other resources for the effective and economic accomplishment of plans.

After plans are established, they must be arranged and placed in proper relationship to be operational. Personnel must be hired, developed, or transferred; relationships between managers and organizational units must be established; procedures, methods, and systems must be made ready for operation; and needed facilities, tools, and supplies provided.

Organizing need not be difficult or complicated. It is essentially the process of departmentalizing activities or resources in line with sound organizational principles. Departments can be set up by functions, products, services, locations, time periods, customers, and processes.

These groupings are revealed in the organization chart, which shows relationships between departments. Increasingly, a new concept of organizational structure is becoming accepted; that is, organizational structure should be based around the objectives of the company. Once the objectives are defined and written, this concept calls for grouping of people, facilities, etc., in such manner as to facilitate achieving objectives.

For example, the objectives of a marketing and processing organization may be stated as being 1) to obtain an adequate volume of a commodity to meet the requirements of a plant, 2) to add services and modify the form of the product to produce acceptable forms for consumers, and 3) to market the product efficiently to earn a profit. In such an organization, three major departments are needed: 1) Procurement, 2) Production, 3) Sales. In addition, service departments may be required to advise or serve these major departments.

This brings us to staff and line organization, a system deeply entrenched in the military. Staff organization is commonly identified as groups of people who support the main line activities through advice, research, etc. They generally assume no authority in these relationships, which leaves the line departments free to accept or reject their services. Common staff positions include the attorney, research unit, planning and development, and accountant, to name a few.

Line organization refers to the operating and decision centers of the business. In a pure line structure, the head of each unit is responsible only to his immediate supervisor, and he has authority over the activities within his unit. Actually, most organizations are a combination of line and staff units, organized in such manner as to work effectively and efficiently in a coordinated manner.

Many company problems are due in part to faulty organizational relationships, which contribute to poor communications and control. Among the important tools available to managers in developing a workable organization are the organization chart, job descriptions, job specifications, and the organization manual. Job descriptions define responsibilities, authority, and relationships between jobs. Job specifications define the special skills or training required for specific jobs.

Directing is the process of getting plans carried out and projects initiated and completed by effective instructions to people. Directing is a part of supervision, which refers to the day-to-day relationships between an executive and his assistants. It also includes the training, direction or instruction, control and motivation, and discipline needed to maintain adequate personnel relations.

One phase of good directing is effective delegation of activities to the lowest possible level in the organization capable of handling a situation. The interrelations of management functions become obvious, since effective delegation is dependent upon proper organization.

Our definition includes instruction as one phase of directing. Each instruction should include three basic features: 1) Compliance should be reasonable; 2) the instruction should be complete as to what is to be done, and when; and 3) it should be clear to the person receiving it.

Directing can be simplified by establishing standard practices, which reduce repetitive instructions and economize communications.

Successful practices in direction are summarized in the following checklist:

1. Determine what jobs are to be done.

2. Determine what tools, supplies, and facilities are necessary to do each job.

3. Prepare clear and effective orders, instructions, and information.

4. Establish standards of performance and control points for each person.

5. Provide for proper communications and relations with and between all organization units.

The board is concerned with directing, for at least two reasons: 1) Because it is essential that proper direction be given by the board to the executive, and 2) to understand the nature of the directing function as a basis for evaluating how well the executive performs in this functional area.

Coordinating is the fitting together of the components of an organization, including people, facilities, and other resources. Each operating unit needs to understand its counterparts to achieve effectively and efficiently predetermined objectives or goals.

Good coordination is required for effective planning, organizing, directing, and controlling the business organization. A coordinated operation is one where the activities of employees are harmonious, integrated, and combined to achieve a common goal. This poses a real challenge to managers, since coordination runs through the whole organization, and it is a necessary and integral part of every managerial action.

Managers may consider several approaches to improving coordination. For instance, effective coordination may require a clarification or change in organizational structure to permit resolving problems within lower organizational units. Clarifying the organizational structure and outlining procedures eliminate many questions as to responsibilities of people and work units. Likewise, coordination must be a part of all planning activities if the business is to reach its planned goals. Plans often fail because poor coordination nullifies potential gains, either because of incomplete scheduling or inadequate timing.

Another approach is to promote voluntary coordination among people and units. Developing standard procedures, encouraging informal contacts, and wise use of interdepartmental committees facilitate voluntary coordination.

It should be apparent that the board also needs to perform the function of coordination. A poorly coordinated board of directors encourages poor coordination at other levels within the business.

Controlling is the process of getting plans followed according to specification, evaluating results, and taking remedial action to prevent unsatisfactory results.

The purposes of control in the business are outlined as follow:

1. To provide planning information.

2. To keep people apprised of progress in achieving plans.

3. To predict trends and to forecast results.

4. To provide useful information for determining what action is necessary to overcome recurring problems.

5. To prevent unauthorized actions by employees or managers, and within departments.

Secondary benefits result when adequate controls are devised and used. For instance, devising controls as meassures of progress requires that clear-cut objectives and goals be developed, that time tables be established, and that adequate planning and coordination exist. Controls require effective performance on other functions and that established policies be followed.

Results cannot be evaluated without a well-designed control program. A minimum of controls may be required in an organization doing effective planning, organizing, directing, and coordinating. Still, controls are needed to measure how well the other functions are being carried out in the business.

Viewed in this manner, controls are not primarily to prevent certain activities from being carried out, although this is the common interpretation given to this function. Controls include the yardsticks for measuring the progress of the business. To be effective, controls require the establishment of standards, motivation of people to achieve these standards, comparison of results against standards, and corrective action when performance deviates from the plan. The board has a special interest in the control function, because it is probably the most important single activity it performs.

These brief summaries of management functions relate the close interrelations between and among the processes of management. Inadequate attention to any one of the functions is an indicator of poor balance in the management processes. The situation is similar to the working of a tractor engine; that is, if one cylinder is not functioning well through a faulty sparkplug, the over-all power of the engine is reduced and its ability to work efficiently is curtailed. In time, the effect may extend to other cylinders and a major overhaul may be required. Careful consideration to the proper balance of the functions of management will forestall such happenings to the business. The board has a vital role to play in insuring the smooth, efficient functioning of the business organization.

<u>Management Processes</u>

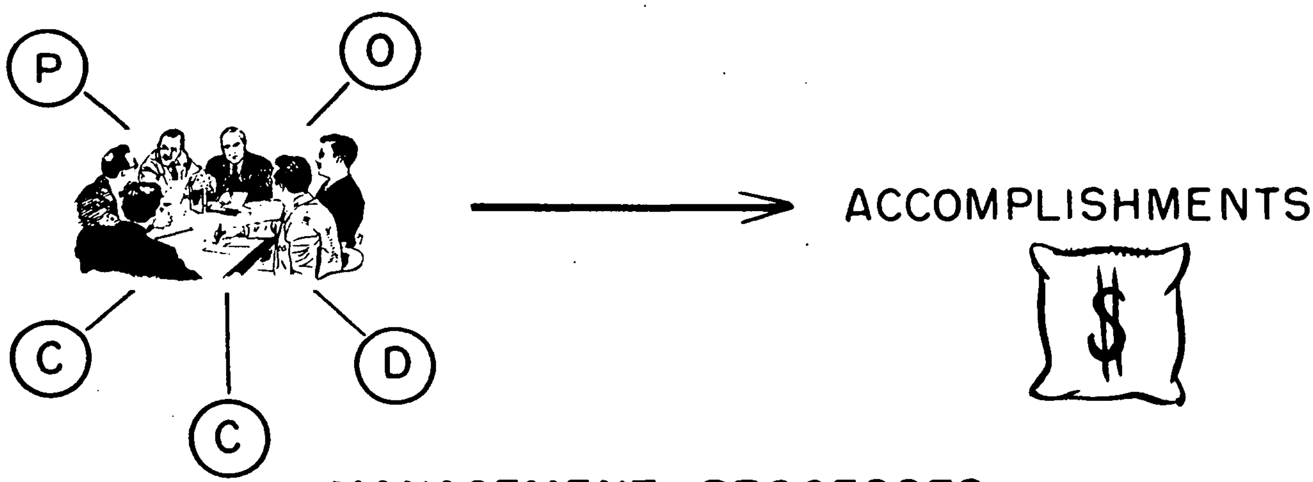
Earlier we defined management as the guidance, leadership, and control of group efforts to achieve common goals. This was followed by a discussion of the broad functional responsibilities of executives, which were identified as Planning, Organizing, Directing, Coordinating, Controlling. This method of viewing the functional responsibilities of executives is helpful in developing a concept of the close interrelations of various activities in managing a business. However, it falls short of describing the processes involved in carrying out the five functions of management.

Therefore, we turn to the management processes to gain this insight, keeping in mind that both boards of directors and executives are a part of the management team. That is, the scalar level of boards of directors, executives, and managers is a distinction based on the types of activities with which each is concerned, and not a distinction of functional areas of activities.

Stated simply, the management processes include:

1. Identifying areas where decisions are required.

2. Determining who shall make the decision.



MANAGEMENT PROCESSES

1. Identifying decision areas.
2. Who makes the decision ?
3. Determining sequences of activities.
4. Determining time schedules.
5. Setting standards.
6. Setting controls.

3. Determining sequences of activities.

4. Determining time schedules.

5. Setting standards for measuring consequences of decisions.

6. Setting standards to evaluate results.

Essentially the manager's and board's role is viewed in terms of decision making. The ability to make wise decisions is essentially the ability to manage or direct effectively. For instance, the board is required to make decisions on the following:

1. How do you appraise the business?

2. How do you appraise the executive?

3. How do you appraise your own board performance?

4. How do you improve each of the above?

Identifying Types of Decisions

Decisions are essentially of two types: programmed and nonprogrammed (repetitive and nonrepetitive). Actually there are many types of decisions, including every conceivable degree of the two listed above. However, this simple classification represents enough distinction between the two to be useful in this discussion.

Identifying types of decisions is important to manage effectively. Programmed decisions are routine or repetitive. Recognizing these is essential if managers are to free themselves of the bother and trouble of making decisions on routine matters. Decisions become programmed because they are repetitive and procedures can be developed to solve them. Inventory reorder levels and vacation leaves are examples of programmed decisions. Handling such matters through established procedures enables decision making at lower operating levels.

Nonprogrammed decisions relate to new or unique problems that occur infrequently. A well-defined procedure for handling these types of decisions doesn't exist because the problems have not occurred before, are complex, or are highly significant to the corporation.

Both types of decisions may present problems to managers of some corporations, although they should not. Programmed or routine decisions can be solved through effective procedures that are understood by those affected. Nonprogrammed decisions continue to require the full capacity and abilities of the management team through the problem-solving processes discussed later.

Methods of Handling Programmed Decisions

There are at least four methods to facilitate the programming of decisions:

1. Standard operating procedures.

2. Policies.

3. Organizational structure.

4. Rules of thumb.

5. Electronic data processing.

To the extent that decision matters can be made routine, decision centers can be shifted to lower levels within the organization, and generally, administrative efficiency improved. Also employee morale may be improved. Standard operating procedures (S.O.P.) make clear to each employee the amount and kinds of decisions he can make. Standard operating procedures are effective means of handling routine decisions. However, when devising standard operating procedures, executives and managers must give careful consideration and attention to interdependence and long-run effects of these. A useful guideline for developing these include observation of methods employees follow when faced with a given problem. Is delegation practiced? Are employees involved in arriving at a decision or are the decisions by administrative decree? Generally, acceptance and understanding are improved by involvement in the development of SOP's.

Operating policies represent a second method of decision making for recurring situations. A policy is a general statement that guides employees of a firm in the conduct of its operations. They are effective in reducing the amount of time an executive must give to a problem, and they are helpful in securing uniform action over time. For instance, a credit policy may outline the general philosophy of the company on the acceptance of credit risks. As such, it broadly establishes the basis for detailed procedures involving the granting or denying of credit.

Operating policies are different from standard operating procedures. A policy covers a broad area or a basic issue, and requires more careful consideration before it is adopted. Procedures normally deal with the way a policy is to be carried out.

A well-formulated organizational structure aids in routinizing certain decision-making situations by clearly identifying relationships among units. Organizational structure refers to over-all organizational arrangements that are planned to develop balance within and between units to achieve the objectives of the business. These relationships are outlined in the traditional organization chart.

When well defined and understood organizational structures do not exist, executives and department heads are apt to duplicate efforts. This probably would not occur if the structure were well identified. For instance, to whom should the fieldman of a processing firm report?

Without a specified reporting relationship he may actually report to two or more managers on similar problems. This discourages routinization of work and economy of effort.

Rules of thumb provide still another means of handling decision-making on a routine basis. Rules of thumb are accepted standards evolved over a period of years as a result of recurring events.

Thus rules of thumb serve as an effective indicator of a manager's reaction to a specific problem, but they should be based on company experiences whenever possible.

They are not the type of problems for which policies can be developed. In part this is true because some of the problems where rules of thumb apply may be beyond the control of the business.

Some executives are quick to devise rules of thumb as standards for measuring outcomes. Where rules of thumb are based on the firm's own experiences, these can be a reliable basis for preliminary decisions. For instance, the executive of a fruit and vegetable processing firm may discover from past records that a 12 per cent increase in wages paid to union workers requires reducing the number of workers by 10 percent to maintain the same unit costs. Of course, there are other rules which could be applied based on company records, as increasing the speed of inspection belts by 5 percent.

Rules of thumb can also be used in decision-making for nonprogrammed, or nonrecurring situations. Their use in such instances requires a more careful consideration of their appropriateness as a basis for action.

Electronic computers and supplemental equipment provide another means of handling routine matters. Electronic data processing is a means of routinizing certain decisions which otherwise may require recurring subjective decision making. Maintaining predetermined inventory levels and statistical quality control in processing plants are examples of sequential decision making where the use of electronic equipment enables nonprogrammed decisions to become programmed.

Handling Nonprogrammed Decisions

An effective administrator or manager needs many skills, but decision making is one of the most important skills required. Routine matters cease to present decision problems when effective methods for handling them are devised. New situations or improved methods of handling old situations may require innovative action. Therefore the major concern of an executive is to make decisions on nonrecurring matters. In reality, the executive's job not only involves making good decisions himself, but also seeing that the entire organization under his control makes decisions effectively. Most of the decisions made in a firm are the result of subordinates' efforts. Because decision making permeates the entire business organization and is the core of effective operations, a separate chapter deals with tools for decision making at the upper management levels. For the present, we will review the basic concepts of handling nonrecurring decisions.

Decisions are nonprogrammed to the extent that they do not recur on a regular basis, or where the nature of the problem is vague or requires special consideration before action can be taken.

There are at least four distinct methods of handling decisions of this type:

1. Judgment or deductive reasoning.

2. Intuition.

3. Predetermined standards based on company objectives.

4. Operations research based on economic and statistical methods, including use of electronic computers.

Decisions are made to guide the course of human action as the basis for perpetuating the business organization. General outcomes of decisions are twofold:

1. To select a new course of action, different from that being followed.

2. To continue present activities unchanged since it represents the best alternative available to the company.

Both outcomes have their roots in the present courses of action. Where a decision calls for a change, it is a change from present activities. Where the decision rejects change, it sustains continuation of the present action.

Judgment, or deductive reasoning, is the basic framework of all nonprogrammed decision situations. Recognizing situations requiring decisions is basic to decision making. Unless those responsible recognize the need for change, no thoughtful consideration will result, leading possibly to continuation of activities which may threaten the business organization.

Judgment as a basis for decision making requires that systematic considerations be given to a situation. Therefore, we will now outline a decision-making process.

Decision-Making Process:

1. Recognize and define the problem.

2. Recognize the workable alternatives.

3. Determine information needed to appraise the workable alternatives.

4. Assemble information needed to appraise the workable alternatives.

5. Evaluate alternatives on the basis of expected results.

6. Reach a conclusion and prepare plans to carry out the decision.

7. Prepare basis of evaluating.

Some writers list only three stages in systematic decision making as follow:

1. What is the problem?

2. What are the alternatives?

3. Which alternative is best?

It is apparent that these steps require considerable judgment on the part of those involved in making the decision. What type of information should be assembled? What are the alternatives? What are the possible results of different alternatives? How do you measure the pay-off? Subjective decision making with its high potential incidence of error has brought about considerable effort to systemize decision making, using recently developed scientific techniques.

Mathematicians, economists, and statisticians have been joined by others to devise methods and tools for fast and effective decision making. These new techniques are not magic, but they do offer a much broader framework for solving a given problem. The basic framework is quite similar to the process just outlined, but the newer techniques permit consideration of many more types of actions and alternatives. With computers, information can be handled so much more efficiently that given the appropriate input of information, nonprogrammed decisions can sometimes be converted to programmed decisions.

Many of the new techniques are based on mathematics, and they require competently trained people to use them. Some firms have staff organizations whose primary function is to provide executives with better information on alternatives using the new techniques. Smaller firms may use outside consultants specializing in analyses based on the "modern" decision making techniques.

Company objectives serve not only as a basis for evaluating certain alternatives in the decision making process, but they may be useful as methods of handling nonroutine situations. In either case, company objectives must be up-to-date statements of the aims and purposes of the company if they are to be useful in decision making. Every business needs a clear statement of its objectives as a guide for action programs.

For example, a marketing cooperative needs an objective pertaining to business growth. It may establish a rapid growth objective, or prefer stability. If either choice is made, there are several alternative courses of action possible. The important point is that the board must establish a clear-cut objective that is related by the executive to operating and planning units. This illustrates the importance of company objectives in clarifying the direction a business may take, and indicates the importance of objectives in decision making. Consider the company with several feasible investment alternatives. One basis of choice among alternatives may be return on investment. If a company has a minimum return on investment objective, then those investments not meeting a certain minimum may be eliminated from consideration.

Decision making involves establishing a systematic method which yields consistent and sound decisions. No matter how long a time period is involved in the decision making process, each decision should be made in a systematic fashion. Fortunately the techniques and tools which can be utilized for decision making are more numerous now than previously. With careful selection of these, executives can reduce, but not eliminate the subjectivity of decision making.

It should be apparent that the board as well as other levels of management are involved in decision making. In a subsequent chapter we will discuss how the board can be more effective in the decision-making processes.

Discerning Questions

Probably the most effective impact a board may make in the consideration of a decision is through the questioning process. Questioning serves to focus the issues, and makes available more information which facilitates effective decision making. Not every director is effective in the questioning process,

TIP-OFFS FOR ASKING DISCERNING QUESTIONS

1. Do plans support objectives ?

2. Are executive explanations reasonable ?

3. Are financial records satisfactory ?

4. Do programs conflict with studies ?

5. Are operating results favorable ?

6. What are industry trends ?

since the process can be diverting from the issue as well as educational. The skill required is that of asking discerning questions at the proper time. This places a heavy burden on individual directors. It means taking time for advance study of the situation, so that discerning questions can be asked at the right time. Most often, discerning questions are the product of thought and study of a corporation's affairs extending over a considerable period of time. It also calls for a breadth of experience, tact, judgment, and often, courage.

Discerning questions should be eductional both to the board of directors and to executives. In the process of being drawn out by careful questions, the thinking of executives will be clarified. At the same time, directors will be broadening their knowledge of the affairs of the company. The privilege of asking questions bears a responsibility also to be a good listener.

Sensing when and where to ask searching questions requires careful thought, since unrelated questions prove to be deterrents to decision making. Tip-offs for questioning may arise from many sources, but most frequently they arise from:

1. Failure of results or plans to support the stated objective.

2. Statements by executives in defense of a questionable proposal.

3. Items on the income statement or balance sheet.

4. Special reports and studies.

5. Unfavorable operating results, as poor quality merchandise, high costs, or inadequate services.

6. Experiences of other companies.

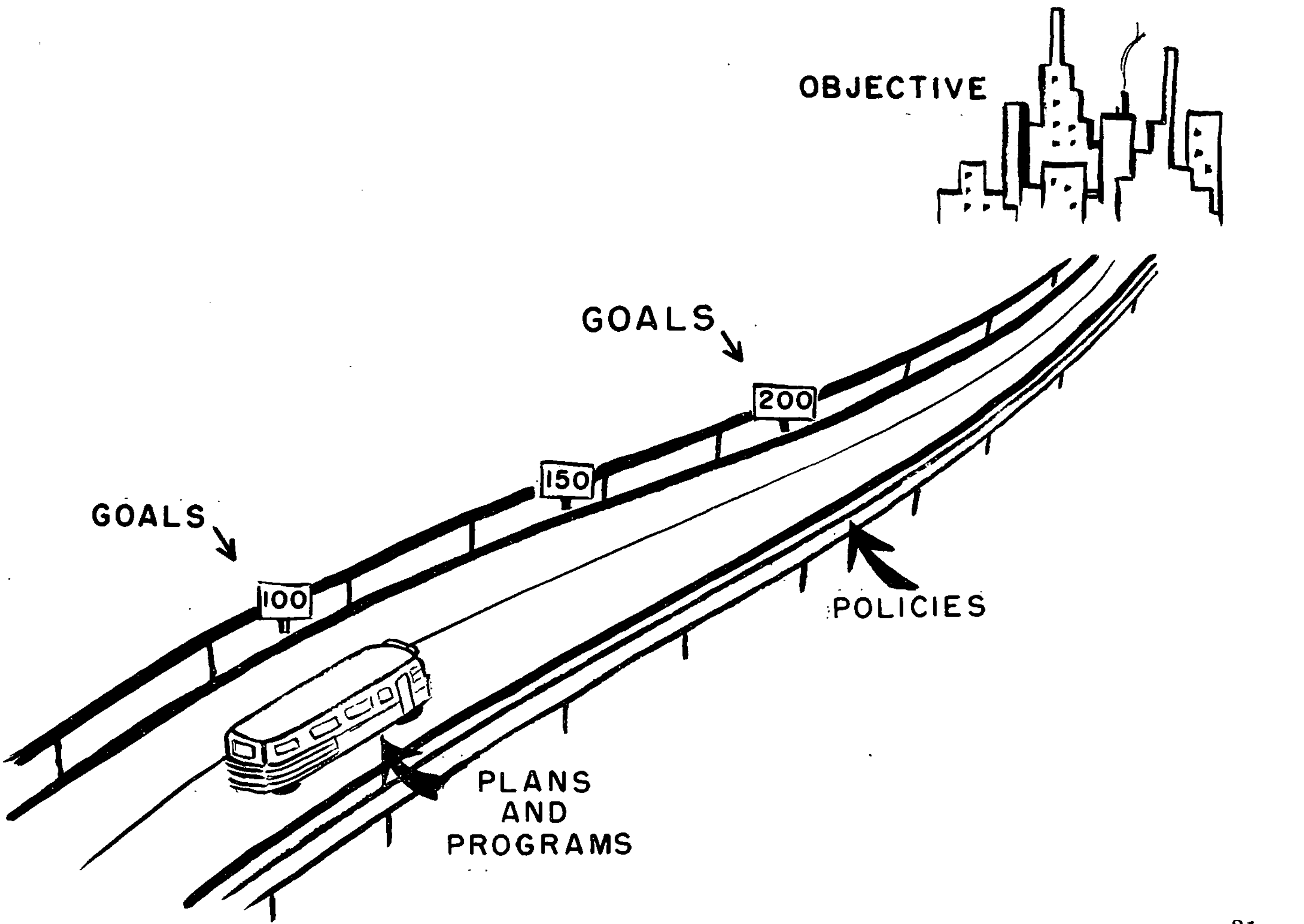
Some executives are uncomfortable when exposed to really discerning questions, to the point where they may avoid being subjected to them. The willingness and ability of an executive to provide answers to significant questions raised by directors is an important test of his qualifications. Questioning is the key means for directors to be effective in decision making, and its careful use serves a truly constructive purpose.

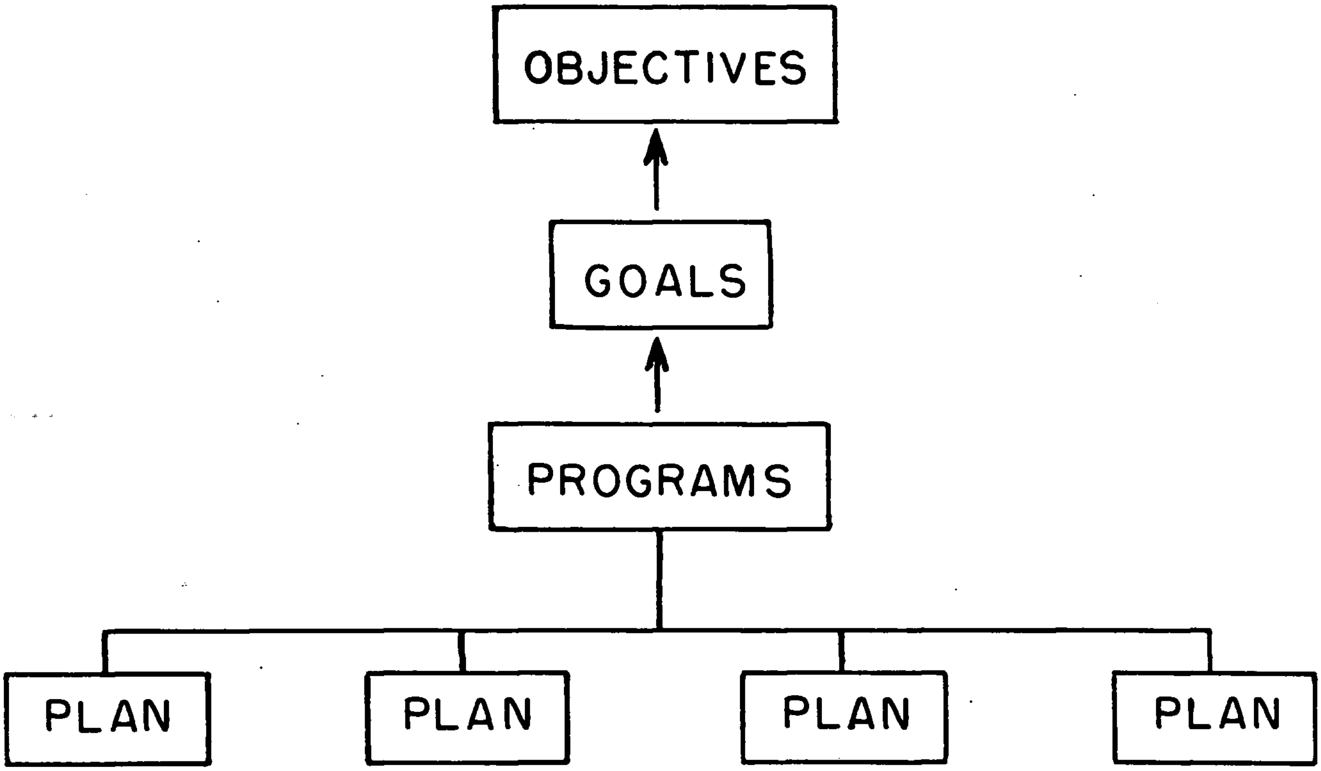
Chapter 4.

OBJECTIVES, GOALS, POLICIES: COMPANY FOUNDATIONS

The foundations for any successful business should be current and well defined company objectives, goals, and policies. These should be to the board what the compass is to the navigator: a basis for charting a course, and a means of determining when the company is off that course.

The board has a key role in determining that objectives, goals, and policies are established. This is most often accomplished through team effort with executive management. This is a responsibility which cannot be delegated to others and the ultimate responsibility is directly that of the board.





Objectives

Objectives are statements of purpose which define what the owners believe to be the company's mission.

A business organization should have objectives that represent a satisfactory integration of the aims and the needs of all major groups involved: employees, stockholders or members, consumers, and suppliers. The needs of these groups are ever changing, as are the external forces influencing the business. Therefore, objectives should be reviewed periodically.

Objectives are required in every area where performance and results directly and vitally affect the survival and prosperity of the business. This means that each administrative unit within a firm, as well as the enterprise as a whole, should have objectives.

Objectives in key areas should help to:

1. Record the direction the company should take.

2. Predict behavior of each unit.

3. Appraise soundness of decisions when they are being made.

4. Improve over-all business performance.

5. Provide a basis for internal control.

Primary objectives should include statements of intent in each of the following areas: (See Appendix B.)

1. Geographic limitations of the business.

2. Market standing.

3. Innovation.

4. Productivity.

5. Physical and financial resources.

6. Profitability.

7. Manager performance and development.

8. Worker performance and attitude.

9. Public responsibility.

Aims of a corporation are often described in the articles of incorporation. These aims often may need to be interpreted as objectives. As other over-all objectives become necessary, the board and executive are responsible for their development. Adoption or approval, however, must rest with the board. In most cases, departmental objectives are developed by department personnel, with approval of the general manager.

Goals

Every business needs attainable goals toward which the resources of the business are directed. Goals are benchmarks of progress desired. They represent steps in reaching company objectives.

Goals are time-oriented, and thus one method of exercising control. Objectives, however, are not time-oriented.

Goals are derived after objectives have been formulated, and are based on courses of action to be taken in a specific period of time. For instance, a marketing firm may have an objective to sell enough of its production under its own labels to be more effective in marketing. The board may consider 50 percent as sufficient. Its goal may be to increase sales from a current 8 percent under its own brand label to 18 percent the second year, 28 percent the third, 38 percent the fourth, and 50 percent in five years.

Goals

1962	8% under own labels
1963	18%
1964	28%
1965	38%
1966	50%

Objectives and goals are an inseparable part of the whole planning process. Plans are sequences of related activities. A group of integrated plans comprise a program. A program, in turn, is used to reach a goal, and goals are steps toward achieving objectives.

Goals:

1. Require integration of plans.

2. Provide direction for planning.

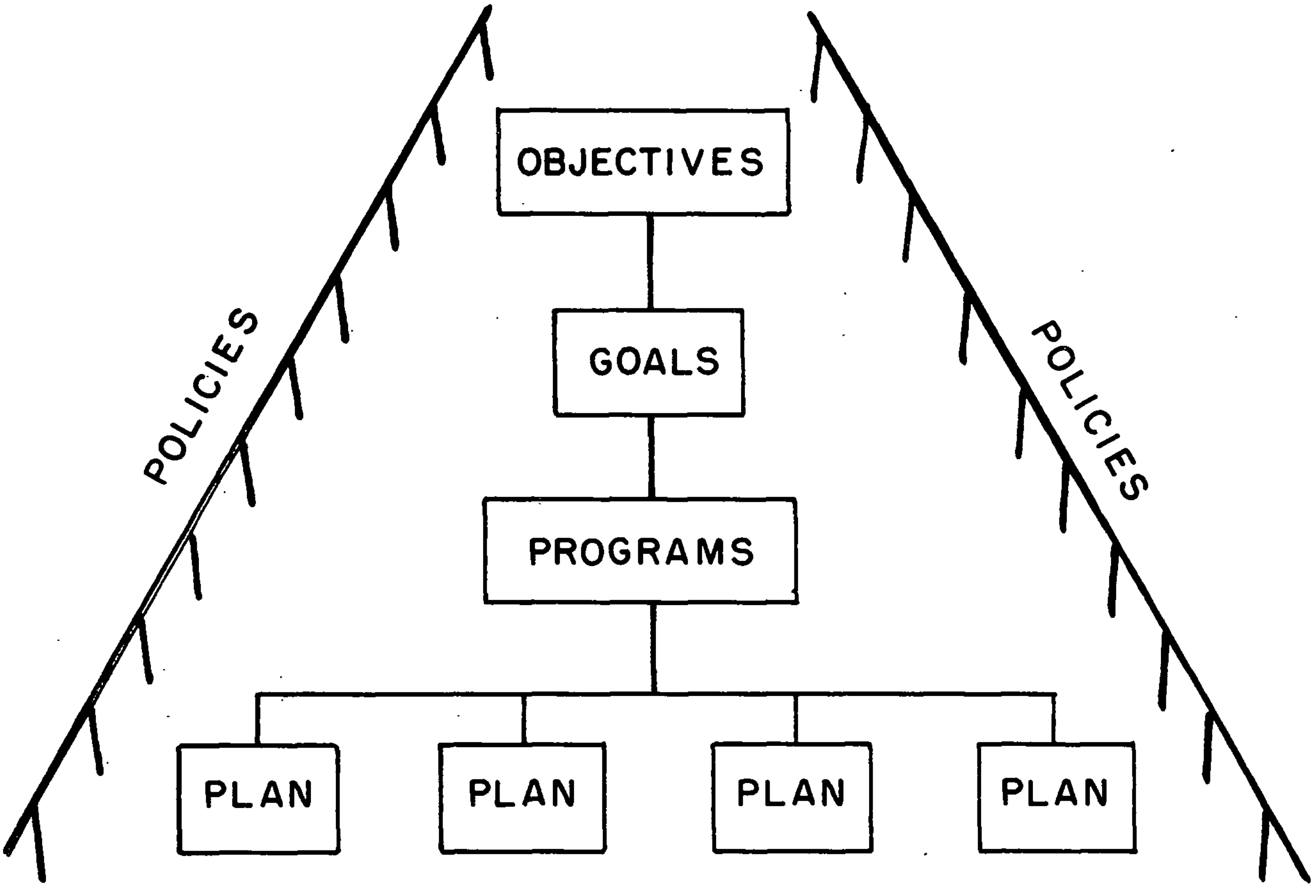
3. Help avoid conflicting and unproductive programs.

4. Provide a basis for control and evaluation of progress.

Although the board establishes objectives of the company with assistance from executives, the reverse is often the situation with goals. These are best established by executives and approved by the board. Executives in turn should translate general objectives and goals to department heads, who then develop operating goals for their departments.

Policies

Every business organization needs "line-fences" which serve as guides for decisions. Policies serve as "line-fences" because they give direction to plans, and set up a framework for decision making. We view policies primarily as statements of intent or promises about the company's philosophy or beliefs on vital issues. Vital issues are those



dealing with conflicts concerning an action or sequence of actions affecting the lifeblood of the business. Issues most frequently arise from the commitment of human and financial resources, alternate production and marketing processes, and over the distribution of gains from the business. Policies should deal with these vital issues, enabling managers and employees to work consistently and effectively toward certain specific objectives.

Policies and objectives are closely related. Policies are an effective way of defining boundaries for acceptable action in pursuit of objectives.

The board may adopt a policy which states "we believe in truthful, informative, and helpful advertising." This provides a framework for developing an effective and sound advertising program. It alerts those involved in developing advertisements that inaccurate or misleading ads are contrary to company policy. Thus a policy aids in decision making by automatically eliminating any ads which are not within the framework of company policy. The plan or procedure followed by those responsible for advertising may call for concentrating advertisements in several key markets rather than smaller amounts in all markets serviced. (See Appendix C.)

Practices are different from policies. They represent what is actually done, whether or not it is related to long-range objectives. Every firm has practices whether or not it has policies. Practices originate from a history of events. When some firms present each employee with a Christmas turkey, they are reflecting company practice, not policy as defined above. The 15-minute coffee break is another example of a company practice.

Obviously what is policy or practice partially depends on from where an issue is viewed. Our emphasis has been to view policies and practices from the viewpoint of the board. For example, the board's policy may be to support a sustained program of sales promotion through honest and reliable advertising media. To the advertising manager the use of trade publications may be a basic "policy". This may be the result of traditional practice of using trade publications as advertising media. Likewise, the 15-minute coffee break may be a "policy" to plant employees, but merely a company practice from the viewpoint of top management. It is important to distinguish between policies and practices. Regarding all practices as policies can stymie original thinking and change.

Policies Classified

Policies permeate the entire business enterprise. In their book, "Principles of Management," Koontz and O'Donnell identify two broad areas of policies:

1. Those related to the management functions.

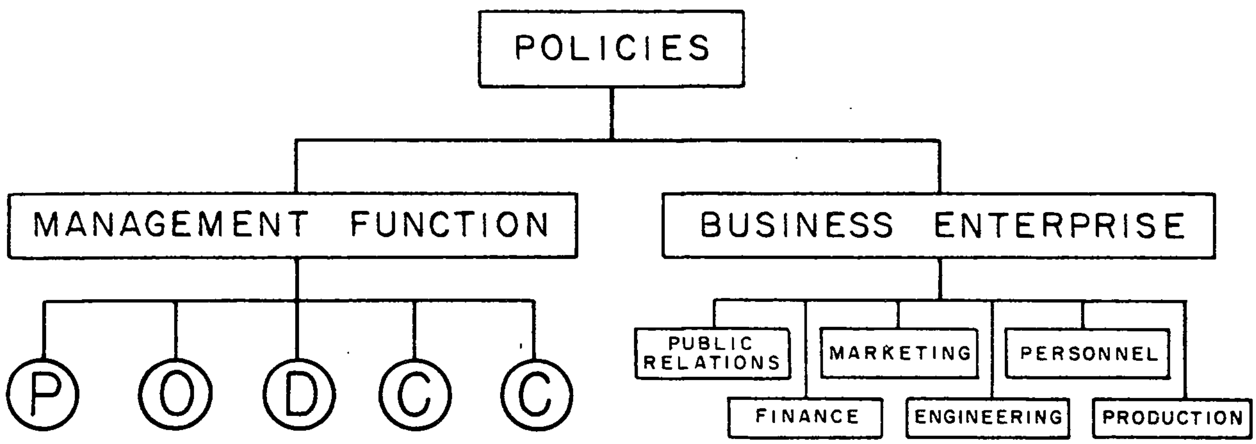
2. Those related to the functions of the business enterprise.

Policies relating to the management functions are those with respect to planning, organizing, directing, coordinating, and controlling. All functions of management require planning, necessitating the formulation of policies to guide executives in their job. (See page 36.)

Policies pertaining to the functions of the business relate the activities of the business to its objectives. This broad grouping of policies include:

1. Procurement
2. Marketing
3. Production
4. Finance
5. Engineering
6. Firm and community relations
7. Employees
8. Members or stockholders
9. Issues concerning the impact of business policy on society.

Policies, goals, and objectives are all closely interrelated. The issues outlined above are restricted by goals and objectives, as well as policies. It may be helpful to visualize these relationships by examining one of these issues further, keeping in mind how policies can be helpful in reaching objectives, in decision making, and for control purposes. (Example on page 38.)



Some Policy Areas in the Management Functions

Planning

Budgets

Long-range planning

Centralization or decentralization of planning functions

Involvement of subordinates

Organizing

Decentralized or centralized structure	)	Span of control
Use of job descriptions	)	
Organizational chart	)	

Fixing responsibilities for each function

Following channels or lines of authority

Directing

Specific vs. broad granting of authority

Degrees of delegation

Methods of handling discipline and grievances

"One boss" principle

Coordinating

Staff planning groups	)	Vertical vs. horizontal
Levels of coordinating	)	
Use of committees	)	

Controlling

Annual profit budgets	)	Performance based on work standards
Profit and responsibility centers	)	
Preventative or corrective controls	)	

Some Policy Areas for the Business Enterprise

Marketing

- Products to be sold
- Customers and distribution channels
- Prices
- Sales
- Promotion and advertising

Engineering

- Processes
- Facilities

Personnel

- Selection and training
- Compensation
- Promotion
- Fringe benefits
- Union relations

Members or Stockholders

- Profit disposition
- Protection of capital
- Services and benefits

Production

- Make or buy
- Size of production run
- Production stabilization

Finances

- Sources of capital
- Uses of capital
- Owning vs. leasing
- Cash & depreciation allowances
- Working capital
- Profit disposition
- Credit

Public Relations

- Industrial relations
- Community standing
- Member relations

Society

- Profit disposition

Marketing: Perhaps the most important area of company planning has to do with its products and services. These determine the facilities and organization needed, influence financial considerations, and are the background for other policy decisions. The extent of product and service planning determines to a large measure the profitability and stability of the firm.

Effective product policies should include statements of the company's viewpoints on new product lines, minimum volumes for product introduction, expansion of existing product lines, and so on. If company objectives call for the firm to be a product leader in the industry, there may be a company policy supporting internal research to originate and test new products. This policy modifies certain courses of action open to the company. Some other alternatives the firm may consider are:

1. Following new product introductions of competitors.

2. Relying on independent inventors and research organizations, and the ability of the firm to purchase manufacturing rights.

3. Farming out new product development under contracts or through grants to universities.

4. Purchasing new products from small producer-manufacturers, and binding these through exclusive distributor arrangements.

Each alternative will likely have certain advantages, but their disadvantages may outweigh these, and leave the firm without a continuing line of new products. Thus a policy supporting an internal new product research unit is consistent with the objective of product leadership in the industry.

A company following the policy of developing its own new product lines must also develop a pricing policy consistent with the nature of competition in its industry.

Alternative pricing policies include:

1. A policy of high initial prices that skims the cream of demand.

2. A policy of low prices that allows for deep market penetration.

3. A policy of full cost pricing.

If a skimming price policy is adopted, the firm may be able to recover its research and development costs in a short period of time. However, if a high price leads to large profits, this may induce competitors to enter production and reduce total earnings for the company. A low price policy would be established if a company desired to discourage entry of competitors into the market. These are a few of the price policies which need to be considered for their effect on the firm's profit and sales position.

The pricing policy adopted will lead to questions on advertising policy. This in turn is related to the firm's objectives regarding the sales areas to be developed. Are national or regional market introductions in order? Will the firm advertise?

These questions serve to illustrate the interrelations of policies. In the example just used, policies on products, markets, prices, advertising, and research are interdependent. Therefore, policies need to be consistent.

Policy formulation also has implications on business strategy. Policy formulation is not an independent planning process; policies must be adjusted in accordance with the external forces affecting the business. These include reactions of competitors, customers, employees, and government.

Business strategies may also require modification to counteract plans and actions of others. Strategies may be changed to conform to new circumstances within the context of existing policies. For instance, a company may produce a product or continue a low profit item it would prefer to drop in order to discourage a competitor. Or the company may purchase manufacturing rights to a new product, even though its policy is to develop its own, merely as a strategy to keep a competitor from gaining it. Likewise, changes in the environment surrounding the business enterprise may require changes in policy.

It may be helpful to classify policies in terms of the levels of management at which they originate. This scalar description is revealed in the table below.

Policy Issues are Interdependent

At the board-executive level policy issues are interdependent and cannot be viewed in isolation. The examples on marketing policies illustrate the interrelations of policy decisions. Many of the major policy issues involve a marketing decision. The following are examples of production and marketing issues that must be jointly considered:

Table 1. Classification of Policies

	Level of Origin	Basis of Development	Interrelated with Other Policies	Time Aspect
1. Broad guidance or executive	Upper levels (Board and executive)	Objectives Statements of belief	Yes	Long
2. Organizational	Executive	Basic policies	Yes	Long
3. Key operating	Executive and functional managers	Basic policies	Yes	Long
4. Operating	Dept. heads Supervisors	Key operating policies	Yes	Intermediate to short range

This scalar diagram shows that the board is concerned with one type of policy issues - those of a broad nature which give the organization some line-fences within which they may proceed in their programs to reach company objectives. Directors, in this scheme, have no function in the development of operating policies, which are developed by executives and managers. The board has a responsibility, however, of determining that policies throughout the organization have been developed consistently.

1. Production scale (volume) vs. marketing potential.

2. Production costs vs. product diversification.

3. Production stability vs. marketing costs.

Many agricultural marketing firms operate their plants at less than capacity for a large part of the operating season. Furthermore, the operating season is generally of short duration. Executives and directors know that increases in volume up to plant capacity result in lower average unit costs. Therefore, there should be continued pressures to increase total volume of the plant to capacity use.

Increased volume may be achieved in several ways. First, it may be possible to increase production of all commodities presently being handled. In the case of multiproduct plants, it may be desirable to program mathematically the entire production volume to determine how plant and equipment could be used more effectively. This may result in volume changes for various commodities and reveal opportunities for total volume expansion.

Another alternative may be to add new products to the commodities being produced. Presumably these would be commodities extending the operating season and making use of plant and equipment facilities used for other commodities. There are other possibilities, as increasing speed of equipment, increasing daily hours of operation, etc.

It is obvious that a number of production alternatives exist. Gaining scale economies (increased production volume) without consideration of marketing potential may prove disastrous. Possible reductions in average unit costs may be offset by lower prices for the expanded volume of output. Inventory and distribution cost may also rise and partially offset production gains. Likewise, increased volumes may require consideration of advertising, finance, and personnel policies. To consider one decision issue in isolation may be very dangerous. The board has a special responsibility to resolve related policy issues.

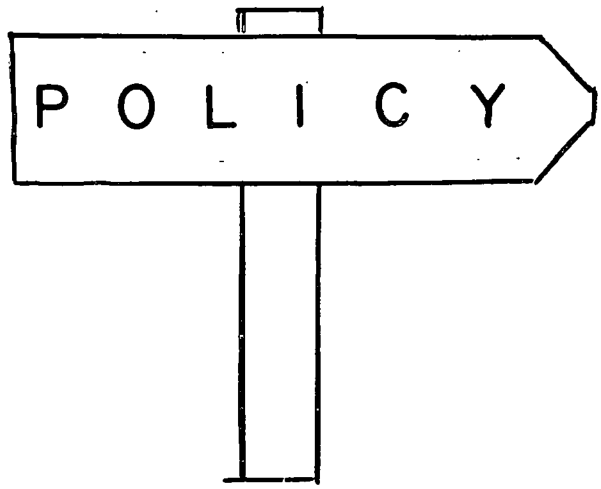
Criteria Identifying Policies

We have seen that different levels in the business organization are involved in different ways in policy formulation, and that all policies are not developed at the board level. It is likewise true that what may be considered policy at lower levels may be more properly considered practices at higher levels of management. In this section we will continue to stress the role of the board with regard to policies for two reasons. First, we must distinguish clearly between policies at different levels in the organization. This avoids confusion when any one group attempts to determine its role in policy development. Secondly, the criteria identifying different types of policies are different at different management levels. Therefore, the following criteria identify policies at the directorate level. Some, but not necessarily all, are applicable at lower levels.

1. A policy is a statement of a company's beliefs that is useful in guiding individual and group action to progress toward the desired objectives.

Objectives, as will be recalled, are statements setting forth the purposes the company is to serve, based on the owners' or members' desires. Establishing objectives is a projection into the future, since they state what the company is striving for, and not only what it wants to happen today or tomorrow. Therefore, policies are guidelines for establishing programs which are used in achieving goals and objectives.

Policies are not statements of practice. For instance, a statement that "our products are priced competitively"



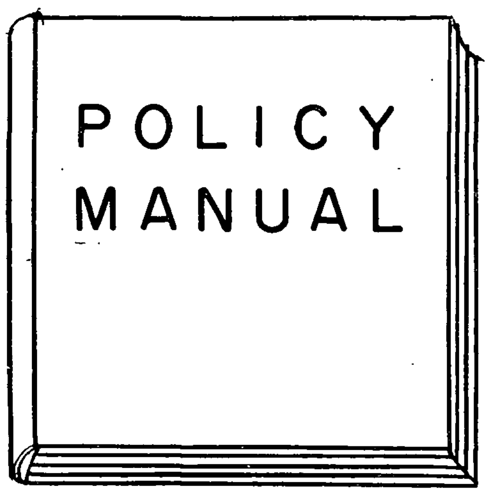
merely explains what the company is doing at the present time. It has no relation to what the company believes it should do, nor does it indicate intent or desire to remain competitive in the future. Therefore, a policy provides guidelines for action.

Most policy statements begin with phrases as: " We believe in," "The company believes," "We intend to," "We stand for," "We will," etc. These indicate that a policy, in a sense, is apromise entered into by the board, which is backed by the integrity of the firm.

Intent or desire is an important feature of policies, because they aid in guiding employees. Policies determine the general direction to be taken, and this direction must be consistent throughout the organization. In this manner, each action contributes progress toward a specific goal or objective.

2. Policies are in writing. Policies that are not in writing are subject to misinterpretation. A group or individual may attempt to justify a course of action or a decision by shading the meaning. Even though the general intent is understood by those affected, it is possible to misconstrue its real intent unless a policy is in writing.

The actual preparation and approval of a policy is difficult unless it is in writing. Consider how difficult it is to recall on the following day the actual wording of a policy decision, let alone attempting to do this correctly a month later. Writing policies makes it easier to consider whether the statement clearly expresses the exact meaning desired. Careful selection of words to convey the exact meaning of the policy is very important for writing any policy. Writing policies provides for critical appraisal prior to adoption and helps achieve consistency over time.



3. Policies are stated broadly. If policies are to serve as guidelines or line-fences for those managing the business, it is necessary that policies be stated in broad terms. This allows for exercising judgment whenever situations are changed or strategies are modified, without the need to change the policy. Policies should not be viewed as "sets of working rules" for management. The board should encourage the executive and managers to exercise initiative in formulating working plans and procedures to reach company goals and objectives. Policies that allow for little flexibility and where empasis is on details will eventually crop up as sources of difficulty.

Although policies should be stated in broad terms, there is no justification for them to be vague in meaning. A policy should state clearly the exact beliefs and intents of the board. A desirable characteristic of policies is that they be specific enough to provide guidance, yet not so detailed as to include procedures.

A company may have a policy which states: "It is the policy of the company to pay wages and salaries as high or higher than those paid by comparable firms for comparable work in our area." Note first, that this is a statement of intent. Second, it is broad; it does not state a specific wage or salary. Third, it is specific in that wages paid for similar jobs in the area are intended to be comparable. Fourth, it does not contain any details involving procedures or methods. Fifth, it allows for discretion in determining through surveys or job studies the wage and salary level the firm intends to attain. And sixth, the policy is brief.

4. <u>Policies are inviolate</u>. Policy statements are strong intentions or beliefs of the business. If they are to serve their purpose well, policies must be enforced with firm commitments. They must not be taken as statements which can be ignored, broken, or disregarded. This does not contradict the previous criterion. The distinguishing feature is something like this: Broad policy statements give direction to plans by imposing line-fences. This provides sufficient flexibility for management to change procedures or methods without contradicting policies. An inviolate policy is not an inflexible one. But policies apply to all persons at all times, and under all conditions without exception. This must be the situation;

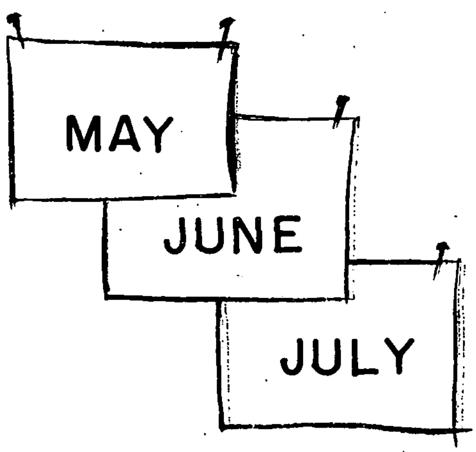
otherwise a decision based on policy would allow for inconsistency and lead to internal organizational disturbances. When a company allows exceptions to policies it is operating without policy.

Because policies are inviolate, the communication, interpretation, and implementation of policy require courage and determination. The opportunities for allowing exceptions are many; however, the moment one exception is made, the door is thrown wide open for special interests to gain a foothold.

There are some occasions when the board may need to modify or temporarily suspend policies. These include policies developed with full integrity but in violation of state or federal laws. Since laws supersede company policies, there must be room for liberal interpretation in such cases. Natural disasters and wars may pose situations which call for temporarily suspending policies, but such changes will usually be of a temporary nature.

It is important that boards and executives recognize that policies are inviolate when they are being prepared. Executives must insist on complete adherence. This requires a realistic attitude toward the fact that policies are meant to stand up under crises. Therefore, utmost care needs to be taken in preparing company policies.

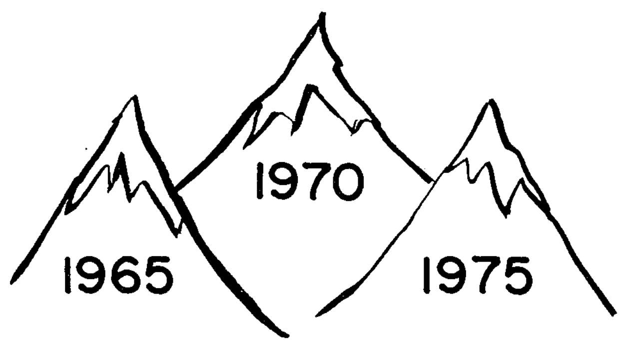
5. Policy formulation takes time and careful thought. A promise entered into in haste may produce sad results which the company may have to tolerate for long periods of time. Policy formulation should be the result of an unusually high level of thinking and study which envisions possible obstacles in future years.



Policy should not be based on the present or past; it should be forward looking toward goals and objectives the company is striving to achieve.

Company intentions are revealed by questions as, "What ought to be? What is the right thing?" Once this intent has been decided, policy formulators should study what the company has been doing to see what fits in, what should be revised, and what should be dropped. In policy, the "why" is involved, which requires reasoning, study, and a balancing of values. This is not simple; yet the consequences of poorly thought out and ill-conceived policies pose real problems unless policy formulation is systematic, thoughtful, and predictive. The board and the executive should spend the time required to develop and adopt good policy statements which leave little doubt of company beliefs and intentions.

6. Policies are long-range, long-term in duration. In a sense, policies must be predictive in nature, because they attempt to carry into the future the



basic beliefs and intentions of the company at the time of policy formulation. Again the importance of careful thought in policy determination becomes apparent. This is one of the most definite criteria for determining whether a statement is actually policy or something else.

If policy formulators engage in careful thought when they write down the beliefs and intentions to which they feel the company should be committed, there will be few occasions when policies will need to be changed. Procedures, practices, and strategies may change quite often, but the basic policy, if well conceived, should serve adequately for long periods of time.

Frequent changes in policies may suggest board incompetency and result in confusion, lack of coordination, suspicion, and general ineffectiveness. This does not imply that once a company recognizes it has a poor policy that it should not bring about a change. To the contrary, this recognition is a mark of an alert board of directors who can recognize when conditions have changed. This recognition in itself is often the result of considerable thought and study on the part of effective directors. The board should periodically review company policies to eliminate those that are obsolete and to update those that need it.

Changes result from many sources; in fact, as someone has aptly stated, change is the only thing of which we may be certain. Changes in state and federal laws, in transportation, in shifts of population, in economic conditions, and other ways all may portend occasions for changes in policies. Internal to the company, the basic philosophy of the members or stockholders may bring about the need for a new policy. These do not change this criterion, however, since they are exceptions rather than the rule. Policies are long-term, long-range oriented.

7. Policies are adopted by the board. Policies may be formulated and suggested at all levels of the organization, but the approval and adoption of policies rest with the top decision group.

Policies must represent company thinking as viewed by the board to provide the consistency needed over time as important personnel changes occur. As key managers change, there is the possibility that the beliefs of the organization may change too. This may be desirable if this is the desire of the board, since it reflects a change in policies. But lacking this intent, policies provide guidance to top executives under trying conditions. Given the metes and bounds of company thinking, a new executive can operate with considerable assurance of making decisions consistent with desires of the board.

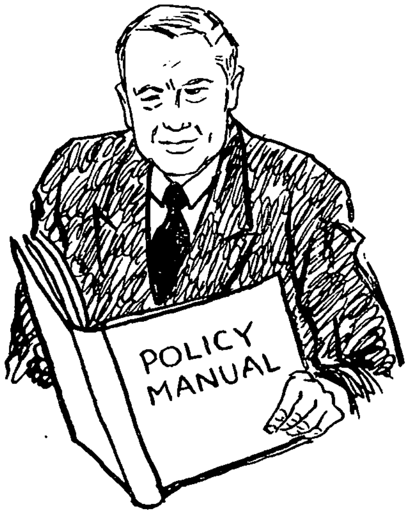
Policy making is commonly recognized as a function of the board of directors. However, often their failure to be effective in this capacity stems from their failure to distinguish between policies and practices. Hence they are apt to divert their attention to matters to which executives should be giving attention. The board cannot delegate its responsibility to approve and adopt policy. It may ask for and receive suggestions from the executive, but it cannot divest itself of responsibility for approving policies. If the board does, it eliminates one of the effective controls it should exercise over executives.

No responsibility of the board is more important than making or approving policies. The extent to which it excels in this area may well be an expression of the board's usefulness.

Usefulness of Policies: Viewpoint of Owners and Top Management

Firms without definite policies often find themselves facing recurring crises. They seem to go from one problem to another, adopting and dropping procedures without arriving at solutions. The board of directors of such firms will find the formulation of effective policies a useful and efficient way of treating similar cases. Policies are useful in these ways:

1. Policies promote continuity in management. A company with policies has an excellent chance of perpetuating the basic direction of the company when major personnel changes are made. Although each individual considered for top management must meet the test of "whether he fits our organization," the board can be best assured of continuing the basic pat-



terns of the company through sound policies. New executives may wish to change some policies. These changes can be appraised by comparison with existing policies and the board may disapprove if the departure is contrary to their underlying beliefs.

The continuance of company policies is important to customers when managerial changes are made. In fact, some companies inform their customers of managerial changes with the assurance that the changes will not affect the basic policies of the firm.

2. Policies facilitate orderly and long-range planning. Policies are useful to the executive in his planning function. An understanding of how they originate, what their purpose is, and how to administer and control them is essential. Because policies are guidelines for pro-

grams, they give direction to plans and provide a basis for evaluating long-range planning decisions.

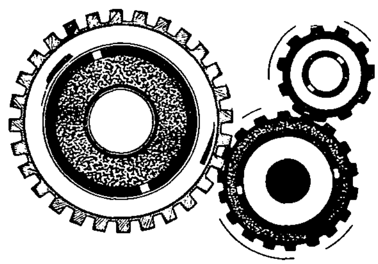
Many companies that grow through acquisition will find conflicting ideas and values, as well as practices, followed by the acquired firm. Policies serve to clarify these differences and indicate what modifications need to be made in adjusting to the new situation.

3. Policies provide guidelines for applying control measures. Unless the board participates in the making of policies and understands what they stand for, the board cannot go far in checking on progress. In companies where the board has been active in formulation of company policies, managers are more careful to keep the board informed of results. The checking-up process presupposes that there actually is something to check up on, and policies are one effective basis of measuring results and performances.

Policies apply brakes to company expenditures and investments. By their existence and enforcement, policies eliminate consideration of programs beyond the scope of the firm.

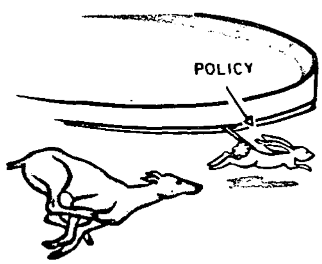
4. Policies assist in coordination. Part of the board's responsibility in policy making is to make sure a proposal fits into the general framework of the firm's scope of activities. The board of directors, as the supreme decision center of the firm, is able to view the firm in its entirety and determine whether a proposal is consistent with

what the board understands to be the company's policies. Policies provide a basis for determining whether proposals mesh together or whether they are in conflict. Policies aid executives to effectively delegate duties to others with confidence that these duties will be carried out within the established policy. This assures consistency of action between individuals and over a period of time.



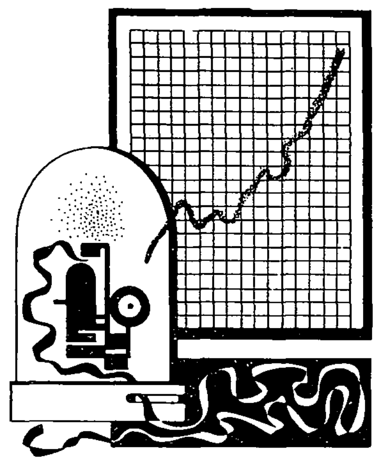
5. Policies stimulate action. A company is not satisfied by the mere making of good plans. Plans are effective in achieving company goals and objectives only if they result in action. Policies implement action by providing guidelines, encouraging better planning, and aid in program development.

When the board expresses itself through written policies, this impels executives to do something about carrying out the policy. For the most part, executives appreciate working with a board of directors which takes the time to study policy issues as a framework for company action. When adequate policies exist these stimulate executive action in line with board desires. Poor programs are due in part to a lack of understanding. In the absence of policies, executives may avoid taking action because the board has not provided effective leadership.



6. Policies lead to more efficient productivity. When executives and managers are aware of programs they can undertake without incurring the wrath of the board, it should result in greater productivity. Good policies provide for coordination and reduce conflicts between units and individuals, resulting in greater efficiency.

Programs require integration or team work, and the results of such combined efforts depend to a large extent on the cooperation between units and individuals. It does little good for a research unit to develop a new product, if this does not fit into the company objectives, product mix, or has no sales potential. Well thought-out policies can help in coordination, with resultant economic and social benefits.



7. Policy formulation is a useful educational process. Questions of policy are among the most important matters a board of directors considers. Policy formulation may be a joint venture between the board and executives, but their adoption and approval must be the responsibility of the board. Men who direct must think situations through carefully, decide what they stand for, project into the future, and anticipate problems that will arise. All of this provides excellent training in management. Those in lower management levels who are allowed to participate in policy formulation also learn the principles of management and become more useful in the organization.

Teamwork between the board and executives is necessary in policy formulation. Sometimes executives must make decisions on policy issues without the benefit of advance referral to the board. Information regarding such decisions can later be brought to the attention of the board, with an opportunity for them to express their views. But effective boards of directors will not tolerate a continuing function as a rubber stamp. Educational benefits from policy formulation work in both directions.

<u>Usefulness of Policies: Viewpoint of Supervisors and Employees</u>

Policies are management tools. As with other management tools, policies may be well defined, or they may be a source of confusion and low morale among personnel. Well-defined and consistent policies can be uniformly applied and are helpful in delegating responsibilities for certain decision making to lower levels. This enables top management to carry reasonable work loads while giving lower levels confidence in decision making. The formality of board approval is not in itself sufficient to gain acceptance. This requires board responsibility and control to be certain the policy is being carried out. The effect of policies on employees and supervisory staff determines to some extent how well policies may be carried out. We now turn attention to this phase of policy.

1. <u>Policies permit freedom for action</u>. Within the framework of policy, the individual supervisor can make decisions, assured of company backing. At the same time, employees have some assurance that their efforts are in line with company expectations. This leads to more productive and efficient production, and more definite action by supervisors.

Supervisors can exercise initiative, imaginative thinking, and resourcefulness when it is understood by superiors that there are many ways of doing a job, just so long as the approach falls within desired limits. Policies allow this freedom.

Employees are assured that operating procedures may not vary too widely with changes in supervision in the plant when policies are well defined and understood. They have assurance of uniform treatment, a source of satisfaction to workers.

To the extent that policy formulation has involved lower levels in management, the more responsive they may be in carrying out company policies. But in the quest for involvement, the board must exercise judgment to prevent managers and unions from taking over completely its basic responsibility. It is fine to permit freedom of action for supervisors and employees so long as their activities further company objectives and are in line with policy.

2. Policies simplify the decision-making process. "Management by exception" is a term which describes how policies enable the supervisor to give attention to the unusual situation rather than the routine. Also, a problem can be resolved quickly by ruling out all the alternatives which do not fit into company policies. Both methods result in simplified decision making.

Sometimes top management and the board may question the quality of decisions made at lower management levels by people lacking the broad view of the firm as well as experience in decision making. Policies enable the upper levels to preimpose certain basic decisions on lower levels. This assures decisions at lower levels will not cause the firm conflicts with customers and its other publics. Decisions at lower levels will be better decisions because of the influence and guidance of experienced executives. Judgment on vital issues by lower level managers and employees is reduced to a minimum.

3. Policies facilitate consistent decision making. Individuals vary considerably in their outlooks, viewpoints, and values. Lacking adequate policies,

a firm is apt to find each unit independently making decisions that may not be properly interpreting the beliefs of the board. Executives and directors would have difficulty in exercising adequate reins on the company. It would be as a basketball team without teamwork. Policies provide a basis of assuring uniformity in key decisions throughout the business enterprise.

4. Policies promote employee security. When they recognize that company policies prevail throughout the entire organization, employees know what to expect if they are transferred to another department or assigned to a new boss. Group security is enhanced, because policies serve to eliminate insecurities based on indecision or fears. A firm with well-developed policies, understood and followed by employees at all levels, will often be a healthy organization.

Chapter 5.

CRITERIA FOR SEPARATING BOARD AND EXECUTIVE DECISION AREAS

The board is expected to serve as the nerve center from which major decisions are transferred through executive management to various operating units. This is in contrast to directors' activities in personal business affairs where they are also the operators or doers. From such situations, embarrassing instances arise where a director gives directions to members of the operating staff, which may be considered meddling by executives.

A director has no executive function in the business organization. Legally, a director has no power except at properly convened board meetings. Failure to understand this concept is at the root of considerable internal board-executive friction. In this chapter, we will examine the basis of board-executive functions in management.

Sources of Authority

The board derives its authority from specific sources. There are usually three sources of this authority:

1. Stockholders.

2. Director expertness or proficiency.

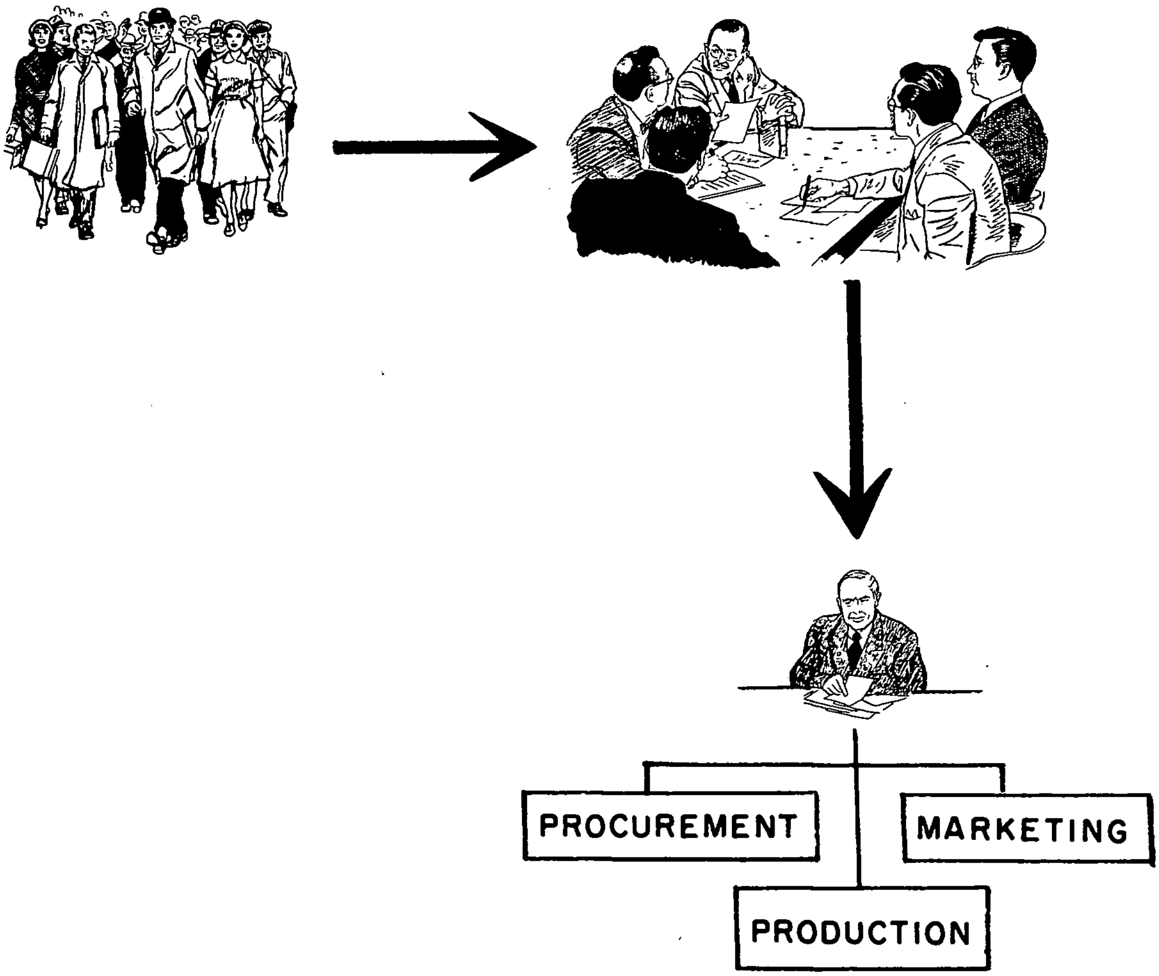
3. Legal.

Basically, all authority stems from these three sources. Stockholders, for instance, delegate certain functions and responsibilities to the board because it is impractical for all stockholders or members either to give attention to every major situation or to be well informed on such matters. State statutes recognize this limitation when they provide for boards of directors with certain rights and limitations.

Sometimes directors gain informal authority because they have special training or abilities which make them experts. Most frequently, lawyers and bankers, whose knowledge of legal and financial matters is considerably broader and deeper than lay directors, fall in this category. Agricultural marketing firms use such experts as directors to a much lesser extent than other types of firms. Often cooperatives are prohibited by law or bylaws from utilizing such experts as board members, unless they are members of the cooperative.

There is much controversy over the role of the expert as a director. Certainly all companies may utilize the staff expert to provide the guidance required for board decisions. Nonetheless the expert who doubles as a director enjoys a special, although informal, source of authority within the board.

State statutes require boards of directors to perform with reasonable care within the powers conferred by the charter and bylaws. In addition, these statutes impose specific duties and liabilities upon directors. Such statutes are permissive as well as restrictive in nature. Thus the authority granted to boards of directors is specific in nature. It is permissive, as well as preventing



them from performing certain acts considered illegal.

There is no fine line of distinction between the executive's and the board's authority for specific action.

Normally, stockholders or members do not delegate directly to executives. Instead, the board itself delegates certain of its authority to the general manager. This brings us to the initial criterion for separating board-executive roles and areas of decision making.

Criterion 1. Ultimate accountability to stockholders or members is vested in the board of directors, who may subsequently grant certain authority to officers, agents, and employees as permitted under the corporate charter, bylaws, and applicable laws. The executive or general manager in turn is accountable to the board and initiates action within the boundaries of authority granted by the board.

Operating vs. Directing Decisions

Part of the difficulty in establishing a clear cut-off point for board-executive decision-making roles arises because both are concerned with the functions of management--planning, organizing, directing, coordinating, and controlling. The distinguishing feature is the scope and focus of responsibility within each function rather than the functions themselves.

It may be helpful to classify decisions into two basic types:

1. Action decisions

2. Idea decisions

An action decision specifies the behavior of an organization. It results in action of one type or another. An idea decision involves approval of an idea and tends to form organizational character. It motivates action. Idea decisions prepare an organization for action within specified and acceptable behavior patterns. These tend to have long-run implications and consequences.

> Criterion 2. The board of directors is primarily concerned with idea decisions while executives are primarily concerned with action decisions.

Continuing within this framework, successful business management requires adequate consideration of objectives, policies, and goals of the company. Basically these are idea decisions and are those which would be made by the stockholders or members, if possible. Since this is not practical in nearly all cases, this function is delegated to the board of directors. Executives can assist in this role, but the board is accountable and responsible for ultimate decisions.

> Criterion 3. Decisions on overall objectives, policies, and goals of the company are the responsibility of the board.

> Criterion 4. Decisions related to how and when objectives, goals, and policies are to be attained are the responsibility of executives.

The time element must also be considered, in addition to the distinction based on the types of decisions made by the board and executives. Time is a part of each decision, whether or not recognized as such. Issues involving long-range decisions also involve questions of facilities and finances to a greater extent than do short-range decisions. Viewed in this manner, the short-range is a reaction period in which the business is not able to make changes in facilities or finance. These are fixed in time, and the company must make the best adjustments it can in view of these restraints. The long-range, by contrast, is truly a planning period. The company may make adjustments in plant, facilities, personnel, and finance. The corporation is able to make all necessary adjustments to achieve objectives and goals.

Therefore, the length of the planning horizon and decision areas associated with it becomes another criterion for separating board-executive responsibilities.

> Criterion 5. Decisions involving long-range and consequential commitment of resources, which include facilities, finances, or manpower, are the board's responsibility.

Criterion 6. Decisions involving intermediate and short-range commitment of resources, and the organization and control of these resources, are the responsibility of executives.

The perpetuation of any corporation depends on the continued existence of the board of directors. This brings in focus two areas of ultimate responsibility that are distinctively the board's.

Criterion 7. Decisions related to the assurance of capable executive succession by providing for executive depth and training are the board's responsibility.

Criterion 8. Decisions specifying the ideal pattern or model of board behavior and performance, and for the review of and perpetuation of this ideal through indoctrination and training of directors are the board's responsibility.

Traditionally, the board of directors exercises control of a company by controlling financial contracts and equity capital, objectives and policies, and by its authority to hire and discharge the chief executive. Boards and executives must have adequate standards for judging performance. The function of control applies to both the board and executives. The distinction is based on the level of organization over which controls are exercised, types, and frequency of use.

Criterion 9. Control over the executive, long-range and substantial financial commitments and financial structure, objectives, policies, public and member relations, and over-all performance are decisions for the board.

Criterion 10. Control over operations, subordinate managers and employees, budgets, formulation and execution of procurement, production, and marketing plans, and industrial and employee relations programs are decisions for executives.

Essentially the board does not engage in the operations or direct management of the business. Rather its main task is to delegate and approve executive programs and actions. By so doing it plans and controls the over-all course and performance of the corporation in line with stockholders' desires.

Maintaining Effective Board-Executive Relations

Board-executive relationships are often keys to company success or failure. If the board performs its functions well, a coordinated operation should evolve. To achieve this, there must be mutual respect and an adequate basis of evaluating executive performance.

There are four major sources of difficulty in maintaining effective board-executive team relationships. These are: 1) Inadequate definition of board and executive roles; 2) inadequate training and indoctrination of new board members, due in part to the lack of an organizational ideal; 3) the tendency of some directors to manage operations; and 4) conflicts inherent in the directorate position. Essentially, problem number one is what this manual and chapter attempt to clarify. We have specifically mentioned problem number two in criterion 8 of this chapter. We will now briefly review each.

Where board-executive conflicts exist, these are often due to different objectives and goals of each. Sometimes conflict arises because the board and chief executive are not aware of their specific functions and responsibilities in managing the company. Developing job descriptions for the board and the general manager will help outline lines of distinction by pointing out the functions and responsibilities of each, and serve to ease future conflicts. In this respect, it will be helpful if stockholders or members electing directors understand characteristics deemed desirable for members of the board. These characteristics and their significance in attaining an effective board are outlined in Chapter 9.

A new board member learns his job from a variety of sources. To maintain board performance consistent with standards it considers desirable, the board must provide the initiative in orienting and training each new director. This should include: 1) briefing on scope and operations of the corporation, 2) use of the director's manual, including recognition of key control and planning areas, 3) distinction between executive and board responsibilities, and 4) identification of sources of further information on specific responsibilities. Criterion 8 identified the decisions regarding the specification of an ideal pattern of board performance and the transfer of this ideal image to new board members as a board responsibility. If the board fails to establish an ideal for board member performance, or fails to transfer this ideal to new board members, it may result in faulty learning by new directors and adversely affect the functioning of the board.

In small corporations, boards of directors can make valuable managerial suggestions in the areas of policy implementation and the solution of operating problems. But participation in these areas must be regarded as opportunities rather than as responsibilities of the board. Board members must depend on the initiative of the executive to raise the issues on which advice and counsel are sought. Participation by board members must be limited to dealing only through the chief executive, because effective administration requires that executive responsibility be vested in one man. Business relationships between board members and subordinate executives typically result in confusion and uncertainty as to the administrative authority in the enterprise. This is bound to happen if directors fail to recognize that their role is not to manage operations or to circumvent the executive's chain of command.

The directorate position may require directors to take certain actions on which they hold conflicting values. A familiar type of conflict is that of ends vs. means, or results vs. the way in which results are achieved.

Another example of conflict is between dependence and independence. Should directors of cooperatives persuade members to agree to the board's decisions, or instead reflect the members' wishes in making their decisions? Or going another step, should the board depend on the executive almost entirely, or should it undergo the processes of accurately distinguishing its role to maintain a degree of independence? Both involve conflict and both involve board-executive teamwork. Perhaps the director's role conflict can most easily be recognized by the familiar dislike of having to refuse to grant favors to friends, or to ask penetrating questions of the executive. The recognition of possible role conflict for the director's position should allow for living with situations in such a way as to minimize board-executive friction from this source.

In this chapter we have identified certain basic sources of conflict arising from board-executive relations, and broadly discussed the factors distinguishing decision areas of the board from that of executives. In subsequent chapters, we will give more complete attention to the specific role of the board in guiding the business enterprise.

Chapter 6.

ROLE OF THE BOARD IN PLANNING.

"Nothing comes of doing nothing"—SHAKESPEARE

Business planning is a necessary ingredient for company success. Some agricultural businesses base all their major decisions on carefully developed plans. Others do very little actual planning of their own, but react to the decisions and actions of competitors. Planning helps to identify alternative courses of action. When a change in direction is required, the planning process provides the next best alternative course of action. For the business which reacts to decisions made by other firms, a change in direction may lead to confusion until management can again detect a course of action taken by competitors.

Planning is deciding in advance what is to be done, when, and by whom. It is the conscious determination of courses of action designed to accomplish desired purposes. Planning, then, is deciding how to achieve desired objectives of the company.

Determining the board's role in planning is important to avoid board-executive conflicts, and to enable the board to achieve a sense of accomplishment when it meets its necessary and useful responsibilities in planning. In this chapter, we seek to clarify how the board of directors can effectively participate in the planning function.

Appraising Present and Future Potentials of a Business

Business corporations are long-range undertakings which must operate in an ever changing environment. A major task of a board is to facilitate the adjustment of the corporation's affairs to these changing conditions. However, the "past is often prologue" for many agricultural marketing businesses. That is, there is a tendency for business firms to continue to perform tomorrow the same tasks and services they performed yesterday. The truly successful business is that which modifies its operations and services to correspond with changing needs of its customers, the competitive conditions in which it operates, and with changes in general business and economic conditions. For instance, a business which continues to offer poultry feed only in 100-pound sacks, rather than in bulk will find its larger customers shifting over to other suppliers. Its sales volume may decline to unprofitable levels. The board can often forestall such a fate by planning periodic appraisals of the corporate operations and organization. Here are some general criteria to serve as guides for the board.

Does the Organization have Well-Defined Objectives?

A business lacking well-defined objectives is like a ship without a rudder. A company reacting only to changes initiated by others is likely to be a laggard in its industry, and to fail to achieve satisfactory earnings for its owners or members. The board of directors can be instrumental in devising and reviewing the objectives of the corporation, and in determining the necessary plans to relate programs to objectives.

Over time, the pressures from owners or members, or from general competitive conditions, may bring about dramatic changes in the scope of the business. Periodically examining the scope of business activities in line with written objectives prevents the business from deviating far off its desired course.

Is the Corporation Achieving Its Goals?

Every business should know where it is going (objectives), and how long it expects to take to get there (goals). Goals are benchmarks by which progress of a corporation can be measured over time. The board may determine certain goals, while others may be developed by the executive and his staff and approved by the board. We are concerned in this chapter with goals as an aspect of planning. Their function in control is postponed until Chapter 7.

Company goals must be based on sound planning if they are to be attainable. Goals may be established for the following:

- return on investment
- sales volume and market share
- turnover of personnel
- unit operating costs
- product quality specifications
- capital accumulation
- dividend rate
- automation
- expansion of trade area
- services provided

Plans in any of these areas, when expressed as results to be achieved in a specified period of time, may be considered goals. The necessity for balance among plans is apparent. Conflicts are avoided by integrating goals. The board is in a strategic position to evaluate the degree of integration achieved.

Is the Corporation Expanding Its Services?

Recognizing opportunities for expanding services is vital in considering the potential of a business. In part, new business opportunities stem from effective planning through each level in the corporation. Also, active participation in industry trade associations, contacts with universities and other public institutions, and a sensitivity to the problems of those served suggest ways for a corporation to expand its services.

Not every corporation should, of course, expand its services. However, most often the problem is that of expanding services without adequate planning and consideration of the effects on the corporation itself. Unwise expansion may be more disastrous to the future of a corporation than a failure to embark on new programs.

Every new service provided to customers bears a cost, and when possible the returns to the corporation should exceed these costs. Crude measures of the effectiveness of new services are the extent to which the firm's trade area is expanded, its market share increased, and its total business expanded. A corporation with current objectives, goals, and with integrated plans is less likely to expand unwisely.

Is the Corporation Serving Its Customers?

This is a most difficult aspect of the corporation's relationships with its publics. In highly competitive agricultural markets, customers may demand and receive extra services, with little regard to cost implications. When the competitive advantage remains with buyers, there is a limit to what the corporation may do when additional and burdensome demands are made.

However, not all service needs of customers are unreasonable. In fact, many are plainly required as sound business practices. The board should periodically make independent inquiries into the nature of these services to determine that customer services are as satisfactory as possible. Examples of some of the services which are potential sources of difficulty are:

- frequency of contacts
- confirmation of sales
- frequency and promptness of shipments
- adequacy of cash discounts
- responsiveness to damage claims or inferior products
- quality of products sold
- packaging and containers

Is the Corporation Respected in the Community?

Another way to state this criterion is to ask whether the corporation and its employees are recognized as good citizens. Without the respect of the community, a corporation may find it difficult to recruit good employees. Participation in community and business activities by executives and employees is often a foundation for community respect. Most corporations believe in sharing equitably in community responsibilities.

Agricultural cooperatives sometimes have special community relations problems, many of which are based on inadequate knowledge by townspeople of the nature of cooperative organizations. Farmer cooperatives, as well as other marketing corporations, often find it good practice to subtly inform the community of their contributions to payrolls, local government taxes, increased income to farmers, etc.

The board may ask itself these questions:

- Is the community kept informed of the nature of the corporation's activities?
- How does the corporation contribute to the prosperity and well-being of the community? Is this information made available to the public?
- Are local groups invited to tour the facilities?
- Is the business represented actively in local trade, service, and business organizations?
- Are employees encouraged to participate in civic projects?

Are Employees Motivated to Perform Effectively?

Employees who take pride in their work, are conscientious, courteous, properly compensated, and who derive satisfaction from their work provide an important key to business success. Unfortunately, every business must resign itself to having some mediocre employees on its payroll. When the mediocre exceed the highly motivated, well-trained, and enthusiastic employees, the company's success may be threatened. Such a company may require outside consultants to analyze its entire employee program.

However, the board can take positive steps to prevent this from becoming a critical problem area. Some questions useful in appraising the conditions of employment and employee satisfaction are:

- Do employees feel free to offer suggestions?
- Do the proper persons participate in planning?
- Are job specifications followed in hiring new employees and does a job description exist for each position?
- Are salaries and wages paid in line with those paid by similar firms for similar work in the area of operations of the company?
- Is there a definite salary schedule for each type of job?
- Are employees encouraged to participate in training activities?
- Is the organizational structure consistent with the objectives of the company? Is it adhered to?

- Are the functions, authorities, and relationships of various units clearly established and understood?

- Are management personnel requirements projected far enough ahead (3 to 10 years), and are qualified replacements available as needed?

- Are salaries and rewards determined objectively on the basis of position evaluations and performance ratings?

- Are working conditions conducive to maximum effort?

Some Principles of Planning

Professor Harold Koontz, of the University of California at Los Angeles, has identified the components of planning so effectively that we summarize these as principles:

Planning Comes First

Planning is a primary requisite to the other management functions—organizing, directing, coordinating, and controlling.

In Chapter 3 we described these management functions, and illustrated their interrelations. The planning function has a unique role among the management functions, however. The establishment of objectives and the setting of goals involve planning. Thus planning becomes the first activity to be undertaken before the board can determine the type of organizational relationships required, the qualifications of personnel, the line or course of action to be taken, and the kinds of control that are to be applied.

Planning Must Contribute to Objectives

Every plan and all of the subplans must contribute in some positive way to the accomplishment of company objectives. This principle is drawn from the fact that the business organization exists for the accomplishment of definite purposes, which are defined in the company's objectives. Since action must result if plans are to be carried out, these actions must be consistent with the purposes or objectives of the corporation. Without plans based on objectives, action becomes merely random, unorganized activity.

Planning Must be Done at All Levels

Planning is a function of the board, the executive, and managers of a corporation; planning is done at every level in an organization. The character and breadth of planning will vary at each level, but the function of planning permeates all levels.

Planning Should be Efficient

Plans must bring about the attainment of objectives with a minimum of undesirable results, and with results greater than costs. Efficiency, as used here, refers not only to the input-output ratio, but also to such matters as individual and group satisfactions.

Planning Must be Based on Consistent Assumptions

Those engaged in planning need to have an understanding of the premises—or assumptions for the future—if they are to be effective in planning. These assumptions may be forecasts of data of a factual nature, or they may be basic policies expected to be applicable to the future. The assumptions are, in fact, the "future" to which those engaged in planning must fit their plans. The nature of the premises—or assumptions—will vary with each level of the corporation, just as the nature of the planning performed varies. For example, planning will be fruitless if the sales manager makes plans based on a boom year and the production manager on a recession year.

Planning Requires Proper Timing

Timing is both a horizontal and a vertical matter. That is, timing must be proper between levels in an organization, as well as between departments on the same level. For instance, it is clearly not enough for the procurement department to get farmers to raise a new processing crop and the sales department to make sales based on this production, if the production department does not have equipment and workers ready to operate when the crop is delivered.

Planning Must be Done Within a Policy Framework

Policies are guides to thinking when making operational plans. Thus, policies are the guidelines for transforming plans into action to achieve company goals. If policies are inconsistent with one another, the results may be damaging. For example, a policy of promotion from within may conflict with another policy of obtaining the best qualified management possible.

Planning Requires Communication

The best planning occurs when everyone responsible has complete information affecting his area of planning. Planners must have an understanding of company objectives, policies, and related plans of the company to do effective planning. Does a systematic means of communicating this information exist? Regular conferences of those engaged in planning provide one means of exchanging and coordinating planning information. Effective communication lessens the likelihood of "planning gaps" between levels in the organizational structure.

Planning Involves Alternatives

Planning seldom involves only one course of action. Planning involves the selection of the alternative courses of action which best enable the corporation to achieve its goals. Often, the alternatives are so many that selection of the "best" alternative is a difficult choice.

Fortunately some newer aids in decision making, based on mathematics and electronic computers, can be employed to aid in the selection of the "best" alternative.

Planning Must Recognize Limiting Factors

Attention must be given to limiting or scarce facts or factors when choosing among alternatives. The ability to select an alternative is restricted by the scarcity of certain strategic factors--as equipment, adequately trained personnel, lack of sales, etc.

Planning Should Allow for Flexibility

Effective planning requires continual checking on events and the redrafting of plans to maintain a course toward a desired goal. Inexperienced planners often believe that planning "freezes" action for the future. However, the future is uncertain, and unforeseen events may render even the best plans obsolete. For example, many firms planning to offer securities to the public in June 1962 cancelled such plans following "Blue Monday," May 28, and the subsequent period of stock market declines.

Flexibility involves the ability to change a plan without undue cost or friction, an ability to detour, and an ability to keep moving toward a goal despite changes in business conditions or even failure of certain plans. The need for flexibility stems from uncertainty of the future. Since uncertainty tends to increase over time, the greatest flexibility is required where the commitment is large and over an extended period.

Built-in flexibility of plans may be more costly than the potential benefit. Whether a company should spend extra money to make a special-purpose plant somewhat flexible, so that it might be used for another purpose if the original program fails to meet expectations, will depend upon the costs of doing so, the effect on operating costs and the importance of the risks to be avoided.

Planning Requires Commitment

Planning must encompass a sufficient period of time to allow for the fulfillment of commitments made. How far into the future should plans extend? Obviously no pat answer can be given for all businesses or situations.

The length of the planning period will be influenced by the length of time it takes to recover costs from an investment, for discharging an obligation under a commitment, and on the extent to which flexibility has been built into the plan. Thus, a firm may be willing to lease a plant for 10 years, even though it is impracticable to plan for longer than four, because of the possibilities of subleasing the facilities. When flexibility is not as feasible, it is desirable to plan for the entire length of commitment.

Planning Involves Strategy

Effective planning requires that a course of action be chosen in the light of what a competitor will likely do as a reaction to the plans made.

Often, merely observing a competitor's reaction to past plans may be a sufficient basis for predicting a competitor's behavior. The policy of one's own business may be clear and its plans well developed, but strategy may require the shading of plans and policies to meet or offset those of competitors.

Components of Long-Range Plans

Effective planning calls for recognition of the components of plans. These have been described in the manual, "Long Range Planning," written by Bock, Farris, Cox, and Day of Purdue University. We summarize the elements of plans as developed in that manual.

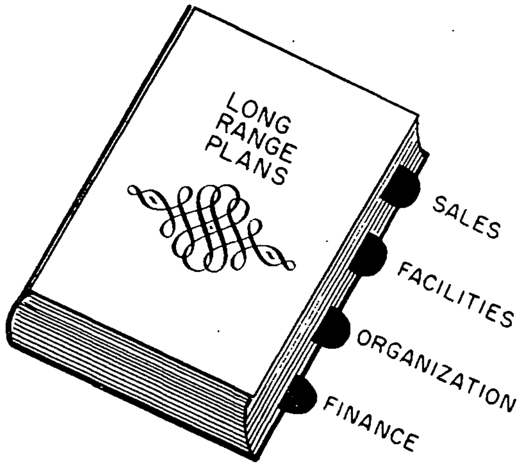
A set of detailed plans consists of:

. a sales volume plan

. a facilities plan

. an organization plan

. a financial plan



Sales Volume Plan

This provides a schedule of the amount of goods and services to be provided, based on economic forecasts. The sales volume plan provides the basis for subsequent detailed plans.

Facilities Plan

The facilities plan is an estimate of the size and type of facility required by the sales volume plan. The facilities plan may include the consideration of renovating or relocating the plant and/ or its equipment. In this respect, the facilities plan must be consistent with technological changes in the industry.

Capital budgeting helps determine the most efficient means of producing a given volume in the long run. Finally, labor planning must be considered in the facilities plan also.

Organization Plan

This gives attention to the organizational structure and personnel necessary to accomplish long-range plans. It provides the framework for hiring and developing management personnel, as well as means of decentralizing decisions at lower management levels.

Financial Plan

The financial plan is a summary statement. It incorporates: a) a profit estimate from the sales volume plan and profit estimating tools, b) an estimate of funds required for additional or modernized facilities from the facilities plan, and c) a plan for new product and new market development.

In determining a financial plan, consideration must be given to a) return on investment by product lines or activities, b) the risk of potentially high-return development projects vs. "conservative" facilities projects, c) the need for developmental projects in terms of growth and adaptation, d) long-run liquidity, and e) the company's capital structure. Integrating these elements into a financial plan for decision-making is a difficult but profitable part of long-range planning described in detail in the manual cited above.

Some agricultural marketing firms may need to develop a separate long-range procurement plan as a companion to other plans.

The Board in Relation to Planning

The foregoing discussion of planning principles and components has a direct bearing on the board of directors. Now we are concerned with identifying those strategic areas in the planning process where the board should be concerned. We will summarize the role of the board in planning, and discuss the question, "What should the board plan?"

In Chapter 5 we stated that the board is primarily concerned with idea decisions. Further we stated that the board is concerned with decisions defining the over-all objectives, policies, and goals of a corporation, while the executive is concerned with how these are to be carried out. Also, we said that decisions involving long-run commitments are the responsibility of the board, as contrasted to shorter-run commitments which are the concern of the executive.

By relating these criteria to the principles of planning, we gain some valuable insights into the relationship of the board to the planning process. Essentially the board is concerned with planning which relates to the long-run affairs of the corporation. The "long-run" is defined as that planning period in which the corporation can make changes in plant, equipment, and key personnel. In the long-run, new firms may enter the market, or competitors may change their operations in such manner as to affect other firms. Therefore, the long-run relates also to the strategy of business firms. We return to this topic shortly.

By accepting the concept that the decisions of the board relate to idea areas and are long-run oriented, the board's ideal relationship to the planning process is greatly clarified.

Conceiving and Initiating the Plan

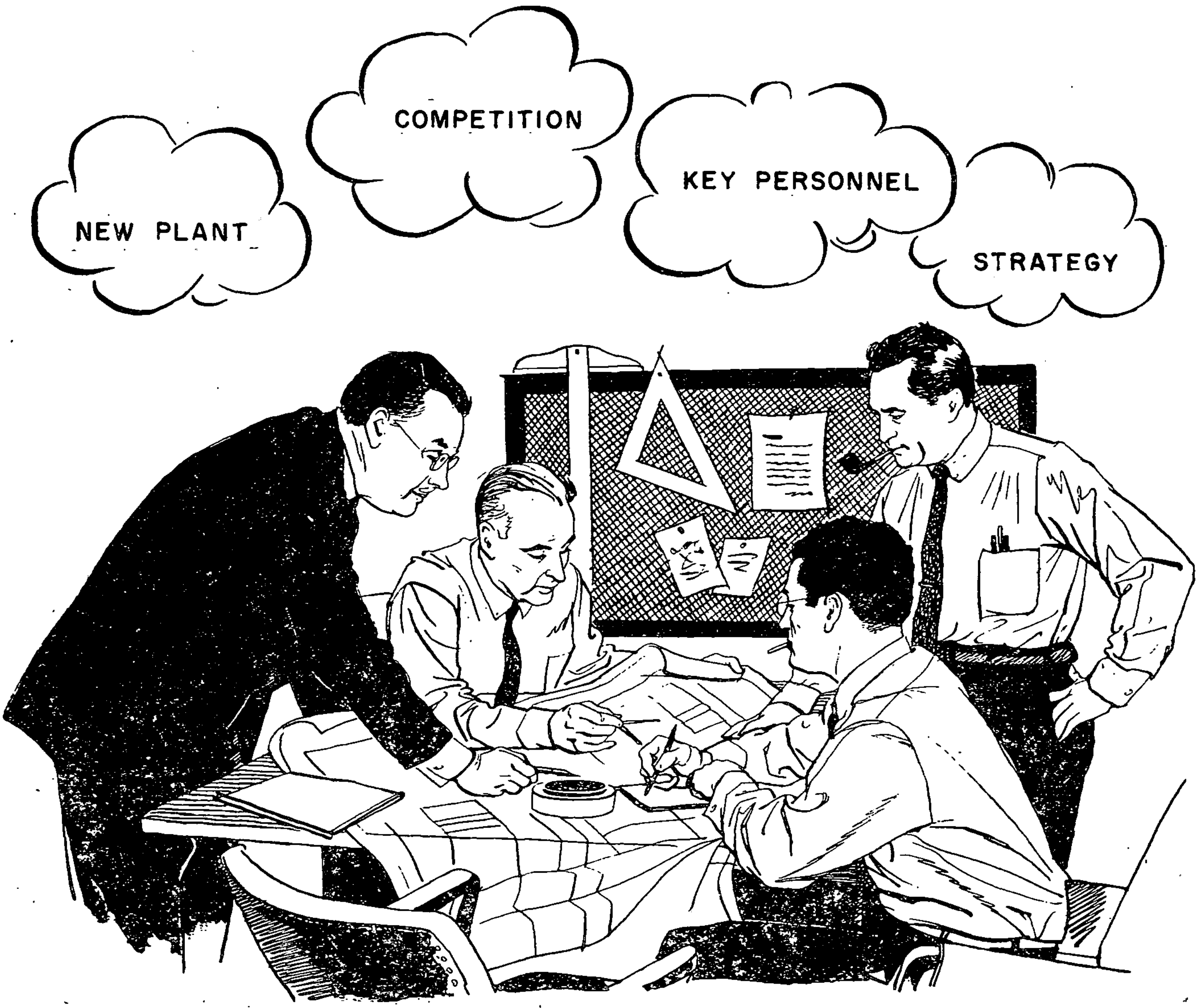
Generally, the board and executive jointly conceive and initiate the plan. Which one first comes to grips with the recognition for the needs of planning depends on several factors. These may be the degree to which the board members are familiar with the business, their previous planning experience, the extent to which the top decision group is board or executive dominated, and the extent to which department managers participate in the planning process.

A board that recognizes the abilities of the executive and managers in devising practical, attainable plans may continue to rely upon the executive to pass suggestions for new plans to the board. It is a wise board which allows the executive to surround himself with capable managers, and then performs its board functions in such a manner as to encourage the transfer to the board of ideas and plans from such people. In this viewpoint, the board's role is conceived as that of a catalyst which stimulates the executive and managers, directing their thinking toward the principal objectives of the undertaking and composing or setting aside differences that are unproductive. The board may squelch or encourage this organizational approach to planning, depending upon how it reacts to suggestions and plans, and what the board does in encouraging action based on approved plans.

Planning Strategies

Planning is a continuous process within the business, requiring periodical appraisal in light of economic, technological, and competitive conditions. Planning is dynamic, constantly dealing with internal and external business forces affecting the ability of the company to carry out its plans. The search for and collection of information is only a starting point of planning; plans must provide for tactics and strategies as well.

Tactics relate to the detailed application of the central ideas embodied in a plan, usually carried out by levels below that of the board of directors.



Strategies include policy-level decisions, which in turn help to specify lower level decisions. Strategy includes objectives, goals, policies, and expected payoff measures for risk. Viewed more narrowly, strategies consist of projecting alternative courses of action to achieve a desired goal in view of the expected and subsequent reactions of competitors. The interdependence of strategy to policy-level planning decisions clearly indicates that strategy formulation and choice is a responsibility of the board of directors and the executive.

Selecting Useful Information for Planning Strategies

The cornerstone for planning strategies is determining what information is needed by the board and executive. Selecting the information that is relevant to a particular planning operation is usually a major problem. Information not directly related to the planning at hand causes the board to flounder and be ineffective in planning. Therefore, determining information requirements is a primary consideration in board planning.

Good planning information has these characteristics:

- It cuts across business functions, such as sales, production, etc. It provides a feasible basis for integration of plans for the company. This would be difficult to achieve if planning was based solely on functional lines.

- It covers fairly long periods of time - months and years - and deals with trends.

- It features outlines rather than details. Excessive detail has been called "the quicksand of planning."

- It provides insights into the future. It is forward looking.

Three types of information are used in planning:

- Environmental

- Competitive

- Internal

The amount of information required varies from company to company, depending on the nature of the industry and the size and operating territory of the corporation. The board establishes standards for the regular collection, transmission, analysis, and presentation of planning information by the executive. This results in a well-developed planning information system.

Environmental Information

This relates to external forces which have an impact on the corporation's decisions. Specific examples are:

- population - growth trends, age distribution, geographical distribution, unemployment hazards by regions, disposable income.

- price levels - retail, wholesale and commodity indexes, and governmental regulations.

- transportation - availability, new developments, costs, competition and alternative methods, regulations.

- foreign trade - common market, balance of payments, exchange rates, convertibility, tariffs, foreign production.

- labor force - wages, unions, skills, availability, changing educational requirements of the company.

These types of information may be referred to as ingredients of business outlook. They are concerned with trends or changes from one time period to another; they are without meaning if based on one period alone.

An example of effective environmental forecasting is a food processing firm which made a systematic study of popula-

tion, employment, and income trends, by which it anticipated the extent of demand for prepared foods by homemakers. It pioneered in introducing prepared foods and meals, and gained a large share of the market before other companies even became aware of this possibility.

Competitive Information

A company needs to distinguish those businesses which are major competitors from those firms which provide minor competition. Agricultural marketing firms have informal access to information about their competitors, primarily in their procurement practices and policies, but there seldom is a systematic attempt to collect other types of information about competitors.

Important examples of competitive information useful in planning and in formulating strategies are:

- past performance - includes information on profitability, return on investment, share of market, etc. This helps identify a company's actual competitors.

- present activity - includes new product introductions, management changes, price strategies and tactics frequently followed, etc. Information on present activity of competitors is useful for planning one's own offensive strategies.

- future plans - include information on facility plans, acquisition intentions, and research and development efforts of competitors.

Competitive information is similar to military intelligence in that it helps assess the major strengths and weaknesses of the opponent as well as his possible future behavior.

Internal Information

This is aimed at identifying a company's own strengths and weaknesses. Internal information includes:

- financial - sales, costs, cost behavior relative to volume changes, cost of capital, sources of capital, capital turnover, collections, etc.

- physical - efficiency of production, delivery performance, manpower resources, raw product procurement, utilization of facilities, etc.

- other - including market and community standing, labor relations, personnel training, etc.

Conventional accounting reports are inadequate sources of internal information when used alone. Accounting reports are designed to fulfill management's responsibility to stockholders or members, the government, and to other groups having a financial interest in the company. They rarely center on success factors that are nonfinancial in nature or even on crucial financial planning factors.

Identifying Key Performance Areas (KPA's)

In most agricultural businesses there are usually a few factors that greatly influence success. A company's internal information system should focus on these "success factors." In food processing, for example, quality maintenance, good distribution services, marketing, and direct cost control are success factors. These constitute a company's key performance areas (KPA's). Results in KPA's must be satisfactory for business success.

An example may illustrate the KPA concept more clearly. An internal combustion engine has several vital parts, and for the sake of simplicity, let us agree that these are 1) the fuel and carburetion system, 2) the electrical system, 3) the cooling system, and 4) the lubrication system. We will consider these the KPA's of the engine, since a failure of any one will affect the ability to operate the engine normally.

The number of KPA's varies slightly from company to company, and between industries. One of the difficult tasks of the board is to isolate, with executive assistance, those areas where performance vitally affects the success or failure of a business. For agricultural marketing firms, the following list may help identify KPA's:

- raw product supply - the availability of a continuous, dependable supply of resource materials on which to gauge production and sales.

- facilities - adequate facilities determine, in part, the relative efficiency of a plant compared to competitors.

- organization - the existence of adequate internal communications, clearly defined unit and employee responsibilities.

- finances - the ability of the business to carry out desired action when necessary, and to meet all current and future obligations.

- production - the combination of human, physical, and capital resources to produce efficiently marketable products.

- sales volume and market position - having an adequate volume of sales for efficient plant utilization, and effectiveness in the market place.

- personnel - definite personnel policies relating to recruitment, training, performance, and compensation.

- member relations - the understanding and acceptance of company objectives and programs by members is a vital area for cooperatives. Also, the ability to keep the services of the cooperative in tune with membership needs.

- public and government relations - including the role of the company in trade or industry activities.

Obviously when performance is being measured, the KPA's should be considered in balance to prevent either bias or unintentional oversights. For example, it may be simple to blame a lack of adequate member relations as a cause for continuously declining business volume for a cooperative. Actually, however, the board may find that membership problems are a symptom of something wrong in the other KPA's, rather than a direct problem itself. Poor procurement practices, for instance, may lead to membership problems. Thus, the board must recognize the interrelations in cause and effect revealed by KPA's, and that KPA's may change over time.

What Should the Board Plan?

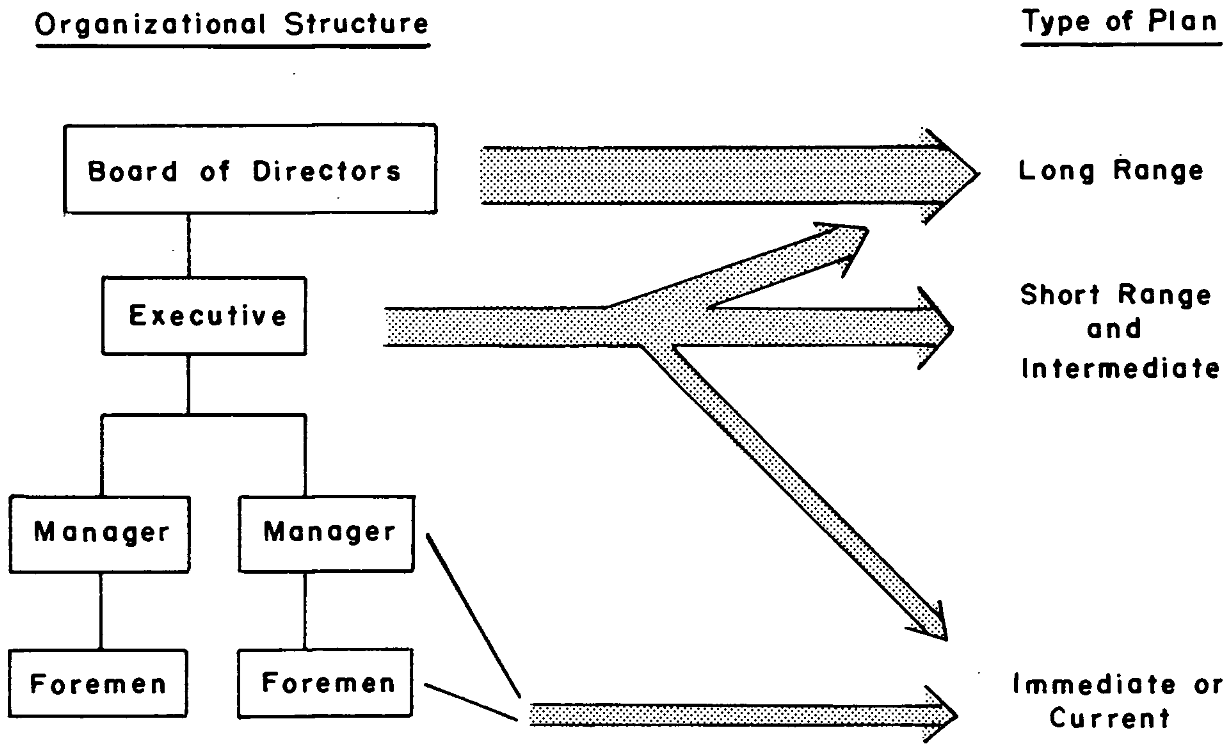
Planning takes place at every level within a company. At the board level, planning involves long-range decisions relating to 1) objectives, policies and goals, 2) the commitment of resources to a new business or investment opportunity, and 3) the planning of personnel succession in key positions. This is not to say that the board necessarily writes out plans in all of these areas. Often the board's main planning function is to 1) accept, 2) reject, or 3) refer back plans submitted for approval. This relates particularly to plans concerning new business or investment opportunities, where the executive and his staff should prepare the necessary plans.

In Chapter 1 we defined planning in terms of the time period associated with plans. These are:

1. Immediate
2. Short-term and intermediate
3. Long range

There exists a direct relationship between these time periods, the types of plans, and the organizational structure of the company. The illustration identifies the board of directors as concerned primarily with long-range plans, along with the executive. Long-range planning is that activity which establishes long-term goals for the company, and then proceeds to develop specific plans by which to attain these goals. The responsibility of developing long-term goals is clearly that of the board of directors.

The board must provide the proper incentive and climate for planning within



the management group. It must be receptive to ideas, make recommendations on needed plans, provide guidance, and encourage the executive to give consideration to long-range opportunities through proper delegation to subordinates.

The board should prescribe certain standards for plans submitted to it for consideration. Some guidelines are included in this chapter under the heading, Appraising Plans. Nothing restricts the executive's and manager's incentive to plan as much as the failure of the board of directors to take definite action once a plan is presented. The board must make the final decision. We believe the framework or rules developed in the following section will provide a reasonable basis for board of director decisions. The board should also encourage decentralized planning, but if it fails to make decisions called for at the top level, it is stalling efforts throughout the organization.

Selecting Strategies for Putting Plans into Effect

Identifying sources of information and selecting useful information is only a means to an end, rather than an end itself. The board must use the information appropriately in making plans to help achieve objectives and goals. This means selecting strategies for putting plans into effect.

Basis for Selection of Alternatives

The essence of planning is selecting a course of action from several alternatives. Thus, decision making is the core of planning. But a plan must be developed not only on what the company wants to accomplish, but also in view of what competitors may do to prevent the company from achieving its plans. Thus, the element of strategy makes the process of planning more difficult. The basis for selecting alternatives for planning are:

. Hunches	Subjective
. Trends	↓
. Probabilities	Objective

Hunches (Informal Judgments)

A hunch is a strong feeling one holds that something will happen. It has no scientific basis in fact. In the past, many important business decisions have been made on hunches. As managing has shifted somewhat from an art to a more scientific basis, reliance on hunches has declined. Nonetheless, many decisions are still based on hunches. This is particularly true when strategy development requires anticipating the probable reactions of competitors.

Sometimes hunches are based on recollections of past experiences. For example, when considering a change in list prices, a company may have a hunch that competitors will also change their price lists correspondingly, because they have in the past.

Hunches can, however, be misleading. Thus successful companies are relying on more scientific methods for selecting alternatives whenever possible.

Trends

A trend refers to the general direction taken by a series of related data. For example, the trend in the sale of feed in 100-pound sacks is down since the end of World War II, while the trend in the sale of bulk feed has increased. Trends refer to figures - to data which can be observed as numbers over a period of time.

The board will find trends a useful aid in planning and decision making because they provide a basis for forecasting. But trend data have shortcomings. If bulk feed sales have tended to increase each year since World War II, will it be fairly safe to predict further growth into the future? Perhaps. But what are the factors behind the trend? Will it continue? In the same direction, or in equal magnitude? Is a technological breakthrough due? These and many other questions must be considered to qualify trend extension as a satisfactory basis for long-range forecasting.

When the board considers long-time commitments of large amounts of capital, it may be wise to obtain outside professional help to analyze the factors responsible for the trend, as a basis for judging whether such trends are likely to continue in the future.

Probabilities

Predictions into the future are not always correct. To minimize the dangers of prediction, all-or-none predictions should be avoided. Whenever possible, a list of possible outcomes should be given. Actually, many boards of directors do this unconsciously when faced with important planning decisions. Formalizing the process will be a valuable aid in selecting among alternatives.

The board might use a scale of likelihoods as "likely" or "unlikely" when referring to the chance of occurrence of each possible outcome. These might be further modified with adverbs as "very", "more", etc.

The board can transform the "likelihood" scale to one based on numbers. For example, a scale of 1 to 10 may be used to represent the range from very unlikely (1) to very likely (10). The scales may be transformed to statistical probabilities. By probabilities, we mean the chances of a predicted outcome actually occurring. For instance, if data show that a competitor has revised his price schedule downward nine times out of the ten that price reductions have been made by your company, the probability of the competitor following your price reduction in the future is $\frac{9}{10}$ =.90, or 90%. However, if a competitor has in the past followed a price rise three times out of eight, the probability of the competitor's following a price rise in the future is $\frac{3}{8}$ =.375 or about one out of three times. Probability is calculated by the following rule:

$$\text{Probability of outcome} = \frac{\text{No. occurrences of outcome}}{\text{Total number of cases}}$$

The concept of probability relates directly to the ability to predict future events. The more the total number of cases on which observations are made, the more reliable will be the probability of the outcome, and when a board makes a decision based on a hunch, it is using a crude measure of probability. When the board considers trends, its measure of probability is not as crude. When perfect knowledge exists, there are no decision problems because the probability of the event occurring is 1, or 100%.

The ultimate choice of alternatives rests upon the net payoff. This recognizes both the probability of an event occurring, and the relative size of earnings that will be realized if, in fact, this event does occur.

Planning Under Risk and Uncertainty

Economists identify states of knowledge where probabilities are known as risk situations. Where probabilities cannot be assigned, this state of knowledge is known as uncertainty.

Risk and uncertainty creep into planning decisions from several sources, both external and internal to the firm. External sources of uncertainty are those which originate outside the business organization, and over which the company has little control. Internal sources of uncertainty relate to those factors which arise from within the company organization itself. One classification of risks and uncertainties facing agricultural marketing firms is:

External Risks and Uncertainties

1. General economy
   - employment
   - wages and salaries
   - gross national product
   - interest rates
   - war
   - import-export policy
   - taxes

2. Industry
   - vertical integration
   - horizontal combinations
   - unionization
   - consumer preferences
   - changes in buyer preferences

3. Technology
   - new methods of processing
   - changes in storage and transportation
   - new procurement techniques
   - costs of new plant and equipment

4. Competitors' Actions (Here we refer to other factors not covered in 2, Industry, above.)
   - price leadership roles
   - price determination roles
   - new product introductions
   - general business strategies

5. Government
   - farm price programs
   - production controls
   - credit policies
   - antitrust enforcement
   - price discrimination enforcement

Internal Risks and Uncertainties

1. Profits
   - product prices
   - raw product costs
   - operating efficiency

2. Personnel
   . training requirements
   . salary requirements
   . sources
   . death

3. Catastrophe
   . types
   . protection requirements
   . production possibilities at the time
   . how to maintain services
   . what to do with raw products

The above classification outlines the principal sources of unpredictable changes which the company should take into account when formulating plans.

An Example

An example may help to relate the principles of the foregoing discussion to a company's planning activities. Assume your board must choose between two alternative projects, each requiring an expenditure of $10,000. The manager of the field department has recommended that a receiving station be built in the next town, near the processing plant of a competitor, to expand the procurement area of the company. The production manager has recommended the purchase of a new improved type of grader to replace one that is obsolete and thereby resulting in high costs.

Table 2. Gross and Net Payoff Table for Alternatives Under Consideration

1 Action	2 Outcome	3 Probability	4 Gross payoff	5 Net payoff
Alternative A				
Invest $10,000 in new receiving station adjacent to competitor.	A_1 Increases volume 10%.	.2	$60,000	$12,000
	A_2 Competitor builds receiving station to protect volume	.3	12,000	3,600
	A_3 Competitor pays farmers transportation allowance.	.5	-20,000	-10,000
	A_4 Competitor raises price to farmers.	.0	0	0
				$ 5,600
Alternative B				
Invest $10,000 in replacing obsolete grader in plant.	B_1 Reduce direct costs 15%.	.2	$30,000	$ 6,000
	B_2 Reduce direct costs 5 %.	.7	10,000	7,000
	B_3 No change in direct costs.	.1	- 2,000	- 200
				$12,800

Alternative A: New Receiving Station

In Table 2 we have listed a few of the possible outcomes for each alternative.

If your company builds a receiving station near a competitor's plant, the possible outcomes are:

1. Your company will increase its raw product volume by 10 percent. The increased volume is necessary because your company is operating below an efficient level of output. It is possible that your competitor will not retaliate by taking steps to protect its supply when threatened by the new receiving station. Your board is assured by the executive that there are two chances out of ten that this outcome can be realized.

2. A second possible outcome is that your competitor will retaliate by building a receiving station near your plant. In this case, the competitor will tap some of your supply, but will not take away as much volume as your company gains from its receiving station. Your executive estimates that there are three chances out of ten that the competitor may build a receiving station.

3. Your competitor may, instead, make a transportation allowance to farmers, to make it more profitable for farmers to bypass your receiving station. As a result, your company may lose considerable volume to the competitor. The chances of this outcome materializing is estimated to be five out of ten.

4. Your competitor may retaliate by increasing the price it will pay farmers to sell their output to it. Your executive believes the competitor will not increase price because of the low margins in the industry, and because his capital position will not provide for even a temporary subsidy to growers.

Alternate B: New Grader

The board must also consider the possible outcomes of investing in a new grader.

Your executive feels your company needs to reduce its processing costs, and a new grader will result in more accurate grading, at less loss in quality.

Upon questioning, your executive figures the possible outcomes for this investment are:

1. Direct costs may be reduced by as much as 15 percent, but certainly by 5 percent. He agrees there are two chances out of ten that the savings may amount to 15 percent, and seven out of ten chances that the savings will be 5 percent.

2. There is some possibility that the cost reduction from the new grader will not be achieved because other pieces of equipment may become a bottleneck. Chances of this happening are figured to be one out of ten, or 10 percent.

These probabilities are given in column 3 in the table. Column 4 lists the estimated payoff or consequences for each outcome if it were to happen. For instance, if outcome A_1 happens, the payoff to your company will be $60,000. However, there are only two chances out of ten that A_1 will occur; therefore, the net payoff is $12,000 if A_1 does happen. (Payoff x probability = net payoff.) If A_3 occurs, there will be a loss of $20,000 to your company, but the net payoff will be $ -10,000. ($-20,000 x .5 = $-10,000.)

Likewise, for the investment of $10,000 in the new grader, outcome B_1 would have a payoff of $30,000, and a net payoff of $6,000. Outcome B_2 would have a payoff of $10,000, and a net payoff of $7,000. Outcome B_3 would not reduce costs at all, but there would be a loss on fixed investment, so the payoff would be a loss of $2,000, and a net payoff of $-200.

The mathematical expectation (sum of the net payoffs) for Alternative A is \$5,600, and for Alternative B, \$12,800.

Faced with these possible outcomes, chances or probabilities, and gross and net payoffs, the rules for planning have been proposed as follows by Irwin D. J. Bross, in a book titled "Design for Decision."

Rule 1. Select the alternative for which the desirability of the most probable outcome (gross payoff) is as large as possible. In the example:

Alternative A - most probable outcome is A_3 = \$-20,000.

Alternative B - most probable outcome is B_2 = \$ 10,000.

Alternative B would be chosen on this basis. However, this selection leads the board to ignore certain information, and therefore we need to consider other rules too. These center on whether the board takes a pessimistic or an optimistic viewpoint.

Rule 2. (Optimistic) Choose the action which could lead to the most favorable outcome (gross payoff). Alternative A would be chosen, since the largest gross payoff occurs in this alternative (A_1).

The chances (probability) of achieving the highest net payoff is quite remote: in fact, only two chances in ten (col. 3, table 2). Therefore, there is still more information which the board should consider.

Rule 3. (Pessimistic) Consider the least favorable outcome possible for each alternative. Of these, select the alternative that has the most favorable of the least favorable outcomes (gross payoff).

In the example, Alternative B would be selected, because the least favorable outcome here is -\$2,000, which is more favorable than in Alternative A, where a loss of \$20,000 is possible.

Rule 4. Choose the course of action which has the largest mathematical expectation (sum of net payoff). On this basis, Alternative B would be selected, since it is the outcome with the largest mathematical expectation of net payoff, \$12,800 as compared to \$5,600 for Alternative A.

Rule 5. Select the action associated with the most profitable of the least favorable net outcomes. In this rule, the board seeks to minimize the maximum loss possible. On this basis, Alternative B would be selected, because the possibility of a \$200 loss is much less than in Alternative A, where a loss of \$10,000 is possible.

We have no basis for recommending any one specific rule as the best guide for a board of directors to follow. Rules 4 and 5 provide the most practical guide for selection of plans. Rules 1, 2, and 3 do not consider all of the relevant information pertaining to a decision because they disregard probabilities and net payoff.

When the plans relate to decisions which may have the possibilities of unfortunate and serious outcomes, Rule 5 provides a reasonably safe basis for making planning decisions. When the plans consist of a decision problem in which only moderate losses or gains are possible, and which occur somewhat frequently, Rule 4 will be of the most value.

Many times the board must consider planning decisions not only on the basis of providing some profit, but also on the basis of providing some guarantee of investor security. However, survival strategy itself cannot be the dominant consideration of the board, since it will forego some needed plans and action and thereby not adequately serve its stockholders or members. Thus, some compromise between profit and security is needed.

Rule 5, which may be stated as saying "minimize the maximum risk," comes close to serving as such a compromise.

Appraising Plans

The long-range nature of planning with which the board of directors is concerned may result in actions or programs which vary in consequences. The ability to predict consistently the uncertain future with a high degree of accuracy is a rare, if not impossible, talent. Nonetheless, the board will need some means of appraising plans 1) when they are conceived, 2) in progress, and 3) at their culmination. Some way of detecting how well a plan meets company needs and philosophy is required. Further it is necessary to know how well plans are progressing, and when the end results of a plan have been achieved.

Thus we come to grips with the question, "Is this a good plan?" The following checklist may provide a useful guide for appraising plans:

1. Are plans consistent with company objectives and goals?

2. Have key industry growth factors been identified?

3. Have company strengths and weaknesses been accurately evaluated?

4. Have competitors' strengths and weaknesses been accurately evaluated?

5. Have KPA's been identified?

6. Have strategies been selected?

7. Have the capacities of different company units been projected far enough ahead?

8. Have company units been developed in balance?

9. Is there a practical timetable?

10. Have plans recognized practical alternatives?

11. Do plans provide for flexibility?

12. Have appropriate levels within the organization contributed to the plans?

Planning is one of the most difficult of the five management functions, because it deals with the future. Thus, it is one of the most creative functions in which the board of directors may engage. Done well, it is often the most rewarding activity. Some refer to long-range planning as their "profit insurance." There is no doubt that a company which consistently carries out its planning functions will have a competitive advantage over other companies. A company making plans based on the principles and decision-making techniques described in this chapter will progress in an environment which it has in part created. It is easier to fight a competitive battle if you are partially able to write the rules of that competitive battle, rather than adjusting to rules imposed by your competitors.

Planning and the Small Corporation

Frequently the board of directors and executives of a small corporation become convinced that planning is only for the large corporation. Harried executives who wait on customers, who check on inventories and invoices, and who perform many details of daily operation actually do not have the time to contemplate long-range plans. As a result, they drift from crisis to crisis without charting a definite course of action. Such executives and boards become easy prey for ill-conceived and poorly-thought-out proposals. The chances of these actually paying off are extremely remote; as a consequence, large amounts of capital may be wasted. Can the small corporation also prepare and carry out plans?

The success of planning by many small corporations indicates that planning can be done profitably regardless of size. It is true, the techniques may vary from firm to firm. This is only natural since planning is not a precise procedure. Techniques vary, just as the objectives and goals of corporations vary. But there must be a desire to plan if it is to be done profitably.

A first step in any corporation is for the board and executive to make a strong commitment to plan. Then develop a plan to plan. Adequate personnel must be available to permit the executive freedom from daily operating details. The board and executive should encourage each other in the process of learning how to plan. The first few attempts will undoubtedly be done clumsily.

The board should become acquainted with planning techniques and tools, as a safeguard in approving plans submitted by the executive.

Finally, the board may desire to hire the services of a professional management consultant to formulate plans for special projects. Economists with the State Extension Service may be able to provide training for the board and executive through short courses or other training conferences. Also, the Farmers Cooperative Service, State Cooperative Councils, and the Small Business Administration often co-sponsor special management courses which will be helpful to the board and the executive.

The small corporation that wishes to keep even with or move ahead of the growth in the economy cannot afford to do a poor job in planning; nor can it afford not to plan for its own future.

As Shakespeare said, "Nothing comes of doing nothing."

Chapter 7.

ROLE OF THE BOARD IN THE CONTROL FUNCTION

Plans are seldom developed perfectly; their execution is even less perfect. There are many ways by which errors may creep into plans: misjudgment, miscalculation, poor skills, inadequate understanding and communication, and improper coordination. There likewise are economic and business conditions which result in plans going awry: actions of governments, competitors' reactions, and economic fluctuations are some examples. But plans seldom go entirely "wrong." Instead, results deviate to some extent from those expected. Controlling is the function by which comparisons are made between what is actually achieved against what was intended to be achieved.

Control, then, is viewed in terms of action, rather than in terms of restrictions. It is a positive aspect of management rather than a negative function. Control is thus defined as the process of measurement and determination of necessary corrective action to make certain that plans are transformed into desired results. Effective controls are dependent upon the existence of plans and the ability to measure progress in light of these plans. Goals and standards are one type of plan, and they serve as benchmarks for controlling. The emphasis on control in a management sense is on planning, measuring, and comparing. Telling people what to do, or what not to do, is part of the management function of directing rather than controlling.

The control function serves six principal purposes:

1. Provides useful planning information

   . What are the company's goals?

   . Are goals consistent with objectives?

   . What changes need to be made to achieve desired results?

2. Reports on progress in achieving plans

   . Do plans provide for goals to be achieved in a specified time period?

   . Are goals being achieved?

3. Predicts trends and forecasts results

   . What direction is the company taking?

   . Will it be able to get to the desired objective?

   . What will be the effects on the company?

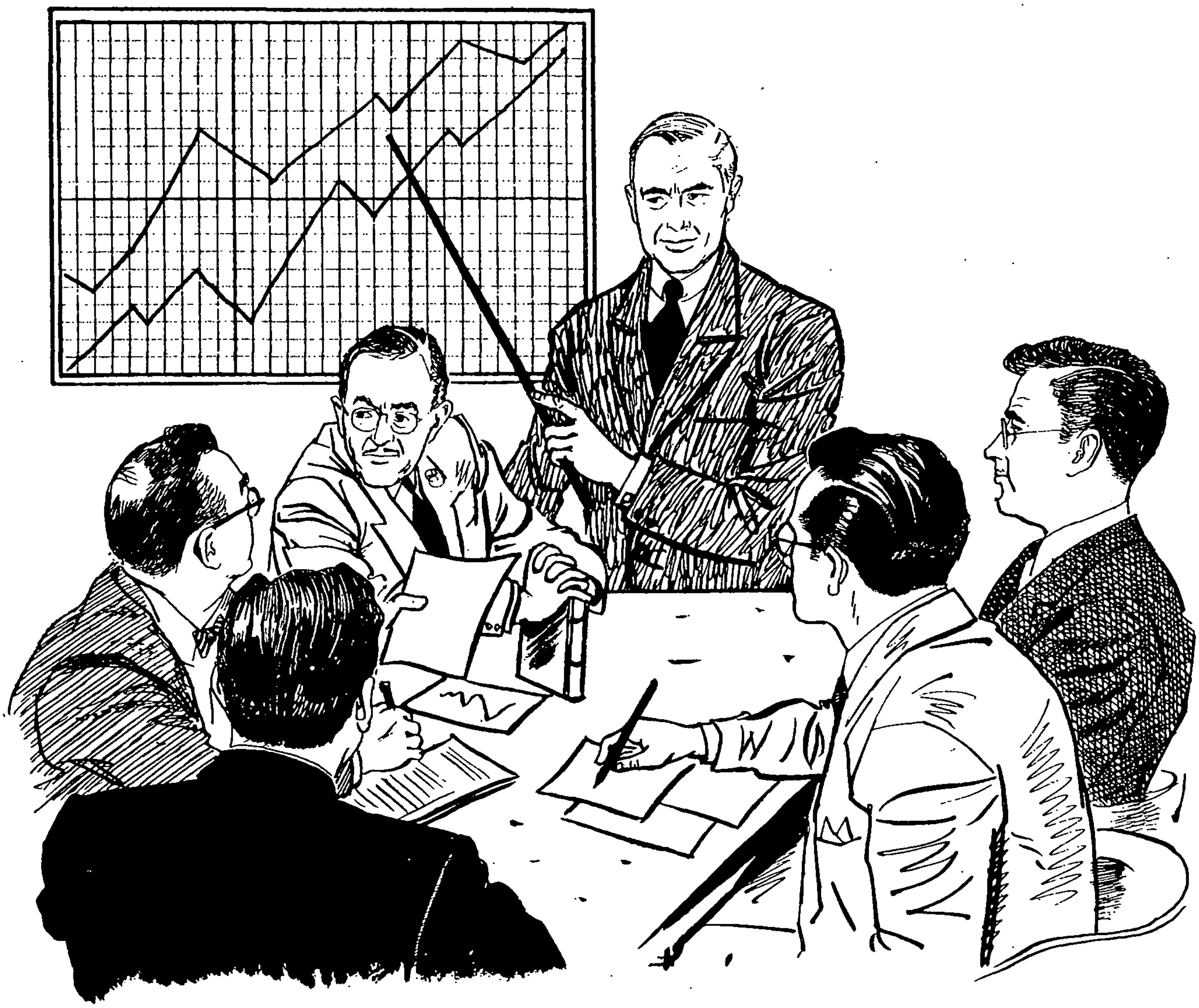
4. Diagnoses what action is necessary to overcome recurring problems

   . What happened?

   . Why did it happen?

   . How can it be prevented from occurring again?

   . What changes should be made?



5. Recalls past experiences

   . Under similar circumstances, what happened in the past?

   . How much progress has the company made?

   . What past experiences should guide our present and future activities?

6. Prevents unauthorized actions

   . Are personnel and departments duplicating efforts?

   . Have standards been established and communicated to employees?

   . Are they adhered to?

   . Could unauthorized actions have been prevented?

   . What corrective action should be taken?

Information is the key to all of these purposes of controls. Controls themselves are information generating, and the end result of controls is to provide information for planning, measuring, comparing, and corrective action required.

Relation of control to planning: Effective planning is a prerequisite to effective controlling. A company which gives serious attention to planning may not necessarily be successful. Plans must be carried out through effective action; the company must operate. Plans focus action on purposes or objectives of the company. It is not possible to control without reference to plans. Without plans, action becomes disorganized. Under these circumstances it is virtually impossible to perform the control function, since the object of this function is to give assurance that events or actions conform to plans.

Relation of control to measuring: The second phase of controlling is based on the availability of information to make measurements. The board of directors must secure the factual information necessary to perform the control function. Facts may be found in written statements of objectives and policies, special reports, statistics, operating results, financial ratios, employee records, membership or stockholder complaints, employee performance, reviews, and cost data. Without such data, it is impossible for the board to carry on the next phase of the control function.

Relation of control to comparison: Factual information must be used to make comparisons with preceding periods and established goals. This means that standards must be available to the board. It is not enough for the board to know that current sales account for 10 percent of the market; they must know their past market-share and current market-share goals. Comparison of current data with past, and with standards of the industry as well as company standards, is a required phase of controlling.

Relation of control to corrective action: When control information indicates that standards or goals may not be achieved, the board must also determine what corrective action may be required. For instance, the board must be prepared to change the organizational structure of the firm, or the products handled, or the strategies employed by management, depending upon the nature of the problem encountered. In other words, the final phase of controlling is knowing what can and should be done to correct in advance of undesirable results the course of action being followed.

After poor results have occurred, it is too late to exercise effective controls except to assure that the action or programs are not repeated in the future.

Principles of Control

The Principle of Key Performance Areas (KPA's)

The most effective control occurs when major attention is given to those business performance areas which are vital to the survival of the company.

Although plans furnish the most complete and accurate basis of measuring performance, it is not possible, nor desirable, for the board and executive to follow every detail of the programs which arise from these plans. Neither can the board watch each of the fairly important phases of performance. The board must know, however, that plans are being carried out in such a manner that they can be accomplished with reasonable closeness to the desired outcome. To do this, the board must concentrate its attention to those performance factors which indicate whether important deviations have or are about to occur.

Board control action is exercised only when current or expected performance deviates substantially from the desired results.

The number of key performance areas, or strategic control points, will vary with the importance of plans, the consequences of deviations, the nature of the industry, and the particular requirements of the firm in evaluating performance.

The Principle of Key Indicators

There are a few vital indicators in each key performance area, and with these we can measure the quality of planned performance.

As with the KPA principle, this recognizes the complexity of organizational activities. It is difficult and unnecessary for the board to keep close watch over all plans and activities. The board must measure performance by carefully selecting key indicators which simplify the observational features of control.

The Principle of Assigning Responsibility and Delegating Authority

Organization, being the main means of coordination, is also useful for maintaining control. The board is the focal point of over-all control, although controls permeate all organizational levels of the company. Thus, control points must be tailored to organizational structure, and the information used to judge performance must be suitable to the position and authority of the responsible individual. Stated simply, this principle requires that control devices be appropriate to the position to which they are applied. For instance, it is unfair for the board to criticize the executive for failure to achieve a certain share of market if the board has restricted research and development activities, while competitors have increased their share of market through new product or packaging introductions. Likewise, it is unfair to criticize high maintenance costs when the board systematically fails to provide the executive with adequate finances to replace obsolete or worn-out equipment.

The Principle of Future Controls

Effective controls must be aimed at preventing serious deviations from plans before they occur. It does little good for the board to find out in December that the company suffered losses in September for something that occurred in July.

Controls based on accounting and statistical data are largely oriented to the past. To the extent that controls are based on information from these sources and are not related to plans, they are oriented to the past and have limited usefulness in terms of the total concept of controlling. Budgets, forecasts, and projections are forward looking, and coupled with current reporting provide a basis of reviewing progress. Timely projections of performance far enough in advance will help foresee problems so that avertive action can be taken.

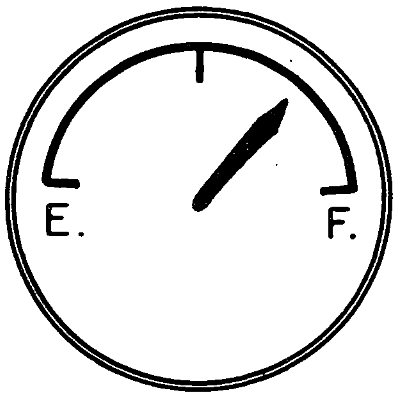
The Principle of Direct Control

The board can exercise positive control by employing high quality executives and managers. One means of assuring that events will conform to plans is to take more direct steps to retain the best possible quality of executives and managers.

If the board has identified the KPA's of the business when planning, it now needs to determine what standards of performance to establish for each KPA. As one authority has stated, many unexplained business failures are caused by boards and executives who are unaware that results with KPA's are dangerously off standard.

Key Indicators (KI's)

To know what the key performance areas of the business are is only part of the job. The board and executive must also know what to look for in each key area. For each area, there may be one or more key indicators (KI's) which alert the board and executive to pending trouble. Obviously, there is much information available to the board and executive for each of the KPA's. Much of this information is of little value to the board for control purposes. A part of the board's control task is to determine what the KI's are for each KPA. Irrelevant information which complicates the control function without making any worthwhile contribution should be eliminated from board consideration.



KI's may be a number, a ratio, a percentage, or a qualitative statement of condition, which serves as a sensitive alarm system on the relative performance or condition of a KPA.

KI's save the board considerable time in examining the company's performance. For each KPA in the engine example, there are meters or gauges which show how well each KPA is functioning. For example, an oil gauge reveals what oil pressures are at a given time. A low reading on the gauge reveals something is wrong with the lubricating system. Thus, the KI points out the area of concern, and in this case, it prevents tinkering with the electrical or fuel system, which is irrelevant to the problem. Thus, for each KPA there are one or more KI's.

Nature of Key Indicators

The board and executive should pick from all indicators those they believe will serve their purposes for each KPA. In reality, however, the board may seek advice from outsiders, such as their accountant, attorney, or business consultant, as well as their own staff, on which measures are most meaningful in revealing the relative performance of the company. Below are some suggestions on the nature of KI's which will serve as a basic guide:

1. The number of KI's should be as few as possible, and yet provide the needed information. When the "pulse" of the business can be taken with a few measures, the board will be able to give these more careful attention.

2. KI's should be expressed quantitatively, such as ratios, percentages, or as other comparisons to standards, whenever possible.

3. KI's should be selected on their ability to influence progress in line with goals and objectives.

4. KI's should be selected which are helpful in the planning process, by permitting appraisal of current and future projections.

5. KI's should be realistic measures of performance.

Selection Criteria for Key Indicators

To this point we have considered the nature of KI's. We will now discuss criteria for selection of KI's.

Relevance

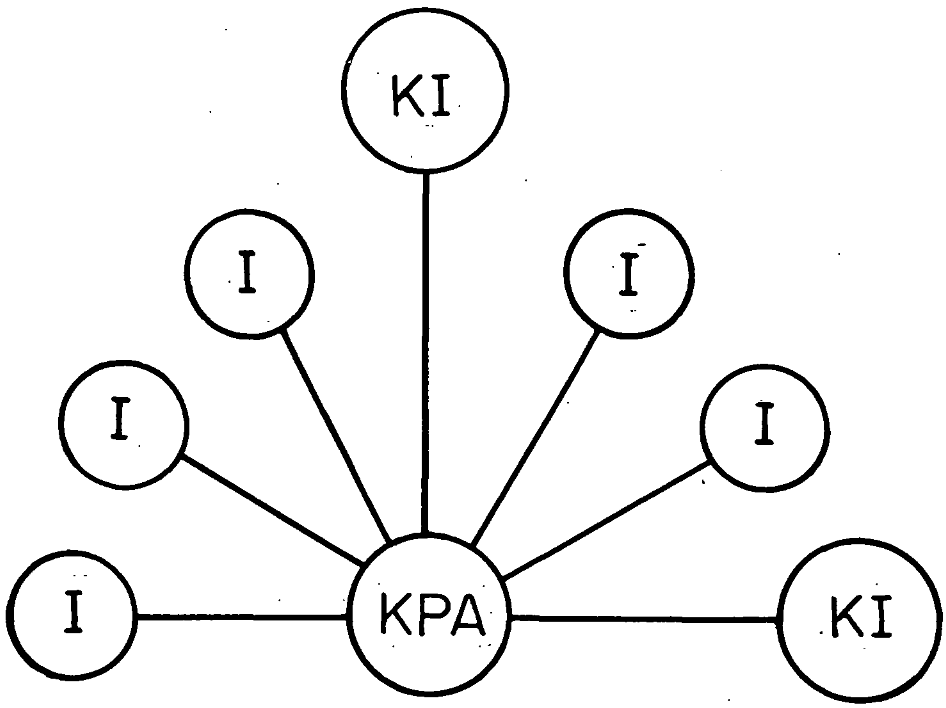
A KI should be relevant to the KPA. For example, a KI for procurement activities may be procurement costs per ton. The data from which this key indicator is determined should allow accurate measurement of procurement costs. If company trucks are used for transporting raw products to the plant as well as finished goods to a warehouse, truck costs should be jointly allocated when determining procurement costs.

Reliability

KI's should reveal the exact measures intended by the board and executive. Basically a reliable measure is one that yields identical results time after time when the relationships measured remain the same.

Validity

KI's must be valid for the purpose for which they are used. For instance,



a company's current ratio is a commonly used measure of financial strength. It is not valid for measuring the profit-making ability of a company. Thus, for a test of liquidity, the current ratio may be perfectly valid, but as a test of profitability it will be invalid.

Relate to desired outcomes

KI's should reflect the acceptable levels of performance consistent with the attainment of company goals. Obviously, a standard of performance must measure up to company goals if the company is to achieve its objectives. A KI for share of market should reflect the company's goal in this respect; otherwise, the company is unable to reconcile its actual achievement with the desired achievement.

Provide balance between short-run and long-run

KI's provide information on performance during a specified period of time - they relate mainly to the current situation. Thus, they are short-run indicators with implications on long-run plans and activities. KI's for each KPA should reveal the long-run direction being taken by the company in each KPA. To fail to do so brings to light an inadequate planning base. Thus, controlling is related to planning when the board establishes time goals as well as achievement goals. One without the other is inadequate for progress.

Timeliness

Information provided by KI's must be reported periodically during the course of the project if it is to serve its ultimate purpose in controlling the affairs of the company. Reports that are terminal to the completion of a project are too late to be of value in decision making. The essence of the control function is to keep track of plans and activities in process of achievement as a means of preventing the course being followed from deviating too far from desired results. Such timeliness allows for corrective action to be taken by the board.

Brevity

Information provided by KI's must be brief and to the point if it is to result in effective control application. Each board must determine what kind of information is desired, and how much. Without proper board guidance, the executive may solve this problem by providing too much or too little information. The board may retain consultants for a periodic review of its reporting system as an independent check on its adequacy.

Performance Standards

To serve their purpose, KI's must be studied and interpreted in terms of performance standards. For many KI's there may be three levels of performance:

1. The standard or normal.
2. The progression, or improvement, goal.
3. The hazard point.

The standard is the normal level of satisfactory performance. Some agricultural marketing firms use their performance over a recent period of time as the norm. Others may rely on industry averages from similar types of companies in their operating region. Sometimes, as in the case of financial performance, a bank or lending institution may have a standard requirement. The standard or norm selected should be realistic enough to enable the firm to compete effectively with its competitors.

When performance is below the prevailing industry standard, the improvement goal may become the same as the industry standard. For example, a firm which handles three tons of product per man hour may have the industry average of 3.5 tons per man hour as its improvement goal.

However, where the standard represents an average performance, some companies may have higher sights toward which they wish to progress in the future.

Finally, the board and executive must have some cut-off points or minimum levels for each KI to signal when a given KPA is dangerously off standard. These are warning signs that immediate action must be taken. In setting these danger points, the board and executive should consider:

- At what level will serious difficulties result?
- When should quick action be taken?
- How much farther can the situation be allowed to go without side effects on other KPA's?

Examples of Possible Key Indicators

KI's for Raw Product Procurement (a KPA)

- average acreage per grower
- transportation distance and costs
- total procurement costs per ton
- potential producing acreage in operating region
- graded yield per acre contracted

KI's for Plant Production and Operations (a KPA)

- average cost per unit
- man-hours per unit
- ratio of cases or tons packed to tons received by grade
- safety record
- ratio of maintenance hours to machine operating hours
- direct and indirect cost variances from budget
- variance from planned production volume
- quality variances

KI's for Organizational Structure and Key Personnel (a KPA)

. key indicators for this KPA may take the form of an annual review of organizational structure. In such a review, the executive should be able to inform the board of any breakdowns in communication within the organization and interdepartmental friction.

. employee turnover

. retirements, resignations, replacements

. absentee record by departments

. salary scales

. performance reviews

. grievance reports

KI's for Finance (a KPA)*

. tests of profitability

1) ratio of net income to total assets
2) ratio of net income to owners' equity
3) ratio of net income to sales

. tests of liquidity

1) current ratio
2) acid test ratio

. tests of solvency

1) ratio of total debt to total assets
2) ratio of long-term debt to capitalization
3) ratio of total debt to owners' equity
4) ratio of fixed assets to owners' equity

. others

1) earnings per share
2) dividend yield
3) inventory turnover
4) average accounts receivable collection period
5) day's purchases payable
6) sales per dollar of working capital
7) sales per dollar of fixed assets
8) break-even point as percent of capacity

KI's for Member and Stockholder Relations (a KPA)

. The number of favorable, compared to the number of unfavorable, letters received from members and stockholders.

. The number of membership applications received compared to the number discontinued.

. The ratio of member sales to total sales, or of tons procured from members to total tons procured.

. The number of inquiries from nonstockholders about the company's operations and financial condition.

. Attendance and interest in annual and special meetings.

. The extent of stockholder participation in exercising "rights" on privileged stock subscriptions.

. The turnover of members. A high turnover may indicate to the board that its raw product supply may be in jeopardy.

KI's for Public and Government Relations (a KPA)

. Extent of participation by key employees and directors in civic organizations.

. The number of column inches of favorable publicity in community papers, trade, and business publications.

. The number of government investigations of company practices in pricing or accounting.

* These are discussed more fully in Appendix A, Number 3.

- The number of instances that the company has had to defend itself from individuals, corporations, municipalities, or state and federal government agencies.

KI's for Market Standing and Sales (a KPA)*

- Market share
  1) company sales to total sales in markets operated in, in total and by products
  2) company sales relative to total purchases of each customer served.

- Market standing
  1) consumer preference of brands in each major consuming market
  2) percentage sold under own brand relative to total company sales.

- Marketing costs
  1) cost per order received
  2) cost per unit sold by size of order
  3) selling cost as a percent of net sales
  4) cost per dollar of gross profit.

- Prices
  1) commodity price trends
  2) price discount as percent of gross sales.

- Sales efforts and results
  1) dollar volume secured from new customers
  2) additional dollar volume from old customers
  3) order size by customer classification
  4) returns or allowances as a percent of gross sales
  5) number of new customers obtained.

KI's for Policies and Objectives (a KPA)

- The number of deviations from existing policies.

- The consistency of policies and objectives with existing internal and industry conditions.

- The extent to which policies and objectives are systematically reviewed.

- The extent to which policies and objectives cover crucial issues coming before the company.

Control Tools

Budgets and Forecasts

Budgeting serves as a control tool for both the executive with respect to department managers, and for the board with respect to the over-all planning aspects of the corporation. Our interest is concerned with budgets and forecasts as they serve the board in reviewing programs and plans. Budgeting is a phase of planning which provides an organized procedure for coordinating activities among departments engaged in planning.

Budgetary control from the viewpoint of the board provides a means of measuring executive performance and of scheduling capital investments to achieve an optimum return on owners' capital.

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* This area should rank high on the list of vital performance areas for marketing corporations. Performance in this area has limited, but vital, ranges over which the corporation can impose its impact. The range is roughly between sales strategies which return only costs incurred (nearly zero profits), and full cost recovery plus adequate profits. A firm may dissipate to buyers the potential earnings it is capable of making due to sloppiness in quality, packaging, pricing, and marketing programs.

To develop KI's in this KPA, it is necessary to isolate the scope of the firm's activities. In what markets is the company competing, and with what types of products? The KI's should help top management evaluate the company's ability to 1) compete in the market place; 2) recognize changes in the market; and 3) plan for these changes.

Some common types of budgets useful for control purposes are:

Physical budgets
- unit sales
- unit purchases
- unit production
- unit inventories
- unit manpower
- unit facilities

Cost budgets
- manufacturing
- selling
- administrative
- financing
- research

Profit budgets
- dollar sales
- cost of goods sold
- expenses

Finance budgets
- cash
- capital outlays
- financing
- balance sheet

Annual budget procedures should provide for quarterly revisions and even monthly revisions on rapidly changing items. However, selling, administrative, quality control, and research cost budgets do not often require frequent revisions, because the factors comprising these budgets are less subject to short-run fluctuations.

Financial Audits

The external auditor's analysis provides the board with some measure of control over financial record keeping by the company's staff. The audit report is often overemphasized as an indicator of company performance. Annual audits do not provide for timely control and are oriented to the past. This reliance overlooks other review devices which may be more helpful in pointing out vital deficiencies in programs.

Scheduled audits are helpful to the board in:

- verifying cash and securities
- verifying accounts receivable
- checking on the accuracy of physical inventories
- investigation of plant property accounts
- investigation of internal control procedures
- verifying financial condition.

The external auditor's annual report is primarily verification to the board that the financial records of the company are what the treasurer has reported them to be, and that financial records are maintained in a professionally approved manner. It helps the board in fulfilling its trustee role to stockholders or members. Many auditors also present certain ratio analyses for the board, as a part of the audit. While this audit is a necessity, the board should not rely entirely on this device. For many firms a periodic management audit may be more useful than the annual financial audit. For example, a financial audit does not tell the board that employee morale is so low that productivity is restricted or that the executive fails to delegate and organize, nor anything about the age distribution of executives and managers.

Inspection Tours and Visits

The board should be familiar with all of the major items of physical property held by the company, its original and replacement cost, and the net current book value. Periodic tours and plant visits will help board members appraise the adequacy of these facilities. The board will find tours to other plants and visits with other boards, sometimes even in unrelated lines of business, a useful source of ideas.

Management Consultants

The board may rely on professional management consultants when concerned with plans involving capital investments, organizational problems, and operations analysis. Some features of these relate to controlling as well. A management and board audit, made by experienced consultants, will provide the board with information on organizational weaknesses which relate to their control function.

Management consultants, when properly selected, can provide unbiased points of view to the board. Although management consultants more frequently are employed to work on problems affecting the executive, such as operations analysis, they likewise can be helpful to the board.

Feedback as It Relates to Planning and Controlling

One purpose of controls is to relate actual with planned achievement. The link between the two is through feedback of information. Unless control results are channeled back into the planning stages, many past experiences will be ignored in decision making. A well-designed information feedback system requires an organized effort to keep track of results and to see that information is channeled to all appropriate decision centers.

Feedback Information

What information to include in the communication network varies with the management level at which the feedback is directed. We are concerned with feedback as it relates to the board of directors, and emphasize this aspect rather than the information feedback process at lower operating levels. The information feedback system on page 86 shows how planning and control information is channeled to board and executive levels. Internal, competitive, and environmental information constitute the inputs for planning. This information is used to establish objectives, formulate strategies, and to decide among alternative investments.

The carrying out of plans results in data that are useful in the control function. Here performance is measured, variations from goals are identified, and this information is used as an aid in further planning. The board of directors should examine the coverage and content of both its planning and control information. The board should require that the executive develop a system for gathering, interpreting, and reporting data on a timely basis.

Board-Member Communication

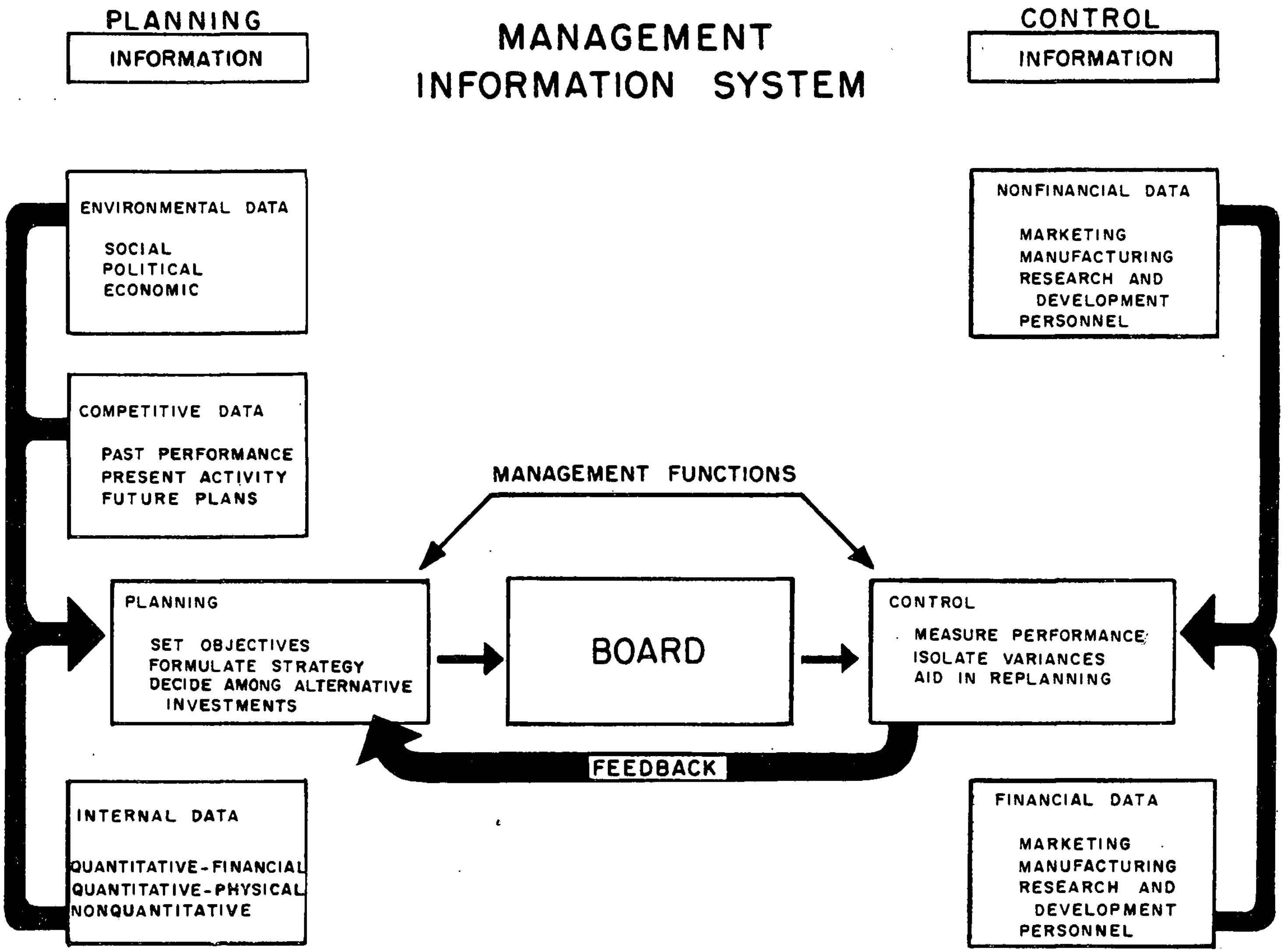
Properly carried out communication is not a one-way process. The board requires information from stockholders or members to keep abreast of their changing needs. Such information should be developed and analyzed carefully to prevent the board from accepting opinions of outspoken individuals as those representing the group's interests.

The board must also be concerned with providing members or stockholders with information. There are three basic channels for providing this information to members. These are 1) reports and newsletters, 2) annual meetings, 3) other communications and contacts. Poor communication techniques may disguise spectacular business results and their full impact will not be made on stockholders or members.

Reports: Frequently, reports contain an excessive amount of figures or numbers which are difficult to analyze and understand. Reports can be made more readable by graphic presentations. Most reports require a combination of charts, tables, and word description to give the proper story. Reporting to stockholders or members is of sufficient importance that the board is constantly challenged to come up with reports which will be read carefully by those to whom they are directed.

Annual and special meetings: Frequently, incentives such as free meals are offered to induce stockholders or members to attend annual meetings. This inducement

MANAGEMENT INFORMATION SYSTEM



is less effective than sincere attempts to motivate members or stockholders to take a real interest in their company. Since the annual meeting represents the one major reporting event by the board to its electors, it is a meeting which justifies adequate preparation and planning.

Other communications and contacts: Another communication tool is the newsletter distributed on a monthly basis, in which the executive, managers, and board report on current problems and progress. Finally, individual contacts and observations are sources of information on "grass-roots" thinking and problems.

Control Responsibilities

Every level in the business organization has some control responsibilities. In this section we give attention to identifying and distinguishing these responsibilities at the board, executive, and membership levels.

Board Responsibilities

The board's control responsibilities should be aligned with its total accountability. In this respect, its control function falls into two categories: 1) control over the executive, and 2) control over decision areas reserved for the board. It is sometimes difficult to isolate the two categories.

Board control over the executive is necessary to determine, through review, how well the executive has organized the total resources of the corporation. The final measure of this is largely determined by earnings.

Other areas for measuring executive performance, however, have been previously identified in this chapter, including key performance areas.

Board control over the decision areas reserved for the board include the decision areas identified and discussed in Chapter 5. On this basis, the board's control function is concerned with:

. Policies and goals — to what extent they have been followed, and how useful they have been in providing guidance to the executive.

. Reviewing achievement in carrying out plans approved by the board.

. Decisions on long-run commitments of resources.

. Managerial development and succession.

Executive, Manager, and Employee Responsibilities

Since our framework for the control function is based on the concept of reviews by which progress is achieved rather than controls based on the concept of prevention of action, all operating levels in the organization become involved.

The executive is responsible for controls relating to decision areas over which he has been delegated authority by the board of directors. These relate to the action decisions discussed in Chapter 5, and include:

1. Decisions relating to how and when objectives, goals, and policies are to be attained.

2. Decisions involving intermediate and short-range commitments of resources.

3. Decisions relating to operations, subordinate employees, budgets, and industrial relations.

Since the executive cannot - and should not - make all such decisions independent of his staff, it is essential that he not make the measurements, reviews, and control criteria decisions without taking into account others in the corporation. This makes it important that managers, supervisors, and employees be well informed on control information (policies, procedures, objectives, goals, standards, etc.), so that decisions can be made at the appropriate level in the organization.

Member Responsibilities

Cooperative members have a unique relationship to their corporation unlike that of the stockholders of other forms of corporations. Because members are owner-patrons of the cooperative, they may exercise their control responsibilities more directly than common stockholders of other corporations. In either cooperatives or other corporations, control is exercised through decisions in the following undelegated areas:

. Approving or rejecting board and executive reports.

. Selecting directors.

. Changing bylaws, articles of incorporation, policies, and approving resolutions. (In some states the board may revise bylaws.)

. Approving mergers and exchange of stock, or corporate dissolution.

Members must receive enough information to understand the issues involved in their decision making. For effective member participation in controlling, there must be a feedback of information from the executive and board to members.

Chapter 8.

ROLE OF THE BOARD IN BUSINESS GROWTH

"An inventory of foresight produces a profit in hindsight."
—J. WILSON NEWMAN

The board of directors must exercise leadership for a positive program of corporate growth. The board as the supreme decision center and as trustee of corporate assets must recognize that business growth or development falls within its realm of responsibility. Growth strategies cannot be completely delegated to the executive and managers. By its actions and decisions, the board creates the basic atmosphere for the survival, growth, or development of the corporation. A board that fails to develop a growth objective in a growing economy is neglecting its obligations to stockholders or members.

In this chapter we explore the board's role in business growth, explain why growth is necessary, and suggest methods of measuring growth.

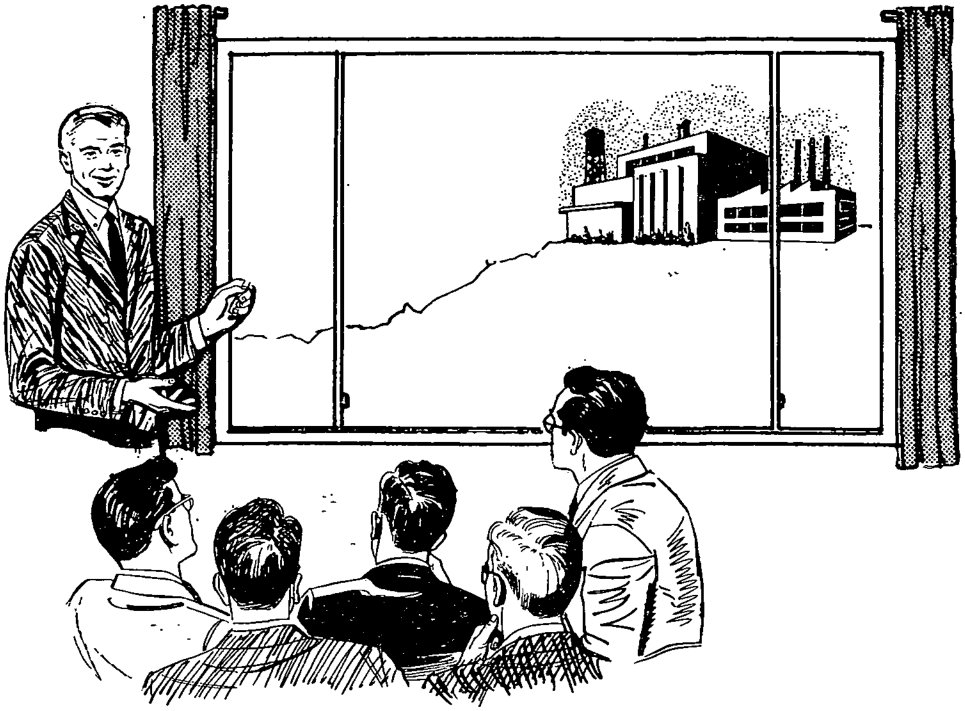
Meaning of Growth

Growth is commonly considered to be an increase in size or amount. Growth which results in an increase in size or amount may result from several sources. First, growth is possible by selling more of a company's existing products in markets it currently serves. Second, growth is possible through research, development of new products, or new applications of existing products. Third, growth is possible through contractual arrangement with another company, customers, or suppliers. Fourth, growth is possible through overseas expansion, either in production or distribution. Fifth, growth is possible by acquisition and merger. These may include horizontal integrations (acquiring similar businesses) or vertical integrations (acquiring businesses with related operations in another stage of activity). Sixth, growth is possible through new services, or by marketing existing services and products in new markets.

These commonly accepted methods of growth may, however, prove meaningless because they do not reflect economic consequences. For example, a company may experience a five percent increase in sales volume over the previous year, but if costs increase due to inefficiency, net profits may decline. Therefore, we need an even more precise definition of growth. Thus, <u>we define growth to include an increase in assets, products or services offered, and market share, the effects of which are translated into increased net earnings or the ability to increase net earnings</u>. Unless a company's programs result in increased net earnings, or place the company in a position to enhance its net earnings in the foreseeable future, the company has not experienced economic growth. True growth is based on the recognition of new needs or desires, from which will evolve new products or services, to serve markets with improved or sustained earnings for the corporation.

Stages in Business Growth

To discuss the role of the board in business growth, it is necessary to identify the stages in the growth of a



business enterprise. We define these stages as 1) establishment, 2) expansion, and 3) consolidation. In a sense, these relate to the degree of maturity of the business as an enterprise.

Establishment

In the initial years of a corporation, many critical issues are encountered by the board. Objectives and policies need to be formulated, competent staff hired, product lines determined, and marketing channels selected. In this stage of business development, the attention of the board is focused primarily on objectives, policies, attracting good management and selecting product lines. The latter requires knowledge of the markets to be developed before the board can determine how product demand is to be discovered or promoted. That is, the board's primary marketing responsibility is to determine policies that will guide the corporation in its effort to obtain a market foothold.

In the establishment stage of growth, firms develop various business strategies. The board will need to give particular attention to the development of a price strategy. In the beginning years the strategy of many firms tends to be one of price-shading, in an effort to gain customers. Often new firms resort to price shading as an alternative to the more difficult, but necessary, task of finding and fulfilling the special market demands which can be met by the corporation.

Another primary board responsibility in the establishment stage is to acquire a competent, qualified executive. New firms sometimes fail to recognize the need for an executive with an established sound business reputation. Instead, they hire underqualified men who lack the necessary managerial know-how and market contacts which so vitally influence corporate success. At this stage a "bargain" executive is probably the most costly mistake a board could make. A board must also be able to assess whether or not it is getting what it is paying for in executive talent.

Firms in this stage encounter numerous problems and obstacles. Cooperatives may lack adequate member support because members simply do not understand their obligations to other members and to the cooperative. In addition to the problems already cited, the mortality rate of new corporations is high because of: 1) inadequate sales, 2) undercapitalization, 3) excessive fixed assets, 4) high operating expenses, 5) accounts receivable difficulties, and 6) poor inventory control. However, today it is much more possible to estimate in advance the prospects of success for a new corporation, thereby avoiding costly mistakes through trial and error. But many firms fail to progress beyond the establishment stage, even though they may remain in business for many years. They fail to develop long-range objectives and clear-cut policies; they fail to develop long-range markets, and their price strategy remains one of price shading. It is questionable whether boards of such corporations are fulfilling their responsibilities to stockholders or members.

Expansion

During the period of expansion, the emphasis on objectives is shifted from that of securing a foothold in the market to excelling and outdistancing competitors. Several noticeable changes in behavior patterns become evident during the expansion stage.

For instance, the goal of maximum sales is gradually substituted for that of minimum risks. Emphasis shifts to competitive efficiency in production and marketing as cornerstones of success. In the establishment stage, the company's efforts are directed to exploring market demands and finding its niche; in the expansion stage, the fruits of this search become evident as sales expansion results. The goal of the executive becomes that of accelerating this rate of growth without a corresponding increase in cost per unit. If facilities were properly planned in the establishment stage, the firm will encounter reduced unit costs with an expansion of sales, providing that expansion occurs during the useful life of the assets acquired in the establishment stage. Unit production costs should decline as fixed costs are spread over more units, and unit marketing costs should decline as sales results are achieved with greater efficiency.

Pricing strategy takes on different features in the expansion stage of business growth. In the establishment stage, price shading is often resorted to as a means of gaining customers, but often with little consideration of production costs. In the expansion stage, pricing strategy often reflects the desire to gain new customers by passing on to buyers a part of the economies achieved through emphasis on efficiency and cost reduction efforts. Thus, although pricing remains a business strategy, the basis for pricing becomes more scientific in the expansion stage. The company may develop some nonprice preferences for its products, such as uniform product quality, brand names, and packaging.

The board's financial policy may shift toward increasing profits at a moderate rate, and plowing back the bulk of earnings into market promotion, product development, and other activities directed toward expansion. Likewise, the board must review the corporation's objectives to make sure its programs and objectives are consistent.

There are many firms which never reach the expansion stage because they fail to face up to the real forces which affect business growth. The board should give consideration to management development programs as one means of assuring that competent managers are available to head up key positions.

Consolidation

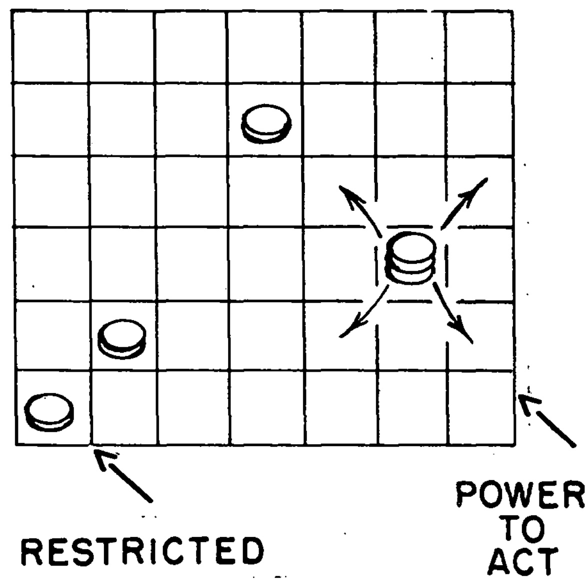
In the third stage of business development, the objective is to gain the most favorable outlook as to stable and continuing profits. The company develops a long-run point of view in terms of profits, and carefully weighs the consequences of a course of action or program on its long-run profits. The board develops an aim to make a good showing year after year, while expanding the assets of the corporation.

The established company becomes a leader who seeks to improve conditions for its industry, while maintaining its relative position within the industry. The board should view marketing strategies in terms of the over-all expansion possible, since the firm's volume-cost relationships require sales expansion efforts directed to all possible users. The firm ceases to rely on a price shading strategy, and instead relies on developing good customer loyalty on the basis of high quality, dependability, new product innovations, special applications or services, and the like.

Executive requirements often differ with a company in this stage of business development. There is less concentration on "hard-sell" tactics, although the firm maintains an aggressive sales program.

Firms at this stage of development are wary of acquiring too large a share of market, fearing possible antitrust action. Instead, there tends to be a strategy of diversification into other products and industries which may or may not complement those in which they are engaged.

In addition to the standing of the mature firm in its industry, there is a certain recognition of the power principle which creates the expectation of continued growth. The "power principle" is simply that an individual or an organization, in order to prevail in the struggle for survival, must make current decisions which do not restrict its ability to act in the future. The power principle has direct application to the stages of business development discussed above. First, there is the objective of gaining a foothold in order to be able to act. Second, there is an enhancement of the power to act through expansion. Finally, there is the attempt to maintain it through consolidation. Unfortunately, few agricultural marketing firms ever



reach the third stage of business development. To do so requires more than a desire and willingness on the part of the board and stockholders or members to have the corporation grow. It requires a positive policy and philosophy which encourages planned growth. These groups may not outwardly object to growth, but neither do they encourage programs and ventures which bring it about. In a word, they tend to inhibit business growth, partly because they fear the possible consequences of growth and partly because they do not understand its importance.

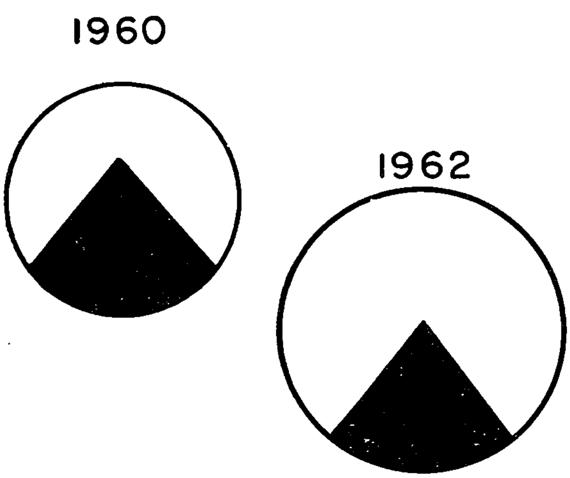
Importance of Growth for Individual Firms

Firms grow to increase or secure their profit position. Growth may influence the level and security of profits in a number of ways. In this section we discuss several reasons for growth which have a bearing on profits.

Maintenance of Market Share

It is not enough for a firm to experience an increase in sales over a previous year. A firm experiencing an annual increase in sales volume may actually be losing its profit-making potential within that industry. That is, a firm must capture enough sales increase at least to maintain or expand its share of market over time if it is to protect its profit-making ability. Unless it maintains its share of sales in its operational markets, a firm is not experiencing a real increase in sales; instead, it is experiencing a decline.

Declining sales can bring about many types of disadvantages. Banks and other creditors may be less receptive to the financial needs of a firm whose absolute or relative sales volume is declining. A firm with sales volume losses may find its distributors looking for more profitable suppliers, and thereby lose distributors. Retaining competent personnel may become a problem, and attracting good key



employees may be more difficult. Finally, a firm which loses sales volume may account for less of the industry's total output, and thereby experience reduced market power. For these reasons, the maintenance of market share becomes a prime business necessity.

Diversification

Growth permits companies to diversify operations as a means of reducing certain risks. Agricultural marketing firms handling one or a few products may find their income position in jeopardy from external factors. Changes in yields, government programs, new technology, and new product substitutes are examples of risks affecting the income of such firms. Firms diversified in a number of products may reduce such risks, especially if the firm has sufficient scale of operations for each commodity or product to be an efficient producer. Diversification without adequate size may find the company a high-cost producer, thus eliminating any advantages of diversification.

Achieving Economies to Scale

New equipment and techniques are constantly being made available to agricultural marketing firms. These new technologies often have one thing in common; their efficient use depends upon larger volumes of output than previously required. The economic principle of economies to scale explains how unit costs decline as the firm's output increases. Many agricultural marketing firms are operating at volumes less than that necessary to achieve minimum unit costs. For instance, one study revealed that unit costs in a turkey processing plant could be reduced by one cent a pound if annual volume were increased from 10 to 20 million pounds. A net cost reduction of about $200,000 annually could be realized by operating at the higher output with the same plant and facilities. In this case, a consolidation of two nearby plants would make this possible.

Thus, growth is a necessary ingredient for firms to achieve economies to scale and for the profitable adoption of new technologies.

Prestige

There is much satisfaction in owning a large successful business. Prestige often becomes a real factor in attracting and retaining qualified managers and other employees, as well as providing a basis of personal satisfaction to stockholders or members. Prestige likewise permeates the community, which gains satisfaction from having a successful company in its midst.

Vertical Integration

The ability of a firm to integrate vertically often is dependent on its reaching a sufficient size to operate in another stage of activity. Thus, firms wishing to extend their operations forward to obtain better markets for their products, or to extend their operations backward to insure adequate sources of supply, have strong motives for growth. For example, a grain marketing firm wishing to operate a formula feed plant should be of sufficient size to finance or underwrite the new venture in such a manner to compete profitably with established formula feed competitors.

Reduction of Reliance on Price Competition

A firm in the establishment stage of growth will wish to reduce its reliance on price competition. Instead, the firm will seek to compete on nonprice factors, which are more difficult for competing firms to duplicate. Some nonprice forms of competition include quality, new product developments, full lines of commodities, packaging, advertising and product promotion, and services. To be able to engage in such competitive strategies, the firm must be large enough to economically practice these forms of competition. For instance, a firm which bases its competitive strategy on new product development or new applications must be large enough to support a research unit for developing and testing new products. Likewise, a firm which employs branding as a part of its competitive strategy should be of sufficient size to support advertising and promotional programs that will attract buyers to its brands.

Market Power

The strength of the large, profitable business is derived from the variety of tactics which it can use and the resources it commands or can obtain. Market power may be evident when a firm purchases materials, obtains credit, provides for transportation needs, and sells its products. För instance, a company with market power can search out lower cost sources for its supplies. It may obtain price concessions by concentrating its buying power, by timing its purchases, and by threatening to produce for itself.

The growing firm attracts favorable attention from customers and suppliers. Suppliers tend to give favorable treatment to a firm which is growing rapidly, hoping to retain it as a customer when it has attained a larger size. A customer buying from a growing firm is more apt to be provided with the services he desires or to obtain special assistance when required.

Factors Affecting Growth

Business growth depends on a complex set of interrelated forces. Some of these may be beyond the influence of the board. If so, the board must identify these forces and make the necessary adjustments. Other forces can be controlled directly by the board and growth may be either fast or slow, depending in part on how well the board undertakes its responsibilities. The board may develop planned strategies to deal with external factors affecting growth. We now give consideration to some external factors which affect growth.

Nature of Industry and Products

Business growth is fairly easy to attain in a growing industry, one where the products of the industry are in increasing demand. Conversely, growth becomes more difficult in an industry with products facing a declining demand. Thus, the board must recognize the potentials of growth made possible by the industry in which it operates. In general, the food industry has favorable pressures from expanding population and rising incomes, but the effects have been widely different and divergent for specific food industry groups.

Market Structure

By market structure is meant the relationship between buyers and sellers, buyers and buyers, and sellers and sellers in a given market and industry. These relationships are considered in terms of the number of firms in the industry, their size in relation to each other, the degree to which industry products are sold under brand names, and the difficulty of new firms to enter.

These conditions of market structure place restrictions on company growth. For example, growth will be difficult for a relatively small firm in an industry of a few extremely large dominant firms, which sell branded products, and where economies to scale require large investments. On the other hand, growth will be more easily attained in an industry in which production is not concentrated in the hands of a few firms, and in the absence of strong consumer brands.

Some food processing industries are increasingly becoming more concentrated with a few dominant firms accounting for a large portion of the industry's output. A few have experienced declining concentration and some have had no material change over a decade. Growth will be more difficult to achieve in those industries where concentration has increased.

Although these external forces may place limits on the annual rate of business development, they do not place absolute restrictions on any one specific firm. Often firms fail to experience business growth largely due to internal forces. We now turn to these forces.

Capital

Normal business transactions require vast sums of capital. This need for capital increases many times when a firm is experiencing business expansion. The difficulty of securing capital restricts the rate of growth a firm may experience. Firms which neither grow nor contract can more readily finance themselves from their own earnings.

The board can influence a firm's potential growth rate by its capital accumulation policies, which in turn, affect its ability to borrow funds from creditors or to float new issues of stocks or bonds as sources of funds.

One important restriction on capital accumulation by agricultural marketing firms is the great reliance on retained earnings and on debt. Outside sources of equity capital have not been sufficiently tapped. Boards of farmer cooperatives face the dual problem of allocating sufficient funds for members' farm capital requirements and the capital requirements of the cooperative. While evidence supports the fact that cooperative investments yield a greater return than farm investm nts, members may be unwilling to invest more in their cooperative. This gives special importance to long-range financial planning by the board. The board must consider alternate sources of equity and debt capital and program its availability under the most favorable circumstances possible to the owners.

Organizational Structure

By organizational structure, we refer to the established relationships between positions of responsibility and authority, departments or units, functional enterprise areas, how these relationships are understood and accepted, and how coordination and communications patterns are defined.

There are strong pressures for growth in companies where organizational structures are well formulated and accepted, and where experienced and competent personnel are employed. Growth pressures stem from any talents of key employees which are presently unused by the firm to capacity. Actually, the firm finds it difficult to completely equalize the supply of services of experienced personnel with its actual needs at any one time. It constantly finds an unequal proportion of either personnel or needs to perform its operations. As new employees are added, their services may exceed those of which the firm can make most profitable use, and thus the firm seeks to expand its business volume to make full or complete use of services possessed.

On the other hand, in companies in which the organizational structure is not well formulated and where coordination is lacking, there is little or no pressure for growth. In such cases, frustrations of personnel prevent them from providing their services to the maximum of their abilities. Growth is difficult to achieve under such circumstances.

Personnel and Personnel Policies

No matter how able the management group is, there are human limits to what it can do. If an organization is to develop, plans must consider the effects of expansion on personnel. The board must be satisfied that existing personnel are adequate in number, training, and experience to enable the planned expansion or business development to occur. Sometimes, new personnel are required, with different training or experience than existing personnel. The board must decide on a company policy of whether existing personnel will be allowed to train for new openings, or whether new staff will be added.

Thus, personnel policies have a bearing on business growth. The board and executive should regularly review organizational structure and personnel policies to see if they are consistent with growth objectives and current growth rates.

Stockholders and Members

Once a company achieves a reasonable degree of growth success, there is constant pressure from stockholders for continued business achievement. This stems from several sources. People take pride in being associated with a "going" concern. It gives them satisfaction. Secondly, members' or stockholders' expectations are based on returns as good as or better than that of the previous year. They consider the past year's level of achievement a stepping stone to greater achievement in the current year.

Where the value of stock is concerned, whatever the firm achieves for the stockholder, once achieved, is of no further use to the new purchaser of the company's security. Once the increased value of the stock is capitalized, the stockholder will earn no more than the normal rate of return on his capital gain. Only if the company pulls ahead at a rate faster than others in relation to what was expected by the market, will the stockholder obtain a special benefit by having invested in this firm rather than another. Thus, the firm faces constant pressures to continue to exceed past business performance.

Sometimes members inhibit growth of their cooperative, when they fail to support expansion programs. Growth deterrents may take on several forms, such as 1) the fear of losing control, 2) fear of the unknown and the acceptance of new risks, 3) complacency from past success, 4) adhering to Rochdale principles, and 5) numerous other local pressures for keeping the business as a local institution.

Directors

Finally, the board itself is a determinant of business development. It may take a conservative philosophy and lag behind, or it may take a heedless course of action which places the company in an unsound position. In addition to its philosophy, how well the board performs its responsibilities as discussed throughout this manual may well determine the direction the company will take in business development. We refer to such responsibilities as formulating objectives, goals and policies, planning, providing adequate training for new directors, harmonizing the diverse interests of stockholders or members, and coordinating short-range decisions with long-range objectives.

The basic threads of growth must be woven by the board. The executive and managers should mold their pattern of activities after that made evident by the board.

Measuring Absolute and Relative Growth

There are two types of business growth: absolute and relative. Each type has several methods of measurement.

Absolute growth refers to the total and actual growth of the firm. Absolute growth may or may not reflect in the earning capacity of the firm, but it nonetheless is an important aspect of growth for certain purposes. New technologies often require firms to be of a certain minimum size or scale if they are to use these technologies economically. Thus, absolute size is a necessity.

Also, absolute size is vital for the firm to achieve other possible economies that may be attainable only after some particular size is reached. These include economies of large-scale production, promotion, and distribution. To achieve economies in any one of these categories, the firm must be of a minimum size to reap completely the economies associated with each.

Absolute size permits the firm to integrate vertically; that is, a firm must be of a minimum size before it can profitably integrate into another stage in the production or distribution of the products handled. Finally, absolute size is important to stockholders as it relates to ownership of corporate assets.

Relative growth refers to the growth of the firm in relation to its industry. Relative growth is of importance because it relates to the strategies which the firm may employ. These strategies relate to pricing, product development, nonprice forms of competition, and leadership in the markets where the company operates.

Thus, both forms of growth are important for the consideration of the board of directors. The following means of measuring each type of growth will prove useful to the board.

Measures of Absolute Growth

Employees

One measure of absolute growth is the change in the number of employees from one year to another. This is a weak measure of growth. A management bureaucracy may occasionally, for prestige purposes, have a desire to increase the number of employees on the payroll. The board of directors should be less concerned with the absolute number of employees than it is in seeing that productivity per employee is increased.

Changes in the number of employees is considered a weak measure of growth because the needs for employees change as new technology is adopted. For instance, new equipment may actually reduce the number of employees required. On this basis, the firm would not have achieved any growth; in fact, growth would be a negative factor. However, on the basis of productivity, output per worker may have increased significantly.

Number of Members

Growth in the number of members is another measure of growth, reflecting the extent to which cooperative ownership is dispersed. When using this as a measure of growth, the board should understand that used alone it is a measure of quantity rather than of quality. Increasing the number of members of a marketing cooperative may be desirable, but it does not necessarily reflect on the total quantity of products produced by these members. If the quantity of products per member is declining, the cooperative will probably face more difficulties in member relations, procurement costs, quality of product produced, etc.

Generally an increase in the number of cooperative members is a fairly good indicator of growth. Stronger measures may be developed by using other qualifying measures, such as size distribution of owners, or concentration of ownership, along with the gross number.

Sales Volume

This provides one of the most commonly used measures of growth. Used alone, it is one of the weakest measures. Changes in sales volume are usually measured in dollar values rather than in quantities of product, thus obscuring important shifts in sales among product lines. Sales volume provides a rough indication of the general direction of the business, but is not always an indication of profitability. However, sales volume does reflect on the company's standing in the business community, and in general is associated with increasing profits.

Assets

Assets are an important measure of business size, because they are the result of accumulation over time. They thus provide a reasonably good measure of company growth, although this measure does have some shortcomings.

Assets are items of value owned by a business. They include land, equipment, buildings, inventories, securities, etc., owned by a company, which have a value. Even the company's brand names may have a value and be included as an asset, although intangible assets are frequently not reported or used in comparisons. Generally, as the business grows so will the assets of the company. Assets are most representative as a growth measure when comparisons are made over a close sequence of time periods. This is because assets are accumulated over time under varying price levels and depreciation schedules, and this presents problems when comparing assets between periods of time separated by many years. The longer the time period over which the assets have been accumulated, the greater the uncertainty about their valuation on a common basis.

Earnings

From the viewpoint of stockholders or members, growth occurs when net earnings have increased over the previous year, even though sales volume may not have changed materially. Increases in net earnings reflected to stockholders or members generally represent growth. Such earnings may result from efficiencies achieved in production, sales, and distribution, by increased sales, or by more favorable selling prices.

Return on Investment

There are a number of ratios for measuring return on investment. (See Appendix A-3.) These ratios are measures of profitability as related to the amount of investment necessary to generate these profits. Any increase in return on investment may be considered an indicator of growth, particularly from the viewpoint of earnings on total ownership investment or on total assets.

In the short-run this growth measure may give a false indication of growth without real growth resulting. By disposing of certain assets, it may be possible to improve the rate of return on investment without improving earnings or future earnings potential. However, over a period of years, the return on total assets employed should be relatively generous, and the trend of return should show a well-maintained ratio for growth companies.

Measures of Relative Growth

Market Share

A firm whose share of market increases when the share of others declines or remains static, may gain an effective competitive advantage. And it may become less vulnerable to a general deterioration in business conditions. The board may conclude that maintaining or increasing market share is important for company success.

Market shares are calculated in several ways. Their reliability depends upon clearly identifying the relevant markets of the business. In some cases, the national market is the relevant one. Some processing firms may account for 15 percent of national sales in one commodity, while they have less than 1 percent of another. However, if they do not distribute this last product in national markets, this is not a fair measure. Instead, market share should be determined on the basis of the areas in which the product competes.

The concept of market share as a measure of company growth is important because of its implications on market power. The ability of a company to exercise some control over its pricing strategies, new product introductions, and quantities is related closely to the amount of market power it has achieved. This is attained through control of enough of the supply of a product or a brand to have an impact on buyers' decisions or on the decisions of those who sell to it.

The market share figures should not be interpreted in isolation. Market shares may shrink for reasons wholly unrelated to managerial failure and expand in the absence of managerial excellence. The board needs to recognize that market-share goals may be in conflict with profitability, risk, and security goals. To state unequivocally a market share goal, without specifying the expenditures it feels justified to attain that goal, may be imprudent.

Price Leadership

Another important measure of relative growth comes from determining whether a company is a price leader or follower. A price leader which is capable of announcing prices for its products, and then securing these prices, is in an advanced stage of business growth. Firms which are price followers may experience absolute growth without experiencing relative growth.

The concept of price leadership is tied to the first measure of relative growth: market share. If a firm has control over enough of the market of a product, it may be in a position to become a price leader. But a price leader need not be the dominant firm in its market; it may gain this position due to better knowledge, better price analysis, lower unit costs, or by merely having management recognized by competing firms as being best able to judge market conditions.

Innovations

Some companies are large enough to engage in research to perfect innovations of their own or in cooperation with others. But a growth firm need not produce the innovations that attract new customers. In agricultural industries, many innovations result from research by public agencies - U. S. Department of Agriculture and the Land-Grant universities.

The crucial point in identifying a growth company is not where the profitable innovations originate. Rather, it is the ability of the company to adopt such innovations and to create its own profitable markets. Many companies have been very successful by simply adapting or modifying innovations developed by competitors and then doing a better job in their own markets.

Market Value of Stock

The investors' valuation of a corporation's stock is an important measure of relative growth. Market value theoretically reflects the investors' appraisal of all aspects of corporate vigor, such as current and future earnings potential, managerial competence, and yield on investment. One element of caution is that growth companies and growth stocks normally declare low cash dividends in relation to earnings because of internal financing; therefore, undue importance should not be attached to current dividend yield.

For cooperatives in similar industries, a reasonably analogous relative measure of growth would relate to the length of time required to revolve equity certificates and the level of current patronage refunds.

From this discussion, it is evident that while many agricultural marketing firms presently are attaining some absolute growth, few are presently achieving satisfactory relative growth.

It is obvious no one measure of absolute or relative growth is all inclusive. Each has some shortcoming which needs to be recognized. They are best used in combination with one another, after careful study of the business and industry. It should also be apparent that many of the absolute measures of growth can also be applied in a relative sense, that is, in relation to competitors' achievements, and should be used when such measures are relevant in decision alternatives.

Product-Market Strategies for Business Growth

There are four basic growth strategies open to a business. It can grow through 1) increased market penetration, 2) market development, 3) product development, and 4) diversification. The board of directors needs to know the basic elements of these alternate strategies so that it can adequately appraise its current and future growth programs.

To begin with, it will help if we define a few basic concepts: The product line of an agricultural marketing firm refers to:

a. The kinds and types of commodities offered for sale.

b. The physical characteristics of the individual products.

c. The market characteristics of the individual products (price, branding, promotion, distribution, etc.)

The market may be defined in terms of:

a. Geographical area.

b. Users or customers.

c. Alternate uses for the same product.

A product-market strategy is, therefore, a statement of a product line and the corresponding set of markets to which the products are to be sold.

It may be helpful to put the alternate product-market strategies in table form. In Table 3 we have shown these relationships. If we let P represent the product line and M the corresponding set of markets, then the combination of P and M represents a product-market strategy.

We can now examine each of the four different types of strategies.

Market Penetration is an effort to increase company sales without departing from the current Product-Market strategy of P_oM_o. Performance can be improved either by increasing the volume of sales to present customers or by finding new customers for present products.

Market Development strategy calls for expanding or adapting the present product line (P_o) to new markets (M_1, $M_2 \ldots M_n$). A food processor who expands from the institutional market to include segments of the retail market is an example of this strategy.

Product Development calls for developing new products, thereby changing the product line to P_1, $P_2 \ldots P_m$, so that the existing market M_o can be better served and result in improved company performance.

Diversification is an alternative calling for simultaneous departure from the present product line (P_o) and the present market (M_o).

Table 3. Product-Market Strategies for Business Growth

Markets / Product line	M_o	M_1 M_2 . . . M_n
P_o	Market Penetration	Market Development
P_1 P_2 . . . P_m	Product Development	DIVERSIFICATION

Each of the above represents a distinct path which a business can take for future growth. How this growth may be accomplished has been discussed under the section defining growth on pages 89-94. In most actual situations several of these paths may be followed at the same time. In fact, a balanced use of all four strategies may be an important indication of a progressive, well-run business.

The board should recognize that the diversification strategy will lead to, or require, greater change. Usually the same technical, financial, and merchandising resources are used for the other three strategies. But diversification generally requires new skills, techniques, and facilities that represent a distinct change from past business experience. While the required adjustments may be greater, the rewards may also be greater. Diversification has probably not been used by agricultural marketing firms to the extent that it has been in other industries and thus may represent a latent source of growth.

Characteristics of Growth Companies

Growth is not achieved automatically. Plans or motivating forces are needed. What clues can be gained from studying companies that have achieved growth?

A study by the Stanford Research Institute of 210 high growth companies revealed tha+ they had the following five practices in common:

- They supported formal planning programs.
- They employed marketing research.

- They used forward product development and research programs.

- They became diversified.

- They had active acquisition planning programs.

There are many ways of supporting these practices that are available to agricultural firms. The fact that high growth companies employed marketing research does not mean that every company must support an internal research department. Such services can be contracted at reasonable costs. The important point is, does some type of program exist, or has definite action been taken in each of these areas? The board should ascertain that practices currently followed are consistent with their objectives.

A prominent executive has this to say about how to make a business grow:

1. Establish a Basic Plan, wherein you

   - strengthen top management
   - set goals
   - build a flexible organization.

2. Adopt a Financial Plan

   - obtain adequate working capital
   - strengthen your credit position
   - provide for future financing.

3. Provide for Product Development

   - get your research effort on target
   - diversify your product line
   - program new markets.

4. Develop an Expansion Plan

   - gain key plants and people
   - tap national and international markets
   - realize your profit potential.

The board and executive management must develop a philosophy embracing growth strategies. Basically this philosophy should permeate every element of growth planning from merchandising to personnel. However, we are interested in two main aspects of management's attitude toward future growth.

1. Does the management, including the board, have a well-defined and carefully reasoned policy as to branching out in new fields? If the company is not growing according to some definite plan, how long will it be before the whole company loses efficiency?

2. Is the board and executive management focusing primarily on expansion of volume or on the building of net earnings for the owners of the business?

   If the former, it is likely to lead to the addition of products carrying inadequate profit margins. Ultimately such a policy will lead to a decline in over-all efficiency and in return on invested capital.

Growth is an important and complex business objective in which the board of directors has a vital role to play. A growth philosophy or policy is a necessary ingredient for a company to achieve growth.

Chapter 9.

BOARD COMPOSITION AND PRACTICE

Board composition and practices are influenced by many factors: size of organization, type of ownership, tradition, history, personalities, products, the nature of the industry, and laws. Thus, no set pattern exists for board composition or organization. Procedures for considering different types of decision areas often emerge with little attempt to clarify relations between the board and the executive. In other cases, the board and executive develop standards and procedures to be followed. These include an understanding of the decision areas for which the board either 1) decides, 2) confirms, 3) counsels, or 4) reviews.

Board Composition

Two considerations determine board composition: 1) essential representation, and 2) workable size. These generally become interpreted into a specific number of directors by the corporation's bylaws. In addition, some state laws prescribe a minimum board size.

Proprietary corporations (as distinguished from cooperatives) may provide for representation of three viewpoints on the board: 1) executive management, 2) ownership, and 3) qualified outside business experience. Cooperative corporations are often governed by more restrictive laws. In some states only members may serve as cooperative directors. In other states public representation is permissible, while in still other states public representation is required.

Size

Aside from legal requirements, bylaw provisions for board size are based on adequate representation of desired viewpoints. This is related in part to the size of the corporation. Farmer Cooperative Service reports small-scale cooperatives most commonly have boards comprised of five, seven, or nine directors. Large-scale cooperatives tend to have larger boards; about 50 percent of the associations studied had boards of nine or more directors.

There is no unanimity of opinion as to what constitutes the proper board size. Boards consisting of large numbers of directors may be criticized as being cumbersome and unwieldy, while small boards may not provide adequate representation. Proponents of large boards believe the use of an executive committee provides for quick decisions while maintaining adequate ownership representation.

The decision on board size is vested in the group capable of modifying the corporation's bylaws. The ultimate criterion must be based on adequate representation of major viewpoints, workable size, and a realization that the director's task is to represent the entire corporation. Unrepresented ownership will eventually seek means to have their "viewpoints" represented rather than special interests, or they may discontinue patronizing the cooperative or completely withdraw.

Ownership Representation

If the board is to fulfill its role as trustee, some basis needs to be devised for representation of major blocks of diverse owner-interests. Ownership representation is often more specific in cooperative corporations than in proprietary corporations. Membership terms and restrictions in state enabling laws and in cooperative bylaws impose definite limitations on those who may be elected as a director. In centralized cooperatives, bylaw provisions nearly always restrict directors to members who are not employees of the cooperative. Bylaws of federated cooperatives are less restrictive, often permitting executives of local units to serve as directors. The laws of each state determine the legal restrictions on director selection.

Obviously, all diverse owner interests cannot be represented on the board. However, some concerted effort needs to be made to compromise minority viewpoints for the sake of internal harmony, and for maintaining business volume and growth. Sometimes cooperatives seek to achieve owner representation through election of directors on geographic, commodity, or service basis. A hazard of these bases of owner representation is that directors may become overly aware of their special representation, and overlook the needs of the cooperative as a whole. Some cooperatives minimize this hazard by providing for owner representation both geographically and on an at-large basis.

In recognition of the need for directors who can make special contributions to cooperatives, some cooperatives are considering outside directors. One of the major unresolved issues for cooperative boards is how to utilize the abilities of experts to guide them in crucial decisions. Some guidance comes from proprietary corporations, which select directors not only on the basis of ownership but also on the basis of how the best available business experience can be channeled to the board.

<u>Management Representation</u>

Proprietary corporations exhibit a wide diversity with respect to management representation on the board. In some instances, representation may be restricted to the executive; while in extreme instances the board is totally comprised of active management personnel.

Centralized cooperatives seldom provide for management representation on the board, while federated cooperatives often do have both owners and management of affiliated local cooperatives as board members. As noted previously, some state laws governing cooperatives forbid other than owners from serving on the boards of centralized cooperatives, while allowing executives of affiliated cooperatives to represent their association on the boards of federated cooperatives.

We do not view the issue of executive management representation on the board as a critical one, provided that the executive and other appropriate employees participate in board meetings.

Advantages of executive management representation on the board, when permitted by statute or bylaws, are summarized as follows:

- To the extent that all key managers or executive officers are on the board, all important functions are represented when decisions require consideration of interrelations of functions.

- Boards with management representation may be better informed about the corporation's business affairs and policies.

There are some disadvantages to executive management representation. These are summarized below:

- Organizational conflicts may arise when department managers assume a role of equality with the executive as board members, yet are subordinate to him in line organization.

- Executives as directors face the difficult task of evaluating their own performance, resulting in possible conflicts of interest.

- The objectives of stockholders may conflict with those of the executive or his department managers.

- When executive management representation predominates, it is difficult to maintain a clear distinction between the needs and important viewpoints of owners, executives, and department managers.

The authors believe the nature of the relationship between executive management and the board is of greater significance than is executive representation on the board itself. Attendance and participation at board meetings give the executive and other key managers an opportunity to present matters for board consideration, provided a satisfactory atmosphere exists for such participation.

Outside Representation

Corporations may provide for election of some directors from outside the stockholder or management groups. These directors may be selected because they are considered experts in certain functions, such as law, finance, or production, or because of their broad business experience. The desire to retain an expert on the board stems in part from a desire to obtain competent advice for a nominal fee. In other cases, boards recognize the limited range of their experiences and desire someone with broader business experience as a director. This issue cannot be resolved here. We discuss basic director specifications later in this chapter. However, the board must exercise its influence with stockholders or members to assure the election of a well-balanced board, capable of resolving issues in view of the interrelations involved.

Boards wishing the services of an expert may retain consultants to provide advice when required. The use of consultants is a realistic alternative to the expert director, because the type of expertness needed is likely to vary from issue to issue. To expect any one director to serve as an expert in several fields is unreasonable.

Some state laws require a public director to sit on the boards of farmer cooperatives. In other states, farmer cooperatives voluntarily provide for a public director on their board. To the extent that this representation is based on special qualifications of the public director, the farmer cooperative stands to gain. However, if the public directorship is only a mandatory requirement and selection is limited, it must be viewed as unnecessary.

Professional Directors

A professional director is one who earns a major part of his livelihood by serving as director for several corporations. Often lawyers are retained by groups of stockholders to represent their interests on the board. This concept of the professional director may lead to conflicts between what is desirable for the corporation and the stockholders.

When the professional director represents no special interests, the corporation often receives the benefits of experience gained from his association on several boards. This advantage exceeds that of having executive officers elected to the board, because the professional is in a better position to judge independently on an issue and its solution than is the executive.

Cooperatives are often prevented by state law from electing professional directors.

Special Types of Directors

In addition, there are several categories of special directors provided for in bylaws or by board resolution. These may be honorary or emeritus, and alternate directors.

Honorary, or emeritus, directors are generally those which have served a period of years as directors and who have reached retirement age. They seldom have full voting right, but may participate in board deliberations. Providing for honorary directors enables a corporation to benefit from the counsel of former directors through selectively bestowing this honorary title on especially capable men. A hazard of retaining honorary directors is that they may not be content to serve in an advisory capacity.

Less common is the alternate director, who is elected to serve in the event of a vacancy in the term of a regular director, or whenever a director is unable to attend board meetings.

Length of Service

Much interest has been evident in recent years regarding tenure of directors. In part this interest stems from recognition of the presumed need for rotation of directors. In addition, it stems from the desire to bring in younger directors.

Length of service of directors is important for several reasons. First, new directors require a period of several years to understand the philosophy and traditions of the corporation. Often new directors make only limited contributions to decision making until they have served for one or more years. Thus, a form of apprenticeship is suggested.

Second, short tenure restricts the planning horizon of new directors to short-range considerations because the new director often lacks the experience necessary for long-range deliberation.

Third, tenure is important to enable the board to benefit from the accumulation of past experiences of seasoned directors. Through a rotation system, new directors are incorporated into the nucleus of an experienced board with minimum curtailment of board effectiveness.

Term of Office

Prevailing practices regarding directors' terms of office vary widely by type of corporate organization as well as depending upon the type of business involved. Farmer cooperatives predominantly elect directors to three-year terms of office, while terms of office in proprietary corporations are predominantly for one year. Public utilities, financial institutions, and transportation companies generally elect directors to one-year terms, while insurance companies most frequently elect directors to longer terms.

Proprietary corporations seldom restrict directors from re-election. Farmer cooperatives often have bylaw provisions restricting the number of consecutive terms a director may serve.

If the assumption that experienced directors are often the most effective is valid, consecutive terms of service should be of sufficient duration to enable directors to have a thorough understanding of operations for maximum service to the corporation.

Interrupted Service

Some cooperative corporations require a minimum period to lapse between successive terms. This period is often one year. There is little basis to evaluate such a policy except in isolated circumstances. There are some instances where the same directors have served continuously for over 20 years. In these cases, a policy of interrupted service would provide for director rotation. Although this is intended to prevent continued board domination by one group, the policy implies a weakness in the ability of stockholders to recognize needed changes in board composition.

Bylaw provisions are a partial substitute for a program of membership education on qualifications desirable for directors. It suggests that members lack an adequate means of appraising director performance.

Age of Directors

According to a recent study of farm cooperative directors, nearly 85 percent of the directors were between the ages of 40 and 69, and their average age was 54 years. A similar study of directors of proprietary corporations shows their average age was 58 years.

The question of age, as it relates to director effectiveness, is a relative issue. The strong board is often a well-balanced board. An age balance also seems advantageous, to blend the vigors and ideals of youth with the experiences gained from long years of service.

Enforced Retirement

Should a corporation develop a policy of enforced retirement of directors at a specific age? Any corporation contemplating such a policy should consider several factors before making this decision. First, a balance of experience is more important than a balance of age alone, providing there is a reasonable percentage of young directors. Too often, age is considered synonymous with business experience.

Second, the corporation should be aware of the contributions of individuals, as well as their age. Inept directors of 50 years are no equal substitute for directors of 70 years who are broadly experienced and capable. The corporation, however, should consider retiring any director whose usefulness is diminished.

A study of enforced director retirement practices by the National Industrial Conference Board suggests a formal retirement policy to be unnecessary.

Compensation

The incentives for accepting a directorship of an agricultural marketing cooperative are most often not monetary compensation. Financial inducements and rewards are small, and often do not reimburse the director for all of the costs involved in attending board and special meetings. Corporations should consider possible means of adequately compensating directors for actual expenses incurred, as well as contributing to other indirect costs involved. These indirect costs may be the cost to the director of leaving his farming or business operations. In this section we give attention to the various methods of compensation for directors.

Retainer Fees

Increasing numbers of proprietary corporations are paying directors on an annual basis through the use of a retainer. While the retainer is seldom provided to directors who are corporate officers or executives, the retainer is provided for outside directors in these corporations. Over a third of the corporations studied by the National Industrial Conference Board in 1958 reported the use of retainer fees for directors. These averaged $2400 annually, ranging from $1000 to over $10,000.

Farmer cooperatives seldom pay directors an annual retainer fee. Consideration should be given to benefits derived from providing directors of cooperatives with an annual retainer. Generally, these directors have a closer financial tie to their cooperative than has the average outside director of a proprietary corporation. We believe other means of compensation are more applicable to cooperatives. However, if cooperatives elect outside directors, adequate compensation must be provided.

Pay of Executive-Directors

As indicated above, officer-directors seldom receive additional compensation through annual retainer fees. The prevailing practice is not to pay the officer-director any extra compensation beyond his regular salary for board participation. Those corporations which do pay inside directors often pay a straight fee for each board meeting attended.

Per Diem Pay

A preponderance of cooperative corporations pay their directors a straight fee per board meeting, plus travel allowance. A 1960 Farmer Cooperative Service study shows the per diem rate of 82 regional cooperatives ranged from $5 to $40, with an average fee of $16. Nineteen regional farm supply cooperatives paid directors an average of $20 per day. Directors of 63 marketing cooperatives averaged $14.

These compare with the common director fee of $100 a day in proprietary corporations in the food and beverage industry.

These data suggest that directors of farmer cooperatives do not receive adequate compensation for services performed, in comparison to fees paid by proprietary corporations. However, this conclusion should be evaluated carefully, since it is necessary to compare the nature of decisions handled before accepting the notion of a disparity of fees.

Travel Expenses

Nearly all corporations endeavor to reimburse directors for actual out-of-pocket expenses incurred in attending board meetings. Often, this is in addition to a per diem or retainer fee.

Committee and Special Fees

It is seldom that the services of a director are restricted to board meetings. Often, they are called upon to perform other duties, such as to serve on special committees, attend industry meetings, participate in legislative hearings, etc. Additional compensation for directors participating in these activities are provided by about one-half of the corporations in the two studies cited in this chapter.

Participation in Employee Benefits

Few corporations permit directors to participate in such employee benefits as life and medical insurance, and retirement programs. Generally this seems a desirable policy, because one of the functions of the board is to objectively evaluate employee benefit plans. If directors themselves are participants in these plans, it becomes difficult for them to be objective in their appraisals of them.

Job Specifications for Director Selection

Director compensation cannot be considered in isolation from other factors. One such factor relates to the qualification and selection of directors, because it is assumed board performance is dependent in part on the personal characteristics and business experiences of directors.

Standards or Job Specifications for Director Selection

1. Personal Characteristics

   - Integrity and good character.
   - Courage to resist pressures from special interest groups.
   - Ability to ask good questions — an inquisitive mind.
   - Community leader, capable of working with people.
   - Ability to analyze and use good judgment.
   - Good educational background, either formal or informal.
   - Progressiveness.
   - Ability to express ideas clearly.
   - Ability to be perceptive and forward looking.
   - Loyal.
   - Emotionally stable.
   - Constructive and energetic.

2. Business Characteristics

   - Successful in managing personal business.
   - Knowledge of the industry.
   - An active interest in company affairs as a member.
   - Ability to organize.
   - Ability to arrive at a decision.

- Ability to evaluate managerial potential and performance.

- Knowledge and understanding of finance and ability to read financial reports.

- Ability to relate information to the affairs of the company.

Standards for director selection outlined above are but some of the qualifications recognized as being important. Obviously they represent a checklist of characteristics which only a few individuals possess in total. Nonetheless, they are important guides in the selection of directors. Also, in total, they represent the characteristics needed on all boards.

Evaluation of Qualification Standards

Some characteristics are more important than others from the standpoint of electing a good board. A board may be a very compatible group, yet they may not perform to satisfaction in spite of being jolly men. Therefore, some means of evaluating the relative importance of each qualification is necessary. Since such evaluation of characteristics is subjective, there is room for considerable difference in opinion among stockholders or members. Likewise, the special needs of the company may require directors with specific attributes.

Job specifications for directors are a useful method of informing stockholders of the characteristics considered important in selecting directors. Specifications should aid in acquiring board balance in view of the qualifications of current directors and the needs of the corporation.

Some clues for evaluating director qualifications follow. Among personal characteristics, integrity and good character are necessary ingredients for a director to command respect. An inquisitive mind enables one to ask discerning questions which help others in decision making. Likewise the ability to analyze and draw conclusions from information acquired during board meetings is an important characteristic.

Success in managing personal affairs is a vital business characteristic desirable for directors, but does not necessarily assure success as a director. Ability to appraise men, as well as their performance, is a common task required of directors. This requires knowledge of tools useful in controlling the affairs of the business, and an understanding of company objectives.

Board Performance Standards

Selection of qualified directors is only a part of the procedure in developing a competent board. This is true even if directors are elected on the basis of desired characteristics. The real test is by evaluating the accomplishments or performance of the board. Some useful questions related to board performance are:

- Does the organization have well-defined objectives, policies, and goals?

- Are objectives and policies followed?

- Is the company expanding its services to members?

- Is it serving its customers?

- Has the company the respect of the community?

- Are earnings comparable or better than those of similar organizations?

- Are dividends and earnings distributed to stockholders or members on a reasonable basis?

- Is there a reasonable harmony of all interests?

- Is growth and development systematic?

These are a few general questions which may guide consideration of board performance because they reflect the broad impact of the firm on the community and owners.

Answers to these can serve as a guide for selection of competent directors.

There should be a minimum of friction with executives when directors understand their role in the management of the firm, and when they are qualified on the basis of personal characteristics and knowledge of business matters. Job descriptions are a further aid in restricting attempts by directors to manage at operating levels.

Boards can be strategic forces for achieving company objectives and goals. Efforts to increase the board's understanding of its role in managing the company, as well as proper use of management tools, should result in improved company performance.

Board Meetings

Monthly board meetings are almost universally scheduled, although boards of some small corporations with executive-directors or corporations with seasonal operations often meet quarterly. Boards of larger corporations probably cannot fulfill their obligations if they meet less often than monthly. A general rule is that meetings should be held frequently enough to permit transaction of board business without undue pressure on time. In addition to the frequency of board meetings, directors should be kept informed in the interim between board meetings.

Keeping Directors Informed

If the information provided to directors is to be of greatest usefulness, it must be made available far enough in advance of a meeting to allow for individual director study and consideration of alternatives. One week in advance may be a desirable goal.

Written materials provided directors prior to board meetings usually are of five types:

- agendas
- financial statements
- operating statements
- budgets and forecasts
- minutes of previous meeting.

The agenda should cover the main items of business to be discussed at a board meeting, along with supporting information on the most important matters.

Financial statements, budgets, and forecasts are often included along with reports on capital appropriations, the amount spent, and balances. A summary narrative highlighting important features is a useful technique. Mailing minutes of the previous meeting enables each director to review the decisions made, and to bring up related issues for reconsideration.

Distributing these types of information in advance of a board meeting enables directors to give attention to specific matters of interest to them, and reduces the amount of time devoted to review purposes at the board meeting. This allows more time for vital decisions, and encourages the board to give more attention to planning and control responsibilities. Delaying all information until the time of the meeting merely restricts the amount of time the board will have for other purposes.

In summary, some means useful to the executive in keeping directors informed are:

- board meetings
- advance agenda
- committee reports
- reports on finances and operating results
- budgets and forecasts
- special reports on currently important matters
- management reports

- newsletters
- plant visits
- personal contacts, and other means of communication.

Referring Decisions to Stockholders

Matters occasionally arise that require the judgment of stockholders or members. Some of these matters are reserved by law to stockholders. However, the board needs to consider which other matters should properly be referred to stockholders for decision. Experience suggests boards refer such matters as proposed changes in capitalization, acquisitions and mergers, and the like to stockholders, often at annual and special meetings.

When referring matters to stockholders, the board must assume that the stockholders are in a position to pass judgment on corporate matters, and that sufficient information is provided for them to make an informed decision.

Board Committees

Matters often arise which require special advance consideration by a committee of directors before a board decision may be made. Committees may be special or ad hoc, and standing. State statutes differ considerably in regard to delegation of authority by a board to committees of directors, since corporate laws provide that the board can act only as a properly convened body. Nonetheless, a system of committees can be a useful instrument for analyzing issues and providing recommendations for board decisions. Here no delegation of authority occurs.

Function of Committees

Board committees may bring together, harmonize, and pinpoint the different views found in a board. Detailed investigation by such a small group sifts out the important matters for consideration by the board. Used in this way, they are particularly useful in planning and controlling. However, the executive or board chairman should be selective when referring matters to board committees.

No board committee should be referred issues which are the executive's responsibility. Likewise, referring issues requiring technical analysis beyond the ability of directors should be avoided.

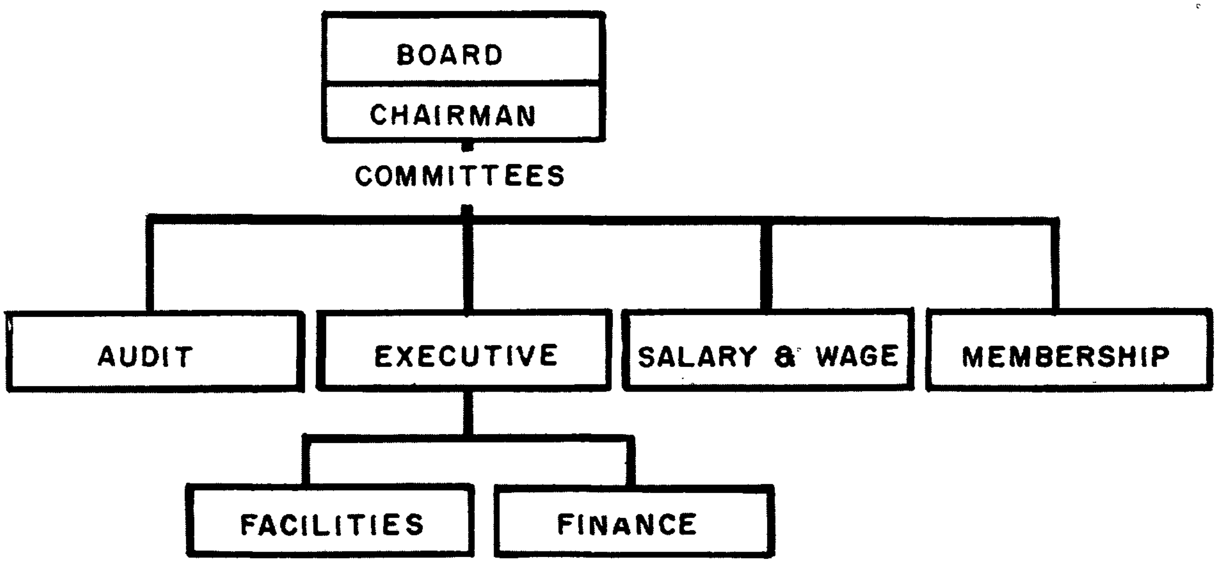
Executive Committee

The executive committee is a standing committee usually authorized in corporate bylaws and sanctioned by state laws. Its purpose varies, but the most frequent responsibility is to act for the board in emergency matters arising between regularly scheduled board meetings. In the absence of statutory limitations, the authority of the executive committee may include any powers and duties delegated in bylaws or by the board.

Restrictions on the powers of the executive committee most frequently prevent it from:

- adapting, amending or repealing bylaws
- declaring dividends or issuing additional stock
- filling board vacancies
- filling executive committee vacancies, or changing its membership
- electing or removing company officers
- amending articles of incorporation
- approving mergers or consolidations
- appointing standing committees
- fixing officers' compensation.

Even though the executive committee has authority to act on matters delegated to it, most executive committees report to the full board on actions taken to obtain the board's concurrence, and to keep the board informed.



Finance and Budget Committee

With the exception of the executive committee, the finance and budget committee often exercises wider authority over corporate affairs than any other standing committee. Although its authority varies, the usual responsibilities in corporate finance include:

- Review of corporate financial policies and procedures.
- Recommendation of dividend policy.
- Financial advice to management.
- Advice on issuance and sale of company securities.
- Review of budgets.
- Review of capital appropriations.

In general, all fiscal matters requiring board action are referred to this committee for recommendations. This includes review of semiannual and annual budgets, financial plans, and financial statements.

Audit Committee

Sometimes the finance committee also has authority to serve as an audit committee. In other cases, the audit, or examining, committee is a separate standing committee. The function of this committee is to assist the board in the discharge of its financial obligations to stockholders. Its activities can be grouped into four categories:

1. Recommendation of auditors.
2. Specifications for audit.
3. Review of audit report.
4. Review of internal accounting procedure.

The audit committee is often a liaison group between the auditor and executive management, and between the board and stockholders or members. It meets with the auditor to review the external audit report, and to gain information regarding policies, practices, or executive attitudes, which may be significant but which cannot be incorporated in the audit report.

The audit committee should not include any executive-directors, but should instead consist of outside or member directors.

Other Committees

The need for other committees may become apparent to the board as it carries out its functions. Standing committees may include:

. salary and bonus

. nominating

. facilities

. membership or stockholder relations

. plant operations

. public, labor, and employee relations

. credit

. transportation.

A board should show restraint in establishing committees of directors, limiting committees to a few, vital areas in which smaller groups can function more effectively. This concept recognizes that by having efficiently functioning committees there is additional free time for decision making by the board. Committees should be set up as needed, rather than as symbols of activity.

Success of board committees also depends upon their composition. The knowledge and experience of members and their ability to devote the necessary time to committee deliberations are important ingredients for committee success. But in the final analysis, board decisions cannot be relegated to a series of committee decisions. The over-all board must prevail. The committee chairman is important, in terms of the leadership given in guiding committee activities and in developing the proper frame of reference to the board. In this respect, the board chairman is responsible for seeing that committees are well staffed, and have received clear instructions on their tasks.

Responsibilities of the Board Chairman

The board chairman has special duties beyond those of serving as a director. His is a role of leadership. The chairman should provide for adequate and timely presentation of information to the board. He coordinates activities between the board and operating executives. The board chairman must be selected by directors on the basis of capability rather than to bestow prestige and honor. The chairman should be elected on the basis of his 1) impartiality, 2) ability to bring out and guide the discussion, 3) ability to plan, 4) ability to bring a discussion to a conclusion, 5) persistence, and 6) ability to coordinate.

Presiding at Meetings; Preparing Agendas

The traditional, recognized duty of the chairman is to convene, preside, and adjourn meetings. But, this is only a part of his job. Every board meeting should have an advance agenda, developed jointly by the board chairman and the executive. In addition, the chairman should assume the following responsibilities.

Emphasize Trusteeship Role

The board chairman is in an excellent position to safeguard the interests of stockholders or members from inappropriate considerations at board meetings. The chairman must be certain that directors recognize their role as guardians of the financial interests of owners. In this respect, the chairman may need to be a harmonizer of self-interests among directors.

Facilitate Management Succession

The board chairman must have frequent conferences with the executive, both as an adviser and in terms of control.

Through these conferences, the chairman becomes better acquainted with the company's operations and personnel than do the other directors. Thus he is able to foresee more clearly the problems of management succession, and to bring this about on the basis of merit.

Emphasize Policy Matters

How well the board attends to its responsibilities, rather than to operating details, largely hinges upon the board chairman and his leadership. As presiding officer, the chairman must be certain that adequate information is available from the executive staff to allow sound board decisions. Furthermore, the chairman must bring out the policy implications of matters referred to the board by the executive. He must be certain that the board understands the decision alternatives placed before it, and the implications of various actions.

Maintain Balance in Organization

Competent board members who are merely asked to approve executive actions will soon become disillusioned. Where board matters are routine, strong directors are apt to become dissatisfied as rubber stamps. The board chairman must maintain proper balance between the board and executive to bring about the most fruitful accomplishments for the organization. This responsibility includes guiding the executive on the amount, type, and manner of presenting information to the board for effective discussion and decision.

Balance is also required when the board reports to stockholders or members. The chairman must provide for adequate reports to stockholders that promote their understanding of corporate programs.

It should be obvious that the board chairman must be selected on the basis of leadership capabilities. Unfortunately in many agricultural marketing firms, directors do not give adequate attention to duties of the chairman. The board should write a job description for the chairman, listing his basic functions, duties and responsibilities, and limits of authority. They should also write a job specification for the chairman's position, detailing what leadership qualities, knowledge, and character traits a suitable candidate would possess.

Chapter 10.

SUMMARY

"Business!" cried the Ghost, wringing his hands again, "Mankind was my business. The common welfare was my business; charity, mercy, forbearance, and benevolence were, all, my business. The dealings of my trade were but a drop of water in the comprehensive ocean of my business."

—CHARLES DICKENS: *A Christmas Carol*

Chief Justice Marshall classically defined the corporation as "an artificial being, invisible and intangible, and existing only in the contemplation of the law." But, this "artificial being" is short one critical faculty: It cannot think. Therefore, a corporation's business must be managed and its affairs directed.

Under law, corporate authority and responsibility is vested in the board of directors. The board may delegate much of its authority to the executive, but ultimate responsibility and accountability cannot be avoided. In practice, however, the boards of many companies have become somewhat of a legal fiction. They have abdicated their vital role to operating management and seem content with the making of proverbial pronouncements of little consequence. There are many reasons for the lack of common understanding as to the board's role. Some of these reasons are more mythical than real, and so let us dispose of them first.

We have successful companies today, ranging all the way from the owner-executive to the publicly-owned and professionally managed. At the one extreme the legal requirement for a board may be satisfied by appointing family members or employees; at the other, the board may consist of full-time directors completely divorced from operating management. Between these two extremes there are many variations in size, composition, and manner of functioning. Thus, proponents of any particular point of view regarding the board's role may cite numerous examples of successful firms that appear to follow their concepts. This preoccupation with the diversity of ownership-management situations skirts the underlying issues concerning the board's role. The statement that — "we're different" or "we can't operate that way," signals a closed mind to alternatives. In effect, the superficial argument of one's individuality provides a crutch for the board's "do nothing" attitude when it comes to pinpointing its responsibilities.

Some argue that it is difficult to find able men to serve on boards. In fact, there are many able board members whose talents are not being used. If the board's function has not been clearly defined and its activities have not been structured accordingly, it is quite natural for board members to regard themselves as nothing more than advisers. Furthermore, since many board members are personal friends of the executive, they are reluctant to act as prosecuting attorneys by asking discerning questions or otherwise probing about the general health of the business.

Perhaps the greatest obstacle to clear thinking about the proper function of the board is rationalization based on the foregoing, which justifies the use of inside board members on the grounds that they are more readily available and more familiar with the business. There is little use in discussing the makeup of boards in terms of "desirable" proportions of inside to outside members as this will merely cloud the real issue. The real issue is how to make the board a useful functioning entity of corporate management. The first step is to get as many directors as possible who 1) bring a fresh viewpoint to bear, 2) are not subordinate to the executive, 3) have no ingrown habits of thinking about company affairs, and 4) can act as truly independent judges.

Cooperatives may not feel that this is of particular significance to them because of the normal practices followed in constituting the board. However, when examined closely, the member-director may often bear a close resemblance to the inside-director. To what extent is judgment independently exercised? How many new ideas are introduced? How ingrown are the present executive and the present board?

The relatively poor record of accomplishment for some cooperative boards will not lead to overly optimistic statements about the advantages of member-boards vs. inside-executive boards.

Some Signs of Decline

To tackle the task of improving current board performance, it is necessary to identify those areas where the board fails to accomplish its basic purpose. This is a difficult job because when a company is going along successfully, the workings of the board and its relations with the executive are not evident to outsiders. Weaknesses in the board become apparent only when a firm falls off from the competitive pace. By contrasting the characteristics of growth firms identified on pages 129-130 with those of declining firms, we obtain some insights on board failings.

Three symptoms stand out: First, a company in poor health has weaknesses that are clearly evident to the trade, to competitors, and even to people within the organization long before they are faced up to by the board. This obviously hints at the fact that the board is not a free constituency, either because it is executive dominated or lacks the independence of judgment necessary to recognize problem aspects that are fairly obvious to others.

Second, there is an apparent failure of the board to understand the key profit-making factors in the industry involved and to evaluate company achievements in light of these factors. The board which fails to concentrate on key performance areas or to obtain the information required to judge performance is neglecting its duty.

Third, companies on a static or downward path are characterized by "ingrownness." This may be evident in a number of forms, such as a lack of cross-fertilization of ideas, absence of new ideas, or a failure to utilize new management techniques. These conditions are most likely to occur where there is a history of long association among think-alike people. When young managers are brought up in such an environment, with little or no outside experience, stagnation tends to be self-perpetuating.

If any of these three common characteristics is applicable to a corporation, the members or stockholders should consider this a sufficient mandate for electing a truly independent board, knowledgeable of its industry and of its company, and one that will continually expose executive management to fresh viewpoints and ideas.

Basic Issues

In this manual we have examined a variety of issues concerning board and executive management.

The basic issues we re-emphasize at this time are those that we feel are central to establishing the board as a vital force in corporate management.

Identifying the Board's Special Function and Purpose

A great deal of the inertia for board action could be removed if a better understanding of board responsibility and authority prevailed among directors, executives, members, and stockholders. In Chapters 1, 2, and 5 we have given special emphasis to identifying these responsibilities. All of this can be summarized in the need for guidance and review of corporate activities by a free constituency. Executives should have the right and privilege of going before a board to lay out a program of action, to defend proposals, and to be judged. In some respects, American corporations are modeled after the U. S. Government. The board acts primarily as a legislative body, while the executive administers.

Congress cannot do executive work but can, and does, establish policy. Once adopted, the execution of policy is left to the executive and his staff. If this is a worthwhile analogy, then it seems clear that the board must devote more thought to planning broad activities and developing a philosophy for action. The second issue deals with how this is to be done.

Management Through Objectives, Goals, and Policies

The board establishes its philosophy for action through the media of objectives, goals, and policies. In Chapter 4 we treated these extensively so they will not be repeated here. However, the immense importance of the board's task in these areas must not be overlooked.

The concept of management by objective means that the board will review or establish objectives and insure that they are spelled out in writing in advance of the time requiring action. Unless objectives are established, there is no way that either the board or executive will know for certain what the corporation is doing. To insure action the board needs to take the following steps:

1. Lay out over-all corporate objectives.
2. Encourage the executive to present a current and long-range program, including goals and policies.
3. Develop or approve policy guidelines and communicate these to the executive.
4. Require the executive to present written objectives and goals by functional enterprise areas, in terms of <u>results</u> to be accomplished.
5. Establish the required evaluation devices to measure accomplishments.

The Board's Role in Planning and Controlling

Planning and controlling are integral aspects of every phase of board management. Establishing objectives, goals, and policies are all forms of planning, as is the approval of long-range plans submitted by the executive. We have discussed the board's role in detail in Chapters 6, 7, and 8. The board has a definite role in establishing plans and exercising control to measure results. The disagreement arises when careful attention is not given to the type of plans being considered. Long-range and strategic plans and those which specify the character of the business organization are most certainly within the board's prerogative of review and approval. Naturally, the initiative lies with the executive for planning, and this is where it should be, but the board should be explicit about when it wants the executive to present plans for board review and action. As far as control is concerned, the board's control is over the chief executive. Effective control requires rapport between the executive and the board based on understanding, mutual respect, and confidence. Both parties must earn this respect and this requires intelligent communication on the central problems confronting the corporation. There isn't any substitute for the board as an instrument of independent review, and a competent executive will always welcome such review by a knowledgeable board. This brings us to our final basic issue.

How can Board Performance be Evaluated?

The ultimate test is what the board actually accomplishes or fails to accomplish for its company. As a practical matter, we cannot measure the particular contribution of the board to the success of the company nor directly evaluate the capabilities of individual directors. We must use evidences or signs of good or poor performance.

Some directors feel that their obligations commence when they enter the board room and cease when they leave it. This may reflect their feelings regarding the meager pay received for attending meetings. Another reason is that most directors are preoccupied with their other business duties. In contrast are the directors who individually study the company's program both before and after board meetings; who communicate via luncheons, telephone, letters, and by visits to the company offices and plants.

The board's rating should not go down when the power of initiating decisions has been vested in the executive, but rather when the board has yielded its power of supervising the executive. Along this line a "must" function of the board is to have executive management audited periodically. An independently retained consultant may make periodic reports on company progress and the quality of its leadership directly to the board.

Some boards, which serve only as ratifying bodies for the decisions of the executive, may be only interested in obtaining statistics concerning savings, increased profits, lower operating expenses, etc., without bothering to examine the means whereby results have been achieved or effects on future plans. These boards will receive low ratings, for they have neglected their job.

The American Institute of Management has established a detailed set of questions for appraising management, and also a rating scale. Part of this audit concerns the board and we have included portions of this questionnaire as Appendix D. This represents a step forward but should not be taken as sufficiently probing for a detailed analysis. The board's record must be examined in light of the economic, social, technological, and political environment of its day. Furthermore, board effects are long-range in nature and what has gone before may place serious limitations upon the current board.

A Program for Action

This manual is only a catalyst for stimulating concern for the role of the board of directors in corporate management. Some of the steps we believe necessary for rejuvenation of the board's role are:

First, members, stockholders, executives and the public must determine what they expect from the board of directors. Certainly the board is not going to get performance until it develops a clear understanding and conviction of what its responsibilities are and how they can be carried out.

Second, when the board has this understanding and conviction, it should be put into writing. This will test the clarity of thinking and aid in communicating ideas to all concerned.

Third, each director should examine the board's agenda and the nature of the issues coming before it. Is it consistent with the role and duties of the board as they have been defined?

Fourth, each director should examine the information the board is receiving to perform its functions. Does it cover the key performance areas of the business? What danger signals and cut-off points have been established? Is the board using self-set bogies as control tools? If the board is not firmly convinced that any function worth performing can be measured in one way or another, then re-examine both the function and the measurements. Generalities do not help in this area.

Fifth, revitalizing the board will often call for recruiting and compensating nonmember and nonexecutive board members. This is often the starting and stopping place of discussion. Executives are apt to throw up their hands in despair, saying such men are not available, and others refuse to consider any proposal which diminishes their control. For cooperatives, this may mean boards including nonmembers vs. boards limited to members. If there is sufficient determination to develop a really effective board-executive team, there certainly are ways to combine incentives to obtain one. Board membership can be challenging, exciting, and interesting.

If the board is to succeed in reshaping its activities, the executive must also modify his approach. He will spend much more time preparing for board meetings; in preparing proposals in such a way as to promote intelligent questioning, in developing criteria to measure performance, and in developing meaningful reports. The executive will need to spend more time on planning and reviewing, and less time on "fire-fighting" activities if he is to satisfy a group of independent, intelligent directors.

Sixth, we believe that the best way to tackle this complex task is to make some improvements in current practice, as conceived by both custom and law, and not to attempt an ultimate solution overnight.

A competent board of directors has unlimited opportunities to serve its stockholders and society. In our competitive economic system, society grants corporations considerable power and freedom in which to operate. The board of directors is the key decision center through which corporations fulfill their obligations to employees, stockholders, and society.

The board's challenge is to do its job in the most efficient and effective manner. Vital boards will seize the initiative by studying and applying the principles and concepts presented in this manual. By so doing, they will be providing the leadership necessary for the success of their corporations.

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Periodicals for the Thoughtful Director and Executive

I. General Publications

Title	Source
Bank Letters	Federal Reserve District Banks, National Banks, City Banks and others
Bureau of Business Monthly Circulars	Bureau of Business Research in various universities
Business Week	McGraw-Hill Publishing Co., Inc. 330 W. 42 St. New York 36, N. Y.
Corporate Director	American Institute of Management 125 S. 38th Street New York 16, N. Y.
The Executive	Graduate School of Business Administration Harvard University Soldiers Field, Boston 63, Mass.
Fortune	Time and Life Building Rockefeller Center New York 20, N. Y.
Harvard Business Review	Harvard Business Review Soldiers Field Station Boston 63, Mass.
Journal of Marketing	American Marketing Association 27 E. Monroe Street Chicago 3, Illinois
Management News for Agricultural Business	Oregon State Univ. Extension Service Corvallis, Oregon
Management Review	American Management Association, Inc. 1515 Broadway, Times Square New York 36, N. Y.
Wall Street Journal	Dow Jones & Co., Inc. 1015 14th Street N.W. Washington 25, D. C.

II. Industry Publications

Cotton and Peanuts

Cotton Trade Journal, Inc.	The Cotton Trade Journal, Inc. Hickman Building, Memphis, Tenn.
Peanut Journal and Nut World	The Peanut Journal Publishing Co. 212-223 Jones Bldg., Suffolk, Virginia

Feed, Grain, and Seed

Farmers Elevator Guide	1011 Lumber Exchange Minneapolis, Minnesota
Feed Age	American Trade Publishing Company 71 Vanderbilt Ave., New York 17, N.Y.
Grain and Feed Journals Consolidated	Grain & Feed Journals Consolidated, Inc. 141 W. Jackson Blvd., Chicago, Ill.
Seed and Garden Merchandising	624 Gravier St., New Orleans 12, La.
Seed Trade News	Seed Trade News, Inc. 222 West Adams Street, Chicago 6, Ill.
Western Feed and Seed	Beeler Publishing Corporation 1280 Columbus Ave., San Francisco 11, Cal.

Fruit and Vegetable Processing and Packing

Canner/Packer	Triad Publishing Corporation 59 E. Monroe Street, Chicago 3, Ill.
Canning Trade	Canning Trade, Inc. 2504 St. Paul St., Baltimore 18, Md.
Food Business	Putman Publishing Co. 111 E. Delaware Place, Chicago 11, Ill.
Food Processing	Putman Publishing Co. 111 E. Delaware Place, Chicago 11, Ill.
Food Processing Review	Oregon State University Extension Serv. Corvallis, Oregon
The Packer	The Packer Publishing Company 2nd and Delaware Sts., Kansas City, Mo.
Western Packing News Service	S. D. McFadden News Bureau 7 Front St., San Francisco 11, Calif.

Milk and Milk Products

American Milk Review	Urner Barry Company 92 Warren Street, New York, N.Y.
Cordially Yours	Edward B. McClain Company Memphis, Tennessee
Dairy Record	Dairy Record Publishing Company 391 Minnesota St., St. Paul 1, Minn.
Ice Cream Trade Journal	Ice Cream Field Publishing Co., Inc. 23 West 47th Street, New York, N.Y.
Journal of Milk and Food	Inter. Assoc. Milk & Food Sanitarians P.O. Box 437, Shelbyville, Indiana
Milk Dealer	Olsen Publishing Company 1445 North 5th St., Milwaukee, Wisconsin
Milk Products Journal	Olsen Publishing Company 1445 North 5th St., Milwaukee, Wisconsin

Meat and Meat Products

The National Provisioner	15 West Huron Street Chicago, Illinois

Poultry Products

Broiler Industry	Garden State Publishing Company Garden State Bldg., Sea Isle City, N. J.
Pacific Poultryman	Watt Publishing Company Mt. Morris, Illinois
Poultry Processing and Marketing	Watt Publishing Company Mt. Morris, Illinois
Turkey World	Watt Publishing Company, Mt. Morris, Ill.

Wholesaling and Retailing

Food Field Reporter	Gaylin Company 14 S. Harrison St., East Orange, N. J.
Super Market Merchandising	Super Market Publishing Co., Inc. 67 W. 44th St., New York 36, N.Y.
Supermarket News	Fairchild Publications, Inc. 7 East 12th St., New York 3, N.Y.

Wood Products

American Lumberman and Building Products Merchandiser	H. A. Vance 139 North Clark St., Chicago, Ill.
Industrial Woodworking	Cleworth Publishing Co., Inc. River Road, Cas Cab, Connecticut
Modern Woodworking Furniture Manufacturers Guide	Walter B. and James D. Powell P.O. Box 752, Memphis, Tennessee
National Hardwood	Memphis Lumberman Co., Inc. 2065 Union Avenue, Memphis, Tennessee
Wood and Wood Products	Vance Publishing Corporation 139 North Clark Street, Chicago, Ill.

III. U. S. Government Publications

Agricultural Marketing Service Reports (Request AMA-48 which lists all available reports.)	Marketing Information Division Agricultural Marketing Service U.S.D.A. Washington 25, D. C.
Economic Indicators Survey of Current Business	Superintendent of Documents U. S. Government Printing Office Washington 25, D. C.
Farmer Cooperative Service Reports (Request FCS Information No. 4 which lists all available.)	Information Division Farmer Cooperative Service U. S. Department of Agriculture Washington 25, D. C.
Marketing Information Guide	U. S. Department of Commerce Washington 25, D. C.
Management Aids for Small Manufacturers Management Research Summary Small Marketers Aids	Small Business Administration Office of Mgt. and Research Assistance Washington 25, D. C. or regional offices

Appendix A.

MANAGEMENT NEWS FOR AGRICULTURAL BUSINESS

(Financial Management and Control Series)

1. Introduction to Financial Management and Control.
2. The Income Statement.
3. Ratios for Financial Analysis.
4. Funds and Cash Flow Statements.
5. Financing Long-Term Capital Needs.
6. The Cost of Capital.
7. Cash Planning.
8. Cost Accounting for Control.
9. Volume-Cost Analysis for Profit Planning.
10. Applying Volume-Cost Analysis.
11. Planning Capital Investments.

This appendix is a collection of Management News leaflets prepared by Extension Marketing Management specialists at Oregon State University. They were distributed to management and board members of Oregon agricultural marketing and supply firms and are used in training programs.

Management News
FOR AGRICULTURAL BUSINESS

COOPERATIVE EXTENSION WORK IN AGRICULTURE AND HOME ECONOMICS
OREGON STATE UNIVERSITY AND U.S. DEPARTMENT OF AGRICULTURE COOPERATING • CORVALLIS, OREGON

FMC-1
November '61

INTRODUCTION TO FINANCIAL MANAGEMENT AND CONTROL

Arnold Haseley and Leon Garoian
Extension Marketing Management Specialists

The sports page writer collects, records, and analyzes the results of last Saturday's football game in yards lost or gained, passes completed, or points for and against your favorite team. The business enterprise uses an accounting system. To understand the performance of either your team or business, you'll need a basic understanding of the system used before moving on to the finer points of the game.

Since managers and directors make considerable use of financial accounting information, we will start with a description of the important concepts, rules, and techniques of financial accounting. Financial accounting has the primary objective of providing information to persons outside the business. Management accounting, on the other hand, is designed for use by management. It will be the focus of future articles.

Financial Accounting: Principles and Concepts

The first principle is that only facts which can be recorded in monetary terms are reported in financial accounting. Accounting does not record that a manager is about to suffer a heart attack or that a competitor has placed a better product on the market. Readers of accounting reports should not expect to find all, or even the most important facts, about a business in them.

Secondly, accounts are kept for business entities. The important question in recording facts is how they affect the business, rather than how they affect the persons associated with the business. Problems may arise where the definition of the business entity is not clear. The business entity distinction also gives rise to the idea of financial accounting as a basis for reporting on the stewardship of management.

The third basic concept is that unless there is evidence to the contrary, accounting assumes that the business will continue to operate indefinitely. The importance of this is that resources acquired are not valued at their current resale value, but rather at their cost.

The cost basis of valuation, therefore, follows. Valuable things owned by a business, called assets, are ordinarily recorded at the price paid to acquire them. However, the amounts listed in the asset

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This is the first in a series of Management News articles on financial management and control. OSU Specialists will publish subject matter of interest to business managers and directors. Future series are planned on: General, Operations, Marketing, and Personnel Management. Our viewpoint will focus on the "what and why", on concepts, and on the use of data for management tools.

accounts do not necessarily reflect what the asset could be sold for. The systematic way of using up assets that have a long but limited life is called depreciation. The depreciation process gradually removes the cost of the asset from the accounts and shows it as a cost of operations. A depreciated asset does not necessarily reflect market value or real worth to a company. Besides the going-concern concept, evaluating assets at their purchase price is more definite and certain than attempting to estimate current market values.

Every accounting event is made up of two aspects, and these aspects are changes in assets and in equities. Equities are claims against assets and consist of two parts: liabilities, which are claims of creditors, and owner's equity or "capital", which are the claims of owners of the business. All assets are claimed by someone; therefore, assets equal equities.

The sixth principle deals with the accrual concept. The generation of revenues in excess of expenditures from the operation of a business gives rise to profit or net income. The accrual concept is that net income arises from events that change owner's equity in a specified time period. Owner's equity changes are not necessarily identical to changes in the cash position of the business. Borrowing $1000 from a bank increases the asset cash $1000 but also increases liabilities by $1000; there is no change in owner's equity.

The final principle deals with the recognition of revenue. Revenue is recognized when it is realized. This may be when service is rendered, when a sales order is received, a contract signed, or when a product is delivered. Revenue does not necessarily correspond to cash receipts. Deferred revenue, a liability, represents advance payments, and accrued revenue, an asset, is a payment due. Some examples of deferred revenue are rent or insurance premiums paid in advance to the owner of the building and insurance company respectively. Interest payment due for funds loaned during an accounting period is recognized as an asset, accrued revenue, even if not actually invoiced to the recipient at the year-ending date. In either case, cash receipts and revenue realization are not the same.

The Balance Sheet

The balance sheet is the fundamental accounting report because every accounting transaction can be recorded in terms of its effect on the balance sheet. It shows the condition of a business at a given moment of time; for example, December 31, 1961, means at the close of business on that day. Let's examine the components of a typical but simplified balance sheet as shown in Exhibit 1.

First off, assets are valuable things owned by a business, which were acquired at a measurable cost. The asset must be owned; for example, a leased truck is not an asset to you as a user. Assets must be valuable to the business. A worn-out machine, which can't be used in future operations nor sold or traded, is not an asset even though it is owned.

Current Assets are assets which will be owned for a short period of time. They are assets which can reasonably be expected to be realized in cash or sold or consumed during the normal operating cycle of the business. The usual time limit is one year; however, this may be longer if the normal operating cycle of the business is longer. Some examples are: cash, inventories, trade accounts, notes or acceptables receivable, receivables from officers or affiliates (if collectible within the course of a business year), marketable securities, installment notes receivable, and prepaid expenses, such as insurance, rents, etc.

Fixed Assets are tangible, relatively long-lived items owned by a business. On the B & D balance sheet these are lumped together into a single term, for simplicity. The figure $26,900 is the cost of these assets when purchased in accordance with the cost concept of value. The next item of $13,500--Accumulated Depreciation--means that much of the original value has already been allocated as a cost of doing business. Depreciation will be discussed further in future issues.

Exhibit 1. B & D Corporation
Balance Sheet as of 31 October 1961

Assets		
Current		
Cash	$3,400	
Marketable securities (Market value $650)	500	
Accounts receivable (net)	4,500	
Inventories	9,000	
Prepaid expenses	200	
Total current		17,600
Fixed		
Land, buildings, and equipment	26,900	
Less accumulated depreciation	13,500	13,400
Other Assets		
Investments	200	
Patent rights	50	250
Total assets		$31,250

Equities		
Current liabilities		
Accounts payable	$4,900	
Est. tax liability	3,300	
Accrued expenses, payable	600	
Deferred income	200	
Total current		9,000
Other liabilities		
Mortgage bonds payable	3,000	
		3,000
Owner's equity		
Common stock	15,000	
Retained earnings	4,250	19,250
Total equities		$31,250

Other Assets may be securities of one company owned by another, or intangible assets such as goodwill, patents, leases, licenses, and other similar valuable nonphysical items owned. Our balance sheet shows $200 in investments and $50 as patent rights.

The importance of distinguishing between current and other assets accurately will be of vital interest when we discuss balance sheet ratios and the lender's use of such information.

Now let's take a look at the Equity side of the statement. In general, liabilities are claims of outsiders against the business. Putting it another way, it is the amount that the business owes to persons other than the owners. Liabilities shown on the balance sheet are claims against all assets, not specific assets.

Current Liabilities are obligations due in the near future, usually one year, whose liquidation requires use of resources classified as current assets, or creation of other current liabilities. Other liabilities are claims that do not fall due within one year. In B & D Corporation none of the mortgage bonds payable falls due within the current year, or part or all of the $3,000 would appear under current liabilities. If a portion were currently due, it would be listed under Current Liabilities, as mortgage bond payable (current portion).

The Owner's Equity section shows the claims of the owners; in case of B & D Corporation, the stockholders. The terminology used in this section varies with different forms of organization. For instance, a cooperative might have both capital stock and patrons' equities listed in this section. The item Common Stock has a listed "stated value" of $15,000 in B & D and this may be par value, price at which it sold, or other figure fixed by the board of directors. The important matter is that once the basis of valuing has been determined it is rarely changed. Owner's equity increases through earnings from profitable operations. It decreases when earnings are paid out in dividends or patronage refunds. The difference between total earnings to date and total dividends to date is Retained Earnings. If the difference is negative the item is labeled deficit. B & D has retained earnings of $4,250 and that is the portion of total earnings which has been retained in the business. Owner's equity also can change by events other than accumulation or withdrawal of earnings. Examples are the sale of stock at premium or discount, and the creation of special reserves. The term Surplus is sometimes used in place of retained earnings. This may be misleading, as surplus represents nothing tangible or "left over", for, in fact, there is nothing tangible about retained earnings. All of the tangible things owned by a business appear on the asset side of the balance sheet.

A statement of Retained Earnings sometimes is prepared to show the balance of the retained earnings item at the beginning and end of an accounting period and to show changes that occurred during the period. Such a statement links the income statement to the balance sheet statement. It most often appears at the bottom of an income statement. It is shown here to relate it to the balance sheet.

Exhibit 2
Statement of Retained Earnings

Retained earnings 10/31/60 (from Bal. sheet)	$3,250
Add: Net Income 1961 (from Inc. statement)	2,000
	5,250
Less: Dividends	1,000
Retained earnings 10/31/61 (to Bal. sheet) (Exhibit 1)	$4,250

In summary, the balance sheet may be viewed as a description of the sources from which the business has obtained capital for operations and the form in which that capital is invested on a specific date. These are, respectively, the equity and asset sides of the balance sheet. The owner's equity section shows the capital supplied by stockholders. This contribution is principally of two types; capital directly supplied and capital supplied by leaving earnings in the business, that is, retained earnings. Management exerts judgment over the optimal mix or combination of assets for the business, and thus allocates all capital obtained from the various sources to assets of one type or another. The combination of assets to generate a continuous satisfactory stream of earnings is the task of management and directors.

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Management News

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OREGON STATE UNIVERSITY AND U.S. DEPARTMENT OF AGRICULTURE COOPERATING · CORVALLIS, OREGON

FMC-2
Dec. '61

THE INCOME STATEMENT

Arnold Haseley and Leon Garoian
Marketing Management Specialists

Last month we introduced the fundamental concepts of financial accounting and the balance sheet. Now, let's take a close look at the accounting report, which summarizes revenue and expense items and the difference between them--net income. The income statement is sometimes called a statement of earnings or of operations, or a profit and loss statement. Technically it is subordinate to the Balance Sheet in that collectively it shows the change in one Balance Sheet item for an accounting period, namely retained earnings. The importance of the income statement is undeniable, because it indicates reasons for business profitability or lack thereof, insofar as accounting data can do so.

The crucial aspects of income statement preparation are the delineation of the accounting period, measurement of expense within that period, and the matching of expenses recognized with revenue recognized. Most businesses now use a natural business year rather than a calendar or fiscal year for the accounting period. Thus, many fruit and vegetable processing firms' accounting periods end March or April 31. The following illustration shows a portion of the continuous life of a business, split into accounting periods.

	Dec. 31	Dec. 31	
	Last year income statement	This year income statement	Next year income statement
	Balance sheet	Balance sheet	

The measurement of Expense involves several complications. First we must distinguish between expense and expenditure. Expense means a decrease in owner's equity that arises from the operation of a business during a specified accounting period. Expense and cost are not synonymous as cost means any monetary sacrifice and this may or may not affect the owner's equity. An expenditure takes place when an asset or service is acquired. This may involve cash, trading assets, or incurring a liability. Expense and expenditure do not necessarily correspond. For example, suppose a cattle feeder purchases 1000 bushels of grain with cash. This is an expenditure but not an expense, as he changes one asset to another. An expense is incurred in the accounting period when the grain consumed is sold in the form of cattle.

The previous illustration shows that there are four types of events between which we need to distinguish: 1) Expenses of this year; 2) Expenditures made prior to this year that will become expenses during this year (these appear as assets on the balance sheet at the end of last year); 3) Expenditures made this year that will become expenses in subsequent years (these appear as assets at the end of this year); and 4) Expenses of this year that will be paid in a subsequent year (these appear as liabilities at the end of this year). Once these distinctions are clear for the recognition of expense, they must be matched with revenues recognized during that accounting period. In other words, the "cost of goods sold" and "sales" items on the income statement should refer to the same products. If expenses can not be traced to specific items of revenue, they are charged to the year in which they are incurred.

The income statement should be prepared in a form most useful to those who read it. No specific format is prescribed, but Exhibit 1 is a typical statement for many companies. Let's examine each of the major headings and the ramifications involved in arriving at the reported figures.

Gross sales is the total invoice price of goods shipped or services rendered plus cash sales made during the period. Normally sales or excise taxes that may be charged the customer are not included because they are collections made for the government and not revenue. Sales returns and allowances represent the sales value of goods that were returned, or on which credit was given because customer specifications were in some way not met. In some cases, a sales allowance may be a specified condition of the sale, such as an advertising allowance. Sales discounts, on the other hand, are discounts taken by customers for prompt payment. If your business offered terms of 3/10, n/30 (3 percent off if payment is made in 10 days and the net amount due in 30 days) for a $1000 purchase and the customer takes advantage of your terms, the business receives $970 cash and records the other $30 as a sales discount.

When income is increased by the sales value of a product sold, it is also decreased by the cost of that product. The difference between cost and selling price is Gross Profit. The determination of cost involves special problems. This is particularly true in a manufacturing business, somewhat less so in a merchandising business, such as the B & D Corporation. Let's compare the cost flows in a merchandising and manufacturing business and how they fit in with the measurement of income.

EXHIBIT 1. INCOME STATEMENT
B & D CORPORATION - YEAR ENDING 31 OCT. '61

Gross sales			$55,000
Less: Returns & allowances		$2,500	
Sales discounts		2,500	5,000
Net sales			50,000
Cost of goods sold:			
Beginning inventory		9,000	
Purchases	$26,000		
Freight and express	4,000	30,000	
Cost of goods available for sale		39,000	
Less: Ending inventory		9,000	30,000
Gross profit			$20,000
Selling, administrative & general expenses:			
Salaries & wages		10,500	
Employment taxes & benefits		500	
Utilities		1,500	
Rent		500	
Taxes & licenses		1,200	
Depreciation		1,400	
Maintenance		200	
Other		200	16,000
Operating profit			$ 4,000
Other revenue		400	
Nonoperating expense		1,200	800
Net income before taxes			3,200
Provision for income tax			1,200
Net income			$ 2,000

In Exhibit 2 we have a simple picture of the flow of costs in a firm performing a combination of buying, sorting, storing, transporting, and selling functions. Revenue is recognized at the time of sale but expense recognition depends on the individual factor input. This diagram depicts only one intermediate stage between the incurring of an expenditure and its transfer to expense. Expenditures are inventoried either as merchandise inventories, or long-life property and transferred to expense as inventories are sold and property depreciated. Some other items such as insurance premiums paid in advance are also shown on the balance sheet, but ignored in Exhibit 1. Most items, such as wages, utilities, etc., are charged directly to the income statement as expenses of the period in which acquisition took place.

The business engaged in manufacturing performs additional economic functions. The cost flows generated by the conversion of materials to finished products are more complex as seen in Exhibit 3. Cost of goods sold is the total of the purchase price and conversion costs of the products that are sold. Because a manufacturing enterprise is constantly converting from raw product to finished goods, three stages of inventory accounts are normally kept. The first stage is cost of materials purchased, plant and equipment acquired, or other assets bought prior to their use. In the second stage (Work in Process Inventory), materials may be in process of completion -- other manufacturing inputs have been added to the basic materials. In the third stage (Finished Goods Inventory), the manufacturing process has been completed but goods have not been sold. Only when finished goods are sold to customers are manufacturing costs listed as expense on the income statement. The tracing of cost through these stages is necessary so that the income statement will reflect costs associated with revenue for a given period. The three stages are indicated by the arrows at the bottom of Exhibit 3. It should be noted that the flow of nonmanufacturing costs is the same in both Exhibits 2 and 3.

In either merchandising or manufacturing firms, the *Cost of Goods Sold* is deduced by determining the value of each inventory account at the end of the period. Assigning values at the various stages in a manufacturing firm complicates the matter beyond the simple deduction shown in Exhibit 1 for a merchandising firm.

The costs, comprising cost of goods sold, are called *product costs*. Typically this is the sum of direct labor, direct material, and factory overhead. Those costs below gross profit are collectively called *period costs*. These typically are selling, general and administrative, and financial or nonoperating costs. Period costs are expenses in the accounting period

EXHIBIT 2. COST FLOWS FOR INCOME MEASUREMENT IN MERCHANDISING COMPANIES

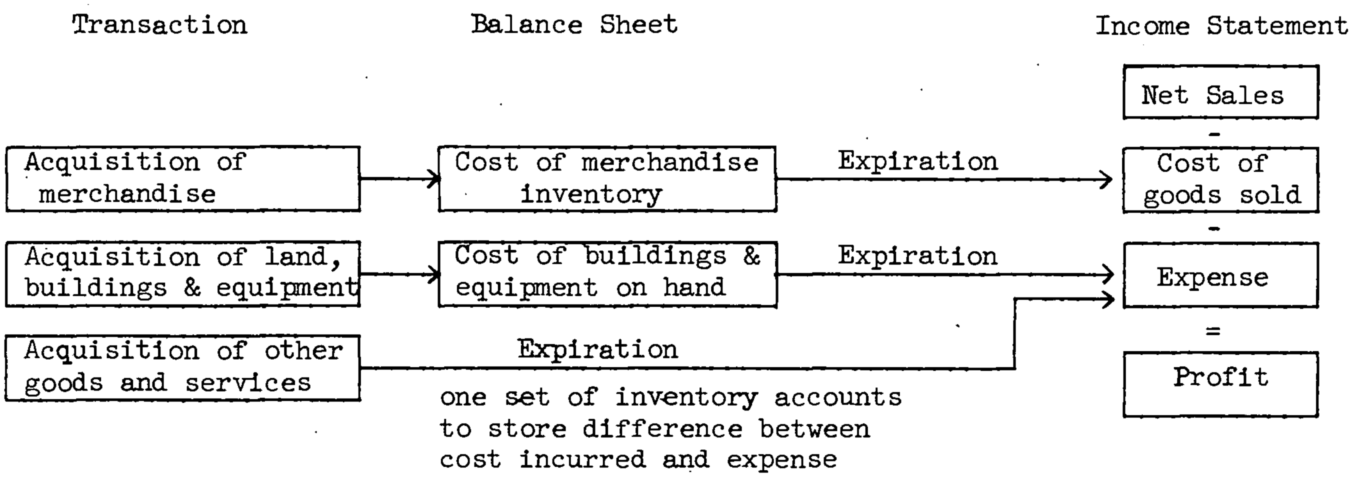
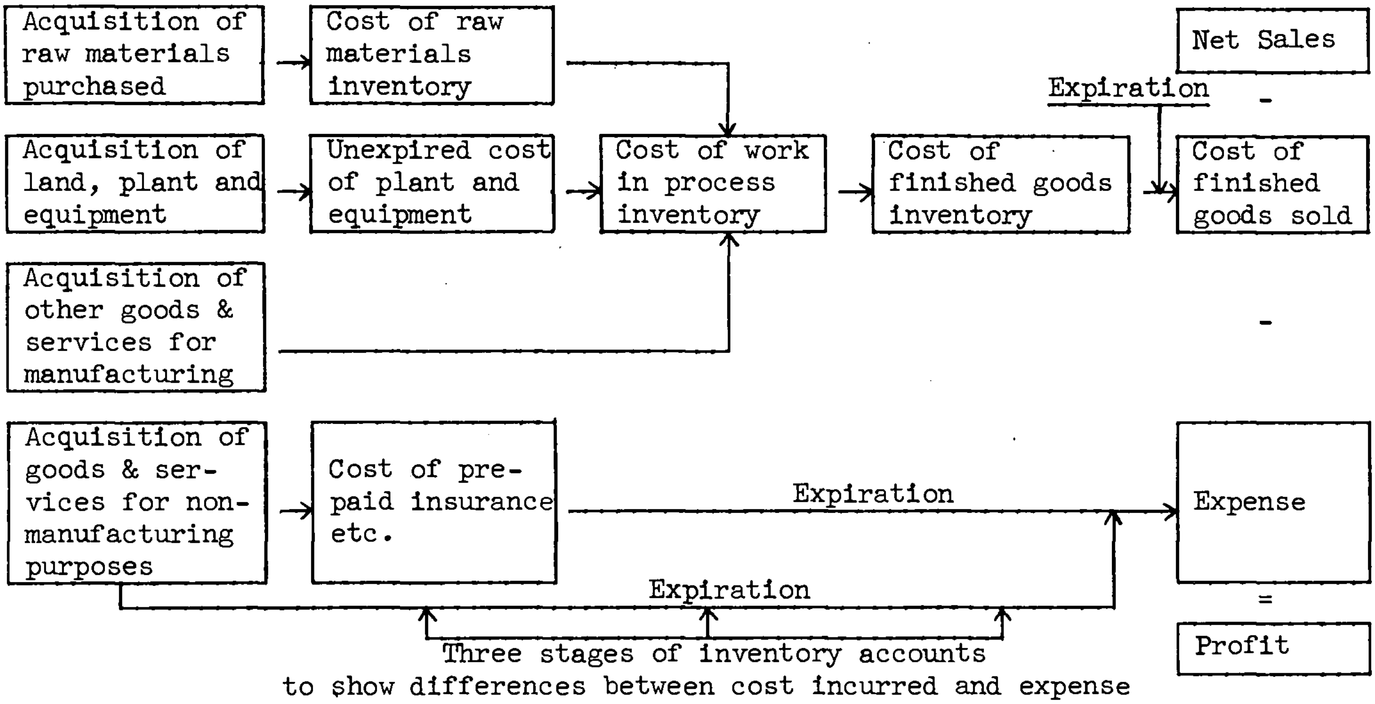


EXHIBIT 3. COST FLOWS FOR INCOME MEASUREMENT IN MANUFACTURING COMPANIES

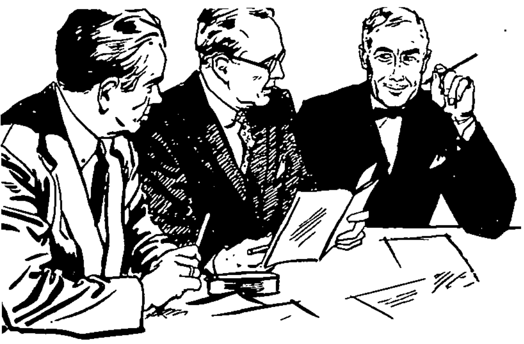


in which they are incurred. Product costs, while adding to the cost of the product, do not have an impact on net income until the product is sold. This may be in another accounting period than when the cost was incurred. Therefore, how a company classifies its cost into period of product costs can have an important effect on reported net income. Also, in a manufacturing company, the larger the inventory in relation to sales, the longer the time interval between the incurrence of cost and its impact on net income.

Operating expenses may be subgrouped under selling, administrative and general expenses. Gross profit less operating expenses equals Operating Profit. Other Revenue or nonoperating revenue may include interest, rent, etc. Nonoperating Expense includes financial and other expense not directly related to the principal activity of the business. Subtracting the net of these items from Operating Profit results in Net Income Before Taxes (NIBT) of \$3200. The NIBT item is the preferred one for several calculations involving profitability and return on investment. Likewise, it is often useful to know financial expense separately from operating profit for other computations. Deducting estimated federal and state income taxes results in our final Net Income figure of \$2,000.

The period costs shown for B & D Corporation do not present serious problems. However, some items are more apt to pose the familiar problem of matching expired costs against revenue. One of these items is income tax. Income tax reported as an expense for a year should be related to the income on which the tax is calculated. The amount of income recognized for tax purposes may differ from the amount measured using the principles of financial accounting. Minimizing current taxes is perfectly legal and ethical. However, management is interested in income earned and if tax regulations result in serious income distortions, they should not be substituted for financial accounting principles.

In summary, the reliability of an income statement depends on 1) The length of the accounting period, 2) The extent to which events of the current period are separated from events affecting prior and future periods, 3) The amount of long-lived assets owned, and 4) The stability of prices. Precise matching of revenues and expenses for a period is not practical. Therefore, the net income figure reported is not an exact measure of the increase in worth of a business in any given period. It is, however, the agreed-upon measuring stick of business performance, and as such deserves careful preparation, interpretation, and analysis by management and directors of agricultural business firms.



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RATIOS FOR FINANCIAL ANALYSIS

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This article introduces a part of the basic framework for financial analysis. Concepts and tools which are helpful to a manager or director confronted with the task of interpreting financial statements and using them as a means of control are introduced. One key attribute of effective management is the art of asking significant questions. In financial analysis this means selecting the relevant tools, factors, and time periods of investigation for the problem or appraisal job at hand. Thinking through the problem will reduce the amount of detail work to be done and increase the yield of the efforts expended.

A director or manager concerned with the financial facts of a business questions: 1) its ability to meet current obligations, 2) its ability to earn a satisfactory return on investment, 3) its ability to withstand possible external or internal setbacks, 4) its ability to raise new funds when required, 5) its ability to perform efficiently the functions it undertakes, and 6) the performance of its management. To answer these questions it is helpful to make significant comparisons between two or more balance sheet and income statement items in the form of a ratio. A significant comparison expresses a logical relationship that is more useful than the raw figures. A ratio is simply one number expressed in terms of another. It is found by dividing one number, the base, into the other. A percentage is one type of ratio where the base is taken as equaling 100 and the quotient is expressed as "per hundred" of the base. Ratios are not ends in themselves; however, selective use may help answer significant questions.

Financial ratios can be grouped loosely into these categories: 1) Tests of Profitability, 2) Tests of Liquidity, 3) Tests of Solvency, and 4) Other Ratios. These ratios will be demonstrated by reference to the balance sheet and income statements of our November and December '61 issues respectively.

Tests of Profitability

The profitability of a firm can be measured by two major groups of ratios: 1) profitability as related to investment, 2) as related to sales. The relationship between the size of the annual income and the investment committed to attaining this income is the most basic single measure of overall performance. There are several ways to calculate this relationship. Some common ones follow:

a) $\frac{\text{Earnings Before Interest and Taxes (EBIT)}}{\text{Total Assets}}$

$$= \frac{\$4,400}{\$31,250} = 14.1\%$$

This ratio measures the earnings of the business on all of its assets before taxes and compensation to the contributors of these assets (creditors and owners). A variation is as follows:

b) $\frac{\text{Net Income}}{\text{Total Assets}} = \frac{\$2,000}{\$31,250} = 6.4\%$

This relates the net income left after taxes and after compensation to the creditors, who are paid interest for their contribution to the firm's assets. Because this ratio compensates creditors for their contribution to assets, the outsider appraising the earning power of all the assets may not want to use this measure. The stockholder interested in the earnings belonging to him relative to the company assets may find the measure relevant. A third very common measure relates net income to owner's equity.

c) $\frac{\text{Net Income}}{\text{Owner's Equity (net worth)}} = \frac{\$2,000}{\$19,250} = 10.4\%$

This is a way of measuring the return to the owners of the business after all taxes and interest expenses have been paid. It is a fairly good measure for appraising the earning power of the ownership investment, and useful to those investing equity funds. Frequently owner's equity is adjusted to reflect the average amount invested for an operating year. Intangible assets such as the $50 patent rights on the B & D statement may be subtracted from owner's equity to present a conservative picture.

Management is also interested in profitability as related to sales. These measures help you appraise the efficiency of operations, although price and volume changes place limits on their reliability. They are not as decisive tests as the ones based on investment. Each of the items on the income statement can be expressed as a percentage of net sales. Thus we have the common ratios of:

d) $\frac{\text{EBIT}}{\text{Net Sales}} = \frac{\$4,400}{\$50,000} = 8.8\%$

e) $\frac{\text{Net Income}}{\text{Net Sales}} = \frac{\$2,000}{\$50,000} = 4.0\%$

f) $\frac{\text{Operating Profit}}{\text{Net Sales}} = \frac{\$4,000}{\$50,000} = 8.0\%$

These ratios are used as general indicators of relative efficiency, especially in intra-industry comparisons. In addition, management should present relationships between sales and specific expense items which are crucial to good performance. These may be fairly important measures of efficiency in period to period analysis for some industries. At this stage we should recognize that a grouping of ratios connected with each other will give a more complete answer than any one alone. For instance, ratio (b) can be found by multiplying asset turnover, (Net Sales/Total Assets), by ratio (e). By looking at all three together a fuller understanding is possible.

<u>Tests of Liquidity</u>

Liquidity refers to the company's ability to meet its current obligations. Liquidity ratios deal with the size and relationship of current liabilities and current assets.

a) $\text{Current Ratio} = \frac{\text{Current Assets (CA)}}{\text{Current Liabilities (CL)}}$

$\frac{\$17,600}{\$\ 9,000} = 1.96$ (CA are 1.96 times CL)

The Current Ratio is one of the most commonly used indexes of financial strength, although it is a rather crude measure. The margin of safety required between current assets and liabilities implies a possible shrinkage of value in such asset accounts as accounts receivable and inventories. The test involves a liquidation approach rather than a judgment on a going concern as it does not explicitly recognize the revolving nature of current assets and liabilities. A general impression regarding this ratio is the higher the better, or that 2:1 is ideal. Neither impression is correct and both are rather dangerous. Excessive inventories or idle cash are imprudent, and a 10:1 ratio may not of itself guarantee reserve strength to meet current obligations. Much depends on the quality and character of the current assets and the type of industry involved.

b) Acid-Test Ratio = $\frac{\text{Quick Assets}}{\text{Current Liabilities}}$

$$= \frac{\$8,400}{\$9,000} = 0.93$$

Quick assets include cash, marketable securities, and current accounts and notes receivable. The Acid-Test Ratio is a measure of the extent to which liquid resources are immediately available to meet current obligations. B & D Corporation has an acid-test ratio of slightly less than 1:1, the common rule of thumb. A ratio far below 1:1 can be a warning signal, but again blind application should be avoided.

A figure related to the current ratio is Working Capital. This is simply the difference between Current Assets and Current Liabilities. The movement of this figure over several time periods is often used by analysts as an indication of reserve strength. Because the Working Capital figure provides a significant bench mark of Liquidity, bank loans are often tied to a specified minimum.

Tests of Solvency

Solvency refers to a company's ability to meet the interest costs and repayment schedules associated with its long-term obligations. The purpose of the analysis is to examine the "cushion" of ownership funds creditors can rely upon to absorb possible losses from operations, decreases in asset values, and poor estimates of future funds flows. Three ratios most commonly used are:

a) $\frac{\text{Total Debt}}{\text{Total Assets}} = \frac{\$12,000}{\$31,250} = 38.4\%$

This ratio compares the total of short and long term liabilities to total assets and shows the proportion of funds contributed by all of the B & D Corporation creditors, other than owners.

b) $\frac{\text{Long-Term Debt}}{\text{Capitalization}} = \frac{\$3,000}{\$22,250} = 13.5\%$

(Capitalization = Long-Term Debt + Owner's Equity.)

This is a more selective measure showing a company's long-term financial position on the balance of funds sources. Equity capital constitutes 86.5% of B & D's capitalization. Both of the above ratios indicate heavy reliance on ownership funds and little risk for creditors.

c) $\frac{\text{Total Debt}}{\text{Owners' Equity}} = \frac{\$12,000}{\$19,250} = 62.3\%$

This ratio shows creditors provided 62.3 cents for every dollar owners invested. This represents a moderate risk for owners relative to all creditors. Deducting current debt (long term debt/owner's equity, \$3,000/\$19,250 = 15.6%), we have the proportion of debt in the B & D capital structure. Generally, the risk assumed by a firm increases as the proportion of debt to equity in the capital structure increases. In B & D this is low, and stockholders have a relatively low risk position. Owners have restricted "trading on equity" by limited use of senior securities (bonds and preferred stock). Trading on the Equity is the use of fixed charge securities in the capitalization of a company. The advantage in income to holders of the common equity can be computed by the ratio of return on existing common equity to the rate of return on the entire capitalization. Using EBIT, we have a ratio of (\$4,400/\$19,250) to (\$4,400/\$22,250) or 22.9/19.8 = 1.2. Management of B & D has struck a balance between low risk and limited common equity pyramiding, at this level of earnings.

Other Ratios

Other ratios are those appraising major balance sheet accounts and market tests. Market tests are not discussed.

a) Accounts Receivable (A/R): The value of receivables, if detailed aging is not available, can roughly be appraised by analyzing "days" sales represented by receivables, or commonly stated as the

Average Collection Period. The promptness of collection, in view of the credit terms granted, is an indicator of the quality of A/R and the effectiveness of credit management. To calculate the Average Collection Period: (A/R)/(Net Credit Sales) x (Days in the Period) = Collection Period

$$\frac{\$4,500}{\$50,000} = 9.0\% \times 360 = 32 \text{ days}$$

Our calculation assumes net sales equal net credit sales. A general rule is that the collection period should not exceed 1-1/3 times the regular payment period. If terms are 30 days, the period should not exceed 40 days.

b) Accounts Payable (A/P): From the point of view of a creditor it is desirable to apply this test to appraise how a firm handles its obligations to trade creditors. To calculate the number of days of purchases represented by A/P:

Average daily purchases =

$$\frac{\text{Purchases}}{\text{Days}} = \frac{\$26,000}{360} = \$72.22$$

Day's Purchases Represented by Payables =

$$\frac{\text{A/P}}{\text{Ave. Daily Purchases}} = \frac{\$4,900}{\$72.22} = 68 \text{ days}$$

The 68 days above may be compared with the terms extended by suppliers to appraise possible abuses of creditor's terms. The trend here as with A/R is an important indicator. It is evident that B & D Corporation is very lax on paying its obligations but aggressive in collecting its A/R if we assume 30-day terms. The difficulties surrounding this measure are the determination of purchases for any specified period, and that A/P often include debts for purposes other than purchases. Consequently this ratio is less reliable than the A/R measure, but useful.

c) Inventory Turnover: This account is often analyzed in terms of its size in relation to other funds' needs and the sales volume it supports. Turnover indicates the velocity of merchandise movement through the business. Presumably, the higher the turnover, the better the performance as the firm is operating with a smaller commitment of funds. However, this must be balanced against possible inventory shortages and resulting loss of customer satisfaction. Also, the economic order quantity of inventory replenishment should be considered. To calculate turnover:

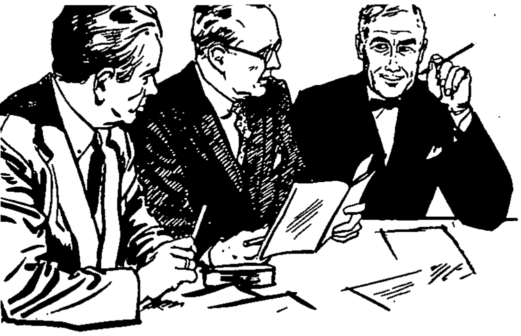
$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} = \frac{\$30,000}{\$9,000} = 3.3$$

Thus, B & D inventory was turned 3.3 times during the year. The final judgment on this figure depends on the industry, company, method of valuing inventories, and any observable trends.

Standards for Comparison

In the control process management constantly appraises what did happen against what should have happened, or actual performance with a standard. A standard is a measure of what the results should have been under the circumstances prevailing. Even with accurate reports of actual performance, finding an adequate standard is a perplexing and difficult matter. Some common problems of developing standards are: 1) Deciding on the proper basis for comparison, 2) difference in situations being compared, 3) changes in the value of the dollar, 4) differences in accounting practice, 5) hidden short-run changes, and 6) using the past as an indication of the future.

In summary, we recognize that ratios are only part of financial analysis. But they can be very useful control tools. Comparisons to any type of standard will suggest important questions to be investigated, but rarely will they indicate answers to the questions. Here are five useful hints to keep in mind: 1) select a limited number of ratios for the appraisal task at hand; 20 calculate these for several past periods and the current--look for trends; 3) present your results effectively by using standards; 4) concentrate on all major variations from standards; and 5) investigate the causes of these variations, by cross checking with other ratios and raw data.



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FUNDS AND CASH FLOW STATEMENTS

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Marketing Management Specialists

Management is faced with two related, but distinct financial tasks: (1) to earn a profit from operations, and (2) to finance the operations of the business and to keep it solvent. The December 1961 issue discussed the Income Statement, which provides for reporting the profitability of a business. This issue deals with the second financial task of management; that relating to financing of operations and to the solvency of the business. These relationships are analyzed in the Funds and Cash Flow statements.

Funds Flow Statement

The Funds Flow Statement reveals causes of the changes in the working capital of a business by summarizing the events of the accounting period in terms of the movement of funds (sources) into the business, and the uses to which these funds were put. An analysis of Funds Flow for any relevant period will show: 1) where management decided to commit funds (uses); 2) where to reduce the firm's assets or investments (sources); 3) where to acquire additional funds (sources); and 4) where to reduce claims against the firm by giving up funds in payment (uses).

Funds refer to the working capital of an organization, or the excess of current assets over current liabilities. This is a broader definition than ordinary usage, where funds are thought to be cash.

Transactions increasing working capital are considered sources; those decreasing working capital are applications or uses of funds. Any transaction which neither increases nor decreases working capital is excluded from the statement. Changes restricted to the current asset-current liability accounts cause changes in the composition of working capital, but do not change its total. Collections of accounts receivable and payment of current obligations are typical transactions omitted from the funds statement because they do not affect working capital. Therefore, the statement of source and use of funds comes from an analysis of the noncurrent accounts. These are accounts other than those included in current assets or liabilities. (See Exhibit 3.)

Each noncurrent balance sheet account is analyzed to determine if a transaction during the period involved a current asset or current liability. Sources of funds are indicated by increases in equities and decreases in assets. Uses of funds are indicated by increases in assets and decreases in equities. Total sources must equal total uses. These relationships are revealed below:

1. Sources = Uses.

2. Increase in Equities + Decrease in Assets = Increases in Assets + Decreases in Equity.

The rules are summarized as:

	Asset Account	Liability Account
Increase	Use	Source
Decrease	Source	Use

Contra-asset accounts, such as accumulated depreciation, allowance for bad debts, etc., act as liability accounts. Contra-liability accounts behave as asset accounts. These relationships can also be explained in terms of debit and credit. Increases in equities and decreases in assets are both credits. Increases in assets and decreases in equities are both debits. Again changes in debits must equal changes in credits.

The basic method of constructing the funds flow statement can be seen by starting with a comparative balance sheet.

Exhibit 1. B & D Corporation

Condensed Balance Sheet

	October 31		Change	
	1961	1960	Use	Source
Assets				
Working Capital	$8,600	8,200	400	
Net Plant & Eq.	13,400	11,000	2,400	
Other Assets	250	50	200	
Total Assets	22,250	19,250		
Equities				
Long Term Debt	3,000	1,000		2,000
Common Stock	15,000	15,000		
Ret. Earnings	4,250	3,250		1,000
Total Equities	22,250	19,250		
Total			3,000	3,000

This statement shows the net effect of funds flows but does not show directly what the flows were. The additional data required comes from the Income Statement (Exb. 1 Dec'61) and the Statement of Retained Earnings (Exb. 2 Nov'61). The current year depreciation charge was $1,400, net income was $2,000, and dividends paid totaled $1,000. Since we have no evidence of fixed asset sales or other transactions, we proceed to the funds flow statement.

Exhibit 2. Funds Flow Statement, 1961

Sources of Funds:		
Net Income	$2,000	
Adjustment for noncash charge - depreciation	1,400	
Total from operations		3,400
Add Increased debt		2,000
Total		$5,400
Uses of funds:		
Dividends		$1,000
Other Assets		200
New Plant & Equipment		3,800
Inc. in Working Capital		400
Total		$5,400

The results show the difference between the concept of net income and of funds flow. During the year the major funds flow was from operations and debt to new plant and equipment, dividends, and working capital. Management may now appraise the magnitude, direction, and proportionality of the funds flow in light of current and future requirements.

Let's review the comparative balance sheet approximations to funds flow and the final funds flow statement. The change in retained earnings, for example, is the net effect of two different types of transactions: 1) the earning of income, a source of funds; and 2) the payment of dividends, a use of funds. The total flow was $2,000, $1,000 as a source and $1,000 as a use. This is obscured without access to supporting statements, and in many cases, the detailed internal accounts. However, the basic question to ask is "Does the transaction affect one of the current accounts?" If not, that item will not appear on the funds flow statement, and nothing further is required. If the answer is Yes, then another question must be asked. "Does it increase or decrease working capital?" Exhibit 3 shows some common transactions and their effect on working capital.

Exhibit 3. Summary of Transactions--Funds Flow Statement

Nature of Item	Effect on Working Capital	Result
Cash dividend paid	Decreases	Use
Sale of long-term securities	Increases	Source
Acquisition of fixed assets	Decreases	Use
Net income	Increases	Source
Operating losses	Decreases	Use
Sale of fixed assets	Increases	Source
Term investments acquired	Decreases	Use
Noncurrent borrowing	Increases	Source
Paying off noncurrent debt	Decreases	Use
Stock dividend	None	None
Annual depreciation charge	None	None
Addition to surplus reserve	None	None

Depreciation

Depreciation often causes the most confusion of all transactions involved with the funds flow statement. Depreciation is neither a source nor a use of funds, although it appears in the funds statement. Depreciation expense reduces reported income, while an offset charge is made to the noncurrent account, accumulated depreciation. This expense does not require a current outlay of funds as do wages and salaries, or telephone expense. Because depreciation has reduced net income, but did not absorb funds currently, it must be added back to net income for the funds flow statement. In this manner, the increase in current funds resulting from operations will be correctly stated.

The total out-of-pocket cost of depreciation expense is recorded as an application of funds when an asset is acquired. Therefore, it is not again reported as a use of funds a second time. Because depreciation does not require a current outlay of funds, it can not directly affect the amount of funds provided. It is true, however, that the increase in currently available funds will be equal to the profit from operations plus depreciation charged.

We can summarize this discussion, and also illustrate that the only real increase results from profit in this manner: If a business can recover all expenses (including depreciation) and show a profit, the effect on the balance sheet is as follows: 1) Owners' equity increases by the amount of the profit, less dividends; 2) Current funds increase equal to profit plus depreciation; and 3) Long-term assets decrease by the amount of the depreciation. Therefore, if the funds "made currently available through depreciation" are used in current operations, then replacement of fixed assets must be provided for in another manner. The actual situation is that depreciation didn't provide anything.

Summary of Funds Flow

The funds flow statement should be used principally to determine the more basic capital movements of the firm. Directors should interpret the funds statement along with other financial reports to appraise management decisions. Should long term applications be matched with long term sources? What proportion of funds for plant expansion should come from term loans, equity capital, or continuing ample profits?

Business strategy may require management to have knowledge of a competitor's funds flow, but few companies publish these statements. However, management can obtain considerable information from the rival's annual reports and prepare a funds flow statement. A reasonably good job of deducing what transactions probably caused the change in balance sheet items can be made.

Cash Flow Statement

The cash flow statement explains what caused changes in the cash balance and changes in the components of working capital. All balance sheet accounts (current and noncurrent) involving a flow of cash are analyzed. Exhibit 4 shows changes in balance sheet items for a two-year period. The first approximation to the cash flows is shown by the plus and minus changes. Assuming no fixed asset sales, write-offs, or other hidden changes, we construct the cash flow statement in Exhibit 5 by knowledge of one additional item, net income. The total flow over the period was $19,550. Important changes in the current accounts are revealed. Further the program of B & D resulted in substantial increases in cash, inventories and investment in plant and equipment.

Exhibit 4. B & D Corporation

Comparative Balance Sheet

	Year Ending October 31 1961	1959	Changes
Assets			
Cash	$3,400	500	+ 2,900
Net Accts. Rec.	4,500	6,500	- 2,000
Inventories	9,000	6,300	+ 2,700
Other Current	700	100	+ 600
Total Current	17,600	13,400	+ 4,200
Gross Plant & Equipment	26,900	20,000	+ 6,900
Accum. Dep.	13,500	7,500	+ 6,000
Net Plant & Equipment	13,400	12,500	+ 900
Other Assets	250	100	+ 150
Total Assets	31,250	26,000	+ 5,250
Equities			
Accounts Pay.	4,900	6,500	- 1,600
Tax Liability	3,300	3,000	+ 300
Other Current	800	3,500	- 2,700
Total Current	9,000	13,000	- 4,000
Long Term Debt	3,000	1,000	+ 2,000
Common Stock	15,000	10,000	+ 5,000
Ret. Earnings	4,250	2,000	+ 2,250
Total Equities	31,250	26,000	+ 5,250

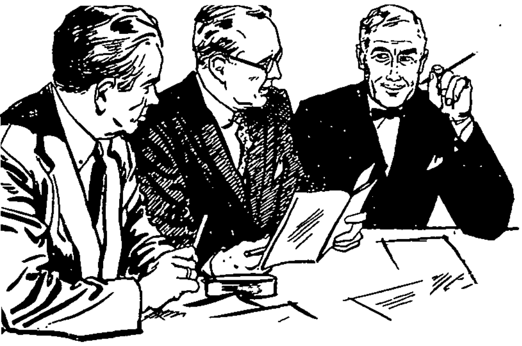
The primary sources, consisting of equity capital and profits, can now be balanced off against these uses. A statement like Exhibit 5 is essential to management for examining short run financial movements. It is most often prepared on a monthly or quarterly basis as the time period illustrated would obscure important seasonal fluctuations.

Two major differences in this statement from the Funds Flow Statement are: 1) The cash flow reveals causes of changes in the cash account, while the funds statement accounts for changes in working capital. Therefore, all balance sheet accounts (current and noncurrent) are analyzed. 2) The cash flow statement uses an adjusted total of both revenue and expense, while the funds statement requires the difference between the two (net income).

Exhibit 5. Cash Flow Statement, 1959-61

Sources of Funds:		
Decrease in A/R		$ 2,000
Increase in Tax Liability		300
Increase in Common Stock		5,000
Increase in Long Term Debt		2,000
Net Income	4,250	
Accum. Depreciation	6,000	10,250
Total		$19,550
Uses of Funds:		
Increase in Cash		$ 2,900
Increase in Inventories		2,700
Increase in Other Assets		750
Decrease Accounts Payable		1,600
Decrease in Other Liabilities		2,700
Dividends Paid		2,000
Investment in Plant & Equip.		6,900
Total		$19,550

A cash budget is a cash flow statement projected to the future rather than based on changes in the past. Use of these tools for planning and forecasting will be discussed in a subsequent issue.



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FINANCING LONG-TERM CAPITAL NEEDS

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This issue introduces determinants of the management decision regarding a firm's capital structure. The capital structure of a corporation refers to the "mix" of funds provided by owners and long-term creditors. The most common mix has variable proportions of debt (term notes or bonds), preferred stock, common stock, and retained earnings. An important task facing top management is to decide from time to time on the mix of long-term securities that is most desirable for achieving objectives.

It is difficult to treat the long-term financing problem alone. All aspects of financing, including short and intermediate credit needs, are interrelated. To appraise alternative capital structures an understanding of basic security types and how they permit the allocation of risk, income or cost, and control is essential.

Basic Security Types

Corporate securities fall into two main classes: (1) contracts of debt, and (2) participation in ownership. Bonds and term notes make up the contracts of debt; preferred and common stock comprise the second class. A summary of the important features is shown in Exhibit 1. You may wonder why internally generated funds have been ignored. Obviously internal funds are a major source of investment capital. Many managements strive to avoid the need for outside financing. A deliberate choice between equity capital generated internally vs. externally is made. Management exercises some control over the growth rate and rate of earnings retention. This partially governs the need for outside financing. However, a rational decision will include a study of effects with new external funds as well as internal.

Reviewing the characteristics shown in Exhibit 1, it is emphasized that the allocation of risk, income, and control is the result of bargaining and negotiation between management and investors. Management has considerable choice as to when to increase debt, grant priorities, or raise additional equity capital. There are some general restraints on management's ability to go beyond certain limits.

First and foremost, the amount and stability of earnings set the foundation for all negotiation for long-term capital. Second, management will seek flexibility to maneuver in the event of unexpected changes. This means always keeping a "reserve" of borrowing power. Flexibility in the broader sense means the ability to negotiate from a position of strength for the use of all sources of capital, at all times. Third, trading on the equity is limited by the fact that the investor's appraisal of the quality of debt declines as the proportion of debt rises. Higher cost of borrowed money is the result. Also, the volatility and riskiness of common stock are increased, thus increasing

Exhibit 1. A Comparison of Basic Security Types on Fundamental Features, and Modifications in the Allocation of Risk, Income, and Control.

Fundamental Features	Basic Security Types* Term Loan, Bond & Other Forms of Debt	Preferred Stock	Common Stock
Guaranty of payment	Yes	No	No
Priority of claims	First	Second	Third
Voting rights	None	Normally - only on some issues	Normally - yes
General level of risk:			
to investor	Low	Intermediate	High
to management	High	Intermediate	Low
General level of cost or return	Low	Intermediate with upper level fixed	Highly flexible
Tax shield on cost	Yes	No	No
Stability of return	Stable	More stable than common	Very stable to very unstable
Risk Modifications	a) Pledge of assets b) Limits on additional debt and other negative pledges. c) Method & timing of repayment; i.e., serial repayment, sinking fund, balloon balance, or repayment linked to earnings. d) Dividend restriction. e) Accelerated maturity.	a) Sinking fund b) Voting right on any additional debt or preferred. c) Call and redeemable features.	a) As senior securities achieve more secured positions the risk is shifted to common. b) Pre-emptive rights - protect against dilution by giving right to buy on pro-rata basis any new issue.
Income Modifications	a) Convertible bond b) Income bond	a) Participating preferred b) Convertible preferred c) Cumulative rights	a) Privileged subscriptions b) Stock rights & oversubscription privileges
Control Modifications	a) Through positive and negative covenants.	a) Through positive and negative covenants.	a) Nonvoting common b) Cumulative voting.

*Cooperative corporations may view capital certificates with fixed interest rates and fixed maturity dates as term debt or as preferred with a sinking fund provision. Non-interest bearing certificates, without maturity dates, unallocated reserves, and other types of retains, may be viewed as retained earnings. Retained earnings are the portion of total earnings retained for use in the business and are part of members' equity capital.

the cost of all elements in the capitalization. Certain security features are to the advantage of the issuer, others to the advantage of the holder. The final capitalization is a compromise of objectives acceptable to management and owners.

Analyzing Alternatives

Decisions regarding the "right" balance for capital structure can only be made with knowledge of circumstances, attitudes and objectives of owners and management at a specific time. There are pros and cons for each alternative. Note holders, preferred and common stockholders, existing and new shareholders may have conflicting views on what is best. We adopt the viewpoint of the existing common shareholders (in a cooperative the current users) as opposed to new shareholders. The reason--holders of the common equity accept the basic risks and commit resources for the protection of senior security holders.

Debt normally offers the best alternative for maximizing earnings per share. This is because of the low cost and the opportunity to trade on the equity of fewer stockholders for returns above cost. But it involves more risk because of the fixed annual burden on cash. Preferred may be less risky because of a smaller and more flexible annual burden. It may be less desirable from an income and control viewpoint. Additional common is less attractive to current shareholders because it may reduce earnings and dilute control.

To analyze alternatives quantitative measures relating the flow of funds to the burden of debt or ownership are required. Two common measures - times interest earned and the debt ratio - are not satisfactory measures of burden. The elements of the cash flow representing the burden of debt are: interest, sinking fund, payment due at maturity, and tax related to the above items. The preferred stock burden includes the foregoing and dividends plus tax related. Because corporate income taxes recognize some items as cost and exclude others, before and after tax items must be adjusted to obtain data that are consistently measured. Tax related is the amount of tax payable on an equivalent amount of taxable corporate income. We use the 30% rate applicable to net earnings up to $25,000. Common has no enforceable commitments but the measures of earnings per share, dividend per share, price/earnings ratio, and yield assume major importance.

Exhibit 2 shows that G & H Corporation debt constitutes 35% of capitalization, debt and preferred 45%, and the common equity is 55%. Standards such as 30% of capitalization in debt are widely quoted. The burden of debt can only be judged large or small in relation to the cash inflows available to meet it. Exhibit 2 also shows a table for the analysis of burden. The initial data for completing the table are indicated by asterisks. Some appear in the before and some in the after tax column. Any combination of before and after tax figures is meaningless. On interest, tax related represents the tax savings provided by debt and the after tax is the net payment. The before tax amount on the sinking fund is what the corporation has to earn to have the required fund after tax. The after tax figure for income shows what income would have been if there were no tax savings from the use of debt. The effect of depreciation is similar to interest. No method giving unequal ratios of burden before and after tax is properly designed. A common error is to add interest and sinking fund without taking into account the tax related.

The payout ratio (a) on common is similar to earnings coverage on bonds and preferred. The price/earnings ratio (b) shows common is selling at approximately seven times earnings. Earnings yield (c) and dividend yield (d) are measures relating dividends and earnings to the price of a share. All of these are important guides to investors. Ratios (e) and (f) show debt and preferred burdens on the basis of earnings coverage. Firms with a regular common dividend policy simply extend the analysis to include ratio (g).

We have illustrated quantitative measures useful for appraising the financial burden of the basic security types. Our next issue will relate these measures to the cost of capital and effect of new financing.

Exhibit 2. Capital Structure of G & H Corporation and Related Ratios for Burden of Debt and Equity Capital on Earnings.

	Amount 1961 (000)	Capitalization Ratios	Shares Outstanding	Earnings per Share (EPS)	Dividend per Share (DPS)	Market Price (MP)	Dividend Yield = DPS/MP
Long-term debt							
4% note payable due 1965	$4,000						
3½% debt certificates due 1961	1,250						
	$5,250	35%					
5% preferred stock	1,500	10	15,000	$130	$5.00	$100	5.0%
Total debt & preferred	$6,750	45					
Common stock	3,750	25	400,888	$ 4.69	$2.25	$ 32	7.0%
Retained earnings	4,500	30					
Common stock equity	$8,250	55					
Total Capitalization	$15,000	100%					

	Before Taxes (000)	Tax Related 30% (000)	After Tax (000)
Earnings before interest and taxes	$3,000 *	$ 900	$2,100
Depreciation charged 1961	2,500	750	1,750*
Approx. net cash inflow	5,500	1,650	3,850
Interest on debt	204*	61	143
Sinking fund due 1961 a/	2,250	675	1,575*
Total cash burden	2,454	736	1,718
Preferred dividends	107	32	75*
Debt and preferred stock burden	2,561	768	1,793
Common dividends	1,289	387	902*
Total burden (incl. Common)	$3,850	$1,155	$2,695

* Indicates initial information from income and balance sheets for completing the table.

a/ $1,000 on note and $1,250 on debt certificate, both due end of 1961.

a) Payout ratio = $\frac{DPS}{EPS} = \frac{\$2.25}{\$4.69} =$ 48%.

b) Price/earnings ratio = $\frac{MP}{EPS} = \frac{\$32}{\$4.69} = 6.8:1.$

c) Earnings yield = $\frac{EPS}{MP} = \frac{\$4.69}{\$32} = 14.7\%.$

d) Dividend yield = $\frac{DPS}{MP}$.

e) Cash burden coverage = $\frac{\$5,500}{\$2,454}$ = 2.2 times.

f) Preferred burden coverage = $\frac{\$5,500}{\$2,561}$ = 2.1 times.

g) Common burden coverage = $\frac{\$5,500}{\$3,850}$ = 1.4 times.

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THE COST OF CAPITAL

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In our March issue we discussed the three basic types of securities and focused attention on the flow of funds called for by contract or as a matter of policy. These flows were called burden, and ratios were developed for relating burden to the inflow of funds from operations. In this issue we discuss another relationship: that of the burdens of a particular security to the amounts that can be raised by issuing that security; that is, to the cost of capital.

There are three primary uses for a computed cost of capital figure: (1) selection of the lowest cost alternative for raising funds, (2) appraisal of anticipated rates of profit from a project against the cost of financing it, and (3) comparing the current cost of financing with a particular security against historical cost for that security. In this issue our discussion centers on the first use.

A wide difference of opinion exists on how to determine the precise cost for each type of long term capital. We adopt the viewpoint that a conservative estimate will best serve our purposes. The cost of capital is the amount of difference between the net proceeds made available to the borrower and the burden incurred as a result of the financing arrangement. It may be defined as the rate of interest that must be earned on the net proceeds to provide the cost elements of the burden at the times they are due.

Bank Loan vs. Extending Accounts Payable

We use this simple, two-alternative case to illustrate a choice based on an analysis of relative costs. Suppose a company has the choice of paying accounts payable on a delayed basis or borrowing $20,000 for a month and taking the discount for prompt payment. The bank quotes a rate of 6% per year. The normal practice on short term arrangements is to discount the loan, deducting interest in advance. The company obtains net proceeds of $19,900 and is required to pay $20,000 one month later, which we defined last month as burden. The cost is not the rate of 6% per year, because that rate was on the $20,000 and only $19,900 was received by the company. The cost is the rate that must be earned on the net proceeds to provide the $100 due in one month. Thus, the cost of the bank loan is:

$\frac{\$100}{\$19,900} = 0.503$ per month, or 6.04% per year (12 x 0.503) before tax.

Now, if the $20,000 is owed on a 2/10,n/30 basis the company can pay $19,600 within 10 days or $20,000 at the end of 30 days. If funds are not available and the company selects to forego the trade discount, the funds provided are $19,600 and the cost is $400. The rate that must be earned to produce the required $400 is: $\frac{\$400}{\$19,600} = 2.04\%$ for 20 days or 37% per year ($\frac{2.04}{20} \times 360$)

before tax. It is clear that the bank loan costing slightly over 6% is a bargain compared to the cost of 37% for raising funds by extending accounts payable. While the amount of dollars saved ($300) in our example is small, consider the implications of extending the practice of foregoing trade discounts on larger amounts over extended periods of time.

Costs of Fixed Return Securities

Costs for fixed return contracts, such as preferred stock, notes, bonds, and leases, are easiest to determine. We shall explain how the cost of preferred stock and term notes can be computed. (A discussion of leases as a method of acquiring assets without ownership is not considered at this time.) The principal types of cash costs associated with financial contracts may be classified as follow:

a) Periodic payments in the form of interest, dividends, or rent.

b) Payments to distributors of public offerings for services rendered and risks assumed. The charge is deducted from the price paid by the investor. Net proceeds go to the company and the difference between price to investor and to the company is called spread.

c) Other incidental costs, such as legal and printing costs, paid by the issuing company.

d) Any payment to a contract holder at the retirement of an issue in excess of the amount originally provided by the investor. This discount applies only to securities with a definite maturity. It may be amortized over the life of the issue as additional interest. A security sold at a premium would involve a downward adjustment of interest cost.

Preferred Stock

Determining cost of preferred without a sinking fund is relatively simple because: (1) Compensation to the investor is limited to a specified basis of dividend payment, and while payment is not mandatory, management should assume that it is; and (2) without a fixed maturity date, costs associated with item (d) are eliminated. We express the cost as an annual percentage on the dollars provided. The following prospectus on a public offering of preferred will clarify the cost calculations.

Amount: 15,000 shares, par	$ 100
a) cumulative dividend	5%
price to public	$ 100
b) spread	$ 2
proceeds to company	$ 98
c) other costs pd. by co.	$5000
other costs as a % of total issue	0.33%
net proceeds per share to company	$ 97.67

Although the public pays $100 a share, the company has available only $97.67 per share. The annual cash payment expressed as a percent would amount to:

$$\frac{\text{annual dividend}}{\text{net proceeds}} = \frac{\$5.00}{\$100 - (\$2.00 + 0.33)}$$

= 5.12% after tax. The reader already knows how to convert to a before tax basis from last month's discussion. At a 30% rate the before tax cost is 7.3%. (Before = After/1-r, where r = tax rate.) The reason for getting the before tax rate is to have a comparable figure to bank rate quotations on term notes. An alternative is to compute the after tax rate for the bank quotation.

Bonds and Term Notes

Because most agricultural firms make limited use of bonds, we omit the cost analysis associated with bonds. The calculations are similar to preferred but complicated by the fact that they must be repaid at a specific future date (cost item d).

Term notes are the debt instrument normally used by agricultural firms. Typically, these provide for serial repayment of principal, interest payable as earned, and often for a deduction of incidental costs associated with the loan (cost item c). An important item to consider when comparing the difference between the effective rate and the stated rate is the

Exhibit 1. Term-loan proposal arranged for calculation of effective rate of interest on weighted average of available funds.

Payment date	Principal due (A)	Interest due (B)	Time period	Principal Outstanding (C)	Available funds (A + B deducted) (D)	Time available (months) (E)	Product (D) x (E)
1 Apr 62	(loan advanced)		1/4/62-1/1/63	$100,000	$ 99,000*	9	$ 891,000
1 Jan 63	$ 10,000	$ 3,750	1/1/63-1/1/64	90,000	85,250	12	1,023,000
1 Jan 64	20,000	4,500	1/1/64-1/1/65	70,000	60,750	12	729,000
1 Jan 65	24,000	3,500	1/1/65-1/1/66	46,000	33,250	12	399,000
1 Jan 66	24,000	2,300	1/1/66-1/7/66	22,000	6,950	6	41,700
1 July 66	22,000	550					
	$100,000	$14,600				51	$3,083,700

* $1,000 incidental costs deducted by the bank from initial funds available when the loan is advanced.

amount available for each time period. A hypothetical term loan proposal will illustrate the cost analysis.

The principal advanced on April 1, 1962, is $100,000, with interest payable as earned at 5% a year but with incidental costs of $1,000 deducted, making available funds of $99,000. Exhibit 1 shows the type of information necessary to consider the cost of funds made available by a reducing loan. Column (A) shows the repayment schedule for principal, (B) the interest due, and (C) the principal outstanding. To obtain a single figure which has the mathematical effect of the various amounts, we multiply the amount available by similar time units (months). The weighted average is the sum of the products divided by total weights or $\frac{\$3,083,700}{51} = \$60,465$ or the average amount of funds available.

The only sure way to determine the effective or real rate from the borrower's viewpoint is to relate the dollar amount paid for interest and other costs to the amount made available. Thus the effective rate is:

$$\frac{\text{Interest + other costs}}{\text{Ave. amount available}} = \frac{\$14,600 + \$1,000}{\$60,465}$$

= 25.8% for 4.25 years or 6.07% per annum

A banker quoting a rate of 5% is merely giving the basis for the computation of the dollar amount. He is not quoting the effective rate of 6.07%.

Cost of Common Equity

The most tangible evidence of value for a common stock is its market price. This is usually based on (1) the income stream realized in dividends, and (2) an anticipated income stream not currently realized in cash. Total earnings as well as dividends are important to the shareholder, as measured by earnings per share (EPS) and dividends per share (DPS). Percentage payout is also important in the determination of market price at any point of time. (See Exhibit 2 of our March issue.) The price may be arrived at from market quotations or the specific terms of an issue. Closely held companies, whose stock is not traded must rely on the latter source or rely on quotations of similar securities - a difficult job. To measure the cost of the common equity capital we need to treat separately: (1) the sale of new common, and (2) internal financing.

New Common: The present cost of common is the earnings yield or earnings per share divided by market price (EPS/MP), illustrated as ratio (c), Exhibit 2, March '62. The problem is that new shares may alter (EPS), affecting (MP), and thus stockholders' return on investment. The minimum acceptable result is one where total earnings increase in proportion to the increase in shares outstanding. How many new shares is determined by the price per share and the funds required. Suppose G & H Corporation (Exhibit 2, March '62) wants to raise $100,000 by sale of new common. The prospectus is as follows:

Amount: 3,226 shares	par	$ 10.00
Price to public		$ 31.00
Spread		$ .20
Proceeds to G & H		$ 30.80
Other costs of issue		$1000.00
" " as % of total issue		1.0%
Net proceeds per share		$30.49
Market price 1961 ave.	$32	
EPS 1961	4.69	

To measure the cost as a rate of return on the dollars invested, we realize that each new share will produce only $30.49 of investable funds and not the 1961 average market price of $32. The after-tax cost of capital on the new issue is: Anticipated earnings per share, if the investment were not made, divided by net price on the new stock, or $\frac{\$\ 4.69}{\$30.49} = 15.4\%$. This is the cost of the new common and the investment project must produce this return to prevent dilution of the existing shareholders' values. Even this return is not completely compensatory to the existing shareholders, because any increase in shares reduces their participation in future growth. The new project should enhance the prospect of earnings' growth enough to counteract this type of dilution. Management should not neglect financing to a safe maximum with senior securities, to protect existing common shareholders.

Retained Earnings: From our discussion of security issues one could erroneously conclude that most of the money raised is from new issues. Actually, the largest single source is the funds produced by operations and retained in the company. Some managers regard retained earnings as being costless. We recognize that some earnings must be retained regardless of cost but argue for assigning a cost to the remainder. Some earnings must be retained to support dividends which maintain investors' confidence in the value of the stock. Cost for these earnings has no significance.

The cost of profits held in the capital structure can be evaluated by opportunity cost or as an equity. Opportunity cost is the income foregone by not investing elsewhere. It places the cost of retained earnings at the highest return which could be obtained by drawing profits out and investing them elsewhere. The equity cost concept recognizes that investors are subject to income tax on dividends received. The sum of earnings that can be retained in a company is greater than the sum that would remain in investors' hands if earnings were distributed. In other words, a company does not need to earn as much as the shareholder to do as well for the shareholders' interests. We suggest using the minimum individual federal income tax rate of 20%. The cost of reinvested earnings will be:

$\frac{(0.80)(EPS)}{(MP)}$, or using previous data,

$\frac{(.80)(\$4.69)}{\$32} = 11.7\%.$

Another tax rate frequently used is the 25% on capital gains.

Summary

We have shown how to obtain the cost of major sources of long-term funds. These have been discussed separately, but there are interrelationships among costs for the types constituting any firm's capital structure. To arrive at a composite cost of capital for a company, a weighted average should be used. This is the sum of the products of the percentage cost of each type of capital times the percent each type is of the total.

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CASH PLANNING

Leon Garoian and Arnold Haseley
Marketing Management Specialists

A business earning annual profits may at times experience severe shortages of cash funds. When the firm's output or sales are seasonal, when collections are slow, or when dividend or capital expenditures are high, the firm may be handicapped by insufficient cash. The cash budget is a management tool that may be used to predict cash requirements, and is an essential part of financial planning.

The cash budget is a forecast of cash receipts and disbursements against which actual cash received during a specified future period is measured. This period may extend to two years. But as a matter of practice, cash budgets or projections are usually prepared on an annual basis, being further divided by quarters and monthly subtotals.

Other terms often used to describe cash planning include cash.budgets, financial projection, financial budgets, cash requirements, and cash plan.

Cash budgets are a useful management guide that will provide the information necessary for:

- Financing seasonal cash needs
- Developing a sound borrowing program
- Developing efficient use of cash
- Developing a sound program of debt repayment
- Providing for investment of surplus cash in profit-making enterprises

There are three basic methods for cash budgeting: 1) Receipts and disbursement method (a determination of the flow of cash, meterials, or expenses charged to and from various classes of accounts); 2) Adjusted earnings method (an adjustment of earnings income by all noncash transactions such as depreciation); and 3) Working capital differential method (a projection of working capital figures on the basis of assumed relationships to anticipated volume).

Cash budgeting by the cash receipt and cash disbursements method is most commonly used, and the one we discuss. It is flexible, and allows for budgeting for very short periods of time - even on a weekly basis if necessary. This method permits effective control of cash, since it provides for comparisons among actual cash receipts, cash disbursements, and budget estimates. Cash disbursements can be timed to cash receipts, making possible close control over payments. Coordinating cash disbursements with cash receipts enables cash balances to be maintained at desirable levels. Therefore, we will discuss the following aspects of cash budgeting by the cash receipts and cash disbursement method:

1. Estimating cash receipts
2. Estimating cash disbursements
3. Estimating cash requirements

Estimating Cash Receipts

The largest single source of cash receipts for most agricultural businesses is cash product sales. Other important sources are collections on receivables, income from investments, sale of company assets, rents, borrowing, and sale of new company securities.

Total sales can be forecast on the basis of past experience and current conditions. Cash sales can be forecast on the basis of past ratios of cash sales to total sales for the time period included in the cash budget.

$$\text{Percent cash sales} = \frac{\text{Cash sales in comparable period}}{\text{Total sales in previous comp. period}}$$

Projected cash sales = Total projected sales x Percent cash sales

Sales projections must take into account expected prices, quantities, and quality of products. Economic outlook based on state, federal, and industry sources are helpful in projecting sales quantities and prices, in addition to internal records. Any unusual trend should be taken into consideration.

Forecasting collections on receivables may be more difficult, but must be done. One method is to obtain from past collection periods a distribution of the time elapsed between the sale and the receipt of payment. For the G & H Corporation, selling on net 30 day terms, the frequency distribution of collections on receivables is as follows:

Exhibit 1. Collections on Receivables

Month after sale	Percentage received
Same month	30%
Second month	60%
Third month	5%
Fourth month	2%
Longer than four mos.	3%

Thus, if we are preparing a quarterly cash budget, we can safely forecast that 95 per cent of our estimated sales in this period will be collected.

If sales terms and collection patterns vary, greater accuracy may be achieved by forecasting collections on receivables for each distinct group of customers. For instance, sales to jobbers may average over 60 days before payment, while sales to institutional buyers may be collected in 30 days.

Estimating Cash Disbursements

Cash payments may be more difficult to forecast because they involve more factors than receipts. Budgets of costs and expenses provide a starting point on estimating cash payments. Capital outlays are obtained from the capital expenditures budget. Purchases may be estimated from the purchases budget. Major items of disbursements are payrolls; operating expenses including fuel, materials, and supplies; purchased services; income taxes; repairs; dividends paid; debt retirement; interest and advertising. (Exhibit 2.)

For some items the time lag between when a cost is incurred and when payment is made is short and uniform. Payroll expense is an example. Normally, however, materials used in production are not equivalent to the purchases that must be paid for during the budget period. If there are no cash purchases, monthly outlays for purchases may be estimated as follows:

Add: gross purchases, in-freight costs, accounts payable beginning of month

Less: sum of purchase discounts, returns and allowances, accounts payable at end of month.

The result is the cash outlay for merchandise or supplies.

It should be evident at this point that the cash budgeting routine requires supporting schedules and cross references for each item budgeted. Payments for expenses, for example, (Exhibit 2, line 3 under disbursements) are supported by work sheets and cross indexed to the budget schedules for manufacturing overhead, selling expense, and administrative expense.

Exhibit 2. Cash Budget, G & H Corporation

Third Quarter

	July	August	September
		Thousands of dollars	
Estimated receipts:			
Cash sales	$ 35.5	$ 36.3	$ 64.5
Accounts receivable	50.0	51.1	88.4
Other income	2.2	2.2	2.2
Total receipts	$ 87.7	$ 89.6	$155.1
Estimated disbursements:			
Accounts payable	$ 33.2	$ 32.2	$ 29.3
Payroll	17.1	19.6	17.3
Expenses	34.5	37.9	43.1
Taxes	3.1	3.3	4.1
Advertising	1.2	1.2	1.2
Dividends	-	12.5	-
Interest payment	3.2	3.2	3.8
Plant and equipment	3.0	2.5	-
Fixed loan repayment	5.0	5.0	5.0
Total disbursements	$100.3	$117.4	$103.8
Net receipts (disbursements)	$(12.6)	$(27.8)	$ 51.3
Cumulative net effect on cash	$(12.6)	$(40.4)	$ 10.9
Beginning cash balance	$ 32.0	$ 19.4	$(26.4)
Net receipts (disbursements)	(12.6)	(27.8)	51.3
Ending cash balance	$ 19.4	$ (8.4)	$ 24.9
Minimum cash balance desired	18.0	18.0	18.0
Cash overage or (shortage) including minimum cash balance.	$ 1.4	$(26.4)	$ 6.9

The cash budget need not be a complicated tool. It may be simply designed and easily prepared. A typical form sheet for the cash budget is shown for the G & H Corporation as Exhibit 2.

Exhibit 2 reveals that although total cash receipts for the 3rd quarter exceed cash disbursements by $10,900, the firm will be short of cash in August. In large part this is due to a dividend payment in August (which perhaps could be deferred).

This schedule reveals that G & H Corporation cash resources are adequate to finance operations during July even though projected cash disbursements exceed cash receipts by $12,600. This is because of the balance of $32,000 at the beginning of the month. Incidentally, G & H has established a minimum cash balance of $18,000 it desires to carry at all times.

In August, projected cash disbursements exceed cash receipts by $27,800. The end of month balance for August is ($8,400), requiring management to provide for temporary borrowing of $26,400 on the firm's established line of credit. This enables management to maintain the minimum desired cash balance of $18,000, and meet their cash disbursement requirements.

In September, cash receipts exceed cash disbursements, for the first time in the 3rd quarter, by $51,300. Deducting the $26,400 deficit for the month of August from the September net receipts of $51,300 leaves an ending cash balance for September of $24,900. This is $6,900 above the minimum monthly cash balance desired.

Estimating Cash Requirements

The G & H Corporation included in its cash planning a desired minimum cash balance of $18,000 (Exhibit 2). The desired minimum cash balance must be selected thoughtfully. Cash is a nonearning asset. Every dollar kept in a cash account is a dollar which is not earning income from being invested. A zero cash balance is not feasible, however, because flows of receipts and disbursements are not perfectly coordinated, and because banks often require a minimum cash balance in customers' accounts.

The minimum balance for G & H Corporation is based on providing a cash cushion to absorb the total excess of disbursements over cash receipts during the cash planning period without creating an overdraft.

Determining the cash balance at the end of any month can be related to cash on hand at the beginning of the period in this manner:

(Cash on hand at beginning of the month + cash receipts during the month (cash sales, accounts receivables collected, and additional borrowing)) - (cash disbursements during the month) = cash on hand at end of the month.

If the cash balance for any month is insufficient, it may be necessary to plan a borrowing program for several months, based on expected disbursements and receipts.

Summary and Conclusions

Cash planning highlights certain financial facts for management, and is a worthwhile activity for that purpose alone. But in addition, cash budgeting forces those preparing such projections to consider many items of business activity which might otherwise not receive adequate attention.

Cash planning of itself is the minimum planning in a business. To do cash planning, the corporation must also do some sales, expense, and inventory planning. For example, sales volume must be predicted, in terms of total quantity and a breakdown of cash sales as opposed to credit sales. This requires an analysis of accounts receivable.

In addition to reviewing receipts, cash forecasting requires that management analyze all expenses, including production, selling, and administrative. Fixed outlays for which the company is committed will be brought into sharp focus, including such items as bank loan repayment schedules and interest charges.

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COST ACCOUNTING FOR CONTROL

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Cost accounting is a tool of both financial and managerial accounting. As part of financial accounting it provides the basis for calculating inventory values and the cost of products sold which are incorporated into a firm's financial statements. As part of managerial accounting, it provides information for planning and controlling current and future operations.

The cost concepts for each of these purposes are different. In financial accounting the objective is to assign to each unit of product a fair share of total costs incurred in its production. For planning purposes, cost information is collected that can help to indicate the cost effects of possible alternative courses of action. For control, the objective is to assign controllable costs to responsibility centers.

Part of the difficulty in cost accounting is in the definition of terms. The appropriate definition depends on the purpose for which the cost classification is to be used.

Cost Concepts for Control

In costing for control purposes, we are primarily interested in: 1) the collection of costs by responsibility centers; and 2) the control of these costs.

A responsibility center is an organizational unit performing a single function or group of related functions with a single head accountable for activities of the unit. A responsibility center may be a department, a section of a department, or a combination of departments, but accountability is vested in a single person. The delineation of cost responsibility centers often uncovers areas of overlapping responsibility in organizational charts. These need to be corrected for effective responsibility accounting.

Cost Centers are often production departments, or subdivisions of departments, down to an individual machine through which the product passes. There may be several cost centers within a responsibility center. Basically, costs are collected by cost or responsibility centers, depending on which is the smaller cost unit, and costs for the other are obtained by addition.

Controllable Costs are costs over which the responsible supervisor can exercise some significant degree of influence. Someone, at some time, has control over every item of cost. However, we are interested in current controllability by the responsible manager. He must be able to do something about these costs. Controllable costs are not quite the same as direct costs. Direct Costs are those that are charged directly rather than on the basis of an allocation. They are costs specifically traceable to a cost center. Controllable costs are those direct costs that the responsible manager can control. By definition an allocated cost is not controllable. At a given responsibility center it is partly a matter of judgment when making the distinction between controllable and noncontrollable. It may also be influenced by the method of charging costs to the center, as illustrated in Exhibit 1.

Standard Costs

Standard cost budgets are one means of comparing what was done with what should have been done. In this section we broadly consider: 1) Standard costs for direct labor and materials; and 2) standard costs for manufacturing overhead.

Framework for Standard Costing

Standard costs imply a formal analysis of the standard relationships between input and output. It is the cost that should have been incurred on a given amount of output rather than the costs actually incurred. Although standard costs were originally developed for manufacturing operations, the same concepts can be used to cover nonmanufacturing services. All that is necessary is that there be measurable output and a standardized relationship between physical inputs and units of output. The relationship between input and output is normally arrived at by inspection of historical data or engineering and statistical analyses of the production process involved.

A standard cost implies a level of costs that is reasonably attainable by the average experienced worker under expected conditions. Setting tight standards to stimulate cost reduction overlooks the distinction between cost reduction and cost control. Cost reduction means reducing the standard cost. Cost control, on the other hand, means reaching cost levels that will meet pre-existing standards.

Direct Labor and Material

Standard labor and material costs are developed on the basis of a unit of product or output. By multiplying the standard time required to produce a product by the standard wage rate per unit of time, we have the standard labor cost per unit. The total standard labor cost for a period is found by multiplying standard labor cost per unit by the number of units produced.

The difference between actual and standard costs is known as a variance and represents the gross departure of the cost center's performance from standard. The labor variance can be broken down into a time and rate variance.

- -- The time variance is the difference between standard hours and actual hours priced at the standard rate per hour.
- -- The rate variance is the difference between the standard rate per hour and the actual rate per hour multiplied by the actual number of hours.

The net variance is the sum of the two or the difference between actual and standard cost.

The reason for breaking down the total labor variance into components is to arrive at the controllable portion of the variance. In most cases, the manager cannot be held responsible for the rate variance but may be held entirely responsible for the time variance on the grounds that he should control the time required to do the job. This is not always the case as the two factors are interdependent. The objective is to isolate the portion of the variance that is the result of efficiency or inefficiency.

Material cost variances are broken down into usage and price variances by the same general procedure as that described for direct labor. In addition a mix variance may be computed to show the effects of price changes in each material used and in the amounts or kinds of materials used. This is the usual case where a process uses several different materials or grades of the same material. The controllable variances are most apt to be the usage and mix variance. The mix variance may also be related to the quality of the product, although this does not appear in the calculations.

Exhibit 1. Some Methods of Charging Maintenance Costs to Operating Departments and the Possible Interpretation by the Operating Department Manager.

Method	Interpretation
A. Do not charge any maintenance costs to the operating departments.	A 1. The operating manager has no responsibility for maintenance costs. 2. The operating manager requests and the maintenance department has the responsibility for doing the job. 3. The operating manager has no motivation to curb unnecessary request.
B. Prorate total maintenance costs to the operating departments on the basis of the number of direct labor hours in each.	B 1. Maintenance costs are expected to vary proportionately with plant activity. 2. The operating manager has no direct responsibility for maintenance work. 3. The operating manager is told what is his fair share of total maintenance costs.
C. Charge the operating departments for each maintenance job at a prescribed amount for each type of job.	C 1. The operating manager is responsible for situations that create the need for work, such as equipment breakdowns. 2. The maintenance department is responsible for the cost of doing the job. 3. The operating manager is unconcerned with the efficiency of maintenance men since he is charged a set amount regardless of actual cost.
D. Charge the operating departments for maintenance work at a prescribed hourly rate for each hour that a maintenance man works in the department.	D 1. The operating manager is responsible for situations that create work and for the time taken by the maintenance people to do the work. 2. The operating manager has some control over the work of maintenance men. 3. The operating manager <u>may</u> have authority to hire outside maintenance people if he believes the work can be done less expensively than the internal rates.

None of the examples given is necessarily better than the others. Furthermore, there are numerous other methods. Generally, control techniques that will motivate people to do what is best for their own self-interests and also be in the best interest of the company will be more successful. What is best, however, is quite clearly a matter of viewpoint.

The essential feature of standard costs for control is that variances are reported by responsibility units, rather than by jobs or products, and as responsibility center totals. By reporting lump sum variances, the supervisor can at a glance see if variations fall within or outside of an acceptable range. Those outside are subject to further study.

Manufacturing Overhead

Two characteristics of overhead costs make it impractical to use standard product costs for control reporting:

1) Overhead costs are common costs with respect to individual lots or units of products.

2) Overhead costs include fixed elements that do not vary proportionately to changes in production volume.

Overhead costs, also referred to as indirect costs and manufacturing expenses, are defined as those that are not or can not be traced to specific product costing units. This means that any standards designed to assist in the control of overhead costs must be departmental standards rather than product standards. Because of fixed elements in overhead costs, standard product overhead costs per unit are too restrictive at low volumes and too lenient at high volumes of output. Useful standards, therefore, are stated in terms of totals for a given time period under alternate conditions of production volume. Standards such as this are known as flexible budgets.

Flexible budgets reflect the amount of cost that is reasonably necessary to achieve certain volumes on the assumption that production is stabilized at this volume. There are several problems involved in establishing flexible budgets, such as the selection of an index of production activity, organizational and descriptive classifications of costs, and the use of techniques for estimating cost variability patterns. The net result is that it is practically impossible to design a system where controllable variances on overhead are reflecting only a responsibility center's performance. Flexible budgets do point out deviations from expected conditions and it is then that informed analysis and judgment must be exercised.

Motivation for Control

Control is a personal thing, since people control rather than systems or accounting reports. Different control methods motivate people to different responses. What control method is best depends on what management wishes to accomplish.

Consider the problem of controlling maintenance costs in a processing plant that has a separate maintenance department. How should the costs of the maintenance activity be charged to the several operating departments in the plant?

Exhibit 1 summarizes some possible methods of charging maintenance costs to the operating departments and the motivation the operating department manager is apt to receive.

Summary

Managerial accounting information can be useful in the control process by providing:

1) a means of communicating information on what management wants done;

2) a means of motivating people to act in such a way as to enhance the attainment of objectives;

3) a means of appraising performance or of deciding how well managers have performed.

Standard costs are one way to provide yardsticks for appraising controllable performance. They also are strong motivators and communicators of what management wants done, when they are properly designed and used.

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VOLUME-COST ANALYSIS FOR PROFIT PLANNING

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Executives are constantly faced with the task of choosing the best of several possible alternative courses of action. For many decisions management needs to know the volume-cost relationships of its particular business. Included are decisions on capital expenditures, make or buy, product mix, pricing, and cost control.

Volume-cost (V-C) analysis involves making an estimate of what a firm's cost will be at different levels of operation and the resultant effect on profit due to the changing relationship between volume and cost. Through V-C studies, management can obtain information on: 1) the minimum volume required to keep itself out of a loss; 2) the minimum volume necessary to reach its profit objectives; 3) the probable profit or loss at volume ranges reasonably expected; and 4) the relevant cost information on such questions as whether to drop a product line or to accept or reject a particular order at a specified price. The formal system of V-C analysis is generally known as variable or flexible budgeting.

Variable Profit Approach

Managers faced with the problem of making decisions on a segment of their company's business will find the concept of variable profit very useful. The segment may be a product line, sales territory, distribution channel, or a particular group of customers. Variable Profit is the difference between the sales attributable to a particular segment and all of the variable costs associated with those sales. It represents the segment's contribution toward the company's fixed costs and profits including those fixed costs traceable to the segment. Variable profit is used to make decisions based on estimates of short-run profit effects of alternative courses of action. Variable profit figures are also used for the V-C-profit relationships shown on profit graphs.

Longer-run and more specific problems will often make use of Contribution Profit. It is the net difference between sales attributable to a segment and all costs that can be charged directly against those sales without allocation of common costs. It is a segment's contribution to common overhead and profit.

Exhibit 1 shows both the variable and contribution profit concepts. The P/V ratic is the ratio of variable profit to sales and can be used directly in the calculation of break-even points as we will show in the next section.

Profit Grafts

Profit graphs are pictorial representations of the relationships between V-C and profit. There are many variations--we will consider only one, the break-even

Exhibit 1. Profit Contribution Income Statement

	Total	Product A	Product B
Sales: (units)	1,000	600	400
(dollars)	$4,000	$3,000	$1,000
Variable Costs:			
Direct labor & materials	1,600	1,350	250
Mfg. overhead	400	350	50
Selling & Adm.	400	300	100
Total Variable Costs	2,400	2,000	400
Variable Profit	$1,600	$1,000	$ 600
P/V Ratio	40%	33%	60%
Fixed Cost - (Product Traceable)	$ 600	$ 400	$ 200
Contribution Profit	$1,000	$ 600	$ 400
Fixed Cost - (Common)	$ 600		
Net Profit (EBIT)	$ 400		

(B-E) chart. Used singly, the B-E chart helps show the probable effect on profit of changes in volume. Two or more can be used to illustrate effects on profits from changes in product prices, mix, and other variables.

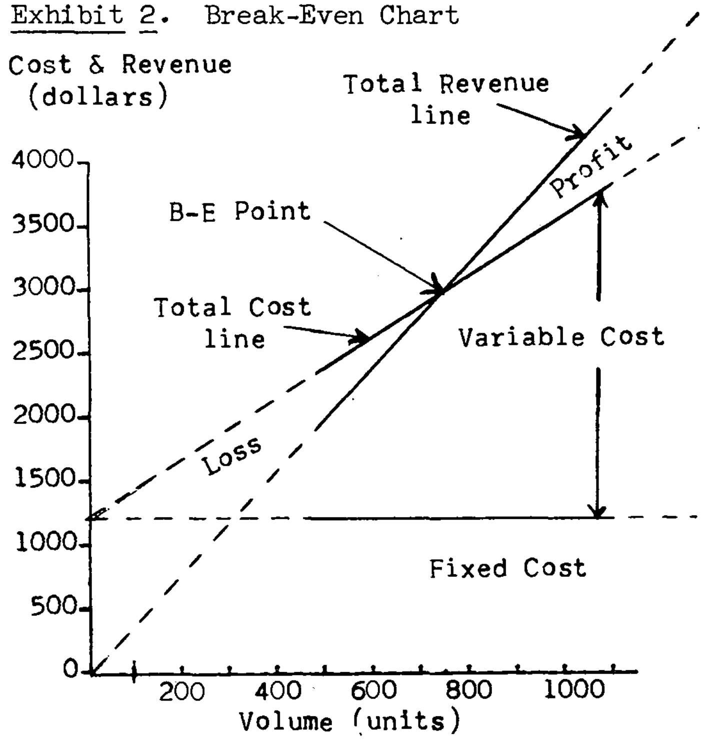
Exhibit 2 illustrates a typical B-E chart and is based on the figures in the total column of Exhibit 1. The B-E chart shows volume, in sales units, on the horizontal axis and cost and revenue, in dollars, on the vertical axis. The total revenue line is plotted by multiplying sales price per unit ($4) times any given volume. Fixed costs remain constant at $1200 over the entire volume range considered. Variable costs of $2.40 per unit are added to fixed costs to give us the total cost line. We show dotted lines outside the 500 to 1100 unit range of volume implying that the straight line functions apply only within this range. The B-E point is where the total cost line intersects the total revenue line. Above this point the firm is making a profit--below it is incurring losses. The B-E point can be calculated as follows:

$$\text{B-E Volume (units)} = \frac{\text{Fixed Costs}}{\text{Selling Price/unit} - \text{Variable Cost/unit}} =$$

$$\frac{\$1200}{\$4.00 - 2.40} = 750 \text{ units;}$$

Or using the P/V ratio we obtain $\frac{\$1200}{40\%}$ = $3,000 of sales, which when divided by $4.00/unit again gives us 750 units. To calculate the volume required to reach a minimum profit objective, simply add the desired profit goal, in dollars, to the fixed costs in the numerator.

Exhibit 2. Break-Even Chart



While the B-E point is of interest in pointing out the margin of safety at anticipated volumes, revenues, and costs, the underlying relationships are much more important. Notice that at a "normal" volume of 1000 units, profit will equal $ .40 per unit. From the relationships shown an important conclusion can be drawn: although normal profit is $ .40 per unit it will be earned <u>only</u> at this volume. At lower volume levels less will be earned; at higher levels, more. For example, at a volume of 2,000 units, normal accounting profit would equal \$1.00/unit. Below the B-E point losses will be incurred at the rate of \$1.60 for each unit drop in volume. This is the variable profit per unit. Above the B-E point, each additional unit will earn \$1.60. These relationships suggest that a useful way of studying the profit factors of a business is to concentrate on fixed cost and variable profit because normal profit per unit is different at each volume. In this framework, there are four, and only four, ways in which the profit of a firm can be increased:

1. Decrease variable costs per unit;
2. Decrease fixed costs;
3. Increase selling price per unit;
4. Increase volume.

The straight line B-E chart shown is valid only within limited volume ranges and on the assumptions of constant prices, product mix, and cost relationships. Unless carefully used, it is subject to a good deal of misinterpretation.

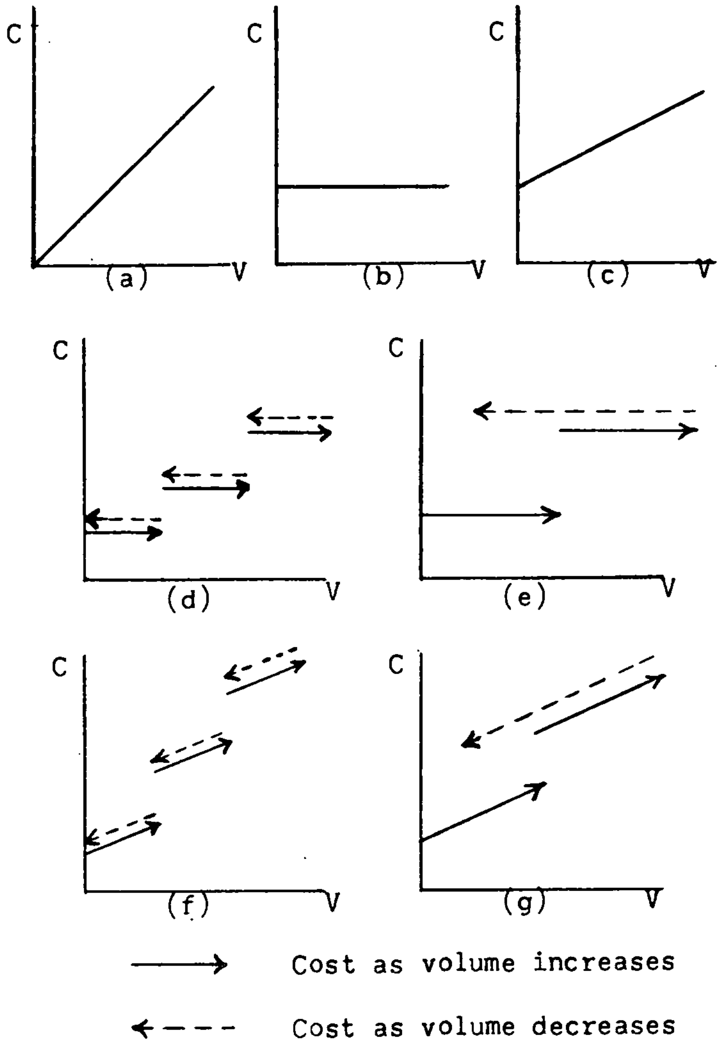
Most of the problems of V-C analysis fall under four headings:

1. Estimating the relationship between cost and volume;
2. Selecting an index of volume;
3. Estimating the relationship between revenue and volume;
4. Allocating fixed costs to specific segments.

Patterns of Cost Variation

The successful application of variable budgeting requires reliable estimates of costs for the period ahead and what the costs should have been in the period just ended. Reliability depends primarily on the accurate determination of cost behavior at various operating centers under forecasted operating conditions. When careful studies of V-C relationships are made the types of cost behavior shown in charts (a) through (g) can usually be found at different cost centers:

(a) Cost changes are in direct proportion with changes in volume of activity. This is a variable cost; e.g., cans in a processing plant.



(b) Cost remains fixed within the practical production capacity of a cost center regardless of changes in volume. This is a fixed cost; e.g., property taxes. The time period is crucial as all costs can be varied with volume if the time period is long. It is usually taken as a year or less.

(c) This cost contains both fixed and variable elements and its V-C relationships can be represented by a straight line. This is a semivariable cost as it varies directly but less than proportionately with volume; e.g., maintenance or clerical costs.

(d) & (e) Illustrate discrete chunks of cost or the step nature of certain fixed costs with volume increases and decreases. Illustration (d) might reflect the behavior of supervisory labor costs while (e) might reflect depreciation costs.

(f) & (g) Illustrate semivariable costs when the fixed element steps up or down when volume moves beyond certain levels. When the fixed element can be removed with volume decreases, such as office rental equipment, then (f) prevails. If the fixed element cannot be removed, once incurred, then (g) is the appropriate illustration.

Estimating Cost Behavior

As a first step, the usual procedure is to plot the historical cost-volume relationship for past periods on graph paper for the particular cost category being studied. This will give some insight as to the presence or absence of association between cost and volume and possibly indicate the general volume levels where steps occur. If the cost category can be represented by a straight line, any budget estimate within the anticipated volume ranges can be determined by the following formula:

$C = a + bV$, where C = budget cost estimate at any volume

$b = \dfrac{C_2 - C_1}{V_2 - V_1}$ $\quad C_1$ = estimated cost at V_1

C_2 = estimated cost at V_2

$a = C_2 - bV_2$ $\quad V$ = level of activity between V_1 and V_2

or $C_1 - bV_1$ $\quad V_1$ = probable low level of activity

V_2 = probable high level of activity

If the cost is completely variable (a) will be equal to zero, and if completely fixed (b) will be equal to zero. This is the formula for a straight line and can also be applied to the step-line cost functions by calculating a separate line for each segment. When the historical cost line is updated to reflect anticipated operating conditions, it becomes a variable budget line.

Selecting an Index of Volume

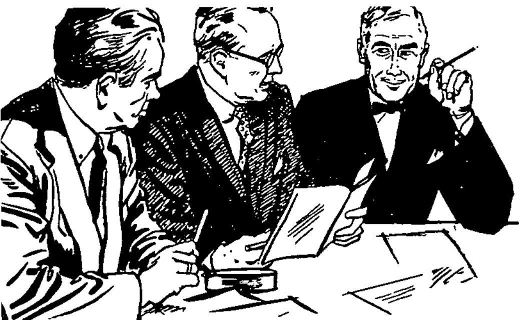
Selecting a proper measure to indicate the level of activity is one of the crucial factors of variable budgeting. V-C studies for profit planning purposes require an index where both revenues and expenditures are considered. The index should be one where a change in the mix of products, channel of distribution, or other variables that do not affect the activity index will not affect profit either. Such an index is hard to find. In companies where a variety of heterogeneous products are made and sold the dollar volume of sales may be used to provide a common index. In a single product plant or where products are more or less homogeneous, the use of units of output is generally more desirable. In a multi-product plant, the V-C-profit relationships obtained from different product mixes will be different if the variable profit from each product differs, regardless of whether physical units or dollar volume is used as a measure of activity.

Revenue Functions

The typical profit graph revenue line is based on the assumption of constant prices and net returns at all levels of output. This might lead to the erroneous conclusion that any increase in volume is inevitably profitable. Certain actions are often necessary to move from one level of volume to another, such as price shading, additional promotional costs and use of lower margin distribution channels, to cite a few. All of these would alter the profit spread. However, for limited volume ranges and in response to factors outside the firm's control, the straight line revenue function may be fully justified.

Fixed Cost Allocations

The fixed cost allocation problem becomes more acute as the segments analyzed are narrowed, such as moving from a total firm position to one product line. The allocation question is important primarily in the calculation of B-E points. The greater the allocation of common fixed costs, the higher the B-E point. This is of no great concern because the precise location of the B-E point is not important for decision making. The B-E point is primarily to increase awareness of the need to cover fixed cost and most allocations will do this job. For V-C implications in decision making the emphasis is on variable profit and fixed cost increments. No amount of allocation will shed light on these problems.



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APPLYING VOLUME-COST ANALYSIS

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Tactical decision making often calls for a knowledge of both variable and fixed cost increments under alternate plans. We shall only touch on the usefulness of the variable and contribution profit concepts in three areas:

1. Pricing.
2. Make or buy problems.
3. Keeping or dropping an "unprofitable" product.

Pricing Decisions

Pricing a product is one of the most delicate management decisions. Many factors are involved, such as whether a company is a "price setter" or a "price follower," but one factor that cannot be overlooked is cost.

Pricing a New Product

The conventional mark-up pricing formula of:

$$\frac{\text{Direct Material}}{\text{per unit}} + \frac{\text{Direct Labor}}{\text{per unit}} + \frac{\text{Overhead}}{\text{per unit}} + \frac{\text{Profit}}{\text{per unit}} = \frac{\text{Price}}{\text{per unit}}$$

is deceptive if management is unaware of the assumptions underlying the computation of unit costs. As an example, let's consider the case of Olympic Feeds, Inc. Olympic has acquired a new 100,000 ton capacity plant that will permit substantial cost savings and the marketing of bulk feed for the first time. The accounting department furnishes the figures shown in Exhibit 1 to the manager for his use in pricing bulk feed. Does the report provide a sound basis for making a pricing decision?

Exhibit 1. Olympic Feeds Inc. -- Estimated Costs and Suggested Selling Price for Bulk Feed.

	per ton
Direct materials	$50.00
Direct labor	2.00
Plant overhead (325% of direct labor)	6.50
Total plant costs	$58.50
Selling and admin. costs (10 1/4% of plant costs)	6.00
Total costs	$64.50
Profit goal before taxes (10% of costs)	6.45
Suggested selling price	$70.95

On the surface, Exhibit 1 appears to be logically arranged, and granting that other pricing factors appear favorable, such as being reasonably in line with competitive conditions, the manager might agree to the $70.95 price. The fallacy lies in the static nature of the cost and profit picture. The accountant has suggested an attractive price based on a projected volume of 80,000 tons. This represents 80% of plant capacity, which

Exhibit 2. Olympic Feeds Inc. -- Revised Cost and Profit Estimates for 40-60,000 Ton Volume Range

Variable Costs	per ton	Fixed Costs	Total
Direct materials	$50	Fixed plant overhead	$280,000
Direct labor	2	Selling and administrative	480,000
Variable plant overhead	3		
Total Variable Costs (v)	$55	Total Fixed Costs (F)	$760,000

Selling price (sp)	Variable profit/ton (sp - v)	B-E Volume (Vm)	Volume to reach profit goal (Vm')*
$ 70.95	$ 15.95	47,649 tons	69,145 tons
75.00	20.00	38,000	55,143
80.00	25.00	30,400	44,114

where, $Vm = \frac{F}{sp - v}$ $\qquad Vm' = \frac{F + P}{sp - v}$

* The pre-tax profit goal (P) is based on 8% return on an investment of $3 million after taxes. (P = $342,857 @ 30% tax rate)

was the normal running capacity of Olympic's old facility. Actually, management projects that its sales will range from 40-60,000 tons in the near future. At the $70.95 price what would happen to profits within this range? Exhibit 2 shows revised cost and profit estimates. The volume required to break-even and to reach a stated profit goal is shown under three alternate selling prices. At the original price of $70.95, the volume required to reach a satisfactory profit goal is substantially above that expected by management, and the B-E volume is above the minimal volume forecasted. This price is unrealistic from a cost point of view.

Even if volume was reasonably expected to equal the assumed 80,000 tons, this method of pricing is superior to the markup pricing formula because it forces recognition of: 1) the fact that actual sales will seldom equal predicted sales; 2) the changing cost-profit relationships at different volumes; and 3) the need for accurately predicting cost structures under actual operating conditions and achieving these cost levels.

Evaluating Price Reductions

Another pricing decision is whether or not to reduce prices to stimulate demand, with the expectation that greater volume will result in reduced unit costs. Whether a price cut will increase profits depends on two major factors: 1) The additional volume generated, and 2) the V-C relationships for the particular business. To make an intelligent decision the first essential is to have clearly in mind the V-C structure for your business over the range of output under consideration. Then either the formula for Vm or Vm' can be used to calculate the minimum volume to prevent a loss or to reach your profit objective under any proposed price reductions.

An alternate method can be used when current profit is considered satisfactory but management wants to know the minimum increase in volume required to maintain current profits under a proposed or forced price reduction. By using the formula:

$$\triangle V\% = \frac{\triangle S\%}{(100 - v\%sp_1) - \triangle S\%} \times 100$$

where $\triangle V\%$ = minimum volume increase required (as % of V_1) to maintain profit with a price cut of $\triangle S\%$,

V_1 = volume before price cut,

sp_1 = selling price before price cut,

v = variable cost per unit,

$v\%sp_1$ = variable cost as % of sp_1,
$\triangle S\%$ = price cut as % of sp_1,

any price decrease can be evaluated in terms of the volume required to maintain profits at the pre-price reduction level. To illustrate, suppose Olympic Feeds wanted to evaluate a price cut of $5/ton or from $80 to $75/ton.

$$\triangle S\% = \frac{\$5}{\$80} = 6.25\%$$

$$v\%sp_1 = \frac{\$55}{\$80} = 68.75\%$$

$$\triangle V\% = \frac{6.25}{(100 - 68.75) - 6.25} \times 100 = \frac{6.25}{25} \times 100 = 25\%$$

A 25% increase in volume is required from the pre-cut level to maintain profits. (25% of 44,114 = 11,029 + 44,144 = 55,143 which checks with Vm' in Exhibit 2 @ $75/ton.) This formula is a useful shortcut for detecting the effect of voluntary or forced price reductions on volume required to maintain profits.

Evaluating Custom Order Prices

A frequent problem faced by management is whether or not to accept a custom order at a price below normal and one that may not cover full unit cost under the usual price and costing procedure. Managers are normally aware of the concept of "spreading overhead" but again this can be misleading if V-C relationships are not really known. Suppose Olympic Feeds is operating at 55,000 tons and they receive an offer of $65/ton for 10,000 tons of feed. Should this order be accepted? One manager might calculate that his full cost at 55,000 tons is $68.82 and therefore this offer is too low to be accepted. Another manager might assume his variable cost at 65,000 tons will continue at $55/ton and a $65 price is acceptable as a $10/ton contribution is made to overhead. Actually, neither approach is correct. Full cost figures are irrelevant here -- what is important is incremental revenue and costs. To evaluate this offer first requires rechecking the accuracy of Exhibit 2 for any incremental increase or decrease in either variable of fixed costs.

Variable cost may increase above the 60,000 ton level and there may also be an incremental increase in fixed cost. The "floor" price above which Olympic might accept the offer depends on total incremental cost/unit, which <u>hypothetically</u> might be as follows:

Increase in materials cost,	10,000 x $50 =	$500,000
Increase in labor cost,	10,000 x $ 3 =	30,000
Increase in variable overhead,	10,000 x $ 4 =	40,000
Total increase		$570,000
Total increase/unit		$ 57

A price below the "floor" price of $57/ton will result in a financial loss. Whether or not the $65 offer should be accepted for its current profitability depends on two other crucial factors. <u>What effect will the acceptance of this order have on the general price structure of the business, and is it price discrimination if the product is not differentiated?</u>

Make or Buy Decisions

A problem that often confronts management is whether it is more costly to make or to buy certain parts or equipment used in the production process. Many of these problems require techniques of investment analysis. Our example of a food processing company analyzing the decision to make or buy field tote boxes is arranged so that the investment aspects are insignificant.

This company has a maintenance and repair shop as part of its processing operation. The tools and equipment necessary for the production of tote boxes are available and the shop has idle capacity for three months (DJF) of the nonprocessing season. The shop foreman is on annual salary.

The company can buy tote boxes for $10 apiece for June 1 delivery and requires 1000 boxes. Engineering estimates have been made on the variable costs and other costs have been estimated by management as follows:

	Cost/box	Total Cost
Variable:		
Direct materials	$ 4.85	$ 4,850
Direct labor	3.85	3,850
Variable overhead	.20	200
Total variable	$ 8.90	$ 8,900
Fixed:		
Set up shop line		$ 100
Tear down shop line		50
Inventory carrying costs (120 days @ 6%)		178
Total cost		$ 9,228
Purchase cost		$10,000
Total savings		$ 772

This analysis shows that a small savings can be made by making the boxes. Notice that no use was made of full cost in this analysis. All of the general fixed costs assigned to the maintenance shop are ignored because they are sunk costs and irrelevant to this make-or-buy decision. It was assumed that the shop foreman could supervise this operation. However, incremental fixed costs that would not be incurred if box production was not undertaken are shown. Finally, other factors, such as quality, the shifting of risk when needs fluctuate, and the need for comparative cost data, might influence the make-or-buy decision at any particular time.

Keeping or Dropping a Product or Product Line

This decision always involves changes in the volume of operation and is therefore often associated with incremental changes in variable and fixed costs. Hence the concept of contribution profit is very useful. The decision to drop or keep a product depends primarily on management's expectation of its future profitability and its profitability relative to other company products.

To illustrate, let's look at the case of a food processor with five product lines (A-E) as shown in Exhibit 3. Product lines A and B are the primary lines with D and E used in various mixes with A and B. Because product line C was somewhat foreign to the main lines of this company and represented a small tonnage procured from a relatively large number of growers, management questioned the wisdom of continuing to pack line C. Since the only product line data available to management was direct cost and total fixed cost allocations, there was no reasonable basis for making the decision. The pertinent question here is how much does the product line contribute to common fixed costs and profit after paying for all costs directly attributable to it? By dropping line C $7000 of fixed costs could be avoided, and possibly some revenue could be realized from sale of equipment, but at a loss of $73,726 contribution profit. Armed with the type of data shown in Exhibit 3, management not only decided to retain product line C but to investigate the potential for increasing its output and/or adding other lines.

Naturally there are many other considerations in whether or not to drop a line. A line may need to be carried even if it contributes nothing to common fixed costs and profit if it is essential to a firm's sales program. On the other hand, when a choice is possible the V-C profit relationships of operating with or without the line should never be overlooked.

Exhibit 3. Variable and Contribution Profit by Product Lines for a Food Processing Firm, 1960

Item	Product Lines					Total
	A	B	C	D	E	
Packs (tons)	3,600	2,123	181	142	56	6,102
Selling price/ton	$ 340	$ 230	$ 836	$ 454	$ 320	$ 319
Variable cost/ton	226	200	390	260	228	222
Variable profit/ton	$ 114	$ 30	$ 446	$ 194	$ 92	$ 97
Fixed cost - Traceable (total)	$ 92,000	$30,000	$ 7,000	$ 3,800	$1,400	$134,200
Contribution profit (total)	$318,400	$33,690	$73,726	$23,748	$3,752	$457,694
Common fixed costs (total)						$400,000
Net profit						$ 57,694

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PLANNING CAPITAL INVESTMENTS

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Investing company funds in productive assets is one of top management's most difficult jobs. Capital investments convert assets from their most flexible form, as cash, to a state in which assets are inflexible and difficult to adjust to changes.

Capital investments are current outlays made in anticipation of future benefits. Capital investment policies are determined largely by profit motives: to maintain or expand sales volume, to maintain or reduce costs, or to shift operations to more profitable activities. Sometimes capital investments are made when immediate economic benefits are not evident: employee recreation facilities, improved lighting and ventilation, or music piped to work areas. The ultimate objective of most capital investments is to provide a rate of profits adequate to attract additional capital to the company.

In this issue, we consider some tools for analyzing capital investments to determine whether a proposal is justified by the earnings it will create over time.

Types of Capital Investments

We consider capital investments relating to 1) expansion (Shall we build or acquire a new plant?), 2) replacement (Shall we replace existing equipment with more efficient equipment?), 3) Choice of equipment (Which of several available pieces of equipment should we purchase?) and 4) whether to buy or lease.

Steps in Considering Capital Investments

Three related steps can be followed to appraise new capital investments:

1. Estimate sales volume, prices, costs of materials, operating expenses, transportation costs, capital investment requirements, strength and nature of competition, rates of obsolescence or depletion, and other relevant economic and business factors.

2. Summarize basic estimates of annual income, life of project, and capital investment for appraisal purposes.

3. Exercise managerial judgment in determining whether or not:

   a) The anticipated return is large enough to warrant the business risks involved.

   b) The investment opportunity is attractive in view of alternative opportunities.

   c) The timing of the investment is right relative to anticipated developments which might affect expected returns.

Of these three steps, we concentrate on alternative methods of carrying out step 2, describing the weaknesses and advantages of several methods of analyzing and appraising capital investments.

Before describing these alternatives, it is necessary to understand how return on investment is computed because it is the basis for comparing alternate investment opportunities. The simplest case involves an annual return with the investment repaid as a lump sum. Thus, a $1000 investment for five years with an annual return of $80 is returning $80/$1000 = 8% return on investment. If the annual return included a partial repayment of the original investment, the denominator should reflect the amount of the investment outstanding during the year. To simplify this type of calculation, tables relating the present value of future returns from a lump sum investment today are used.

Return on investment is the discount rate that, when applied to earnings, equates the present value of the earnings to the investment. It gives the present value of dollars to be earned in some future year in terms of the return on investment needed to make that a current value. For example, $250 to be earned a year from now has a value today of only $232 at a discount rate of 8 percent.

Determining Desired Rates of Return

The company's cost of capital provides one standard for appraising the desirability of undertaking a capital project. (See FMC-6, April 1962.) If the discounted rate of return does not exceed the cost of capital, an investment should not be made.

A company goal may establish a minimum rate of return. A discounted rate of return below this cut-off point eliminates some projects.

A third consideration is whether the planned investment precludes the company from undertaking other investments that fit better into long range plans, or earn a higher rate of return on investment.

Methods of Computation

Three methods of computation are commonly used:

1) Payback period, 2) Average return on investment, and 3) Discounted cash flow.

Payback Period

This computation tells how much time it will take for expected earnings from a proposal to pay back the initial capital outlay. This payback period can then be compared with a standard payback period to determine whether the project is acceptable. Payback period is computed by the following formula:

$$\text{Payback period (years)} = \frac{\text{Investment outlay}}{\text{Average cash earnings per year}}$$

For example, if the installed cost of a new piece of equipment is $60,000, and it will produce cash operating savings of $10,000 a year, it has a payback period of six years: $\frac{\$60,000}{\$10,000} = 6$ years.

Payback can serve as 1) a rough screen to pick out desirable high-profit projects and to reject those which show poor promise, 2) a measure of relative risks involved in projects, and 3) a useful procedure when a shortage of funds forces accepting only proposals promising a payback period after taxes of two or three years.

Although this approach is simple to compute, it is generally inadequate except for the above purposes for three reasons:

1. It ignores the economic life of the facility. If replaced 10 years from purchase date, the project will have produced a zero rate of return.

2. It ignores any time pattern in investment outlays and cash earnings, and ignores any recovery value. If earnings are zero in the first year, and rise gradually for six years so the average earnings are $10,000, the proposal will be less valuable than another in which earnings start at a

high level and gradually dwindle as the facilities get older.

3. There is no way to decide what the maximum length of payback period should be.

Average Return on Investment

This approach uses the following formula in computing the average return on investment:

$$\% = \frac{\text{Average annual cash earnings} - \text{Annual depreciation}}{\text{Average lifetime investment}}$$

Average lifetime investment may be computed by averaging the beginning and ending investment figures, no matter what method is used for depreciating the investment. Average investment in the preceding example is \$30,000, assuming no salvage value. Assuming a life of 10 years, average annual depreciation is \$6000, and the average return on investment is 13.3 percent.

$$\frac{\text{Average net earnings}}{\text{Average investment}} = \frac{\$10,000 - \$6,000}{\$30,000}$$

$$= 13.3\%$$

This method overcomes objections 1 and 2 of the payback method. It takes into consideration the expected life of the facilities and the amount of salvage value. However, it fails to allow for differences in the timing of outlays and earnings. The average return on investment procedure considers a project where earnings do not appear until the 10th year and a project where earnings are received uniformly over 10 years as being equally profitable. A method of discounting returns overcomes this objection, and is a preferable method of computation.

Discounted Cash Flow

The basis for this procedure consists of finding the interest rate that discounts future earnings of a project to a present value equal to its cost. This interest rate is the discounted rate of return on that investment. Briefly, the procedures involved are to:

1. Estimate total investment cost, including installation, etc.

2. Estimate gross annual earnings before depreciation.

3. From a table of present values, find the interest rate which equates the present value of the future earnings to the present cost of the investment. This is the discounted rate of return.

4. Compare this discounted rate of return with the minimum acceptable to the company. If the discounted rate of return is less than the desired cut-off point, the project should be rejected.

The underlying principle is that in making an investment outlay, a company is actually buying a series of future annual incomes by making a current investment. This is illustrated in Exhibit 1, where we examine the same problem considered by the average return on investment approach, now using the discounted cash flow, or present value, method.

Comparing returns from a \$60,000 investment with a uniform stream of earnings computed by both methods, the average return on investment approach showed a 13.3% return, compared to an 11% return computed by the discounted cash flow approach (\$60,649). If the company had a cut-off point at 12%, it would have accepted the project by the average return method, but would have failed to recover its full discounted investment by -\$1762.

Exhibit 2 shows computations for an investment proposal for new equipment of \$2000 plus \$200 installation cost, with an anticipated life of five years. There is no salvage value. This example differs from Exhibit 1 in that annual gross returns vary each year in Exhibit 2, but were constant in Exhibit 1. Gross earnings in this example range from \$200 to \$1200 annually.

Looking at year 4, the \$1200 to be earned in that year has a present value of \$710 at 15%, and \$596 at a 20% return. In Exhibit 2, an interest rate of 20% is

Exhibit 1. Discounted Cash Flow Rate of Return with Uniform Stream of Earnings.

	Return on Initial Outlay of $60,000			
	10%	11%	12%	13%
Annual gross earnings	$10,000	$10,000	$10,000	$10,000
Earnings discount factor, 10 years	6.3213	6.0649	5.8238	5.5958
Present value, 10 years	$63,213	$60,649	$58,238	$55,958
Net present value	$ 3,213	$ 649	$-1,762	$-4,042

found to make the present value of the future earnings cash flow ($2198) equal to the present cost of the machine ($2200), so this is the rate of return on this investment.

Stated differently, if the company's cut-off point for return on investment is 15%, the company can afford to pay as much as $2538 for the machine and still earn the desired rate of return. If the company's cut-off point was a 22% return, it could only afford to pay $2078 for this equipment.

The discounted cash flow is a useful method for evaluating the desirability of investment outlays for these reasons:

1. It is economically realistic in confining the analysis to cash flows, and disregards arbitrary bookkeeping allocations.

2. It focuses on the whole life of the project and on its lifetime earnings.

3. It reflects the real difference in the value of near and distant cash flows.

4. It gives results comparable to cost-of-capital ratios so that decisions can be made safely on the basis of the relationship between indicated rate of return and the value of money to the company.

5. Earnings are stated as gross cash receipts (not figuring depreciation). Therefore, it is not necessary to allocate the cost of the machine over its life before computing return. Depreciation is allowed for because the interest rate which discounts the sum of present values to zero is the rate of return on investment after annual provisions for repaying the principal amount.

Our three methods of comparing return on investment have been simplified for illustrative purposes. However, it is necessary to bring into consideration the effects of income taxes where applicable. In the discounted cash flow method this is done by deducting the expected tax from the gross annual earnings.

Exhibit 2. Discounted Cash Flow Rate of Return with Variable Stream of Earnings.

	Gross earnings	Present value of earnings discounted at		
Year	before depreciation	15%	20%	22%
1	$ 200	$ 186	$ 182	$ 180
2	600	480	446	432
3	800	550	486	462
4	1200	710	596	556
5	1200	612	488	448
Total	$4000	$2538	$2198	$2078

Appendix B.

EXAMPLES OF STATEMENTS OF COMPANY OBJECTIVES

1. A Food Processor

   . To concentrate on premium quality products with large markets.

   . To control production scientifically.

   . To conduct continuous research.

   . To liquidate production annually.

   . To maintain an organization of top caliber men.

   . To pursue a continuous program of budgetary control.

2. A Steel Manufacturer

   . To earn sufficient profits to
     . pay a good rate of cash dividends to shareholders
     . maintain its properties in good competitive operating condition
     . build up and maintain sufficient working capital
     . reduce outstanding debt as rapidly as practical.

   . To develop a strong financial position through sound management of the capital structure.

   . To operate, maintain, and develop plants and facilities with maximum attention to quality, new product development, customer requirements, efficiency and decreased costs.

   . To obtain maximum sales volume with products matched to existing facilities at fair, competitive prices.

   . To assure present and future raw material supply adequate in quantity and quality and competitive in cost.

   . To improve labor relations and productivity by fair dealing with all employees and their lawful union representatives.

   . To improve and strengthen the corporation's management through acquisition and development of good personnel and through continuous effort toward simplification of organization structure and procedures.

   . To make all elements of the economy aware of the corporation's sincerity and good faith, to participate actively in good citizenship activities in the communities in which it operates and to encourage employees to participate in such activities.

- To develop and maintain an active program of research aimed at
  - improvement of diversity and quality of products
  - economies of operation.

- To improve the corporation's position in all of the above objectives in relation to
  - its competitors
  - its own past accomplishments.

3. A Household and Industrial Products Manufacturer

- Profits - Continuous adequate dividends to the stockholders, reserve for the development of the business, and participation by all employees in the profits of the business which result from their industry and teamwork.

- Control - Continuous financial control in the Board of Directors and general management.

- Management - A balanced general management that plans, organizes, coordinates and controls the business through good departmental administration and unifies the management through a management committee.

- Personnel - Men and women who average high in intelligence, industry, personality, and the ability to work harmoniously together.

- Products - A widening family of regular and specialty items of wax and allied raw materials, which will provide the consumer everywhere -- the family, institution, or industrial plant -- with products which contribute toward better living or working conditions, which foster cleanliness and health, and preserve and beautify material possessions.

- Markets - Healthy, economically sound expansion through increasing outlets and developing consumer uses throughout the world community.

- Plants - Modern facilities and equipment well located.

- Costs - Low competitive costs.

- Prices - Adequate prices to continue giving first grade products using the best means of distribution and communication to consumers and industrial users.

- Policies - To have the soundest and most progressive of business policies based on the best available information and research which the world affords.

- Pleasure - The business is to be operated in a manner to provide working conditions for employees and management that make work a pleasure.

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Appendix C.

EXAMPLES OF COMPANY POLICY STATEMENTS

1. A Food Processor

   A. Financial
   - . To maintain adequate capital in liquid form for
     - . working capital
     - . expansion and modernization of production facilities.
   - . To carefully budget and control every operation.
   - . To maintain a thorough system of current cost analysis.

   B. Growth
   - . To expand only when proved market exists.
   - . To spread the risk.
   - . To expand only after careful preparation and analysis of an operating budget.
   - . To do substantial share of business in chosen products.

   C. Production
   - . To emphasize quality.
   - . To urge economy and efficiency.
   - . To develop production through research.
   - . To control operations.

   D. Personnel
   - . To pay employees adequately for service rendered.
   - . To maintain reasonable hours of work and safe working conditions.
   - . To provide continuous employment.
   - . To place employees in work suited to their ability.
   - . To promote from within.
   - . To aid employees in times of need.
   - . To accord employees the right of discussion with management.

   E. Agricultural
   - . To preserve our soil heritage.
   - . To develop agriculture through research.
   - . To maintain a mutually beneficial growers' contract.
   - . To promote understanding between company and grower.
   - . To grow a portion of our own acreage for research and control purposes.

   F. Purchasing
   - . To choose suppliers on basis of reliability.
   - . To purchase at lowest ultimate cost.
   - . To keep inventories at minimum requirements.
   - . To purchase locally when practicable.

G. Sales
- . To liquidate annually.
- . To keep demand ahead of production.
- . To ship rapidly.
- . To consider nothing finally sold until consumed.
- . To emphasize company brand names.
- . To develop sales policies and methods through research.
- . To build industry, trade and consumer good will.

H. Price
- . To price for reasonable profit.
- . To price competitively.
- . To offer uniform quality at lowest possible consumer price within each grade.
- . To price alike to all of trade.
- . To sell F.O.B. less freight.
- . To guarantee price against our market decline.

I. Advertising
- . To spend for advertising a fixed minimum amount per case.
- . To time advertising to fit availability.
- . To make advertisements "events on a planned basis."
- . To distribute advertising impressions nationally.
- . To maintain advertising integrity.
- . To develop advertising through research.
- . To make the agency a part of the company.

J. Organization
- . To fix responsibility for each function. The manner in which such responsibility has been fixed is recorded in the Company Organization Manual.
- . Authority and accountability shall accompany the delegation of responsibility and the three are inseparable.
- . Individuals shall not circumvent the lines of authority.
- . Each employee shall, in so far as practical, have only one administrative supervisor.

2. A Grocery Products Manufacturer

A. Research
- . This company is dedicated to a program of research and expansion.
- . We believe that future growth, future employment, and national prosperity depend upon increased output of products.

B. Service to the Public
- . This company exists because of its ability to perform an economic service for the benefit of the public.
- . It can continue to exist only so long as it renders service to the public by efficiently producing and distributing quality products, thus satisfying the needs of the public and providing employment.

C. Free Competitive Enterprise
- . We believe that free American competitive enterprise, under constitutional democracy, is the best of all economic systems, productive of the greatest good for the greatest number.

- We believe that labor and management—together with farmers, consumers, stockholders, and government—are mutually dependent, and must all work together.

D. Human Relations
- We believe that the men and women of this company, with the integrity, experience and "know-how" which they represent, are the company's most important asset.
- Nothing is to be left undone which contributes to stable jobs, continuing opportunity, and security for our employees.
- We must maintain and improve the retirement system, health association, training courses, safety programs, and all other activities designed to protect the welfare of our employees.
- In addition, we must develop new programs to the same end.

E. Adequate Compensation
- We believe in fair wages and salaries, based on the nature and scope of services performed.

F. Quality Products at Fair Prices
- We believe in the maintenance of the highest quality and the greatest uniformity in all our products, and in the sale of these products at fair prices.

G. Fair Profits
- We believe in reasonable profit rewards for industry in relation to the services rendered. It is our duty to see that the stockholders receive a reasonable return for the use of the tools and facilities which they furnish and which make jobs and the business possible.

H. Sound Advertising
- We believe in truthful, informative, and helpful advertising.

I. Modern Selling
- We believe in broadening the customer acceptance of our products through aggressive, up-to-the-minute selling and through modernized sales, advertising, and marketing methods.

J. Realistic Accounting
- We believe that conservative and realistic accounting procedures are a vital safeguard for the stockholders' investment and for the jobs of our employees.

K. Public Relations
- The public has a big stake in our company. We believe in telling the public all the essential facts about the company that will give them full knowledge of its activities.

L. High Output and Lower Prices
- We believe that prosperity and world peace are founded on a vigorously functioning, highly productive economy—an economy of abundance.
- Greater efficiency and higher output per man hour (with lower unit costs) make possible lower prices and increased wages.

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Appendix D.

APPRAISING MANAGEMENT

Economic Function

1. What is the nature of the company's business?

2. Have the company's main products consistently contributed to the economic development of the nation? In what way?

3. Did the company reach important stature during the life of the founder?

4. Has the fundamental nature of the business ever changed? How, when and in which ways?

5. Who are the company's largest competitors? How has this picture changed since the company's inception? How have they fared relatively?

6. What technical improvements have competitors introduced? Have their effects upon this business been adverse?

7. Has the company's competitive standing risen since its inception? What proportion of the total market in its line of products does the company now obtain; what was the proportion 5 years ago—10 years ago?

8. From where does it get its supplies? Has this changed? When and how?

9. Where were its original markets? When and how have these changed?

10. What changes have occurred in its bylaws since the inception? What caused these changes?

11. What mergers have occurred?

12. Has the policy in merger been through exchange of paper or for cash?

13. What is the history of the acquisition of its fixed assets?

14. What changes in stock control have occurred?

15. Have any large stockholders disposed of their holdings? Were the reasons disclosed?

16. Has there ever been a struggle for stock control? What were the circumstances and the outcome?

17. Have any new dominant interests developed? Give particulars.

18. What has been the history of the company's banking connections?

19. Through what agencies, at different times, has the company placed its fire and liability insurance? Is it self-insured? If so, since when?

20. What changes have occurred in legal counsel employed by the company?

21. What changes in advertising agency or counsel?

22. What changes in public accountants?

23. Has the company ever defaulted on a public debt or a commercial bank debt?

24. To what extent in the past have its officers and directors held public office?

25. Has it ever engaged a registered lobbyist? In Federal or state legislatures?

26. Have the common stockholders always enjoyed pre-emptive rights?

27. In the past, what stock, if any, has been issued to executives and employees below the market?

28. What changes in managerial personnel have occurred since the inception? What was the significance in each major instance?

29. Has the company ever reduced salaries of chief executives? If so, when, why and whose?

30. Has the outlook of the management always been well harmonized with social changes?

31. Has the company ever passed through a management crisis or radically revised its corporate operations or methods?

<u>The Corporate Structure</u>

32. Who exercises the principal authority?

33. What are the relative powers of the Chairman of the Board and the General Manager?

34. What "outside" interests, if any, influence the management in the decision making?

35. Is there a "team" of directors on the board who attempt to influence other board members?

36. Who are the officers? Give full details regarding each.

37. What committees exist? How often do they meet? Who composes these committees?

38. Do the board and committees meet regularly or irregularly?

39. What records of meetings are kept; how are they distributed? What action results from their findings?

40. Does the formal structure or plan of organization of the company operate on a decentralized basis geographically or is control exercised over all functions from a central point?

41. Why were the plants first put where they are? Do these reasons still hold true?

42. Is location of plant best advised relative to raw materials, transportation, labor supply and markets?

43. Is the structure of the company such that the profitableness or unprofitableness of each product—under its going method of production and distribution—is at all times apparent?

44. In determining profitableness or unprofitableness how is administrative and selling burden loaded against the various divisions or products? How is the factory burden loaded—on an over-all plant basis or on "production centers"?

45. Is control of manufacturing operations and sales on a product basis or by divisions including several related products?

46. What percentage of the company's sales represent unprofitable business?

47. What proportion of the flexible burden does such unprofitable business absorb?

48. How many products are currently marketed and to what extent are they allied lines?

49. What products have been discontinued in the last 15 years and how many added?

50. Which product lines are most important and which are most profitable?

51. What percentage of the total market does each product represent? What percentage to the company's gross sales?

52. How does the profit on each product compare with the average for the industry?

<u>Directorate Analysis</u>

53. Who are the directors?

54. What is the length of service and age distribution of the board members?

55. How does age of directors compare with age of officers?

56. What other business connections of each director?

57. Why was each man put on the board and whom does he represent?

58. Is there a dissenting minority on the board?

59. By whom are meetings customarily conducted?

60. Are the meetings conducted harmoniously?

61. Is the board management dominated?

62. If the board is management dominated, what officer or officers carry the most influence?

63. Does the board act only on matters passed on by the executive committee or by an ad hoc committee?

64. Are major policy divisions presented to the board with explanatory information and with adequate time for consideration?

65. What is a director's remuneration? Expenses?

66. What are the stockholdings of directors? How have these stockholdings increased or decreased in the last 10 years?

67. Is it an inside board or an outside board? Since when?

68. What cross-directorates?

69. What proportion of directors are lawyers, bankers, customers, suppliers, competitors?

<u>Executive Evaluation</u>

70. What changes have occurred in executive personnel in the last 15 years?

71. Do any of these changes appear to have been made other than on merit?

72. What has been the cause of these changes? Dismissals, deaths, retirement, etc.

73. To what extent does the executive group represent neighbors, fraternity brothers, a specific college?

74. Is there, or has there ever been, nepotism in the organization?

75. Is there any one officer charged with Forward Planning on products from the sales and over-all policy position, or is the source of new products from research activities or from offerings from outside sources? To what extent are inventors encouraged to offer their ideas to the company?

76. Are there any rules written, or unwritten, which forbid employment of two or more members of the same family in supervisory and/or executive positions?

77. What are the personal characteristics of the boss?

78. Does he lead through intensiveness and aggressiveness?

79. Do his activities tend to create enthusiasm within the organization?

80. Does he merely select division heads or does he make division decisions?

81. What method is used to select executives?

82. Is it based on price or quality?

83. How do executive salaries compare within the industry?

84. What evidences are there of teamwork between executives?

85. What performance and results has the executive group attained in public "good will" as expressed by:

(1) Public Relations
(2) Community Relations
(3) Supplier Relations
(4) Customer Relations
(5) Stockholder Relations

86. In the case of each separate officer and/or department head:
    (a) Who is being trained to succeed him?
    (b) What is the rate of turnover of trainees working under him?
    (c) Which men trained by him now occupy an important office in other companies?
    (d) Is he regarded as a good man under whom to receive training?

Health of Earnings Growth

87. What growth in earnings and assets is shown by a 15-year study?

88. How has the company fared in all the significant trade cycles?

89. Has the company always kept itself in a highly liquid condition?

90. How have its asset ratios compared with those of its competitors?

91. To what extent and when did it go into the capital market for senior and/or equity funds?

92. In 15 years, how have its operating ratios compared with those of principal competitors?

93. Has it ever omitted preferred dividends or defaulted on its bonds?

94. When it has raised additional money, was the purpose to provide for future growth? Sinking funds?

95. Are there any non-callable senior securities?

96. Has it ever passed through a financial reorganization? Give full details.

Fairness to Stockholders

97. What percentage of earnings has been paid out as cash dividends in each of the last 15 years?

98. Has there been an established dividend policy?

99. Did the company pay dividends through all recessions? From current earnings or from surplus account?

100. What, if any, stock dividends have been given, and when?

101. Has the company ever underdepreciated in order to pay dividends?

102. Have there been any property write-ups based on valuations?

103. Have intangibles been written off the balance sheet?

104. How does the dividend pay-out percentage compare with that of the rest of the industry?

105. How many uninterrupted years of dividends and how many without reduction of rate?

106. Have dividends been so large as to prevent an adequate rate of growth of surplus?

Fiscal Policies

107. What has been the effect of fixed capital growth on liquid funds? Has fixed capital been financed from outside sources or from liquid funds and profits?

108. What has been the quick asset turnover?

109. What is the history of inventory turnover?

110. What is the history of collections and bad debts?

111. Depreciation—to what extent are plant and equipment depreciated and what has been done with the funds?

112. If expansion has been financed by new issues or borrowings give fullest possible details.

113. Has the company a controller? To whom does he report?

114. What is the position of the company as an insurance risk?

115. What contribution is made to pension or retirement fund by the company in proportion to the employees' contributions; are such contributions by the company related to net profits?

116. Who is Trustee of the Pension Fund?

117. What operating reports are issued and to whom; and in what form?

118. Are too many operating reports issued?

119. What budgetary control is exercised?

120. Are manufacturing statements projected as against estimated sales?

121. Are cash flow sheets prepared for a long time in advance and how frequently adjusted? Are cash disposition sheets issued for each month's operations with an analysis of changes in current position and reasons therefor?

122. Can the following record be obtained for the past 15 years?

Statistical

Earned per share ..... preferred
common
Dividends per share ..... preferred
common

Fixed charges earned:
Before income taxes and depreciation
Before income taxes and after depreciation

Time charges and preferred dividends earned

(Continued on next page)

Financial and Operating Ratios

Current assets + current liabilities

% cash and securities to current assets

% inventory to current assets

% property depreciated

Capitalization
- % long term debt
- % preferred stock
- % common stock
- % surplus

Sales + inventory

Sales + receivables

% sales to net property

% sales to total assets

% net income to total assets

% net income to net worth

Analysis of Operations

Net sales by products
Cost of sales by labor, material and burden
Selling, advertising, general and administrative expenses
Operating profit
Other income
Total income

Interest expenses, etc.
Other deductions
Net income before income taxes, etc.
Net income

Statement of aggregate cash flow for the last 15 years.
(All revenues collectively and statement of their disposition.
Not by years.)

Adapted from an actual management audit containing 301 questions to management, developed by the American Institute of Management.