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You Can't Compete with Careless Overhead

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IN the business battle of 1928, the fate of most enterprises, whether they are concerned with production, distribution, or service, will be determined largely by a single factor – overhead.

Master your "burden" and you will have pretty well mastered competition. Neglect it and you will inevitably be competing with your own careless overhead.

That reducing overhead is no longer a mere matter of penny-paring economies is brought out forcefully by Mr. Macauley in this article. He points out three ways in which overhead may be careless – because it is wastefully high, because it is wastefully low, because it is improperly distributed. Drawing on his broad background of experience, he outlines policies that will serve to correct careless overhead in almost any line of business.

CARELESS overhead pervades American business today. And careless overhead is something which no business can afford in the present circumstance of industries with production considerably beyond the market's capacity to absorb, of high wage levels, of low margins of profit. Nor is this condition confined to manufacturing industries. It is reflected on the whole surface of business. It is not especially difficult to do a respectable volume of business today; but getting a satisfactory profit from the volume is a very different sort of a story, indeed.

Because it is a little bit mysterious to most of us, we are inclined to think of it none too concretely. Therefore we tolerate a slackness in the whole relationship of our businesses and overhead – I am using the term "overhead," and shall continue to use it, not in the technical sense of the certified public accountant, but to refer to that whole undigested "burden" of cost and expense that every business carries above the perfectly obvious and readily handled direct costs.

The average rate of return on capi-

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tal investment under present conditions decreases steadily. Take the company with which I am most concerned: The standard return on capital in our business must be the measure of what use to make of our money. We have only so many dollars that we can put to work. Where can we use these dollars most profitably? If a new sales effort will probably yield 25%, a new battery of automatic machines 40%, then naturally we must choose the machines. To do otherwise would be to burden ourselves with careless overhead.

Overhead may be careless because it is too high, representing either extravagance in expenditure or waste in methods and practices. Or it may be careless because it is wrongly distributed over the business. Or because it is too low and represents penny-saving penury. The three varieties of carelessness are important in the order given. Perhaps I can make clearer just what I mean by each if I use illustrations.

If a business has five $10,000 men so that there may be two of them absent every afternoon in the week to play golf, its overhead is carelessly high. It could get along just as well, probably better, if it had four men of this caliber working hard every day, with week-ends for golf.

The company is suffering no less from careless overhead if its "burden" charges are improperly distributed among its lines so that one department of the store, or one product of the factory, or one branch of the service is consistently regarded as highly profitable, when a proper distribution of the overhead would indicate the necessity for reforming that part of the business, or doing away with it altogether. And this is no hypothetical illustration. In my many years in the cash-register and adding-machine industries I saw this very situation uncovered scores of times among our customers.

TAKE a company I knew of that sold several products. One of them sold very easily in competition with all other products in that line because the price was "right." Another and far more meritorious article in the line, one which on the face of it ought to have sold well in competition, was carried for years with very small sales because its price was just a little over the market and the company never could get a large enough sale to produce the volume necessary to make it the leader it should have been. Both these items were out of line with the rest of the products made by the company because one sold almost too easily and the other failed to meet the expectations of the management.

FINALLY the situation attracted the attention of one of the more thoughtful and analytical members of the firm and he set out to investigate. He found that in the making of the easy selling product a great deal of a rather expensive acid was used. This same acid was used in making several other of the firm's products, including the one which did not sell very well.

A little quiet investigating disclosed that for some reason or other this acid, bought by tank carloads, went into general overhead. His subsequent figuring showed that if the quantity of acid used in each product was charged directly to the product, the easy selling item would have to carry a very large share of the cost of that acid, and the item which had failed to meet competition would be relieved of just enough of the general overhead to bring it down into the competitive price range.

He promptly adjusted this careless allocation of acid and revised prices in line with the altered costs. The poor selling item became a leader, while the easy selling item became more difficult to sell but held its own very well against competition. The net results were increased sales and greater earnings for the business, for the item which had always been a slow seller had much larger sales potentialities.

I believe there is considerable adjusting to be done along this line all through our business structure, from production down through to the retail store or agency.

Then there is the company which carelessly permits the overhead to be too low. Take, as an example of this in the smallest and simplest terms, an observation which was forced on my attention in connection with my favor-

"A FUNCTION of management in eliminating careless overhead is to employ available dollars where they will bring the greatest returns. So we adopt no changes which pay less than 33% a year. We are shifting over a power-plant layout at a cost in seven figures – but it will pay for itself in short order."

ite brand of hats. For many years the salespeople in the store where I buy hats were supplied with no scratch-pads. If a customer wanted to make a memorandum he was given the back of an old envelope which had been carefully cut away from the address side. This was the firm's way of saving money. To me these envelope backs symbolized the reason why that firm had always had to struggle to keep going. Eventually a new management came in, took the clamps off the check-book, and the business is now prosperous. Trivial? Perhaps. But this brand of careless overhead keeps many a business from going ahead. The principle applies in the broader phases of management, including such activities as development and research, service to customers, and the like.

One reason why overhead comes in for so much attention now is that sales extension is steadily becoming more costly – which means less profitable. Today's changing business conditions make some of yesterday's standard methods as obsolete as the hoop-skirt. Yet a great many companies are spending money right now in trying to force volume when they could unquestionably make better returns on investment by cutting overhead and cutting costs.

AS the profits are steadily being eliminated from sales extension, economies are as steadily becoming the source of profit. The one dropping raises the other in importance. The two weights on a grandfather clock change relative position in identical fashion.

When his careless overhead is called to the attention of the average business man who unwittingly permits it, his immediate inclination is to strike out at the first head that shows. He wants to get rid of a few clerks, or economize on carbon-paper, or slash whatever comes first into his mind or to his attention. The chances are, of course, that his overhead is too high. It is in many companies. But this procedure is as far wrong as it is to allow careless overhead in the first place. For this is careless curtailing of costs.

The one sensible way to go at this problem of careless overhead is first to back away from the details of the business, and then make an analytical approach. Take one of the examples already cited – that of a company which has an apparently profitable department or product which is really losing money when the overhead is properly reapportioned. If such a department or product cannot be made a money-maker, then doing away with it entirely is often the one best treatment. Nobody likes to give up an enterprise after he has started it. It seems unpleasantly like letting go and admitting a lack of original judgment. Yet often it is the wise thing to do.

Only a few years ago we took such a step. We dropped our motor-truck business – deliberately let it slip painlessly out of existence. It had been doing an annual volume of about $25,000,000 and earning a net profit of $2,000,000. Looked at from the distorted perspective of our nearness to it, it looked extremely attractive. And $2,000,000 is not an annual profit to be lightly cast off.

BUT when we stood away at a distance we found that the motor-truck enterprise was out of drawing. When one organization tries to handle two or more widely divergent lines, it gets into too high an overhead expense. We saw that there was a better way to employ our energies, our time, our money.

The truck business required a disproportionate effort to operate. Despite its apparent similarity, it was wholly different from our main business of making and selling passenger automobiles. So we took our courage in our hands, closed out our trucks on hand and in process, then converted the manufacturing facilities which were thus made available to making passenger automobiles.

With the increased manufacturing facilities and the concentration of our energies on the remaining models, we went ahead at a rate far faster than ever we had expected. The $2,000,000 annual profit which we regretfully compelled ourselves to forego has grown to several times as much. Keeping on with trucks would have been keeping on with careless over-

head in the sense of a careless use of our capital and our effort.

Step number one, then, in battling careless overhead is to step back and view the business, as a whole and by units. What happens next must depend on the company and on its management. One manufacturer, in an industry at the other pole from ours, sold off a whole division of the business to the managers of that division – following which split both the parent company and the offshoot have made remarkable strides.

In the field of sales and distribution it works out similarly. Just recently there came to my attention a company in a mid-western state which makes a line of goods selling through retail channels principally in country towns. Working toward national distribution, this firm had salesmen in many states.

A new sales manager found the heads of the business particularly pleased with the current business they were getting from Kansas, and with the prospects of the Montana man. By training and inclination the sales manager loved figures. His first few days on the job were spent in gathering all manner of data. When his evidence was complete, he walked into the office jointly occupied by the president and the treasurer. Here is what his statistical witnesses proved.

"'. . . . instead of making profits from your salesmen.'"

The Kansas man was doing a reasonably good job, considering the extent of the territory and the distance between towns. He was getting few reorders by mail, however, and in consequence his average sale was about $25 and his average cost per sale was approximately $12. The Montana man was averaging $18 per order at a cost of $10. One salesman, however, was covering Wisconsin, the upper peninsula of Michigan, southeastern Minnesota, and northeastern Iowa. This man was making average sales of $39, at an average expense of $4. He was getting around his territory twice a year – by hard work. The towns happened to be better for the product than in the states farther west and the towns were so close together he could make three times as many calls in a day.

"You have been thinking in terms of building a national business instead of making profits from your salesmen," the sales manager told them. "With your permission, I'm going to call in the Montana man, the Kansas man, and the Wisconsin man. Then we're going to divide the Wisconsin man's territory into three pieces. As fast as we can get the right men, we'll put three more into Wisconsin and the neighboring territory. Our man ought to see his customers once a month, not twice a year. After we get this local gold mine working well, we can begin to worry about the more distant states."

The change was made less than a year ago. Already the sales in the Wisconsin territory equal 50% of the previous total sales of the company. Iowa, Illinois, Minnesota, Michigan, and Indiana total 75% of the previous total sales. Meanwhile the selling expense over the territory covered by the present distribution is 12%, where it was 19% when the efforts were scattered from Montana to Georgia.

"To meet today's problems of shrinking margins."

The situation is comparable with the one so frequently seen, of a company going after export business at great expense when there is a bigger market to be developed at less cost at home. The mid-western manufacturer with national aspirations was letting himself labor under the burden of careless overhead until his new sales manager showed up the condition by a proper allocation of the expenses. Four or five years ago, when sales came relatively more easily, the mistake of sales policy might never have been discovered unless some one of an accounting bent had entered the department.

In line with the necessity to meet today's problems of competition and shrinking margins, it is obviously no longer merely advisable to make sure of accurate allocation of all overhead items. It is mandatory.

No matter how accurately an accounting department may work, no matter how logically the allocation of overhead may be planned out, there must always remain a bulk of items in any business that nobody can conceivably distribute with mathematical precision. These must be divided according to some one's best judgment, which means that their allocation is simply the closest approximation it is possible to make.

It seems to us that a policy of ours brings us the closest feasible approximation to accuracy. We have set up the premise that we do not pay clerks to make guesses and then record their conjectures. As the logical conclusion, instead of having each individual item, or class of items, split by a clerk and allocated to what he considers the proper destination, we accumulate these debatable items into an overhead account which makes a sizable lump. Then an executive with full knowledge of the business uses his ability to allocate the lump sum at that point in our accounts where it becomes necessary to know exactly where we stand in regard to individual items. We find that one executive's thoughtful analysis is better than a lot of clerical conjectures.

The basic need in a business, whether it is manufacturing, distributing, or service, is to get an accurate allocation close to the product which is sold, and not at non-essential intermediate points. It is a simple job of reasoning – for any one in any line – to determine what facts are valuable and then concentrate on these, discarding the rest.

It was in this respect that the manufacturer was unpardonably careless of overhead in charging expensive acid to general overhead instead of allocating it to the various products, as eventually had to be done. While it is desirable to allocate every possible item of cost or overhead as closely as possible to the various products in a line, this meticulous allocation of charges should not be carried to the extent of giving split-fraction figures on, say, intermediate parts or subassemblies which are seldom or never sold as such.

"What we needed to know costs on was the finished car."

We found, for example, that we could actually better afford to give away the occasional crank-case we sell separately than to keep complete records so that we might price it accurately. It is better sense to make a shrewd estimate of the cost and price accordingly.

For many years we maintained a battalion of clerks to keep costs on various parts as we turned them out in the plant. When we began to analyze our requirements we arrived at the not obscure conclusion that what we needed to know costs on was the finished car – we divide between the body of the car and the chassis because our price differentials come in on this basis.

If we still permitted careless overhead, if we still permitted the theoretical advantage of knowing every cost to overshadow the horse-sense practicality, we should still be spending hundreds of thousands of dollars to

maintain non-essential records on the cost of parts and subassemblies.

It is easy enough to make a special study of such costs when there is occasion. We buy comparatively few parts. But on those which we are willing to consider buying, our rule is that we will make the part ourselves unless we can save half the overhead. Thus if the direct cost of making a piece is $8 and the overhead $2, we must get a price of $9 or less to make it worth buying outside. Similarly, we can tell without a great deal of difficulty whether it will pay us to turn over to a distributor the handling of our automobiles in a given territory, rather than use a factory branch of our own. But we do not keep a great accumulation of figures always ready so that we can make a quick decision on the rare occasions when such questions come up. It involves less trouble and expense to make up the figures specially for the occasion. We have dropped that overhead; it represented expensive luxury.

"One of the chief sources of careless overhead."

It is the same way with other paper work. Needless paper work is one of the chief sources of careless overhead in many businesses. It could easily be so in ours if we did not watch it every minute. To avoid all the excess overhead that we can we have centralized control of practically all overhead functions in the man who controls our budgeting. He has the "sympathetic glass eye" for the whole organization. And his office is the logical place for this control, since budgeting ties in intimately with the whole question of careless overhead. Essentially, budgeting consists of backing away from the business, and, from the advantage of perspective, sizing up what will happen. Control of the budget gives this individual authority to banish a great share of careless overhead.

For instance, he undertakes to say what reports a department head should have and how they will come to him. This prevents a duplication of information by unassociated departmental groups, and it prevents gathering information which is needed only rarely. Likewise, the reports are made in such form that they are interchangeable throughout the business; the treasurer's office can understand a sales report in standard form just as well as can the sales manager. Thus we have the production of essential reports only, through central control. And if a department head wants a set of facts for a particular purpose, he goes to the central authority and is told: "So-and-so already gets a report on that, borrow his; I'll compile this for you in my statistical department"; or, "You may have it made up this time but don't do it regularly."

The budget control on the departments helps to control this. If a department head wants to add a clerk, he has to show cause. If, then, his cause is the need for reports, he is caught red-handed. We couldn't sell our cars in today's highly competitive market if we had them loaded with this kind of overhead.

"Two points are well worth watching when analyzing overhead...."

Budget control also makes sure that the approach to cutting careless overhead will be analytical – for unless the man who handles the budget is analytical, he has no business handling it.

Two points are well worth watching when analyzing overhead and devising ways to keep down the careless part – time to elapse before the expected return is effective, and rate of return.

An automobile plant must maintain a thoroughly competent engineering force. Yet we find we save on overhead and maintain our position in the industry by using outside consulting engineers to find the weaknesses of our manufacturing that our own men overlook. As a result, we are getting some suggestions, previously overlooked by our plant men, which pay their cost in 30 days; plenty of the suggestions pay out in a year.

In accordance with the principle already pointed out, that a function of management in eliminating careless overhead is to employ available dollars where they will bring the greatest return (whether in sales, production, or what-not), we have been forced to rule that we can adopt no changes which pay less than 33% a year. As an example of the sort of change we are making, we are shifting over a whole heating and power layout at a cost in seven figures – but it will be at work this autumn and will pay for itself in short order.

It has been substantially this sort of improvement, made over the years, which has improved the effectiveness of our plant so greatly that today we have five times the production capacity of 1920 with practically no increase in bricks and mortar.

So much for the question of proper allocation and analytical study of overhead items. It should make clear the point that there is little use of taking little slices indiscriminately here and there, when a major operation may be indicated in a quite different region. It is only after the accurate allocations have been made that it is possible to begin an intelligent scanning of overhead to ascertain where to take hold, where to cut, and where to lay out more money with the assurance of increasing profits.

Let us revert for a moment to the illustration used at the start of this article – that of a company with too many $10,000 men playing golf too much. This sort of careless overhead seems principally a matter of slackness in the top layer of the management. Certainly if we cannot trust a man to want to work hard – if he gets too old or too wealthy to have that urge for work which is the greatest safeguard of good corporate management – then we are going to put him in some place where he won't be harming the business. "No relatives, no relics," is a good motto for the executive ranks of any organization. It helps keep out careless overhead.

Just as bad in the long run, as excessive overhead.

Of course it is good business to spend money to increase profits, whether the outlay accomplishes this by cutting costs or by increasing volume. It is not impossible, even today, to make considerable gains in volume in many lines of business. As soon as a manufacturer or a merchant, or any other business man, increases the desirability and utility of what he offers for sale, the public will buy it. The difficulty is in attaining this added merchantability. Plenty of people could successfully make the same appeal to pride of ownership that the automobile industry makes with its annual change of styles. Most of them do not do it because they are not sufficiently equipped with ability to forecast what the public is going to like. It takes a good deal of ability in an organization to do this, and ability costs money. It runs up the overhead. Doing without it will pull down the overhead, no question about it. But in the long run too much of this kind of economy does not pay. It is just as bad a form of careless overhead as when the overhead is excessive, though it does not come so forcibly or so quickly to the management's attention as does extravagance.

There must always be leaders in an

industry, no matter whether it makes cement or dresses, typewriters or motor-cars. The leader of the industry is almost bound to have an overhead higher than some of his less progressive competitors. This is one of the prices he pays for his leadership. The business which has the greatest aggregation of ability and uses it is the one which goes ahead. And the money may go into improving the utility, the beauty, the service, the selling points of his line.

Take our own experience. We go through the same cycle every year. The first six months we spend money lavishly on designing the new model. The minute we get this completed and the first cars are shipped to branches and dealers, we start in to see how money can be saved in making the car. To direct our attention to production economies at the start would be to risk not getting hold of the market for the new car; to continue to spend on the lavish initial scale would be to endanger our dividends.

"Then the business will be free of the burden of careless overhead."

Any well-managed company goes through the same sort of cycle, even if not so regularly. It spends money improving what it has for sale, then gets back this added overhead plus a profit in the ensuing period through economies. Also, the leader must get back during the first selling season whatever part of this added overhead he expects to recover. For, after this, others will imitate it and they can cut the price because they had little or no development expense. Hence the developer must repay himself before the inevitable imitators of his product arrive in force to push him to new improvements.

Finally it is well to remember that a little ingenuity often produces desirable results quite as effectually as the expenditure of money. Ingenuity, after all, is largely a matter of analyzing your situation and then devising something to meet the particular requirements of that situation.

If the same formula is applied to overhead expenditures, if the situation is analyzed and the results accord with the analytical approach, then the business will be reasonably free of the burden of careless overhead and will be able to compete even under today's strenuous competitive conditions.

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