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MANAGEMENT ENGINEERS

COST, PRODUCTION, SALES, FINANCIAL AND LABOR RELATIONS PROBLEMS

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NOW IS A TIME FOR COST REDUCTION (Concluded)

Most industrial managers are interested at all times in keeping direct material costs and productive labor costs as low as possible, and are alert to all possibilities of obtaining and utilizing equipment which will reduce production cost, but the control of factory overhead cost frequently receives less attention than its importance justifies. Probably this is because it is more complex and difficult.

Office expense and distribution expense also are cost factors which receive less attention in many manufacturing companies than they should receive. The same thing may be said regarding financial expense.

In many cases, a greater cost saving, percentagewise, is possible through the reduction of these indirect costs than is possible through effort spent on reducing the cost of directly productive labor or direct materials.

Some companies which exercise elaborate controls over direct costs have no effective procedure for controlling indirect costs and no means of knowing whether such costs are in proper relation to direct costs. This situation is particularly dangerous at the present time because of the vast expansion in indirect costs which developed during the war, and because of the compounding increase in such costs which is developing at the present time.

Declining volume in some industries is already increasing indirect cost per unit of output. This situation will eventually exist in many industries. It will necessitate greater reduction of overhead costs than would otherwise be necessary.

Now is a time to study all the functions of every business—especially those which come under the general classification of indirect expense—in order to fit them into the current pattern of competition. If this is not done, a golden opportunity to reduce costs in the overhead departments may be lost.

In this, our final article on cost reduction, we will call attention to some of the approaches to the reduction of factory indirect expense, office expense, distribution expense and financial expense, mentioning incidentally some of the tools of cost control.

INDIRECT LABOR AND MATERIAL COST

The control of manufacturing expense for overhead, while complex, is feasible through the medium of properly itemized expense accounts, by means of which measurable units of work for each function are established.

The most obvious way to reduce indirect cost is to eliminate some of the operations. This is not easy because the various overhead departments and functions are highly inter-related. Eliminating some operations might result in increasing total unit costs and in impairing general efficiency in various ways.

Sound industrial engineering studies, including methods studies of indirect labor, can be as effective and as valuable in analyzing overhead operations as in analyzing direct operations.

Incentive methods of paying employees engaged in indirect work, including supervisory work, can be devised and applied with results that may represent large cost reductions. As we have said before, there is need in most manufacturing businesses for applying incentive wage and salary methods of payment more generally than is the case at present. Incentives can be set up to operate directly or indirectly, as circumstances may require.

Expense budgets are required to control indirect expense properly. The object of budgetary procedure is to establish standards and to localize the control of operating expenses around the head of each division which controls expenditures. Expenses rise or fall with the planning of the day's work by the division head and should be under constant control.

Standards should be established, not from past performance alone but also by engineering analyses of expense factors, such as the indirect personnel, the indirect materials and tools required to meet the particular production schedule that is established.

The indirect labor requirement is based on a careful study of the most effective and economical way of accomplishing essential duties. It is necessary to visualize how various duties are to be combined, contracted or expanded as volume goes up or down.

Allowable expenditures for other factory overhead expense, such as supplies, involve the establishment of standard allowances at varying volumes of output for each particular class of overhead expense.

Allowances of indirect labor and of other overhead expense should be expressed, if possible, both in dollars and in physical quantities, such as man-hours, pounds, etc., for the division head is accustomed to working in man-hours of labor and units of supplies.

It is not sufficient to establish budgets. Management must receive current reports of budget performance. The period of the report and the comparison of actual and budgeted expense will vary with the nature and importance of the item being controlled. Some are important enough to be controlled weekly, others only monthly.

OFFICE EXPENSE

The efficiency of office management and of office systems, methods, equipment and personnel has, in the case of most companies, lagged far behind the techniques developed in the production departments. In many companies, there is an inadequate realization of the amount of money that might be saved on office expense without sacrificing essential services.

There can be false economy in reducing the cost of operating a general office, a sales office or a factory office arbitrarily and without adequate study as to the end results, and such action can have serious results. Sound economy stems only from sound management. Money spent to improve operations which result in better profits is money well spent. But it is not sound management to spend money which could be saved without adversely affecting the service which an office should render.

Cost reduction in the office takes one of two forms:

1. ***Elimination of unnecessary records, routines, reports, letters and services.***

Some central authority should be established to control all these office operations and services. A clear justification of every office record, report or service should be required. There is an amazing amount of work done in most offices which could be dispensed with without injury to the business, and with a large reduction in expense. Records, reports and routines become a habit, and frequently are continued long after the reason for them ceased to exist—if a valid reason ever did exist.

2. ***More efficient performance of necessary operations.***

Means to this end include proper office layout, use of the most efficient equipment available—especially modern mechanized duplicating, tabulating, accounting and billing equipment which reduces human effort—work simplification and method improvement, standardization of procedures, establishment of standards and budgets for cost control, scheduling of work, and sound selection of employees and their careful training. There should, of course, be sound salary administration and some system of incentive reward.

If the office is a large one, the office manager probably will need expert assistance in the study of what operations can be eliminated, and of work simplification, and in the setting of production standards. Seldom if ever will he have the time to do this work himself. The manager of an office should have ample time for planning and management and should not be immersed in details.

DISTRIBUTION EXPENSE

At present there is a marked trend toward the improvement of distribution methods and the reduction of unit costs of distribution. Distribution is the prime function of every industrial and commercial business. As the pressure of competition increases, as it surely will, it will become increasingly important that it be done with maximum efficiency and at minimum cost.

Many leading corporations have become so market-minded that they have appointed outstanding merchandising specialists as their president.

There is an increasing realization by top management that American industry will have to sell consumers about twice as much in dollar volume as was sold before the war, or greatly curtail our present production, and that this will require greatly increased and more effective sales effort. They know that, if they are to secure the necessary volume of sales, prices must be kept low enough to enable people to buy the greater volume that must be sold, and they also know that during the past six years the cost of distributing goods has increased greatly and that the efficiency of selling forces has declined, or at least has not increased sufficiently to offset the increased selling cost per unit of product.

Certainly, in view of the high percentage of the consumers' dollar which is consumed by distribution expense—(the Twentieth Century Fund estimated it as 59 per cent in 1939)—it is highly important not to waste money in distributing goods.

Revolutionary changes in distribution methods are not probable. Improvements in the future, as in the past, will come from constant study, careful cost analysis, refinements and constant evolution, to the end, mainly, that there shall be less misdirected effort in marketing—in other words, that there may be a ***positive increase in sales effectiveness.*** The most important improvements will be the results of better sales organization, more scientific sales policies and procedures, and selective selling, all based on "up-to-date" facts, and not on tradition.

It is not easy for sales management to "break with tradition"—to break away from old channels of distribution, old products, old customers, old friends and, particularly, old salesmen. Inability to do so has in many cases been the principal reason for the decline or failure of old and reliable companies. Those that progress are constantly reappraising their markets and their products and changing their policies to meet the conditions which they know exist.

From now on, there will be an increasing emphasis on such means toward greater sales at lower cost as the following:

1. ***Know the Market and Customer Wants***

To know what products will sell in satisfactory quantities, where and how to go after business, and whether the goods sold are satisfactory to customers will aid greatly in decreasing selling expense and manufacturing cost.

Many companies are wasting money in concentrating effort on total volume rather than on what can be sold at an adequate profit—in trying to sell in markets which are too thin, in trying to carry two large a line, in going after orders which are too small to justify the expense of getting them and handling them, in selling and in advertising in the wrong way.

We realize that there are some small accounts which have development possibilities. Skill and care in appraising future possibilities are required in deciding which small account is worth cultivating even though the present cost of handling it may be too high.

Market research is the means by which such mistakes can be avoided most effectively. The basic elements of a research program are these:

(1) Gathering the facts which are needed to do a marketing job scientifically rather than by hunch, intuition or unreliable information. Information furnished by salesmen has a value, but it is unsafe to rely on it solely. Salesmen do not have the specialized experience or patience to ask the type of questions which will produce helpful answers.

(2) Planning a program of sales management based upon correct information.

(3) Evaluating the success of the program.

The objectives of such a program are:

(a) To lower distribution cost ratios—by combining marketing efficiency with increased volume;

(b) To secure a larger share of the market—by selling what people want to buy and by knowing competitive strengths and weaknesses;

(c) To maximize and stabilize profits—by selling what is profitable, by the most efficient methods.

Not all companies can afford to maintain an adequate market research department. It may be too costly, and the results may be unsatisfactory. The solution in such cases is to utilize the services of market research specialists. An outsider who is expert in questionnaire procedure and in testing markets can get the best results at the lowest cost. We have a department which is doing this kind of work.

2. ***Analyze Sales Costs.***

To avoid misdirected sales effort, which raises selling cost unnecessarily, a company should know the actual cost of selling each of its products or product classes, of selling each customer or class of customers, of operating branch offices, and the effect of all of these factors upon total net profit.

Total profit figures conceal unprofitable commodities, departments, customers, territories. Distribution cost analysis is a means by which to discover unprofitable segments of a business.

There has been too little progress in determining distribution cost by products. The common method of adding one percentage figure to production cost to cover distribution cost of all products may result in penalizing one class of customers at the expense of other classes, and of encouraging the sale of the wrong products.

The logical action is to concentrate effort on selling goods which have a satisfactory margin to customers whose accounts can be handled without excessive expense. To do this, it may be necessary to decide whether or not

(a) To stay out of certain "thin" territories;

(b) To drop accounts below a minimum annual volume;

(c) To set a minimum order size limit or to increase quantity price differentials;

(d) To handle accounts in small towns through jobbers or mail order.

The major factors affecting the cost of distributing goods in most industries are these: Price, sales volume, number of customers, number of orders, number of shipments, tonnage, number and amount of credits and allowances, credit losses, selling effort required, amount of inventories carried.

3. *Eliminate or Reduce Unnecessary or Excessive Distribution Expense.*

The possibilities for reduction are too numerous to enumerate here. Special attention should be given to warehousing, stock handling, packing and shipping expense, order handling and billing, customer service, advertising expense, salesmen's travel and entertaining expense.

4. *Operate Sales, Production and Expense Budgets.*

A budget is a guide to sound planning for the future, a measuring stick of performance and a means of stimulating the interest of employees in results. The principal value of expense budgets is in enabling executives to make important decisions with a knowledge of the pertinent cost facts. Sound mangement performance is unlikely without such knowledge.

5. *Upgrade the Sales Force.*

By better selection of salesmen, by scientific matching of the salesman and the job to which he is best adapted, and by giving salesmen the training which will make it possible for them to utilize their abilities most effectively.

Sound selection of salesmen and assignment to the right sales job requires, in addition to past history and personal interview, scientific testing such as is done by our psychological department. By this means alone can the aptitude and mental and emotional characteristics of applicants be definitely discovered. There are too many misfits and incompetents in the sales forces of many companies. They probably are very expensive.

6. *Adopt the Best Plan of Salesmen's Compensation.*

The best plan will be the one which most inspires enthusiastic effort directed toward profitable results as defined by the company's policy on volume and markup. Many methods of compensation are faulty by this standard. No one plan will produce the desired results under all circumstances. Objectives must be taken into account, also the type of business, and the mental characteristics of the sales force. Under almost every condition, a plan which offers a bonus for results above a certain standard will be better than one which does not.

7. *Make Your Advertising Expenditure as Effective as Possible.*

Much money is wasted in advertising in the wrong way, or in the wrong media, or without creating conditions that are essential to realizing all the possible benefit of the advertising. Much of this waste could be avoided by having market studies made, both in preparation for deciding on a plan of advertising and as a subsequent check on the reaction of potential customers.

FINANCIAL COSTS

There may be worth-while opportunities for reducing costs generally classified as financial costs. The more important possibilities of this kind are in the avoidance of excessive fixed investment in buildings and equipment, too heavy investment in inventories, unnecessary interest on borrowed money; and in the minimizing of credit losses.

CONCLUSION

The time to start a thorough cost reduction program is now. The most satisfactory and enduring results will come from expert investigation and analysis, resulting in a complete and a practical program covering every function which is not being performed at maximum efficiency.

(We will welcome an opportunity to discuss with any company, without obligation, the procedures and details of any of the cost reducing opportunities which we have mentioned in this series of articles.)

There will be no issue of the Digest in August.