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Gordon L. Murray

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The Principles of Profit Planning

by GORDON L. MURRAY
Partner, Executive Office

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OUR OBJECTIVE here is to consider the broad subject of *Profit Planning*, as well as its various techniques, in such a context that profit planning as an approach comes into focus. A good point of departure would seem to be to raise the question, "Profit planning—what is it?"—and then proceed to attempt to answer that question. It seems to me that there is quite a bit of confusion about what profit planning really is. We all observe such terms as forecasting, budgeting, standard costs, responsibility accounting, responsibility reporting, long-range planning, and the like. When profit planning, as a term, came into vogue this term certainly confused me. In checking into the matter I found instances where profit planning was defined as budgeting, and budgeting was defined as profit planning, and all sorts of combinations in terminology. What helped resolve this matter in my mind was the realization that profit planning encompassed all these things—budgets, forecasts, responsibility reporting, standards, and so on.

In this perspective profit planning comes into focus as a structure or modus operandi for bringing together the sales forecast; a production plan designed to meet this demand, converted to production costs; and planned or budgeted engineering, distribution, and administrative expenses necessary to support this sales and production activity. The result is planned profit, earnings per share, and return on investment. The scope of the structure may be extended to encompass cash requirements, inventory levels, capital asset controls, and other factors dependent on planned profits as well as the elements of sales and production underlying a profit result.

In this context profit planning is not a technique per se; rather budgets, forecasts, standards, and other elements within the structure are techniques contributing to profits and thus to a profit plan. Budgeting is not a term synonymous with profit planning but is a technique for predetermining and controlling expenses; standard costing is a technique for predetermination and control of production costs; sales forecasting is a technique or series of alternative techniques for predetermining expected sales. These and other techniques may all have particular applications in a profit-planning structure.

The purpose of the structure is to point the way to an achievable profit result, and techniques are selected according to their utility in achieving that objective.

If this idea of structure versus technique appeals to you, let us go a step further. Profit planning is in an important respect more than a structure—it is a corporate way of life—it is a philosophy for running a business. It is of paramount importance that this be recognized by the people at top levels in a company if a program of profit planning is to have a fair chance of success. This is not a matter of singular concern to the accountants and bookkeepers. Rather it is a programmed approach to decision-making and for ordering the affairs of the business. Such a program, to be played successfully, imposes certain ground rules, and certain types of actions may be ruled off-limits. To some, particularly the wheeler-dealer, seat-of-the-pants, intuitive-type operator such ground rules may prove to be intolerable. It is best that everyone know the rules before they take to the field.

Before the concept and term *profit planning* came along, companies predicted sales, developed production costs, budgeted expenses and the like. What are the essential ingredients added by profit planning? I believe there are four:

First—profit planning brings over-all corporate objectives into the process and provides that they be formalized and quantified as never before.

Second—the several forecasting, planning, costing, and reporting activities are integrated into a coordinated program.

Third—attention to these activities is moved up into the top echelon of the business rather than being left as departmental or accounting matters.

Fourth—profit planning becomes a corporate way of life and a fundamental approach to the management of the entire enterprise.

ADVANTAGES OF PROFIT PLANNING

If you agree, then—at least for the moment—that profit planning is essentially a structure in which you apply those techniques most applicable to development of a basis for managing the business, let us turn to advantages. What has been wrong with the way we have been operating? Why need we get so formal and fancy concerning matters our people have been taking in stride all along?

One company president put it this way. We hire the very best

people. We pay them more than they could command anywhere else and a bonus besides when the company earns a fair return. We assign them to their job, give them a reasonable span of authority, and let them operate. This doesn't require a lot of accounting, reports, and paper work. This is the good old American free enterprise system; isn't this all right?

I don't think so. It isn't even fair—to either the man or the company. No function or department of a business is so independent that it is not affected by actions taken in other areas, nor can it be effectively managed without information from others. The philosophy of management expressed by this president doesn't provide a man with basic information to make sound decisions in his sphere. It doesn't require the incumbent to come in with a plan as to how he expects to discharge his responsibility. And this is something the company is entitled to. It merely says here is the job—you have at it—and we will judge your performance. Judge by what standards? The incumbent has a right to know what the standards are to be and is entitled to participate in their establishment.

As compared to this approach, the logic underlying profit planning is difficult to refute. Every person in a key position in a business is forecasting, budgeting, costing, and making profit-control decisions whether he realizes it or not. Every time he makes a major decision he inevitably or intuitively assesses the economic outlook, expected sales and production volume, the cost consequences, and the effect on profit. Yet a man in one functional area of a business does not necessarily have the knowledge of plans and conditions in other areas. It makes but common sense to proceed on a basis that says: What are the key factors in this business; what are the better techniques for predetermining expected results in each factor; what information is required; who is in the best position to use the information, apply the technique, and exercise judgment on the matter? It makes but common sense to conclude by providing all those expected to make decisions with the results of this process once they are approved at the top. In this way everyone is tuned in on the same program, and this has obvious advantages.

Profit planning has advantages for most companies regardless of size. To a significant degree all successful companies utilize the fundamental elements of good profit planning and control. Smaller concerns or those with simple marketing problems, product lines, and production processes naturally require a simple system. Successful

smaller companies may apply profit planning and control principles informally or even intuitively; nevertheless, they are employed. In these situations only a few people may be concerned with management of the company. There may be considerable reliance on direct observations of operations and more personal communications, yet to be successful they in some manner or degree identify control factors, plan, account, report, evaluate, and take action.

As a company grows or is bursting to grow, a critical point is reached. More people are required in the management group, more authority needs to be delegated. The morning rattle through incoming orders and the walk through the plant no longer suffice. More formalized planning and control is required. This is a critical point, and some companies with good opportunities remain small through failure in making the transition. Delegate, yes—but under a program where the president exercises a right to receive a plan of what subordinates expect to do with their delegated authority; the subordinate is informed on what constitutes acceptable performance; the accountant measures performance and reports in a way that helps the subordinate to correct and improve his performance; and the president receives a feedback on how well people are performing. This is where profit planning contributes to business success.

PROFIT PLANNING STRUCTURES

We have said that profit planning is a structure, and budgeting, forecasting, and the like are techniques applied within that structure. What do we mean by structure? Has anyone ever seen one? What does it look like?

Various people concerned with profit planning no doubt have different ways of approaching it and laying it out. Too frequently however, the step of laying out the over-all structure is missed, and instead, effort is diverted directly to the several techniques of forecasts, budgets, and so on.

In our work we are continually faced with finding means of displaying concepts in an understandable form—*selling* if you will. This problem gets particularly “sticky” when you need to convince a non-accounting audience to accept an accounting oriented concept. The very purpose and nature of profit planning requires conviction on the part of the non-accounting members of the management.

One approach, found effective in practice, is to develop an over-all scheme or structure along the lines of the generalized example you

have before you headed, *Scheme Illustrating the Application of the Planning and Control Concept, Exhibit 1* (page 391).

I shall not deal with this example in any detail here, except to mention the major features.

Essentially, this scheme or structure brings together the key elements of profit planning and control—control areas, planning, accounting, and reporting. Taking the columns on the report:

Control areas are developed by a studied dissection of functions to identify all significant factors that need to be controlled to meet profit goals and keep in equilibrium the various factors necessary to administer the business. In practice the detailed breakdown is generally greater than shown in this exhibit, and you might have a general summary layout and subsidiary detailed analyses.

Planning represents the conclusions reached in examining how best to establish a goal and measure of performance for each control factor. You will note that here is where techniques come into the picture.

Accounting indicates the specifications for record-keeping, and in profit planning *accounting* is defined in a broad sense to include all the types of accounting, statistical, and operating data required.

Reporting covers the appropriate content of the reporting system and the distribution of reports. It is at this point that organization matters assume importance. Generally, in practice such a scheme has columns for each of the major positions in which are entered codes opposite each item of report content. The codes indicate which position is to receive the report and for what purpose—control and action, planning, or information. If it is not possible to enter the code for control and action in a single column, it means that the assignment of responsibility needs clarification or the control area or factor is not sufficiently definitive and should be further sub-divided into the elements that are the primary responsibility of a single position.

As you can see, this type of analysis and layout of structure forms a blueprint for the whole undertaking. It gives you a fix on scope. It permits you to compare the techniques and procedures already existent with what will be required and to come up with an action program or task list for accomplishment.

Under this approach the next step is to design pro-forma reports. Given the structural layout, or scheme, and a set of reports you are ready to deal with the procedural matters necessary to generate planning and actual data for the production of reports.

SCHEM ILLUSTRATING THE APPLICATION OF THE PLANNING AND CONTROL CONCEPT

CONTROL AREAS	PLANNING	ACCOUNTING	CONCEPT	DISTRIBUTION
<p>Sales: Volume Price Profitability Reliability Type customer Customer Geographical Sales order Sales order Turnover rates Equipment vs. service parts Backlog Etc. Production level vs. capacity Control</p>	<p>Planning may be in form of: Forecasts Budgets Standards Internal External (published industry indexes, etc.) Leadtimes Sales order Turnover rates Etc.</p>	<p>Records of actual results: Dollars Units and quantities Hours Number of occurrences Etc. Includes accounting or measuring in broad sense - accounting, statistical, operating data.</p>	<p>Adequate coverage of each control area to show: Position Variations from plan Responsibility Integrated to bring together and effect Factors - show cause Pyramided from low to higher echelons.</p>	<p>Distribution tied to assignment of authority and responsibility under organization plan - only one person responsible - others may receive for information and planning purposes if report is related to their assigned functions.</p>
<p>Material: Usage Cost Price Expense: Variable/fixed Controllable/non-controllable Rates Cost center/departement Performance Scheduling: Stock Lead times Procurement: Competitive prices Schedule performance/shortage Supply/available sources Quality - receiving inspection</p>	<p>Overall operating results Inventory position Balance sheet Cash position Accounts receivable status Collection performance trend Fixed asset budget status Industry and competitive position: Sales performance vs. competition Competitive merchandising Sales performance vs. other AMC units and Harvard data Sales: Score Dollars Transactions Cash, charge, contract, etc. Dollars Dollars Dollars Per capita Merchandising departments: Sales Pricing, mark-ups/mark-downs Anticipation and cash discounts Sales volume Selling expense Etc. Workrooms Dollars Costs Etc. Work centers Expense Etc. Quality of service Personnel Property and liabilities Insurance</p>	<p>OTHER ILLUSTRATIONS OF MAJOR CONTROL AREAS</p>	<p>FOOT OPERATION Revenues: Operating revenues Department Major type: Dollage, shedding, tollage, leases, etc. Non-operating revenues: Subsidies Investments Etc. Activities: Fulfillment Current activity and trend Competitive position Costs and expenses: Non-revenue producing departments: Docks Harfs and sheds Banana conveyors Harbor patrol Administration Etc. Commodity warehouse: Etc. Etc. Non-revenue producing departments: Design and construction: Costs and expense Application of charges to projects: Through overhead Etc. Operating gains or loss Construction program: Long range: Major projects: Costs Sources of funds Short range Etc. Balance sheet items Cash</p>	<p>REVENUES OPERATING REVENUES DEPARTMENT MAJOR TYPE DOLLAGE, SHEDDING, TOLLAGE, LEASES, ETC. NON-OPERATING REVENUES SUBSIDIES INVESTMENTS Etc. ACTIVITIES FULFILLMENT CURRENT ACTIVITY AND TREND COMPETITIVE POSITION COSTS AND EXPENSES NON-REVENUE PRODUCING DEPARTMENTS: DOCKS HARFS AND SHEDS BANANA CONVEYORS HARBOR PATROL ADMINISTRATION Etc. COMMODITY WAREHOUSE: Etc. Etc. NON-REVENUE PRODUCING DEPARTMENTS: DESIGN AND CONSTRUCTION: COSTS AND EXPENSE APPLICATION OF CHARGES TO PROJECTS: THROUGH OVERHEAD Etc. OPERATING GAINS OR LOSS CONSTRUCTION PROGRAM: LONG RANGE: MAJOR PROJECTS: COSTS SOURCES OF FUNDS SHORT RANGE Etc. BALANCE SHEET ITEMS CASH</p>

The scheme and report package are ideal for review by the executives concerned to obtain their views and concurrence. This material is in terms that non-accountants can readily visualize. These executives are not concerned with procedural aspects and all the intricacies of technique. They want to know what they are going to get, what it will do for them and the company, and what action is required on their part. The scheme and report package fills that need. Further, by getting to this point early in the game, you have spent a minimum amount of time, effort, and cost and avoided procedures work that may not get approved or which may require alteration.

How much better this is than another approach too frequently taken. The other day I visited with a substantial client who is in the first stages of just such a program as this. They have an IBM 7070 and two 1401s that have been used principally for sales, production, and inventory applications rather than for accounting or profit control. Their approach is to develop input documents and program the data processing for all the kinds of information they feel someone might like to have. No reports have been laid out, no structure has been developed. Instead, they plan to get the data flowing and then inventory what the various executives would like to have for planning and control and construct reports on that basis.

This is probably a good place to make one other point. This matter of approaching planning and reporting problems through an inventory of what various executives indicate they would like to have, really does not work out soundly. First, they are not often in a position to respond adequately because they just don't know what the possibilities are. Further, they necessarily view the question mostly in terms of their own particular job, when a proper answer depends on the relationship of one job to another. For example, two or more people will express a need for the same particular information, while other important areas will not be mentioned by anyone. The fair way to do this is to take the over-all planning and control structure together with the organization chart and develop the report package. You now have a proper package for review with the incumbents in the positions. Sure, you will make changes and recognize individual preferences and modify this package, but you have assurance that all the bases will be covered when you are finished. Frequently a man will ask for certain information without realizing that someone else receives it, and more properly so. He may also insist on detailed data rather than summaries if he is not aware that subordinates will

get the details. When you review reports with a man, one at a time, out of the context of an over-all scheme, the opinion you get is valid only within the four corners and two sides of the page, not in terms of the over-all reporting structure.

My message, then, is to start at the beginning. The beginning is to think the problem through, identify control areas and relate them to organization, select appropriate planning, and accounting techniques, and complete this phase with an over-all structure and report package. Only when requirements have been so defined can you achieve a meeting of the minds with management and proceed intelligently to consider methods and procedures.

THE PLANNING AND CONTROL CYCLE

Let us assume that we have our structure, report package, procedures and, hopefully, management's approval. What are the basic steps in the cycle of planning and control?

Exhibits 2 and 3 illustrate the basic steps generally included. This is taken from a planning and control system developed for a manufacturing company and represents only the primary steps in the cycle. Obviously there are many details not shown here that in fact were further illustrated in chart form and ultimately reduced to written procedures.

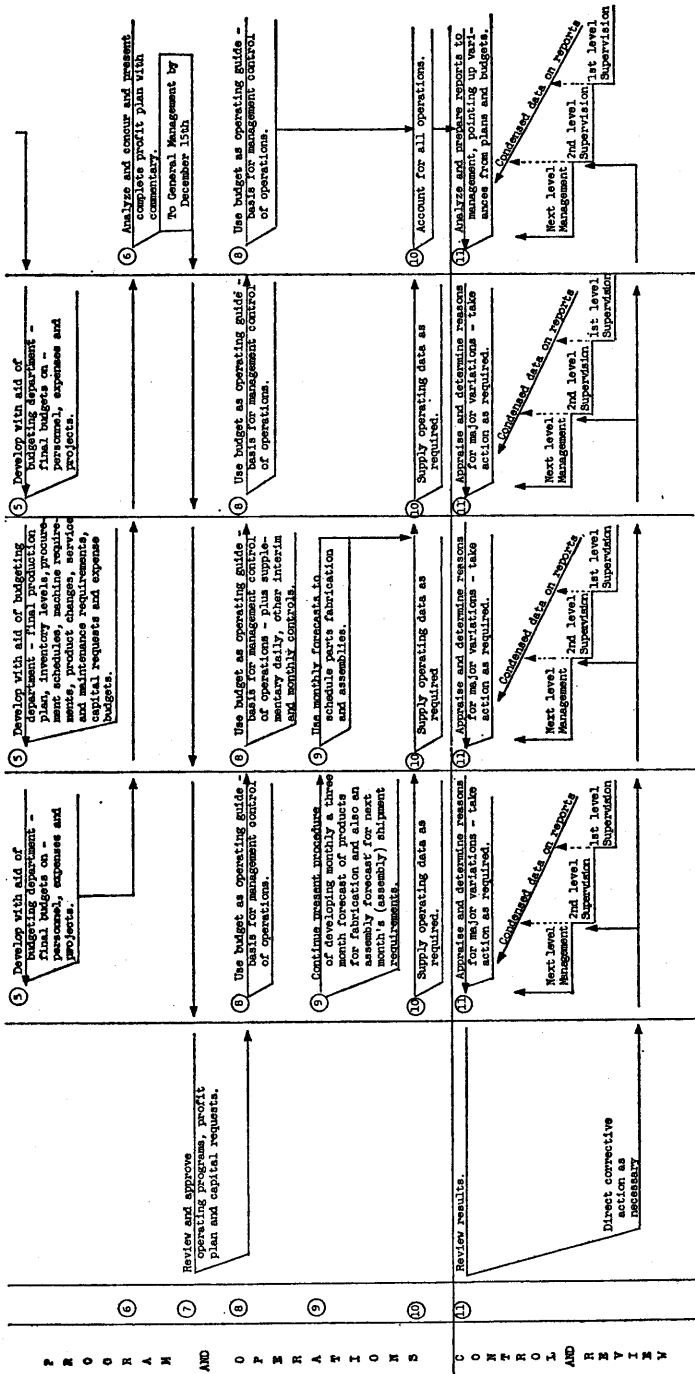
Looking at Exhibit 2, I would make a few observations.

First of all, you will notice from the functions across the top that everyone is in the act. This is not something developed in a back room by the accounting department. Participation is fundamental and is one of profit planning's chief contributions to management effectiveness.

Notice also, in the upper left-hand corner of the chart, that reference is made to premises and goals. If the heads of the various functions of a business are to establish functional plans that will integrate into a company plan, all planning must be based on common premises and common goals. Some of these matters, such as new products and facilities, basic organization changes, and the like can only be made at the general management level. If each department proceeds on its own assumptions on such matters they are apt to have them changed and will have to re-plan when the general management review and approval takes place. The need and practicality of establishing premises and goals is sometimes difficult to sell to the chief executive and top management when this type of program is introduced

MANAGEMENT PLANNING AND CONTROL CYCLE
ANNUAL PROFIT PLAN

	GENERAL MANAGEMENT	SALES	MANUFACTURING	ENGINEERING	FINANCE AND ACCOUNTING
P L A N N I N G	<p>1 Establish premises and goals for annual profit plan; comment on the plan, including a timetable for action.</p> <p>2 Margin, profit and return on investment objectives. New products and facilities. Organizational changes. Level of service to customers. Level of employment. Level of inventories. Other objectives.</p> <p>3 Review and approve</p>	<p>1 Use goals as operating guide for sales.</p> <p>2 Detail monthly forecast for first quarter of year - Prepare estimate of selling expenses</p> <p>3 Preliminary draft October 1st Adjustment, if necessary, in "..."</p>	<p>1 Use goals as guide and develop forecast requirements in terms of: • Products and machine data • Labor levels • Facilities and service activity requirements • Estimated manufacturing expenses</p> <p>3 Use goals as guide and develop requirements in terms of projects. Estimate engineering expenses.</p>	<p>1 Use goals as guide and estimate general and administrative expenses. Provide financial evaluation of preliminary operating plan including a cash forecast. Preliminary Draft October 15th</p>	<p>3 Budget general and administrative expenses and help coordinate plan, budgets and capital load projections into a final profit plan and forecast of cash requirements.</p>
	<p>4 Determine if plan meets objectives listed in Step No. 1 - Repeat process if further analysis is required. Approval by November 15th</p>				



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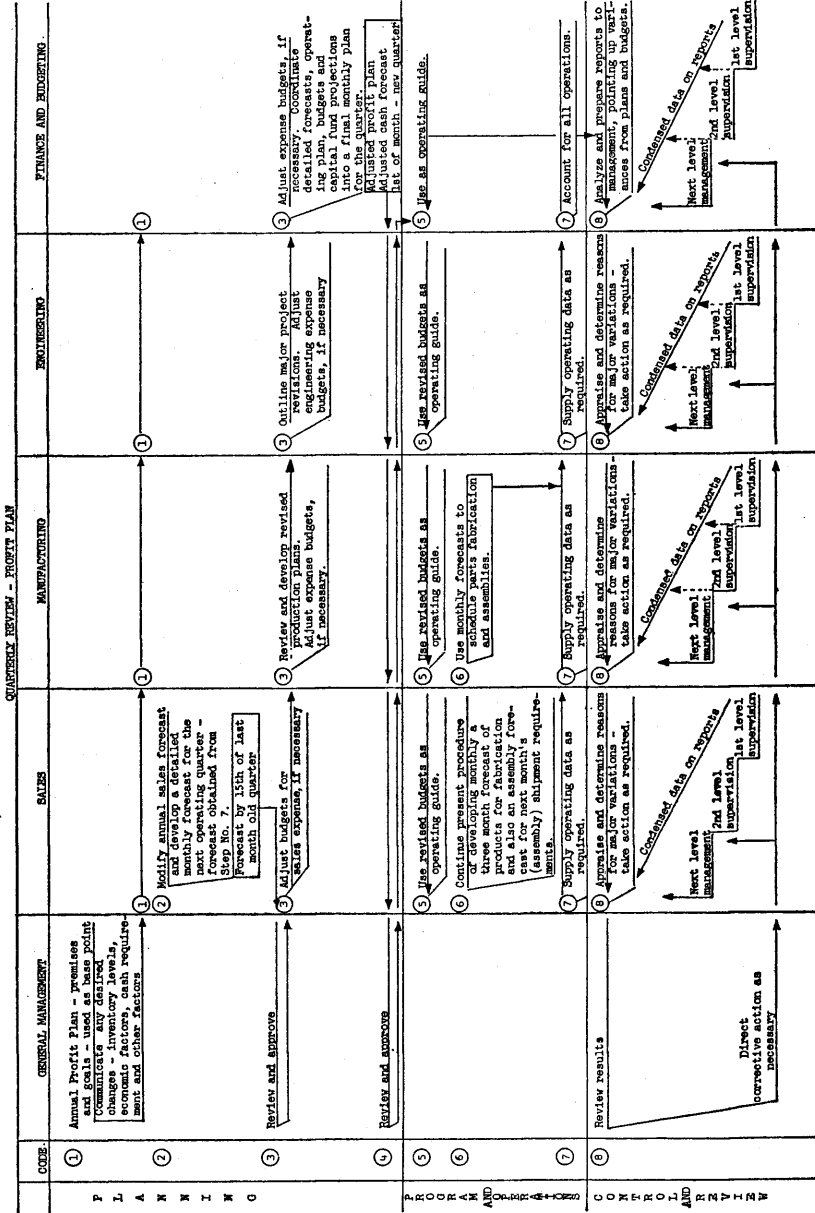
for the first time. They may say: "What do you mean by profit objectives? We want the maximum profit we can get." This is not necessarily so, as strategic decisions are entailed. It may, at any point in time, be strategic to forgo immediate profits in the interests of launching a new product or opening up new territories, or incurring research and development costs, or opening facilities with more capacity than currently required. They may say: "What do you mean by a level of employment?" We mean, "Do you want to plan for a single or a multiple shift operation; is overtime to be relied on to cover peak periods; are we to build inventory during slow shipping periods and level the work force, or are we to plan on lay-offs and rehires to match the shipping cycle?" All these types of factors have sales, cost, and profit implications and should be decided at the outset. In some matters where management can't decide the issue off-hand, plans may be developed on more than one premise so that the profit effect can be evaluated. In any event, if you sit down and think through the matter of planning premises and goals in any given situation, you will find a considerable list of items that require definition.

In establishing premises and goals and also at the stage of review and approval, the matter of balance and conflicts in interest requires consideration. An obvious example is inventories. Sales would like a large inventory so no customer would be denied immediate service. Finance is interested in having minimum working capital tied up in inventories. Production would prefer level rates of production and to let inventory take the ups and downs. Generally you can say that, other things being equal, each function prefers to play the game to facilitate its own objectives. The fact of life is that other things are usually not equal, and it is up to general management and the chief executive first to establish premises from a corporate point of view and then to review plans developed by the several functions in terms of balance. There is a proper balance between objectives within a function as well. For example, management wants a balanced performance in meeting the several production objectives of cost, schedule, and quality. Not quality at any cost. Not performance on schedule regardless of quality. But a balance among all three. The proper balance should be decided at the planning stage.

So much for Exhibit 2; the rest of it merely indicates basic steps and sequence followed in developing the plan, utilizing it as a guide to operations, and the reporting, review, and action on results.

Exhibit 3 illustrates the major steps in a quarterly adjustment of

MANAGEMENT PLANNING AND CONTROL CYCLE



the plan. Essentially, this consists of modifying premises and goals and the plan in the light of experience and new developments, and follows the same pattern as in establishing a plan at the beginning of the year. The question of how frequently the plan should be revised is a moot one, and there is little general agreement among profit planners. You could resort to the cliché—"That depends on the circumstances"—and be on safe ground. It does depend on answers to such questions as: How difficult is it to forecast sales very far ahead? How volatile is the market (style changes)? How sensitive are raw material or finished goods prices? How far ahead is business booked? How much backlog did you have when you made your plan? How long is your production cycle? Do you build to order or to shelf? and upon similar questions. All these factors really come down to the single question of the odds that events may occur that produce errors of major significance. One view is that the plan should be changed for every significant change in markets or operations. Carried to an extreme you could change the plan at such frequent intervals that plan could not help but coincide closely with actual. This, to me, defeats the whole purpose. The other extreme is to say you should not change a plan at all and this may also be too extreme. Generally, I am a member of the don't-change-it-very-often school; review it—say quarterly—but don't change it unless new conditions are of such major consequence that your plan just isn't going to be useful at all. One reason I say this is that you should not pacify the fellow having to face unfavorable variances by plowing them under in a revised plan. For some variations not to be expected the market and operations must be inflexible and the plan has no purpose. Further, some decisions made on the basis of the plan are not susceptible to change in the very short run—such as new financing, construction, or contracts to buy or sell—and you had best keep the original plan in front of you to evaluate the seriousness of operating variances on such commitments. In the last analysis, while you want to be as accurate in planning as you can, it should be recognized that there is a limit to the accuracy obtainable in any prognostication. If a plan has been reasonably well prepared, major events requiring changes are generally the exception and not the rule.

One approach to this question that we have found effective in some situations is to hold the plan for a year but provide for preparing a new projection of the year either monthly or quarterly. In effect,

reports show results to date, the original plan for the year, and the revised plan for the year. In doing this you are saying that the real target is the totals for the year. You recognize that there will be variations generated period by period, but in effect you evaluate the to-date variations by coupling actual to-date with a re-projection to year end and compare this to the original plan for the year. This will show whether you expect to hold the favorable and recoup the unfavorable variances, or whether these were merely a matter of when events took place (e.g., an order came in this period and we planned it for a later period and thus there is really no increase in the total for the year).

An overriding problem in the planning cycle is to estimate the economic climate in which you expect to operate during the period being planned. I believe it is Dr. Arthur F. Burns, Chief of President Eisenhower's Council on Economic Advisors, who terms this the problem of the boat and the passenger. To evaluate the ups and downs of the passenger, you must take into consideration the ups and downs of the boat. Most businessmen try to move in a straight line or in a line slanting upward. This leads to a tendency to use a straight-line measure of performance in a sine-wave environment. No individual business man is going to do anything to eliminate the sine-wave situation. This is an order of problem for governments to work on, and even they only achieve a slight flattening of the curves or perhaps heightening of them. Business cycles—prosperity, recessions, depressions—have been with the world since the beginning.

The practical implication of all this to a company in its profit planning is that it should recognize this economic fact of life, rather than pretend cycles don't exist, and learn to use them advantageously in the conduct of the business. Learn to live with economic cycles instead of struggling against them—be a bear in a bear market and a bull in a bull market—as it were. A company should evaluate its plans according to the cycle most closely affecting it—the industry forecast—and then be realistic about its position in that industry. The well-managed company is one that makes its fair share of dollars when the cycle is on the downside as well as the upside. This means that contrary to what many appear to believe, there is no rule against a plan's calling for less sales and production activity than in the prior period. I know sales managers who are sure they would be fired if they came up with a sales forecast showing a decline—and they are

probably right. This, of course, is wrong and so long as the plan calls for holding or improving its share of the market it becomes a matter of planning a trim in operations to meet that situation. This, I think, should be part of the philosophy underlying any profit-planning program and should be understood by all the management.

PROFIT PLANNING PRINCIPLES—FROM CASE EXAMPLES

So far I have given you my views on the definition of profit planning and advantages. We have looked at structures and the planning and control cycle and highlighted some of the major matters to be dealt with in these stages of a program. I should now like to take you through some highlights from actual presentations made to client companies and comment as I go. I have exercised a little license here because the interjection of factors from several situations brings out better the points I want to make and provides a convenient tree on which to hang some principles and concepts.

The starting point in the solution of any problem is to recognize you have a problem and resolve to take action on it. Profit planning seems so logical, purposeful, and when properly adapted is so generally applicable it is difficult to find reasons why it is not more universally applied. Some who claim to be devotees of profit planning really don't have such a program but rather have a budget, forecasting, or estimating system, cost system, or some other single technique. Many others don't even claim to plan profits. I suspect that this problem results in part from the fact that accountants—who usually take the initiative on this—are not noted as the world's best salesmen. If you are going to get the most out of the week spent here, you will want to go back home and get something started or improve what you already have. This will no doubt require convincing someone else so you can get approval, and perhaps this discussion will provide you with some arguments.

The particular company in point is a substantial, well-established concern manufacturing an industrial line of products. The management consists of outstanding men, predominantly with engineering backgrounds. The company has enjoyed considerable success; in fact, this was part of the problem. Their research and development had been so successful in keeping them in the forefront of the market that this strength carried the company.

Three events converged, however, to change the picture seriously:

1. The economy in general, and this industry in particular, experienced the beginnings of a recession with activity beginning to fall off.

2. The R&D curve leveled out, and they appeared to have reached a point of diminishing returns from such efforts. Their product was a raw material to their customer and not a basic one at that. They were approaching a point where improvement in the ingredients they supplied could result in but a limited increase in the utility of the finished products produced by their customer.

3. The product line was fairly simple to produce and did not require a substantial investment in facilities. Their customers, however, had generally not established their own facilities, as the product was relatively minor in their total picture and they wished, in effect, to "buy" the supplying company's R&D effort as long as R&D was an important factor. With the R&D factor assuming minor importance and the recession creating an incentive to capture all the possible profits incident to their products, customers began to move toward a *make* rather than a *buy* policy, thereby promising to reduce further demand for our client's output.

The company responded to these conditions by actions to broaden their product line, to seek new markets—including, for the first time, overseas markets—and to initiate manufacturing operations at several rather than a single location in order to reduce freight cost and improve service. Among other consequences were establishment of a Western Hemisphere Trade Corporation and a multi-corporate set-up of separate subsidiaries and separate corporate entities for sales and manufacturing in some instances.

The convergence of these factors upset what had been a successful pattern of corporate existence. For the first time the management was unsure, they were groping, and they were receptive to new disciplines and to recognizing the contribution that planning and control offered.

The presentation that resulted in the implementation of the profit-planning program outlined the profit-planning concept, as related to their problems in the following terms:

"Over-all Objectives

Develop an appropriate program of profit planning and control, including forecasting, accounting, and reporting methods that would—

1. Provide Directors with proper reference points for evaluating the results of over-all operations, and
2. Provide officers and other key personnel with proper norms or standards for managing the functions assigned under the plan of organization."

(You will notice that at the very start the point is made that the program is directed toward directors and officers and key personnel—not directors so they can judge the officers or officers so they can judge the others—it covers all those concerned with profits. It also says that the program is to provide these persons *with* something—profit planning is something that is done *for* people not *to* people—it is a positive program. The importance of organization is brought in at the beginning by saying the program is to help them do their jobs better—with the job defined according to the assignment of functions under the organization structure.)

"Major Factors Considered

Company operations have changed in recent years as shown by trends toward:

1. Multiple versus single plant.
2. Multiple versus single corporation.
3. Broader product line versus narrow product line, and
4. Downturn in sales and profit.

The implications of these changes are that:

1. Operations are more decentralized,
2. Influence on profits is more diffused and decentralized—organizationally and geographically,
3. Sales, costs, profits flow through new channels, and
4. Traditional reference points are no longer wholly applicable."

(This section of the presentation summarized the basic changes, which we discussed earlier, and their implications, thereby pointing to a need for more sophisticated planning and control. The loss of reference points is what really bothered the directors and officers. In the past, accounting and reporting had been wholly on an actual basis, comparing this year and last year. The key accounting figures were charted and reviewed at a monthly meeting. The participants had been at this so long they knew most of the numbers by heart and each had his favorite index of what he considered good or bad performance. The most generally accepted index was earnings per

share which you cannot quarrel with as an ultimate measure of success. What can be questioned is limitations in an ability to determine what an attainable per share earnings would have been or an ability to discern readily where problems existed and who should take what action on what subject matter.

Comparison with last year is really a pretty poor index of performance. Last year reflects your sins as well as your virtues and while last year is one of the factors you should consider in planning next year, once you plan you should shoot at planned performance, not last year's performance.

(Here was a group faced with difficulty. Instead of viewing the simple results of a single-plant corporation, they were faced with multiple sets of reports and consolidated figures with all the confusion of eliminations, inter-plant and inter-corporate transactions, and the like. Last year had lost its significance as an index.)

"Other Factors

The accounting system is quite comprehensive, providing practically all the accounting data (though not the planning data) that should be required for control purposes.

A major blind spot, however, not presently provided for in accounting systems or reports is gross margin. What are the causes for variations in margin—mix, price, volume, etc.?"

(The company's accounting system provided for the ultimate in detail on all the various expenses—so much so, in fact, that reports represented trial balances. Cost of sales and gross profit, however, were based on average costs and relied on a beginning and ending inventory figure to "force out" a cost-of-sales figure. This made it very difficult to analyze variations in gross profit. Sales analysis revealed unit and dollar sales by product and dollar sales by customer. These sales figures were not regularly costed to arrive at gross profits, and even if they had been only average, cost data were available. This would have meant that product or customer gross-profit data would reflect a combination of both sales and manufacturing performance and be only partially useful. This point will be discussed further.)

"Conclusion

The major effort required is in:

1. Forecasting and planning,
2. Defining reporting requirements, and

3. 'Exploding' the factors behind the gross margin figure."

(The presentation went on to outline the application of the control principle, in six steps.)

"Application of the Control Principle

1. Establish premises for forecasting and planning for a given period:
 - a) Economic climate
 - b) Margin, profit, and return on investment objectives
 - c) New products and facilities
 - d) Organizational changes
 - e) Distribution strategy
 - f) Labor contract changes
 - g) Research and development program
 - h) Other applicable factors
2. Plan for the period, in quantitative terms, covering all profit contribution factors (e.g., sales, cost, expenses) through:
 - a) Planning by the head of each significant organization unit for the functions under his jurisdiction.
 - b) Compiling individual plans into an over-all plan for each company and for the company consolidated and then review, evaluate, and approve."

(These two steps establish the norms through use of organization and participation.)

"3. Account for actual results of operations.

"4. Report actual results compared to plan and point up exceptions."

(Steps three and four permit detection of deviations and areas for action.)

"5. Evaluate significance of exceptions, causes for significant variations, and action required."

(Step five requires the application of the principle of tolerance in evaluating the significance of variations.)

"6. Take action to meet established norms and eliminate unfavorable variations—by and through the person assigned authority for control of that factor under the organization plan."

(As the plan is built up through organization channels, so corrective action flows through organization channels.)

(To emphasize the logic of the six-step control cycle, the following additional points were made.)

"Points on Basic Approach

1. All business decisions are based on forecasts—assumptions regarding the future; facts are largely historical.
2. Some decisions entailing forecasts or assumptions must be made and are readily made, e.g., price setting, wage setting, procurement, production schedules.
3. The necessity for other types of forecasting and planning is not as generally recognized—e.g., sales volume, costs, profits—because:
 - a) Such action can be avoided (whereas prices, wages, etc., cannot be), and
 - b) There is an inherent lack of precision in such forecasts—they are not railroad timetables, and
 - c) They can be used unwisely as primitive devices."

(It was important to make these points and discuss them in this situation as in many situations. They had not had such a program before and were as concerned about what profit planning might do *to* them as for what it might do *for* them. Were they going to run the risk of being judged on their ability as forecasters and planners as well as performers? Would they show up as well having their performance subject to quantification and measurement as compared to a more flexible position where they could brag when it's good and rationalize when it's questioned? Some years before this company had attempted a budget system. I am in no position to know what it consisted of but was made very aware that the term "budget" was *verboten*.

(These are sometimes very real problems. It is my feeling that they stem largely from the way some such programs have been administered. If a punitive attitude is adopted, resentment is sure to follow. This is where the principle of tolerance comes into play. The administrator must realize that forecasts, budgets, and standards or even measures of actual performance are not absolutes. Some reasonable tolerance must be applied in concluding what is good or bad, correctible or uncorrectible. Effort is most properly directed toward

improvement in future plans and performance and in taking action to adjust other factors when a related factor has gone askew.

(Arbitrary actions also contribute to reluctance to accept a program. An arbitrary decision to slash personnel across the board by ten per cent is not planning and can only undermine confidence and coöperation in the program. In one company with which I am familiar such arbitrary actions have been taken time and again. The department heads are past masters in judging the figures and inflating their staffs in quiet periods so they can withstand the cuts when the axe falls. The program has become a game, where division and department heads are challenged to continue operating in spite of the plan.

(Unfortunately, some programs have run into these problems. Some coaching of those administering the program is as important as coaching those developing the plan and applying the techniques.

(In another situation the director of sales and marketing simply refused to accept the premise that some estimate of sales could be made or to acknowledge any responsibility for forecasts prepared by others. One of his subordinates was in fact already forecasting six months ahead to meet a practical requirement of purchasing and production. Forecasting here was relatively easy, as a substantial proportion of a year's business was on long-term commitments. In response, the sales director pointed to the possibility that one of these commitments might be canceled and throw the forecast a way off. What does he do then? There are a number of things you might do, but you won't do anything if you don't recognize that identification of such an event is what you need to know. In this case the program was abandoned before it was begun, which is usually the right decision when the key people won't coöperate.

(In one other situation the chief executive took the position that he did not need any such tools, as he grew up with the business and had confidence in certain bench marks—he proceeded to sketch out these measurements on a three-by-five piece of paper. He accepted the program, however, on the thesis that while he had long experience and intimate knowledge of all the important factors, the other members of management did not. He proved, however, that he was a "big man" when he called after getting the first results from the system to report that a substantial variation showed up in the usage of a primary raw material. Investigation disclosed that the facts were correct, and his bench mark was substantially out of date. He acknowledged that this one factor paid for the system.)

- “4. Forecasting and planning are desirable even if lacking in precision.
 - a) Planning requires that problems be anticipated, analyzed, and quantified. More strategy is developed with less reliance on short-term tactical moves.
 - b) Objectives, goals, and standards are basic to control and tie together accounting, organization, and reporting as a sound basis for administration.
 - c) Projections of future results, by the best person in the best position to apply the best data to assumed conditions, is always an improvement over using prior results as norms.
5. Persons assigned responsible positions in an organization have a right to:
 - a) Know what constitutes acceptable performance and to
 - b) Participate in establishing standards of performance.
6. Over-all management has the right and duty to see that individual plans be made known in advance and are consistent with over-all objectives and policies.
7. Authority and responsibility can be delegated effectively, provided there is a feedback of information on status and performance.
8. Attention is focused on profit.
9. Application of the principle of tolerances avoids negative or punitive actions.
10. Intelligent administration of long-term commitments, capital investment, research, etc., requires control of short-range profits.”

“Features of Program Proposed and Implemented

1. Development of planned profit for consolidated operations by planning operations of each plant and company in proper sequence.
2. Control of gross margin by customer as well as by product.
3. Control of factors resulting in gross margin variations, e.g.,

- a) Sales volume
 - b) Mix of products of differing profitability
 - c) Sales prices
 - d) Variations in standard cost for different plants
4. Use of standard rather than average costs so that manufacturing cost variances of each plant are identified."

(The actual presentation then went on to display the profit planning structure, flow charts of the planning and accounting—reporting cycles, and illustrative control reports.

(One particular feature mentioned in this case material was the matter of exploding the information behind gross profits. Exhibit 4 illustrates the approach applied to this phase of the problem.

(This is a pro-forma report, and you will note a breakdown by domestic and export and major customers. In order to report by customer the planning must be by customer. In order to report mix variations by customer you must plan by product and by customer. It is axiomatic in profit planning that the possibilities of analysis of actuals depends on the detail built into the planning. If mix variations by customer are important, you must plan by customer and product.

(Looking at the column headings you will notice that this report is concerned with gross margin and not gross profit. By eliminating fixed production overheads and using standard variable costs, variations due to production volume or other manufacturing cost variations are eliminated. This report, then, meets another criterion of good reporting, as the results shown are clearly all the responsibility of sales management.

(The gain or loss from plan in marginal profits is identified as due to volume, product mix, sales price, or plant cost differences. Volume refers to whether you sold a customer more or less in quantity at planned prices. Mix refers to whether the products you did sell contained a higher or lower proportion of the more profitable or less profitable products. Sales price refers to whether you got a higher or lower price for what you did sell. Plant cost differences refer to differences between plants in the standard cost of the same products. As a company opens new facilities it is generally expected that they will be more efficient than the old. It may be significant, as it was in this case, to identify the effect of this cost differential. Therefore, sales was asked not only to forecast how much of each major product they planned to sell, but from which plant they planned to ship it.

ANALYSIS OF VARIATIONS IN GROSS MARGIN (AT STANDARD COSTS)

	Actual.....		Planned.....		Marginal Profit Gain or (Loss) from Plan.....	
	Sales	Variable Cost	Marginal Profit	Marginal Profit	Product Mix	Sales Price
	To Sales	To Sales	To Sales	To Sales	Volume	Differences
<p> <u>EXPORTING</u> Citica Service D-X Survey Escoc Standard Gulf Oil Etc. </p>						
<p> Other basic line customers Other product customers </p>						
<p> <u>EXPORT</u> Subsidiaries and Affiliates: XYZ of Canada, Ltd. ABC Ltd. DEF International GHI of France, S.A. OPQ G.m.b.H. Other Export: Asiatic Petroleum Esso Standard Esso Gulf Mobil Overseas Etc. </p>						
<p> Other foreign customers TOTALS </p>						

Such a prediction is usually necessary, in any event, if you are going to base the production plan on the sales plan, and in this instance it permitted the segregation of another important gross margin variation.

(One additional feature not shown on this Exhibit was semi-annually to position the cost of research and engineering provided each customer against the gross margin from that customer. The nature of the products was such that the company undertook development of special variations in formulae for a customer or ran tests to determine how a new customer product would perform using their raw material. Such work was undertaken at no-charge and in some cases the work was substantial. Obviously, in negotiating prices or in administering the policy on research and testing, your position will depend in part on the profitability of that customer, all factors considered.)

CONCLUSION

In conclusion, I remind you that we have been discussing the "Principles of Profit Planning." You have my definition of profit planning as a structure or modus operandi for administering the affairs of a business. This has been discussed as a broad concept, philosophy, and corporate way-of-life. We have seen one way of laying out the profit-planning structure, discussed some of the advantages, and looked at the major phases in the planning and control cycle. Along the way, some of the problems in selling and implementing such a program have been identified.

