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Managing for Business Effectiveness

• Analysis • Allocation • Decision

By Peter F. Drucker

What is the first duty — and the continuing responsibility — of the business manager? *To strive for the best possible economic results from the resources currently employed or available.* Everything else managers may be expected to do, or may want to do, rests on sound economic performance and profitable results over the next few years. Even such lofty management tasks as assessing corporate social responsibilities and cultural opportunities are not exempt from this presupposition. And certainly not exempt, by and large, are the individual manager's *own rewards* — money and position.

Accordingly, all business executives spend much, if not all, of their time on the problems of short-run economic performance. They concern themselves with costs and pricing, with scheduling and selling, with quality control and customer service, with purchasing and training. Furthermore, the vast array of tools and techniques available to the modern manager deal to a great extent with managing *today's* business for today's and tomorrow's economic performance. This is the subject matter of 90 out of

any 100 books in the business library, and (conservatively) of 90 out of any 100 reports and studies produced within businesses.

No Time for Clichés

Despite all this attention, few managers I know are greatly impressed with their own performance in this work. They want to know how to organize for the task; how to tell the important from the time-wasting, the potentially effective from the merely frustrating. Despite the flood of data and reports threatening to inundate the manager today, he gets only the vaguest generalities. Such banalities as "low costs" or "high profit margins" are bandied about as answers to the question: What *really* determines economic performance and results in this particular business that I work for?

Even in the boom times of a "seller's market," managing for economic performance tends to be a source of constant frustration. And as soon as times return to normal and markets become competitive again, managing for economic performance tends to generate such confusion, pressure, and anxiety that the decisions made are most

unlikely to be the right ones, even for short-run results, let alone for the company's future.¹

What we need are not more or better tools — we have already many more than any single business (let alone any single manager) can use. What we need are simple concepts — some crude rules of thumb — that will help organize the job by answering:

- Just what is the manager's job?
- What is the major problem in it?
- What is the principle for defining this problem and for analyzing it?

Misplaced Emphasis

I do not propose to give here a full-blown "science of management economics," if only because I have none to give. Even less do I intend to present a magic formula, a "checklist" or "procedure" which will do the job for the manager. For his job is *work* — very hard, demanding, risk-taking work. And while there is plenty of laborsaving machinery around, no one has yet invented a "work-saving" machine, let alone a "think-saving" one.

But I do claim that we know how to organize the job of managing for economic effectiveness and how to do it with both direction and results. The answers to the three key questions above are known, and have been known for such a long time that they should not surprise anyone.

1. *What is the manager's job?* It is to direct the resources and the efforts of the business toward opportunities for economically significant results. This sounds trite — and it is. But every analysis of actual allocation of resources and efforts in business that I have ever seen or made showed clearly that *the bulk of time, work, attention, and money first goes to "problems" rather than to opportunities, and, secondly, to areas where even extraordinarily successful performance will have minimal impact on results.*

2. *What is the major problem?* It is fundamentally the confusion between effectiveness and efficiency that stands between doing the right things and doing things right. *There is surely nothing quite so useless as doing with great efficiency what should not be done at all.* Yet our tools — especially our accounting con-

¹This was brought out clearly by J. Roger Morrison and Richard F. Neuschel, "The Second Squeeze on Profits," HBR July-August 1962, p. 49; see also "Different Dollars," by Louis E. Newman and Sidney Brunell, in the same issue, p. 74.

cepts and data — all focus on efficiency. What we need is (1) a way to identify the areas of effectiveness (of possible significant results), and (2) a method for concentrating on them.

3. *What is the principle?* That, too, is well-known — at least as a general proposition. Business enterprise is not a phenomenon of nature but one of society. In a social situation, however, events are not distributed according to the "normal distribution" of a natural universe (that is, they are not distributed according to the U-shaped Gaussian curve). *In a social situation a very small number of events — 10% to 20% at most — account for 90% of all results, whereas the great majority of events account for 10% or less of the results.*

This is true in the marketplace. A handful of customers out of many thousands produce the bulk of the orders; a handful of products out of hundreds of items in the line produce the bulk of the volume; and so on. This is true of markets, end uses, and distributive channels. It is equally true of sales efforts: a few salesmen, out of several hundred, always produce two-thirds or more of all new business. It is true in the plant: a handful of production runs account for most of the tonnage. It is true of research: a few men in the laboratory produce all the important innovations, as a rule.

It also holds true for practically all personnel "problems": the great bulk of the grievances always come from a few places or from one group of employees (for example, from the older, unmarried women or from the clean-up men on the night shift), as does the great bulk of absenteeism, of turnover, of suggestions under a suggestion system, and of accidents. As studies at the New York Telephone Company have shown, this is true even in respect to employee sickness.

Revenue \$ vs. Cost \$

The importance that this simple statement about "normal distribution" has for managing a business has been grasped by all too few businessmen. It means, first: *while 90% of the results are being produced by the first 10% of events, 90% of the costs are being increased by the remaining and result-less 90% of events.*

In other words, costs, too, are a "social phenomenon." If we put it into mathematical language, we see that the "normal distribution

curve" of business events is a hyperbola with the results plotted along the plus half, and the costs along the minus half of the curve. Thus, results and costs stand in inverse relationship to each other.

And now, translated back into common language, *economic results are, by and large, directly proportionate to revenue, while costs are directly proportionate to number of transactions.* The only exceptions to this are the purchased materials and parts that go directly into the final product. For example:

- To get a \$50,000 order costs no more, as a rule, than to get a \$500 order; certainly it does not cost 100 times as much.
- To design a new product that does not sell is as expensive as to design a "winner."
- It costs just as much to do the paper work for a small order as for a large one — the same order entry, production order, scheduling, billing, collecting, and so on.
- It even costs just as much, as a rule, to actually make the product, to package it, and to transport it for a small order as for a large one. Even labor is a "fixed" cost today over any period of time in most manufacturing industries (and in all services) rather than a cost fluctuating with volume. Only purchased materials and parts are truly "variable" costs.

Furthermore, there is the implication that, "normally," *revenues and efforts will allocate themselves to the 90% of events that produce practically no results.* They will allocate themselves according to the *number of events* rather than according to results. In fact, the most expensive and potentially most productive resources (i.e., highly trained people) will misallocate themselves the worst. For the pressure exerted by the bulk of transactions is fortified by the person's pride in doing the difficult — whether productive or not.

This has been proved by every single study made; it is, in other words, supported both by principle and by concrete experience. Let me give some examples:

¶ A large engineering company prided itself on the high quality and reputation of its technical service group, which contained several hundred expensive men. The men were indeed first-rate. But analysis of their allocation showed clearly that they, while working hard, contributed little. Most of them worked on the "interesting" problems — especially those of the very small customers —

problems which, even if solved, produced little, if any, business. The automobile industry is the company's major customer and accounts for almost one-third of all purchases. But few technical service people within anyone's memory had even set foot in the engineering department or the plant of an automobile company. "General Motors and Ford don't need us; they have their own people," was their reaction.

¶ Similarly, in many companies salesmen are misallocated. The largest group of salesmen (and especially the most effective ones) are usually put on the products that are "hard to sell," either because they are "yesterday's products" or because they are "also rans" which managerial vanity desperately is trying to make into "winners." Tomorrow's important products very rarely get the sales effort required. And the product that has sensational success in the market — and which, therefore, ought to be pushed all-out — tends to be slighted. "It is doing all right without extra effort, after all," is the common conclusion.

¶ Research departments, design staffs, market development efforts, even advertising efforts have been shown to be allocated the same way in lots of companies — by transaction rather than by results, by what is difficult rather than by what is productive, by yesterday's problems rather than by today's and tomorrow's opportunities!

Unaccountable Accounting

"Revenue money" and "cost money," to put it dramatically, are not automatically the same "money stream." Revenue produces the wherewithal for the costs, of course. But unless management constantly seeks to direct these costs into revenue-producing activities, they will tend to allocate themselves *by drift* into "nothing-producing" activities.

One major reason why managers do not, as a rule, understand this fact is their mistaken identification of *accounting* data and analysis with *economic* data and business analysis.² The accountant has to allocate to all products those costs that are not actually and physically tied to a particular unit of production. Today, one way or another, the great bulk of the costs — the 60% to 70% that are not purchased materials and parts — are, consequently, allocated, rather than truly "direct," costs.

Now the only way the accountant can allocate costs is in a way that is proportionate to volume

² See Morrison and Neuschel, *op. cit.*; and John Dearden, "Profit-Planning Accounting for Small Firms," HBR March-April 1963, p. 66.

rather than proportionate to the number of transactions. Thus, \$1 million in volume produced in one order — or in one product — carries the same cost as \$1 million in volume produced by 1 million individual orders or by 50 different production runs.

Similarly the accountant is concerned with the cost per unit of output rather than with the costs of a product. His focus is on profit margin rather than on profit stream — which is, of course, profit margin multiplied by turnover. Finally, the accountant does not classify costs by the economic activity to which they pertain. Instead, he classifies by organizational or geographic locus (e.g., “manufacturing” or “plant”), or by legal — or legalistic — categories (e.g., “payroll”).

I am well aware of the work done on these and related problems of accounting theory and practice — indeed I owe whatever understanding of accounting I have to this work and to the accountants engaged in it. But it will be years before the results of this work will penetrate accounting practice, let alone change the way businessmen use or misuse accounting data.

Rifle Approach

More important than the reasons *why* we have not drawn the right conclusions is: What *are* the right conclusions? What line of action will produce the best possible economic results and performance from the resources available to a business? Let us begin by setting some guidelines:

(1) Economic results require that managers concentrate their efforts on the smallest number of products, product lines, services, customers, markets, distribution channels, end uses, and so on which will produce the largest amount of revenue. Managers must minimize the attention devoted to products which produce primarily costs, because their volume is too small or too splintered.

(2) Economic results require also that staff efforts be concentrated on the very few activities that are capable of producing truly significant business results — with as little staff work and staff effort as possible spent on the others.

(3) Effective cost control requires a similar concentration of work and efforts on those very few areas where improvement in cost performance will have significant impact on business performance and results — that is, on those areas where a relatively *minor* increase in efficiency will produce a *major* increase in economic effectiveness.

(4) Managers must allocate resources, especially *high-grade human resources*, to activities which provide opportunities for high economic results.

Unpardonable Profligacy

No wonder so many businesses did poorly the moment the “seller’s market” was over. The wonder, rather, is that they did not do worse. For most businesses — those abroad as well as those in this country — operate in direct opposition to every one of the four well-known rules I have just spelled out.

Instead of product concentration we have product clutter. Remember how it used to be fashionable to attack industry, especially U.S. industry, for its “deadening standardization”? Then, a few years ago, it became fashionable to attack industry for its “planned obsolescence.” If only there *were* any validity to either of these charges!

Most businesses — today’s large U.S. corporations are perhaps the worst offenders — pride themselves on being willing and able to supply *any* “specialty,” to satisfy *any* demand for variety, even to stimulate such demands in the first place. And any number of businesses boast that they never, of their own free will, abandon a product. As a result, most large companies typically end up with thousands of items in their product line — and all too frequently fewer than 20 really “sell.” However, these 20 items or less have to contribute revenues to carry the costs of the 9,999 nonsellers.

Indeed, the basic problem of U.S. competitive strength in the world economy today may well be product clutter. If properly costed, the main lines in most of our industries will prove to be fully competitive, despite our high wage rates and our high tax burden. But we fritter away our competitive advantage in the volume products by subsidizing an enormous array of “specialties,” of which only a few recover their true cost. This, at least, is what I have found in such industries as steel and aluminum. And in electronics the competitive advantage of the Japanese portable transistor radio rests on little more than the Japanese concentration on a few models in this one line — as against the uncontrolled plethora of barely differentiated models in the U.S. manufacturers’ lines.

We are similarly profligate in this country with respect to staff activities. Our motto seems to be, “Let’s do a little bit of everything” — personnel research, advanced engineering, custom-

er analysis, international economics, operations research, public relations, and so on. As a result, we build enormous staffs, and yet do not concentrate enough effort in any one area to get very far. Nor do we know what to do to remedy the situation. The common way to control costs is still the one everybody knows to be ineffectual if not destructive: the "across-the-board-cut" by 15%. We have not really made a serious attempt to manage resources and pinpoint our efforts. Things are left to drift along.

Three Giant Steps

Criticizing is easy; anyone can find fault. Readers have every right to say, at this point, "Just how can we go about doing a better job of managing?" Even if I had all the answers — and I do not — an article would not be long enough for me to offer a satisfactory reply. This would require a book; and even then every company would *still* have to work out the methods best suited to its own affairs.

So, if readers will bear with me, I will present a series of steps — sketched out only in the lightest of strokes — that I have found to be highly effective in actual business situations, at least as first approaches. Specifically:

Step 1. Analysis — Here the manager has to know the facts. He needs to identify:

- The opportunities and true costs of products.
- The potential contributions of different staff activities.
- The economically significant cost centers.

Step 2. Allocation — Here the manager has to allocate resources according to results anticipated. For this, he needs to know:

- How resources are allocated now.
- How resources should be allocated in the future to support activities of greatest opportunity.
- What steps are necessary to get from what *is* to what *ought to be*.

Step 3. Decision — The manager must be prepared to take the most painful step of all — that of deciding on those products, staff activities, or cost areas that breed clutter rather than bring opportunity and results. Naturally, productive resources of any magnitude or potential should never be allocated to these. But which should be abandoned altogether? Which should be maintained at a minimum effort? Which could be changed into

major opportunities, and what would it cost to make such a change?

Analyzing the Facts

In the analysis stage, the first job is to take an unsentimental look at the product line. All the standard questions should be asked about each product: its volume, market standing, market outlook, and so on. There is, however, one new key question: What does the product contribute? What does a comparison of its revenue with its true costs show?

In this analysis, revenue should be defined as total sales dollars less costs of purchased materials and supplies. And true costs should be estimated on the basis of this (most probable) assumption — that the real cost of a product is the proportion of the total cost of the business that corresponds to the ratio between the number of transactions (orders, production runs, service calls, and the like) needed to obtain the product's revenue and total number of similar transactions in the business — less, again, materials and parts costs. Since this is cumbersome, let me give a concrete example:

A company had annual revenues of \$68 million, after taking out costs of materials and parts purchased. Total costs of the business — materials and parts excepted — were \$56 million.

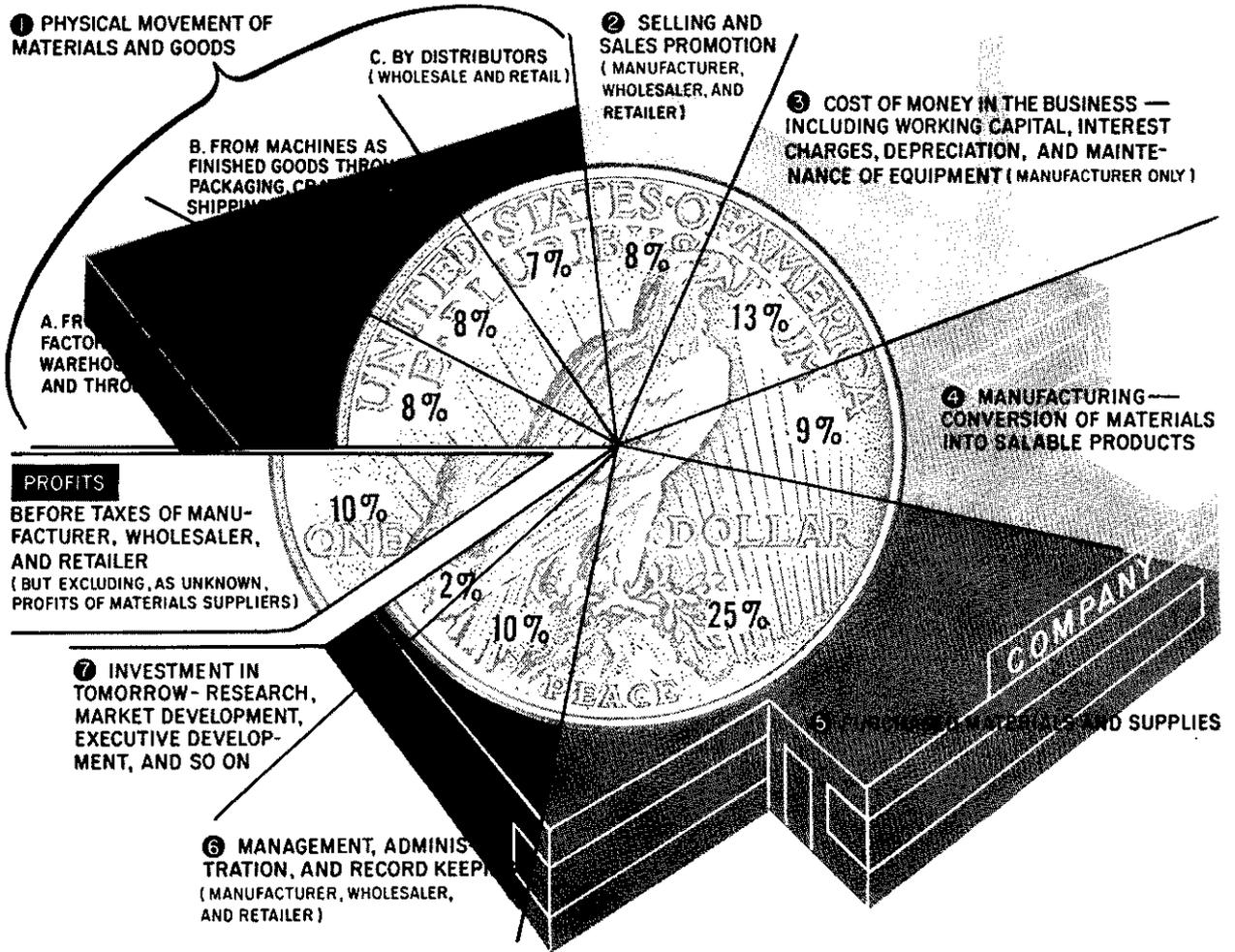
Product A showed revenues of \$12 million a year. It required, however, 24% of the total number of transactions — measured in this case by invoices. Its true costs were, therefore, calculated to be \$13.5 million a year, which meant a negative contribution, in sharp contrast to the "official" profit margin of almost 12% that the accounting figures showed. (This, by the way, is typical for "yesterday's product," which has either lost the main customers or can be held in the market only by uneconomic efforts.)

Product B, by contrast, despite an "unsatisfactory" profit margin of only 3%, showed a net revenue contribution of almost \$4 million — the largest single contribution to profit. It went in sizable orders to a small number — about 50 — of substantial customers.

As the examples show, this analysis looks at *all the products* of a business rather than at one at a time. This by itself is unusual and rarely done.

While the product breakdown is normally the most important and most revealing analysis, customers, markets, distribution channels, and

EXHIBIT I. THE CONSUMER'S DOLLAR — WHERE IT GOES



end uses all need to be analyzed similarly in respect to their present and their anticipated contributions.

Staff Contribution

The questions to be asked in this analysis call for managerial judgment rather than for economic data. Here is a list of queries I have found useful:

- In what areas would excellence really have an extraordinary impact on the economic results of our business, to the point where it might transform the economic performance of the entire business?
- In what areas would poor performance threaten to damage economic performance, greatly or at least significantly?
- In what areas would it make little difference whether we perform excellently or poorly?
- What results have been attained by the work done in the area? How do these compare with the results promised or expected?

- What results can realistically be expected for the future — and how far ahead is the future?

Cost Centers

The object here is to isolate those areas of the business where a concentration of cost control efforts will pay off. Rather than describe methods by which this analysis can be carried out, I would like to show the results of an actual study made by a substantial manufacturer of nationally distributed consumer goods (see EXHIBIT I). For convenience, the figures for the various cost centers are given in absolute terms, but each is an approximation. In the actual study, the summary of "total costs," for example, ranged from 90% to 94%, while other figures had ranges somewhat less extreme.

The only innovation as to methods used by the manufacturer is that "cost" is defined (as it must be when one talks about economics) as what the customer spends on the product. In

other words, this analysis looks at the entire economic process as one cost stream, and ignores the accountant's restriction that only those costs which are incurred *within* the legal entity of the business should be considered.

As to results, the important conclusions in this particular example are obvious: where most businesses concentrate their cost control efforts — i.e., on manufacturing — there is not much to be gained except by a real "breakthrough," such as a radically different process. The potentially most productive cost centers either lie *outside* the business, especially in distribution, and require very different treatment from the usual routine of "cost reduction," or they are areas that management rarely even "sees," such as the cost of money.

What Ought to Be

The next practical step is that of analyzing how resources are *now* being allocated to product lines, to staff support activities, and to cost centers. The analysis must, of course, be qualitative as well as quantitative. For numbers do not by themselves give the answers to questions like these:

- "Are advertising and promotion dollars going to the right products?"
- "Are capital equipment allocations in accord with realistic expectations for future demands that will be placed on the company?"
- "Is the company's allocation schedule supporting the best people and their activities?"
- "Are these good people deployed full-time on important jobs, or are they spread over so many assignments that they cannot do any one job properly?"

Answers to questions of this sort are often unpleasant, and the remedies they cry out for unpleasant to contemplate. Moving from the allocation stage to the decision stage, consequently, often takes courage.

Priority Decisions

There is only one rule that applies here. Specifically:

The areas of greatest potential for opportunity and results are to be given the fullest resource support — in quantity and quality — before the next promising area gets anything.

Perhaps the area where the toughest and most risky decisions have to be made is that involving products, for the choices are seldom clear-cut and simple. For instance, products will often tend to group themselves into five groups — two with high-contribution potential, three with low- or minus-contribution potential, one in-between. What is fairly typical is a breakdown such as this:

- *Tomorrow's breadwinners* — new products or today's breadwinners modified and improved (rarely today's breadwinners unchanged).
- *Today's breadwinners* — the innovations of yesterday.
- *Products capable of becoming net contributors if something drastic is done*; e.g., converting a good many buyers of "special" variations of limited utility into customers for a new, massive "regular" line. (This is the in-between category.)
- *Yesterday's breadwinners* — typically products with high volume, but badly fragmented into "specials," small orders, and the like, and requiring such massive support as to eat up all they earn, and plenty more. Yet this is — next to the category following — the product class to which the largest and best resources are usually allocated. ("Defensive research" is a common example.)
- *The "also rans"* — typically the high hopes of yesterday that, while they did not work out well, nevertheless did not become outright failures. These are always minus contributors, and practically never become successes no matter how much is poured into them. Yet there is usually far too much managerial and technical ego involved in them to drop them.
- *The failures* — these rarely are a real problem as they tend to liquidate themselves.

This ranking suggests the line that decisions ought to follow. To begin with, the first category should be supplied the necessary resources — and usually a little more than seems necessary. Next, today's breadwinners ought to receive support. By then even a company rich in talent will have to begin to ration. Of the products capable of becoming major contributors, only those should be supported which have either the greatest probability of being reformed, successfully, or would make an *extraordinary* contribution if the reform were accomplished.

And from this point on there just are no high-potential resources available, as a rule — not even in the biggest, best-managed, and most profitable business. The lower half of the third

group and groups four, five, and six, either have to produce without any resources and efforts or should be allowed to die. "Yesterday's breadwinner," for instance, often makes a respectable "milch cow" with high yields for a few more years. To expect more and to plow dollars into artificial respiration when the product finally begins to fade is just plain foolish.

The "also rans," who after four or five years of trial and hard work are still runts in the product litter and far below their original expectation, should always be abandoned. There is no greater drain on a business than the product that "almost made it." This is especially true if everyone in the company is convinced that, by quality, by design, or by the cost and difficulty of making it (that is what engineers usually mean when they say "quality"), the pet product is "entitled" to success.

This is part of the last and most crucial "how to do it" requirement: the courage to go through with logical decisions — despite all pleas to give this or that product another chance, and despite all such specious alibis as the accountant's "it absorbs overhead" or the sales manager's "we need a full product line." (Of course, these are not always unfounded alibis, but the burden of proof of every alibi rests with those that plead it.) It would be nice if I did, but unfortunately I know of no procedure or checklist for managerial courage.

Conclusion

What I have sketched out in this article is the manager's real work. As such it requires that he

attack the problem of increasing business effectiveness systematically — with a plan of action, with a method of analysis, and with an understanding of the tools he needs.

And while the job to be done may look different in every individual company, one basic truth will always be present: every product and every activity of a business begins to obsolesce as soon as it is started. Every product, every operation, and every activity in a business should, therefore, be put on trial for its life every two or three years. Each should be considered the way we consider a proposal to go into a *new* product, a new operation or activity — complete with budget, capital appropriations request, and so on. One question should be asked of each: "If we were not in this already, would we now go into it?" And if the answer is "no," the next question should be: "How do we get out and how fast?"

The end products of the manager's work are decisions and actions, rather than knowledge and insight. The crucial decision is the allocation of efforts. And no matter how painful, one rule should be adhered to: *in allocating resources, especially human resources of high potential, the needs of those areas which offer great promise must first be satisfied to the fullest extent possible.* If this means that there are no truly productive resources left for a lot of things it would be nice, but not vital, to have or to do, then it is better — much better — to abandon these uses, and not to fritter away high-potential resources or attempt to get results with low-potential ones. This calls for painful decisions, and risky ones. But that, after all, is what managers are paid for.

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