H E W L E T T - P A C K A R D

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FROM: Dave Kirby DATE: October 25, 1988

TO: HP Archives SUBJECT: Dave Packard Talks to HP Managers (1974)

Attached are copies of two informal talks presented by Dave Packard to groups of HP managers in February, 1974. These copies were given to me by Al Bagley, who at that time was general manager of HP's Santa Clara Division.

By way of background, HP had experienced a disappointing year in 1973, at least in the eyes of Packard and Bill Hewlett. Inventories, accounts receivable and other expense items exceeded appropriate levels and there was even talk among some managers of seeking outside financing -- incurring some long-term debt -- to get the company over its rough spots.

It was against that background that Dave Packard embarked on a series of "pep talks" to HP managers. Attached are unedited transcripts of two of those talks.

The talks are interesting because they show an "unvarnished" Packard -- with his temper up, his irritability clearly in evidence, and his motivational juices flowing.

The impact of these talks was immense and immediate. Within months, or even weeks, the company achieved a significant improvement in its operations and any thoughts of seeking outside financing were abandoned. Dave Packard had accomplished what he set out to do.

Attachment:

DK

2/11/74

2/11/74

Bagley

I want to welcome you to this EPG meeting. Since Mr. Young and Mr. Demere couldn't make it, they asked me to just make a very brief announcement introducing Dave who is going to kind of give us his personal analysis of the annual report for '73 and maybe tell us about some implications for '74. It's our pleasure to have you here. There's an "up" switch on the lectern.

Packard

Well, gentlemen, I think it's a good thing for us to take a few minutes here this year and go back and remind ourselves of some of the things that we seem to have forgotten. I suppose each one of you was just as shocked as Bill and I were when we got the figures together and found out that the profits were such that they did not support as high a bonus this year as they did last year, and you know Bill got a little mad about it and I guess he got carried away over the PA, and he really didn't blame the right people, but in any case, I think it happened just because we were kind of soft about it, and there are a number of things that troubled us, but I guess one of the most serious was that we had known that there had been some problems during the year. We didn't realize that the problems were as bad as they were, and the fact that we didn't know until the last minute was a very, very troublesome thing. So I thought it might be helpful to take a few minutes and turn around and see if we can really define what some of our management objectives in this company should be and what I'm going to tell you today is not anything that you don't already know or shouldn't already know, but for some reason we've gotten a little bit off the track in the last couple of years. I think last year in

particular. For some reason, we've got this talking about one of our objectives is to increase the share of the market, and I want to start right out by telling you that that is not a legitimate management objective of this company, that it leads you to the wrong kind of decisions, and that hereafter if I hear anybody talking about how big their share of the market is or what they're trying to do to increase their share, I'm going to personally see that a black mark gets put in their personnel folder, and I want you to understand that because that's extremely important. Anybody can increase the share of the market by giving away their products, and that's exactly what we did in some cases in this company the last couple of years. This is not a subject that you people here were responsible for, but we have a rather significant share of the market in CATV amplifiers, and we'd be just a hell of a lot better off if we hadn't ever touched that business and if our share was zero. So, that's one of the first messages that I want to get over, and I just want you to understand that that's one of the reasons in my view that we've made some very bad mistakes in management, and that's the first lesson of this afternoon.

Now, I want to really go back and talk about some of the things that we've talked about before. I just happened to be reading the February 9 issue of Business Week in which Peter Drucker was quoted in regard to a new book he's written, and Peter Drucker, as some of you know, is one of the real students of management in this country, and he makes a lot of sense. I just want to read a couple of things here, a couple of excerpts, which may kind of set the pace.

He says this about profit, and I'll get back to that. "Profit is seen as a minimum need of a corporation, not as a maximum goal of business." He's complaining that this is what often happens. To Drucker, businessmen who talk about profit maximization are doing more to hurt the system than anyone else. They're merely convincing people that there is no defense of the system. What strikes Drucker as most moronic is that the maximum profit which managements hope to achieve with their maximum goals is often less than the minimum profit needed to keep the business healthy and growing. It seems moronic to me the way many businessmen explain the reason for profit. He says: "Making the money is a demand on you, whether you're really interested in it or not." Now, Drucker wouldn't be quite as tough on you as I would in this company because he goes on to say that his consulting clients think he makes a horrible profit demands on them, and he says anyone who has had less than a 12% return in the past few years has been frittering away his assets. Well, I can assure you that we're not going to talk about 12% return around here, but I just thought that you ought to know that there are some other people who have been thinking about this problem, and I want to quote a couple of other things here that are kind of relevant to what we're talking about.

He says this about the growth company. He says, "A business that grows at an exponential rate, let alone at a higher rate than the much proclaimed 10% each year, would soon gobble up the world on all its resources. The growth company is not a sound investment. Such a company sooner or later, and usually sooner, runs into real difficulties. Sooner or later it runs into tremendous losses,

has to write off vast sums, and becomes in fact unmanageable. There are few exceptions to the rule that today's growth company is tomorrow's problem." And, gentlemen, what our job is is to make this company one of those exceptions, and I can assure you that if we continue to do the kinds of things that we did in 1973, what Peter Drucker says about the growth company is exactly what's going to happen to this company of ours.

Now he goes on to say that on managing growth, "Growth always requires that management of one man or a small handful of men be replaced by a genuine top management team. One way in which the chief executive of a small business that has growth ambitions can prepare himself for that day when the company will have outgrown management by one man is to build a top management team at the earliest possible moment." Well that, of course, is what Bill and I have been trying to do, and if our results in 1973 are any indication, we've not been very successful so far, so what I'm talking to you about is that we've got to somehow get this management team of ours so that its on top of the job and this is going to determine the future success or failure of this company, and it's a very serious matter. So I want to go back now and go through some of the figures in our annual report, and I asked that annual reports be distributed to you, and some of these percentages are not worked out, but we start with the figures that are shown there on the page 1 I guess it is, the fiscal highlights. If we run those out, we find that our sales increased by 38%, our net income increased by 32%, and our pre-tax income increased by 27%. How on the face of it, that looks like a pretty good performance. We had known that the profit performance

was soft and we knew that the calculators were a significant part of this overall result, but in order to bring this out, I have gone back and taken some other figures, some of which are from the chart that's shown on page 3, and this of course is the first time that we have broken down the various segments of our company into the product groupings and shown the sales and the pre-tax earnings. The reason we show the pre-tax earnings is because it's very difficult to reflect down unusual gains and losses, any impact of the taxes back to the individual groupings in the company, and as a matter of fact if we look at the pre-tax performance of the company in 1973, the overall pre-tax performance showed a growth of pre-tax earnings of only 27% as compared to a growth of shipments of 38%. Now, the pre-tax income is really a better measure of management because the difference comes about from undetermined, unpredicted gains and losses, and in this case by some tax arrangements we had in Singapore so that the measure of how well we've been on top of our job I think is better measured by the pre-tax income.

Now, if we go down and look at this in terms of the various segments of the company, we found that Data Products looked very good. Indeed, their sales increased by 99% from 1972 to 1973, and their pre-tax earnings increased by 75%. Now this looks good, except that the one message that I want to get over today, I haven't gotten around to it yet but I might as well tell you what it's going to be, is that management (?) couldn't understand that word requirement of the future is to get your pre-tax earnings to increase annually as fast as your sales, as fast as your shipments, so that by that measure, Data Products' performance, even though it was

spectacular in terms of its overall magnitude, did not represent what I consider to be the kind of management that's going to keep this company on a sound footing in the future.

If we look at analytical instruments, here the increase in sales was 32% and the increase in pre-tax earnings was 29%, and so by the measure that I would apply, the boys there did what I consider to be a very good job and that area came the closest to doing the kind of a management job that we would expect of any segment in the whole company, and that's by these measures that I'm talking about now, and these are the measures we're going to be looking at, and we're not going to be looking at market share or anything else in the future. We're going to be looking at how well you can get your earnings to grow in relation to your shipments.

Medical instruments area did a good job increasing their sales. It went up by 39%, but their pre-tax earnings went up by only 9%, and so again by the measures we're talking about today, that's not very good performance.

If we look at the big area of the company of which you here are a part, the test instrument EPG group, here there was a sales increase of 17% and a pre-tax earnings of only 7%. This is particularly troublesome, not so much because of the 17% because 17% is a perfectly legitimate, an adequate, rate of overall growth, and you have had some problems in this area, but the fact that you could not get more than 7% increase down to pre-tax earnings is the real problem we have, and this is the thing we were talking about.

Now, where we really begin to see the trouble is if we look

at the overall performance of the company when we take the Data Products area out of it, and under those conditions, the overall growth in our sales was 20% and the overall pre-tax profits were only 8%, and so here again, by the measures that I'm talking about today, the performance of everybody outside of the Data Products area was indeed the cause of our problem.

Now if we go further and look at what the total company performance was without APD, without the Advanced Products Division, here we find that our sales went up by 25%, but our pre-tax profits went down by 2%. Now that, gentlemen, is why the profit sharing bonus this year was not up to expectations. You fellows just didn't make enough money to justify the responsibility of h , and if we take the total company without the calculators, meaning we take the APD and the Loveland calculators out of our figures, we come up with a sales increase of 23%, still a good healthy sales increase, but a pre-tax earning that was 8% less than 1972. So that, gentleman, is really the outline of the problem and it's a very, very serious one.

Now, I'll get into giving you some more specific guidelines and ways that I hope will be helpful here in a minute or two, but I want to just point out again from the balance sheet, and you can look at the balance sheet figures on the back of the annual report and you can work these things out for yourself if you want to, just in case I made a mistake with a calculator, which is entirely possible. In any case, our accounts receivable went up from 1972 to 1973 by 58%, and that contrasts with a sales increase of 38%, and I submit to you that there was absolutely no

justification for our accounts receivable to go up in one year any more than our sales went up percentagewise. Now it turns out that fortunately we've got a few people working on this problem, and one of the difficulties here was that somehow you fellows didn't think this was a part of your responsibility, I guess, because you didn't do anything about it, and we've got a few people working on it now, and we've got, at last report, damn near $20 million out of accounts receivable just in the last couple months. To point out what this means is that this was a $69 million increase in the money we had up in accounts receivable which was more than the total profit we made after taxes for the whole company for the whole year, which as you recall was $50 million, and we just cannot run a railroad that way. Our inventories, finished goods went up 49%. For the life of me, I don't understand why the hell we had finished goods inventories going up 49% when we had sales going up only 38% and when we had plenty of orders on hand to ship more. What the hell are we keeping all this goddamn stuff in finished inventory for? Now that's your job. We have work-in-process that went up 49%, and here again there may be some rationalizations for having work-in-process go up. There were some problems, but nevertheless we apparently didn't have any trouble making more finished goods than we could ship, and I don't see any reason why the hell we couldn't have kept our work in process down at a level of increase roughly comparable with the increase in our shipments. When you talk about raw materials, our raw material inventory went up 92% between 1972 and 1973. Now I understand that in running a manufacturing shop that it's a hell of a

lot easier to run it if you've got three times as much raw materials on hand as you need, and that just makes it a very easy job, and if that's the way we're going to run this company, we don't need professional managers. We need a bunch of kindergarten kids, and so if you fellows who are responsible for running this manufacturing area can't keep your inventories in line, we're just going to find someone that can, and it's just as simple as that. We cannot afford to have a 92% increase in raw material inventories in the year in which our shipments go up only 38%. We had a lot of meetings during the the year, and everybody had an excuse and a lot of rationalization, and all we want to worry with is try to get the idea over, but we're not going to put up with this in the future, and I just want you to all understand that. Our total inventory went up 59%, and that amounted to $70 million, was the increase in the cost of our inventory the additional money that we tied up during this last year in inventory alone, again $20 million more than we generated in profits. If you take profits and cash flow together, we only generated $73 million, and the increase in inventory took almost all of that. If you take the increase in inventory and the increase in accounts receivable, we did not generate anywhere near enough money from profits and cash flow to cover those two items alone. If you look at our investments in property, plant and equipment, that looks a little better. Before depreciation, that actually went up only 39%, so we can't find very much fault in that. We did have a larger increase in the after depreciation amount, and I think, but I haven't looked into it exactly, I think that's probably because we had

substantially more construction in process which didn't come under depreciation, but in any case, I think we recognize that we were behind in plant and equipment, and so the amounts we committed last year were not significantly out of line, but as I'll come to later, this is an area which is going to require some better attention.

Well, the shareholders' equity, as you can again see from the report there that shows the comparison of the two years, went up by 23%. A return on equity, if you want to look at it on that basis, was a little bit better than the previous year but nowhere near adequate to keep up with our increase in sales. Now I guess that you've judged by now that what I am getting back to is that one of the traditional policies of this company has been that we were going to manage it so we would finance our growth from earnings, cash flow, and as we somehow seem to have gotten away from that and I see absolutely no reason why that should not still be our basic objective, and I'll talk a little bit about why not only it should be but it has to be in a few minutes.

Well, of course, what happened in order to cover these increases in accounts receivable, inventory, and our capital items was that we had to resort to a very substantial level of borrowing from the banks. Our borrowed notes payable went up as you can see from $17 million up to $120 million, which you have to take both the notes payable and the commercial paper items together there. This was in increase in our borrowing during the year of $103 million, and at the current interest rate with what we usually have to do in terms of compensating balances is costing us over 10%, so that means that this increase in our borrowing

has added a pre-tax cost of at the rate of $10 million. Actually this build-up was during the year, and we did pay out $5 million in interest as a cost of operation to provide for this financing.

Now, the thing that I want to emphasize today is that the overriding objective of the management of this company has to be to generate a return on equity which, together with our cash flow, will increase our resources on the average and over the long range, and we can tolerate some ups and downs from year to year, but this has got to be done on the average and over the long range, at a rate which is equal to or greater than the rate of growth of our sales. As a matter of fact, with some of the trends we have in the company, the need for more sophisticated equipment for the kind of products we're making, we probably are going to have to increase our capital faster than the increase in sales dollars, although this gets back to the pricing question, and we have a further problem that if you look at the replacement cost of equipment and facilities that wear out and have to be replaced, the inflation adds a cost there, so that we probably cannot replace what we have on the books at the original cost let alone, of course, at the depreciated figure.

END

Well, the thing that I want to say to you today is something that you all know, but it's so important that we've just got to get back and keep this in the forefront of our thinking and everything we're doing. Our job is to generate an adequate return on our equity to finance the growth of this company as we move along. Now, you don't do that as a direct action, as a direct management action, so I want to outline the specific management actions that are your responsibility and which, if done properly, will result in this end result we're talking about.

The first responsibility you have is to control your profit as a percent of sales, and you have in this area, three specific ways by which this can be done. The first one is by pricing, and while I think that you people in this area did a fairly good job in that regard while we were constrained by price controls, I was shocked to find some places in the company where we came out with a hell of a good product and where people had failed to price it in order to make a profit on a current basis. They got into the same goddamn trouble I used to have when I was on the Board at Varian that they were always going to make a profit manana, thinking they could get their costs down, and they never could, and they never did, and I found some of that in our company here, and so I want to just say to you that when we talk about pricing, I expect this pricing to be done in a way in which it's going to pay off the first year of that product and not when you think you're going to get your learning curve down because you're never going to get your learning curve down where you think it'll go. I've seen this happen over and over again. As I say, I think you fellows in this area perhaps haven't done so badly, but I want to emphasize that, and that is an essential requirement, and

it relates to the thing that I talked about earlier that getting a market share is not an objective and if you've got to price your products too low to generate a profit to get an adequate level of business, you're making the wrong product, and you've just to get that through your heads when you're talking about pricing, and I know that most of you know this. We've had a history that I'm going to go back and show you that we've been doing this job right for the last 10 years, the last 20 years. There's absolutely no reason why we can't continue to do it right, so what I'm talking about is not any unusual requirement, I've just been talking about what has been done and what most of you fellows have been done, and we just got off the track this last year. So pricing is one of the most important management actions that has to do with the control and establishment of an adequate profit as a percent of sales, and I'm not going to set down any precise guidelines on this because they're circumstances, and if there were a magic formula, why, every company would be successful and every business would be the best in the world. It takes knowledge and judgment and sometimes it takes guts to do the thing that has to be done, and that's the thing that I want to re-emphasize to you, and that is so important. Now, we've had the price control problem. I think we're probably going to be out from under that on the first of May. We asked everybody to go back and look at this pricing problem again the first of the year within the policy that we were going to implement those price increases that we thought were appropriate in the international market where we could immediately and follow that up domestically whenever it was possible. I'm not convinced

that, I don't say you people because I'm not sure which ones each of you fellows did, but I'm damn sure that a lot of people in this company did not do that job right and I'm going to ask everybody to go back and look at their pricing in terms of what I'm talking about today and be prepared on the first of May to take such actions as are necessary to get us back where we ought to be.

The second management action which deterines, which affects, which influences the profit as a percent of sale is the project cost control, and I'm sure there are some areas in which we can do a better job in cost control. I'll show you a little bit later what's happened over the longer period and where we've gotten out of bounds, and we've had a pretty good record over the years of keeping our costs under control, and, as a matter of fact, the record does show that the cost of goods sold has in fact over a long period of time been kept under good control. I don't remember the figures last year; I may have those here.

And the other management action which influences the level of profit as a percent of sales is, of course, all of those things which you bring into the general term of productivity. This includes using better methods, better equipment. It includes motivating your people. All of you, you know all of these things, and you know, generally speaking, what to do about them, and these things are extremely important.

The other action of management that is necessary to achieve this return on assets which is absolutely essential for the future of success and even survival of this company is in the management and the conservation of this company's assets, and

this, of course, is where we fell down very badly. Accounts receivable I've already talked about. That's you job; that's not somebody else's job, and it's your job to see that this gets done and we just didn't do that last year. Everybody thought that was somebody else's business, and I even found some cases where a salesman had gone out and, in order to get a sale, told a customer that he doesn't have to worry about when he pays his bill. Well, I'll tell you, that's not going to happen very often if I find out about it again, but those are the kinds of things we just can't tolerate, and it comes back from this idea that we got into our heads that getting a share of the business is important. A share of the business is no concern of yours whatsoever. Proper profit on assets, the return on assets, to pay for the things that we all want to do together is your concern. We've talked about inventories, and I have no doubt that we've got a lot of people who are working pretty hard on inventories and doing what they thought was the right thing, but it's you fellows who have the overall responsibility to provide guidance and direction and to be sure that these things get done and the performance on inventories in 1973 is a performance we cannot afford to duplicate. Another year or two like that, and we'll be right where Peter Drucker says all your other growth companies are going to be, and that's just exactly what'll happen to us.

The third area is in the cost of plant and equipment, and again, you know this. We don't have to have every goddamn thing we're doing gold plated, and we can find places where we can save money and we can get the job done just as well, and we've asked Ralph Lee to go back and ask each one of you to go over your

capital budgets again to make sure that you've got only those things that are necessary and only when they're necessary and to see if we can't trim out a little fat there, and though we've had some bad experiences, we got some equipment in here that didn't work right and all kinds of problems, but if we didn't have problems, we wouldn't need capable people to manage this company, so that's why we've got smart guys like you responsible for this job because there's problems, and these problems have got to be solved, and they're your problems and our problems. So I guess that really where I came out that our management team failed in just about every count that I would call a measure of good measurement in 1973.

The other area which I haven't touched on, and this is one which again you know, we had an awful lot of surprises that came up at the last of the year. Looking over the statements, we've got an awful lot of accruals. I always felt that whenever I was working on this job that you're supposed to keep track of everything that was going on as currently as possible and if you didn't know about what was going on, you better find out some way to learn, and here we found around the company there are all kinds of things that people just didn't know about and you can't manage something if you don't know about it. Some of these things I'm talking about have to do with our systems and procedures. I understand that, and we're going to go back and do some work on those things, and there are no doubt some suggestions that you people will have as to where the problems are on a specific basis, but we've just got to do a better job of knowing where we stand.

Now, I'd like to say a word or two now about why the growth

and profits on an annual basis is so important. You are, I hope and I assume all or most of you, are stockholders in this company. Whether you are or not, as managers we have responsibilities to our stockholders, so I thought I'd take a couple of minutes and review for you how the market evaluates the price of a growth stock, and I'm going to generalize a little bit here because the precise numbers vary from year to year, but essentially at this time if you want to loan some money, you can get about 10% on your money or that's what we have to pay if we borrow it. Now, that's an investment which you're absolutely sure you're going to get your original investment back and also in which the earnings or dividends or however you want to measure them will be returned to you in 10 years. In other words, this simply says that the price to earnings ratio if you want to put it in stock terms is 10 to 1, and what that means is that you will get your money back in earnings in 10 years. Now that's the precise formula that people apply when they're thinking about stocks except obviously when you're talking about a stock, you wouldn't expect to get some money back a little faster because there's some uncertainty in it, and when you're talking about the price to earnings ratio, the traditional price to earnings ratio has been lower than the current money market. For some reason the last few years it's gone the other way, but let's just assume that it's going to be the same and that's, I think, a pretty good assumption for our purpose. It just turns out that if we can generate a growth in earnings per share of 32% per year for the next 10 years, beginning with the earnings that we had in 1973 of $1.89, the stock price of the Hewlett-Packard Company at this time should be $88, which is not too far from where it is, and

this is just sort of to indicate that this is really how people figure out what the price should be. In other words, we've had a record of growth that's pretty good. People took a first look at our annual report and assumed that we had an increase of 32% in our earnings this year, and that's basically the reason that the market has been supporting a price of around $80. It's gone down a little bit, and it's going to go up and down from time to time, and I think we've got some real trouble here because if the people out on the street had a little better idea on some of the problems, the price would probably go down a hell of a lot further than it is now, and I want to give you some examples of that. In addition to the price being at $88 per share, assuming that this formula didn't change very much from year to year, it would mean that the price of the stock would increase at the rate of about $30-35 a year. So, when people are buying stock, when advisors are advising people to buy stock in the $80 range, what they are saying is that we believe Hewlett-Packard Company will continue to increase its earnings at the rate of about 30% per year and that this will continue over the long term. Now, let's just take a look at what they would have said if they'd seen the performance of the company without the Data Products area. I told you that if we simply take the whole Data Products area out, that shows that we had a growth in earnings of 8%. On that basis, again with a price of $1.89, the market for Hewlett-Packard Company stock today should be $27, and we would expect it to grow at the rate of about $4 a year. Now if that's the kind of performance you're going to be satisfied with, you just do the job that you did in '73 another year or two and you'll be there

or you'll be even worse. Now, this is what we're talking about. The market doesn't give a damn about your sales, they don't give a damn about your share of the market; the only thing that counts is rate of growth of earnings if you're going to be in a growth company, and a growth company is not growing in size; it's growing in earnings potential, and this is the thing that is so important for all of us to understand and is so important to do something about because we're just facing a disaster if we don't.

Now, I would say that, given the opportunities we have, and we've got a hell of a good base of all kinds of things that are better than anybody else can do, a company that we can be proud of and performance that we can be proud of in every respect, and I don't see any reason why we should not have as our prime objective that of maintaining the growth in our earnings at the rate of 30% per year, and I think that's a perfectly legitimate objective for us to undertake, and I am simply asking you to think about this and to go back in your area and to see what you can do to help us get there and I realize that this doesn't mean that everybody can be at that place, but where you've got a product that is clearly ahead of the market, you've got to price it right, you've got to work on cost control, you've got to do these other things, and we've got to preserve our assets because if we do not do so, we're going to have to go out and borrow some money or sell some stock, and this again will change the factor by which these people evaluate the appropriate price of the stock in the market. Both of them will tend to deteriorate.

So I think that perhaps rather than to give you a specific figure a better way to put this is, and this is an objective, that

I see no reason why we shouldn't ask of everybody, and that is your objective on profits for 1974 is to make sure that our growth in earnings is at least equal to or greater than our growth in shipments. It shouldn't be very hard to do that, and that's the guide because the summers you can't achieve this 30% gain in market, but if it's only 10%, make sure your earnings increase 10% or whatever it is, it's the growth in earnings that count, and it's not the share of the market or it's not the growth in your sales account.

The second objective for 1974 I've already touched on, and that is to recognize that you have a responsibility for the management of the assets of this company, and we can establish as a target here that we should be able to get at least $25 million out of our accounts receivable under operating conditions as of the end of the year. Now, we've already done a good part of that as a matter of fact. We've got some people working on this a couple of months ago, and I don't know why the hell they weren't working on it before this, but it wasn't very hard to get this matter taken care of. There are lots of things that affect this, not the least of which is to get your billings out when you ship something, and I find out that there have been people here who have been shipping products and not billing them for 8 or 10 days later. This does two things. It adds whatever delay period to our turnover time and ties that month's money up for that much longer, but it does another thing. It gives a message to our customers that we don't really care whether you pay the bill or not, and that's no way to handle this proposition. You fellows have the opportunity to, if not the opportunity you've got the

responsibility, to do whatever has to be done in your area to make sure that our billings get out properly with shipments and that we do all those other things that are necessary to handle accounts receivable. Now, we're going to try to give you some more help on this and we've been talking with the Marketing people and we're already trying to get the message over to them and we'll continue to do so, but you people who are working here in the divisions can be a big help in getting accounts receivable down. Some of your friends are going to call you up for some special service or a little help now and then. If you know whether this guy's paid his bills or not, that can be a good place to talk about this subject a little bit at a level where it'll be understood, and this is not a job for our clerks and our people down at the lower level. This is a job for you fellows who have the management responsibility of the various divisions and units and significant groups of activities in this company. It is nobody else's responsibility; it's yours.

The same thing is true of inventory, and I think that we should have a target of getting at least $25 million out of the inventory in terms of the operations as they were the end of the year. In fact, I think we should be able to do better than that. I think we should be able to do better on both counts because both accounts receivable and inventories went up faster last year than there was any reason for them to do so.

In conclusion, I would like to just take a few minutes to find out that what I'm asking you to do is not anything unreasonable because we have been doing the kind of a job that should have been done up until this last year. If you take the period from

1964 to 1973, we had an annual rate of growth of our sales of 19.2%. Now that wasn't the 30% we're talking about and in those days the market was willing to give you more than 10 years to get the price of the stock back and they may do that again, but, and it may be unrealistic for us to get up to this 30% I'm talking about, but we had a net sales gain of 19.2% and our net income increased 20%. In other words, we did increase our net income more rapidly than our sales over this last 10-year period, and we had a couple of rough years in that period too when things leveled off, so this 20% figure was down for that reason. The figure on net income per share was a little bit lower because of our stock purchase plan and because of the exercise of options in the company, but we increased our net income per share over this 9-year period from 1964 to 1973 by 19%. If you look at '64 to '69, we did the same thing. We had a net sales gain of 20% and a net income gain of 21%. We recognize that there were some sales problems in the 70-71 period. If you look at the period from 71 until 73, we did a pretty good job. Again, we increased our net sales by 33% and our net income by 45%, that's mainly because we did a good job last year in getting our net income back where it should have been before this level-off period we had. But in 1973 the figures I've already given you, the net sales gain of 38% and we were able to get the net income up only by 32% after taxes, per share it was only 30%, and it was entirely because of the calculators. If it hadn't been for the calculators, we would have just looked absolutely terrible in 73, and that's the message I'm trying to get over.

Now, if you look at this overall performance just to give

you some idea about the fact we have kept things under control, our net sales gained by 19.2% per year, our revenue gained by 19.4% because we had some other things, we got some trading income, a few things like that. You did a good job in the control of cost of goods. That went up at the rate of only 18.3% per year as contrasted to sales of 19.2%, so the cost of goods was not a problem. You did, over this period, keep that under control, and the fact that we did not have to generate any long term debt or substantial borrowing meant that during this period, you did keep your inventories and your accounts receivable where they should have been. The R&D costs were controlled over this period at an annual growth rate of 18.7%, still below the gain in net sales, and this was an area which was well controlled and if anything you might argue that the R&D costs ought to be allowed to grow as rapidly as our sales. Where we fell down is in the area of Marketing, Administration, and general expenses which went up 21.4% over this period per year compounded as contrasted with a gain in sales of only a little over 19%. During
all
this period, just to put it in the same terms, our interest cost went up at the rate of 55% per year compounded. Of course, that applies to the last year, but that shows how badly out of hand that was as the result of the fact we did not manage our resources. Gentlemen, that's essentially the story I wanted to get over and just let me conclude my saying that maybe, in talking about a 30% growth, this is more than we can expect. Let me just go through the same calculations on a 20% growth. If the market gives you 10 years to get your price back at a 20% growth, the price of the stock today would be $49. If they give you 12 years to get

it back, the price would be $74, so that I think that if we can in fact over the long term maintain the kind of performance we have in the past that we can do the kind of a job our stockholders expect us to do, but it's going to require a job that was not done in 1973.

Well, gentlemen, that's the message I wanted to get over to you. I have one final document here. I'd like to just read a couple of excerpts from this. It's a letter from our certified public accountants addressed to the President of the company and this involves some recommendations that they made in regard to the management and some comments about our management action. They pointed out the unfavorable trends in inventories. They say cost of sales in '73 was only 1.66 times a year in inventories which represents a substantial decline in this important ratio from 1.89 in 1972. Now, that's just another way of identifying and verifying that this inventory problem was out of hand, but there's some other things that trouble me. Here's a comment they made:

"Cash. Bank reconciliations are afforded a low priority, and in some entities, such accounts have not been reconciled for several months."

Does that sound like anything you fellows learned in business school or learned in studying business management? Is that the way to run a business--not paying a goddamn bit of attention to whether or not your bank accounts are reconciled? Now you may not have any here, but if you do, I hope you're listening. Receivables, aside from the increase in receivables one would expect from increased sales, there has been a general build-up

in receivables resulting from billing errors, credits due, and customer acceptance of shipments. Those are all your responsibilities, so this build-up in receivables is not something that belongs to somebody else. It belongs to you.

"Inventory. More meaningful variance analysis could be achieved through more diligent compliance with the company's prescribed procedures for setting inventory standards."

It's a little shocking, gentlemen, for me to find out that some of you people are not following our prescribed procedures, and as you know, we've increased our internal auditing efforts and Mr. Hewlett and I are looking over internal auditing reports, and these are not the kind of things we can put up with. And the other problem is in general uniformity in the time at which standards are set during the year in regard to inventory. That's a detail; I'm not sure how important it is.

Here's another problem. They say that in regard to property, plant, and equipment, "Prescribed accounting policy for property, plant and equipment is not being followed, resulting in lack of control over such assets after acquisition." So our outside auditors who have the job of coming in and finding out whether our management people are doing the right job are telling me the same thing that I've been telling you that somebody hasn't been doing the very important management job of undertaking the responsibility for the management, control and utilization of assets.

There are some other comments here, and they do also point out that we've had some problems with procedures. I think it can be fairly said that we have been, well, I don't know whether it

can be fairly said or not, but it is my opinion that we are taking too much time trying to work out targets and not enough time managing our day-to-dav affairs, and we're going to see if we can't do something about getting this targeting procedure simplified down a little bit, and I understand that this is a particularly serious problem as far as the accounting people are concerned because right at the time they're supposed to be working on getting the books closed and telling new managers what to do, everybody asks them to do a lot of work on targets, and I think that is a mistake, and I think we're going to try to do something about that particular thing.

So, that's the message, gentlemen, and I'm sure we can get hold of this problem, and all I ask you is let's forget about this share of the market nonsense. I don't know where we got onto that, but where we got onto it, it's the wrong thing to be talking about, and let's get back on the fundamental principles of management that have worked well for this company in the past, that are going to work well for this company in the future, and this is not anything that is unreasonable for Bill and me to ask of you gentlemen. I'll be glad to answer some questions.

Let me answer just one question which was raised here during the coffee break, and that question was that is this a problem we've got to get fixed on one-time basis is that really resulted from our very rapid growth in sales last year and the thing I want to point out is that if you take calculators out of the equation, the rest of the company grew only 20%, so there was no abnormal growth in sales in the rest of the company. There may have been in some areas, but that's the same rate of growth that

we've been living with for the last 10 years. There was no excuse for all these things to have happened because of any big increase in sales. That wasn't the problem.

Now the other thing that, and I should have these figures for you, we can perhaps get them, the question of whether the calculator area generated some of these inventory and accounts receivable problems we're talking about, and I don't have the figures here, but as far as I know, Ralph, you can check me on this, their accounts receivable have been down about 30 days, I understand, haven't they? APD? So APD did one of the best jobs of controlling accounts receivable and inventory, and obviously, they were shipping those things as fast as they could get them made, and they were working hand to mouth. As soon as they got any raw material in, they got it in a calculator and out the door, and we finally got them so they could build them in time. That took a little while to get that done, but we were having some trouble there in the beginning. They finally got going. The problem is not one that we can blame on any abnormal growth. Now, I think we do have some problems that maybe have to do with our systems. What I'd like to suggest is this, and I don't think we can accomplish this here this afternoon. I'd like to have you fellows go back and think about some of the things that I've talked about here and maybe have some meetings among yourselves, and we'll get together with small groups, either Ralph Lee and Bill or me and some of the rest of us, and give you fellows a chance to give us some suggestions as to what you think can be done to help out here, and I'm sure that you can help us in getting back and giving us some ideas.

Another question? Well, what I'm suggesting is this; That our inventories were too high in the end of '73 by any measure we apply, and I don't know whether $25 million is the right figure, but I'm confident that we should have been at least $25 million lower in inventory at the end of '73 than we were, and what I'm essentially asking everybody to do is to try and take the actions which will get the beginning inventory down company-wide, not just the divisions represented here but company-wide at least $25 million lower than it was at the beginning of the year, and then see that your inventory growth during the year is no greater than your growth in sales, so that if you have, as you were talking about, a 10%-11% growth in sales projected, what I'm saying is the Santa Clara Division ought to be able to get their share of the $25 million out of their inventory. It may not be uniformly distributed; I don't know. Ralph and the rest of us will try to work with you on this, and I'm not sure well I am sure that the $25 million is a reasonable figure to talk about, and I think we should do better than that actually, so that we would try and take those steps which should get this inventory down to where it should have been and then recognizing, of course, that if you have a substantial growth area, you're going to have to have inventories that go along. There are a lot of things that can be done here. Finished goods is a problem, and we've already talked about some things that will help there. The consignment inventory is a problem, and I realize that there's been great pressure to have a lot of raw materials on hand, but I'm sure that we didn't need a 92% increase in raw materials, that maybe something less than that

would have been adequate.

Another point that I think we've got to keep continually in mind. We're getting bigger and we're already going to computerize systems of one sort or another. These computerized systems are not going to substitute for management judgment, for making the right kind of decisions, the best they can do is to give you some information, hopefully the right information, hopefully faster. The computer can't make a decision for you, and you better just remember that, and if our computerized systems are not giving you information which is timely and useful and that enable you to make the decisions that are necessary, then we'd better do some more work on our computerized systems, and I suspect we have some problems there, but those are the kind of things I'd like to get some feedback because you're the guys on the firing line and you're the ones that we have to depend on to get this job done. I can't do it for you and Bill Hewlett can't do it for you and Ralph Lee can't do it for you. You're the guy who's got to do it, and we want to help you in any way we can.

Well, let's go back to work and we'll see you again a little later.