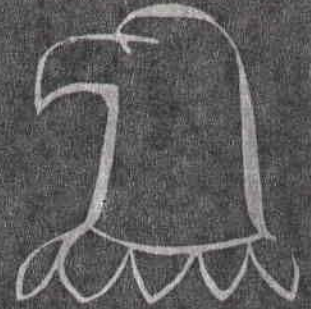


DEPARTMENT OF STATE

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CASE STUDY

CERTAIN ASPECTS OF THE
MULTINATIONAL OPERATIONS OF THE
INTERNATIONAL HARVESTER COMPANY OF CHICAGO

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FOURTEENTH SESSION
SENIOR SEMINAR IN FOREIGN POLICY
Washington, D. C.
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THE SENIOR SEMINAR IN FOREIGN POLICY

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CERTAIN ASPECTS OF THE MULTINATIONAL
OPERATIONS OF THE INTERNATIONAL HARVESTER
COMPANY OF CHICAGO

A CASE STUDY

BY

Robert K. Sherwood

May 1972

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INTRODUCTION

Increasing national attention to the role and operations of U.S. multinational corporations led me to select this general area for my case study. Lack of time forced me to limit my visits to International Harvester's subsidiary companies in the United Kingdom (London office only), West Germany (plants at Heidelberg and Neuss), France (Paris office and plant at Croix), and Zurich. I had no contact with the IH major production line of trucks, because the subsidiaries visited concentrated on farm equipment, some construction equipment, and components, such as engines and transmissions for other IH plants. I also talked with the regional sales representative in Athens. In addition, lack of technical expertise on my part confined my questions to certain aspects of operating circumstances, particularly the labor situation, financing techniques, and the control mechanism by which the subsidiaries and IH in Chicago are linked for management over-viewing and evaluation. The following brief report, therefore, is illustrative, not exhaustive, and is intended only for the general background information of the reader. Although based on conversations with IH officials, responsibility for the text and any errors therein is solely mine.

The International Harvester Company is in the business of manufacturing and selling self-propelled heavy machinery and vehicles, both rubber-tired and crawler types, for use on and off the highways. IH is a major producer of trucks, both gasoline and diesel powered, in a broad range of weight classifications; farm and industrial equipment including agricultural tractors and a full line of self-propelled, towed and mounted farm equipment, light and medium industrial tractors, and allied equipment such as loaders and backhoes; and construction equipment, including earth moving equipment such as crawler tractors and loaders, self-propelled scrapers, logging tractors, and other earth moving and material handling equipment. IH is also a major producer of gasoline and diesel engines in a broad range of power ratings and configurations for use principally in its products. Many models of the three major product groups as well as the gasoline and diesel engines are manufactured or assembled outside the United States by IH's subsidiaries in North and South America, Western Europe and the Far East.

Wholly owned finance subsidiaries in the United States, Bermuda, Canada and Australia provide wholesale and retail financing for IH's products. Several finance subsidiaries have been organized for the purpose of obtaining short and long term funds from sources outside the United States to aid in financing the requirements of International Harvester's overseas operations.

International Harvester's products are sold through independent distributors and dealers as well as its own retail organization. Manufacturing and assembly subsidiaries outside the United States sell their products in the country in which they are located. They also export their products to other countries for resale and import and sell products manufactured in the United States or by other subsidiaries. Some components manufactured by subsidiaries outside the United States, primarily farm equipment, are imported by IH and sold through its selling organizations in the United States. The IH wholly owned subsidiary, International Harvester Export Company, sells on a world-wide basis a wide range of products manufactured in the United States as

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DISCUSSION

well as products manufactured by subsidiaries and facilities in other countries. There is a substantial degree of interdependence among IH's worldwide manufacturing operations resulting in extensive intracompany and intercompany transfers of both end products and components: approximately 30% of its production is so transferred. Accordingly, International Harvester is unable to determine precisely its income by product group because of the considerable dependence on transfer prices and the allocation of common costs.

PRODUCTION OPERATIONS OBSERVED

The International Harvester products which I observed being assembled from components manufactured by IH or purchased from outside suppliers are listed below. In Heidelberg I observed industrial loaders which are a kind of backhoe and shovel combined, model 3654, and the Payloader models H30B, H50B, H65B, and H90E. In addition, in Heidelberg, certain spare parts for discontinued models of farm equipment are also produced as needed. At Neuss I observed the production of three, four and six cylinder diesel engines and tractor models 324, 424, 724, 824 and 1046. At Croix, in Northern France near Lille, I observed the following products being assembled: combines in four different models; balers for hay and straw in two models; mowers, including the new IH rotary mower, in three separate models; rakes; plows, including one-way, roll-over, harrow, chisel and disc plows; grain drills or seeders; disc harrows; and cultivators.

Due to a railroad strike I was unable to visit Doncaster in the United Kingdom, where transmissions are produced and tractors and some other farm equipment are assembled. Also I did not visit the plant at St. Dizier, France, where production is undertaken for transmissions for Germany and France, tractors for the French and French export market, and a foundry turns out grey iron for transmissions and gear boxes for the mowers and balers at the Croix plant.

The industrial processes which I watched were many. The foundry operations included casting grey iron for engine blocks and heads, piston sleeves, connecting rods, and crank shafts. The foundry operations also included the creations of molds and cores necessary for the production of these items. Two types of foundries were observed, one an electrical or reduction foundry and the other was known as a cupola foundry. Another operation was that of stamping and pressing sheet metal, bars, and other metal forms by both cold and hot stamping processes. A third process was observing how dies are used, both for current production and for discontinued lines. Another operation included lathes, both individually and automatically operated. Also, I observed how jigs were used for the preparation of sub-assemblies prior to the movement of the item to the assembly line. I also saw welding and cutting by electric torch, milling machines, and drilling operations. In addition, I observed forging, painting, quality control testing and final checks of the finished product. One of the most interesting of the industrial processes was an assembly line, how it was laid out and how the storage was undertaken nearby of the necessary components to assure that the right part would be present at the right moment. Lastly, I observed an automated line for the production of engine blocks and heads.

DISCUSSION

The following examples drawn from the foregoing illustrate the complexity of IH's inter-company shipments, some of them national, some international.

1. Diesel engines produced at Neuss were for tractors to be assembled at both Neuss and at St. Dizier; for payloaders at Heidelberg; and for combines at Croix. The transmissions from St. Dizier were used at Neuss, Heidelberg, Croix and IH plants as far away as Mexico. Sheet metal produced at the Heidelberg factory is shipped to Neuss and St. Dizier. Certain axles from German suppliers are used in several of the plants. Big engines come from the Melrose Park, Illinois plant for example, for use in the largest payloader, the H90E model, assembled in Heidelberg. Tires and hydraulic systems are generally supplied by outside suppliers in Germany or, in the case of hydraulic systems, from a firm in Belgium. The transmissions for payloaders come from Libertyville but in the future some will come from IH's recently established affiliate with the Komatsu Company in Japan. Transmissions from Doncaster are shipped to the United States. The frames, buckets, and booms for payloaders are produced at Heidelberg except for the largest ones which are shipped from Libertyville to Heidelberg. Clutch assemblies are normally bought locally, as are carburetors from the Bosch Company of West Germany. Also fuel pumps and radiators tend to be supplied by local suppliers. Lastly, some of the necessary parts for the balers assembled at Croix are shipped from Memphis, Tennessee where International Harvester has one of its major farm equipment plants.

As examples of where some of these finished products are shipped, I can cite that tractors assembled in Neuss are distributed in Germany, Africa and Italy. Tractors from the St. Dizier plant in France are for the French market as well as overseas areas formerly associated with France. At Croix the combines are assembled for the French market, the German market, and the United Kingdom. Balers at Croix are shipped throughout Europe but in addition some balers are made in Doncaster, England also for the European market. Lastly, Croix farm equipment is produced for the Scandinavian, Belgian and Dutch markets.

FEATURES OF THE LABOR SITUATION

Now, moving to the operating situation facing these IH subsidiaries in Western Europe, it was my intention initially to inquire about the range of operating problems in each of these three producing countries, but it turned out that the labor situation received the most emphasis. Such questions as materials handling, subcontractors, and the cost of basic materials were scarcely touched on. In part, this is because they did not seem to be a "problem." Subcontracting did not appear to cause any difficulties as to quality and delivery in any of the three countries. Overall production coordination at Croix had been a real problem in the past due to the complexity of manufacturing and assembly processes, coupled with the aged physical layout. However, this problem was too much for me to grasp in any case.

The International Harvester Doncaster plant and foundry are located in a coal mining area in Northern England where the unemployment rate is 7%. The supply of labor is such therefore that the bargaining situation is favorable to International Harvester at present. Bargaining is essentially local. Inter-union rivalries and jurisdictional disputes have marked the inter-union relations in recent years. In general, though, IH has had labor peace in the U.K.

DISCARD

The U.K. managing director estimated that the average hourly wage payments were about the same as those in France, less than those in Germany, while fringe benefits were lower than in the other countries, giving a direct labor cost advantage to the U.K. plant. Productivity, however, was another matter, and there was some doubt of it matching that of France or Germany.

One feature of doing business in the United Kingdom which is advantageous is the pro-export attitude of the U.K. Government which leads it to be very cooperative in assisting International Harvester of Great Britain. The Board of Trade and the Export Guarantee Agency, as well as the member of Parliament representing Doncaster, can be counted on to be helpful in a positive manner. The U.K. manager also thought that Prime Minister Heath would use the exchange rate as a tool to stimulate exports if necessary.

Price inflation in recent years has been at a rate of 10% to 15% annually and the prospects of labor difficulties which began only this year do not bode well for the U.K.'s competitive position in some lines as it enters the Common Market. This is a conclusion which I drew from conversations in London and Paris.

The labor situation in West Germany is in marked contrast to that of the United Kingdom. Full employment conditions for many years have encouraged the use of foreign nationals. In the Heidelberg plant, for example, over 100 Turks are employed among the piece rate workers. A German commission recruits Turks through offices in Ankara and Istanbul, obtaining both skilled and semi-skilled employees. German manufacturers like International Harvester specify their needs as to skills, and agree to a one year contract with the foreign-born employee. The latter is assured of employment at the going rate for a year. After that time, he can still be employed but the employers' hiring and firing powers are increased. At Heidelberg the Turks -- most of whom left their families in Turkey -- live in barracks near the plant.

A major development in International Harvester's labor situation was legislation in 1971 increasing the voice of the labor force, whether union or not, in the management of the plant. The SPD (Socialist Party of Germany) was obliged upon coming to power under Willy Brandt to improve the lot of the working force. A "works council" was established under the legislation in which both management and the labor force meet periodically to discuss a wide range of subjects. Each 100 employees has one representative on the works council. Management is expected to explain its plans for the near future, for example, and hiring and firing issues are discussed. Special courts have been set up to enforce the legislation. The works manager at Heidelberg believed it was still too soon to judge whether the works council would become a handicap from the management's point of view, but he speculated that the eventual goal of the workers would be a 50-50 share of all the major decisions.

Employees are divided into staff, who are paid on a monthly basis, and hourly and piece rate workers. The latter may average about 7DM per hour, while fringe benefits would add about 50%. The benefits include social insurance, health insurance, two weeks' paid vacation, a Christmas bonus of about two weeks' salary, and a contribution to special savings account if the employees so wish.

The German metal workers' union is the principal union with which International Harvester of Germany must deal. Annual negotiations take place on a local level, rather than a national level. This would appear to favor International Harvester and other employers at the present. In an effort to change this pattern the union last December struck one state -- Baden -- which happened to include the International Harvester Heidelberg plant,

and hoped to extend the settlement arising from the strike to other states. The union was not successful, however. The annual negotiation sets a base wage, to which ten different job classifications are related. IH normally starts paying at the third level above the minimum.

At each level an additional 7-1/2% can be paid for superior performance. The union wants to make this "extra" a permanent part of the wage structure rather than dependent on performance. Similarly, the union is attempting to make a major part of the Christmas bonus a fixed part of the wage rather than conditional on the company's decision. These are cited as examples of how the union will attempt to raise wage levels on a permanent basis.

The officials of International Harvester France saw their labor problems as distinct from that of Germany where they thought there was little or no difficulty, or the United Kingdom, where the labor situation was regarded as "disorganized." In France the situation is "not so bad." At Croix, for example, the decline of the coal mining industry has created a ready labor supply. French workers are reluctant to migrate, and will stick close to their homes and families rather than seek better opportunities elsewhere.

Two major national issues are beginning to "heat up" in the French labor situation and will probably dominate the relations between International Harvester and the unions in the future. One issue is raising the minimum wage level which will push up International Harvester's costs accordingly. The other issue is that of earlier retirement, that is to say, retirement at the age of sixty. The French unions are also attempting to move piece rate workers onto a monthly salary basis regardless of their productivity. It also appears to International Harvester management in Paris that the labor supply in France will become more tight, and therefore assist the unions in their attempts to move wages up.

Although International Harvester of France has been free of strikes since 1968, last December the strike in Germany which hit the Heidelberg factory mentioned above, cut off some of French subsidiary's sheet metal supply, forcing a slow down in their operations. This situation illustrates the occasional vulnerability of the multinational company in depending on its affiliates' production in neighboring countries.

ASPECTS OF FINANCING

It would be helpful to summarize very briefly the restraints on U.S. international financial flows since the early 1960's, under various programs of the U.S. Government, aimed at easing the balance of payments problem. In 1963 the Interest Equalization Tax (IET) was imposed to reduce the outflow of dollars due to foreign governments and other entities including foreign companies, seeking to raise long-term funds on US markets. In 1965 the "Voluntary Foreign Credit Restraint" (VFCR) program for banks and other financial institutions established a base level for foreign assets and limited increases above that level. While this measure and the Regulation Q requirements which limited the rate of interest paid in the U.S. on time deposits, did reduce the outflow, major banks with foreign branches were able to expand the business of these branches greatly, using foreigners' dollar deposits in those branches. And, at the same time, interest ceilings in the United States led them to expend their own borrowing on the Eurodollar market.

The most complex of the programs to restrain out-flows has been the Foreign Direct Investment Program (FDIP), of January 1, 1968, which was aimed at the major companies doing business overseas. The FDIP applied to capital outflows and earnings retained by U.S. foreign affiliates. In general the major companies with investments in Western Europe were limited in their new investments to a modest percentage of their average direct investments for the 1965-66 base period, insofar as U.S. sources were concerned. They were induced to turn to foreign sources. In general this

program did not reduce the level of direct investment by U.S. firms in Western Europe but shifted the source of financing. Close coordination of the IET, VFCR, and the FDIP programs by U.S. authorities has been necessary to achieve their overall intent. (Some observers have noted that even before these measures of restraint, foreign affiliates were reducing their dependence on the parent companies for capital expenditures and working capital and were borrowing abroad increasingly, as well as relying on internally generated funds, both earnings and depreciation.)

To facilitate offshore financing whether short, medium or long term, International Harvester has created several companies: The International Harvester Overseas Finance Company of the Netherlands Antilles; International Harvester Overseas Capital Corporation of Delaware; International Harvester Acceptance Corporation of Bermuda; and International Harvester Finanz of Zurich, Switzerland. Only the last named company will be taken up in this report as an example of the adaptability and flexibility which recent years have required of International Harvester's overseas financing requirements.

The Office of the Treasurer of International Harvester in Chicago provides assistance in obtaining outside financing needs of the subsidiary companies. Loans for capital needs and guarantees of subsidiaries' borrowings are the Treasurer's responsibility. He is also the principal contact for compliance with the U.S. Government programs mentioned in the preceding paragraphs. In recent years the Treasurer has had to pay increasing attention to foreign money markets, exchange rate and similar problems and especially the functioning of the Eurocurrency market. The relations between controllers and the local national banks or local branches of U.S. banks are of immediate interest to the Treasurer, but it does appear that the controllers have the primary role in deciding on short term financing sources.

In the United Kingdom local lines of credit are established with major clearing banks. A limited amount of credit is available from U.S. banks which have been attracted to London in recent years because of the growth of the Euro-dollar market and the traditional role of the "City" as a financial center. However, relations between the International Harvester Company of the United States and major U.S. banks does not find much of a parallel in London, for example, as the U.S. branches are usually very restricted in the volume of credit which they can extend. "Back-to-back" financing is available too, whereby the International Harvester of Great Britain borrows pounds sterling from British companies while arranging for them to borrow dollars for their U.S. needs. There is thus no dollar outflow from the U.S. yet International Harvester of Great Britain obtains a part of its sterling needs. Recently it was decided that short term indebtedness was too heavy and a long term offshore Eurodollar loan was arranged through the Netherlands Antilles subsidiary to pay off and consolidate a portion of the short term debt. Generally since the devaluation of 1967 credit has been readily available in the United Kingdom.

Interest rates for short term financing -- actually overdraft financing in the U.K. -- have fluctuated from about 4 to 7%. The "bank rate" was the measure at one time, with "prime rate" about 1/2 of 1% higher. The system changed in 1969 and the key rate is now the "base rate" which can vary slightly between banks. It is currently from 5 to 5 1/2%. The present indebtedness of International Harvester of Great Britain fluctuates around 20 million pounds sterling, approximately one-half short term and the balance long-term.

The financing situation in International Harvester of Germany is considerably different. The tendency has been to borrow a high proportion of deutsche mark needs from the Eurodollar market rather than from local banks. This situation is changing though, with the advent of restrictions on the profitability of using the Eurodollar market. Since July of 1971 the West German Government has required that 40% of Eurocurrency borrowings must be

deposited in non-interest bearing accounts; thus raising the effective costs of the 60% of the funds which the borrower can use. Certain exemptions are allowed which will permit IH of West Germany to borrow about 12 million DM from outside markets, while the balance of its short term needs will be found in West Germany.

Currently International Harvester has lines of credit with three major German banks and two U.S. banks in Dusseldorf. In addition a consortium including a major U.S. bank made available an "umbrella" of 20 million DMs to be drawn on when needed.

Short term funds are averaging about 6 1/2% although rates as low as 5-4/10% can be found for discount financing. Generally the controller will renegotiate loans when a lower rate appears likely. Past fluctuations in interest rates have ranged from 4 to 10%. The controller also engages in forward trading of some currencies and the revaluation of the deutsche mark has provided some gains in forward contracts in dollars.

Turning to International Harvester of France the controller faces a different situation again. The French Government and the Bank of France have erected a far more centralized control over economic activity than found in West Germany or in the United Kingdom. International Harvester of France must go to the Bank of France for approval of their projected short term financing needs for a year. Annually IH officials develop their anticipated needs for overdrafts, promissory notes, commercial paper, and export financing, which are then discussed with the Bank of France. The latter's approval in hand, International Harvester then goes to a pool of six banks and divides their borrowings among them. Included are branches of U.S. banks but as their lending ceilings are relatively restricted they do not participate significantly. The pool normally gives a preferential rate to International Harvester. This does not exclude other banks who are interested in International Harvester's business from making loan offers. The current level of short term interest rates is about 7% where as a year ago it was 9%. The ceiling for these operational needs, that is to say for payrolls, suppliers' invoices, interest payments and so forth, can be raised, with the consent of the Bank of France.

For medium term and long term loans, that is to say five and twelve years respectively, International Harvester has sold about sixty million francs of promissory notes, guaranteed by the parent company. The proceeds were used for additional investments as well as for the "balance sheet."

Current French regulations prohibit any significant use of the Eurodollar market, or other outside markets. A ceiling of two million French francs is placed on these sources.

International Harvester Finanz, in Zurich, was established in 1965. It is responsible to the Treasurer of the parent company. Its role is to locate and lend short term funds to International Harvester's subsidiaries all over the world, except where exchange controls prohibit such an action, as in the U.K. and France. International Harvester of Germany has normally been the largest customer, but funds have been channeled to Canada, Belgium, Italy, Mexico, etc.

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Where permitted the controller will query Finanz what it can do for short term funds for a certain period of time for a specified amount. Finanz will in turn ask the three major Swiss banks what the lending terms might be: for example, deutsche mark interest rates might be 2% for one month, 2-1/4% for two months, 2-1/2% for three months, etc. Within a few hours of the initial query, Finanz can reply to the subsidiary. Occasionally Finanz will "solicit" business from the subsidiaries, for example, advising Mexico that it can supply dollars at 7-1/4% for six months. Finanz was established with a fifteen million dollar borrowing on the Eurocurrency market at five percent. It can lend up to five times this capitalization. Tax payments on net income are 15% to the Swiss Government and 85% to the U.S. Government through the parent company.

Finanz performs another service, a bookkeeping service which keeps track of all intercompany transfers and nets out the results monthly for each subsidiary. This avoids the need for each subsidiary approaching the banks to purchase and transfer the appropriate currencies, on which the banks would make a fee. Only the minimum amounts are finally transferred. Finanz will use exchange rates obtained from the Swiss banks, disinterested parties, and avoid intersubsidiary squabbles over the rate which might result if each subsidiary set its own value on the exchange rate.

Fees charged by Finanz cover its operating costs. The fee may change depending on whether it is near its lending limit or not. A higher fee is likely if the limit is approaching. The fee is lowered should Finanz have a good lending margin so as to make it more attractive as an alternate source to the subsidiary.

CONTROL MECHANISMS

International Harvester exercises control over subsidiaries through its share ownership, and its selection of the key officials in the subsidiaries' management. Frequent visits by key officials are another form of control. In addition periodic projections and regular updating of capital and operating budgets, prepared by the subsidiaries along lines described below, provide IH Chicago a close and continuing look at what's happening.

By November the International Harvester subsidiary has prepared a capital budget plan for the year ahead on a monthly basis and thereafter for three years on an annual basis. Capital budget expenditures of over \$500,000 must have the approval of the Board of Directors which meets on the third Thursday of each month. Proposals between \$250 and 500,000 need the approval of President McCormick. Smaller sums can be approved by the Vice President of the Overseas Division. Examples in the past year of capital budget items included: (1) the replacement of certain machines tools; (2) factory changes due to the beginning of a new product model such as a larger payloader at the Heidelberg plant; (3) upgrading the diesel engine through improvements; (4) the modernization of certain products; (5) the construction of an office building.

Also for the past six years each subsidiary has prepared a profit performance control plan or a detailed operating budget, on a monthly basis for the year ahead, i.e. for the IH fiscal year of November through October, and annually for the next three years. Sales, both domestic and export, and expenses are projected and net profits calculated. This plan is updated by the subsidiary for each month by the eighth day of the following month on a cumulative basis through the year. Exchange rate information is now included for each subsidiary so that fluctuations due to it can be filtered out. Thus, the Board of Directors in their monthly meeting have a current picture of all the operations in relation to the plan. Variations of variances from the projections are explained by the managing directors of the subsidiaries by letters and by telex and in the course of visits by IH officials. After six months each of these two

plans, the capital budget plan and the operating budget, are updated by the subsidiary, i.e., revised for the balance of the year.

Beginning in 1971 the Executive Vice President and the Vice President of the Overseas Division and the Controller of the Overseas Division visited the major subsidiaries to discuss and give initial approval to these plans before they were finalized.

The managing directors in England, France and West Germany noted that they began their thinking on this projected operating budget during the summer months. These projections, as indicated above, are made on a month to month basis for the following year and on an annual basis for three years thereafter. The projections are broken down into the following categories: net sales by dealers and other users both domestically and for export, by categories of motor trucks, farm equipment, construction equipment, and fiber and twine.

Costs of sales are divided into manufacturing and engineering components to which selling and administrative expenses are added. This sum is then subtracted from the net sales and operating income is thus found. To operating income is added other net income, such as interest and commissions, to arrive at income before taxes and before any exchange rate adjustments. Provisions are made for taxes and exchange rate adjustments which are then deducted from the income before these calculations to give the net income or loss for the period. Income retained for the period is derived by taking the retained income from the previous period, deducting cash dividends, if any, and making the other debit or credit adjustments to the surplus. In addition, this "comparative statement of income and income retained" includes a gross sales figure by dealers and users, both domestic and export.

The foregoing estimates are expressed in both dollar and local currency terms of the subsidiary company and, where appropriate, percentages are given, such as the percentage of net sales for farm equipment sold domestically or exported.

This overview of the subsidiaries' operations is supplemented by many back-up comparative statements. They include the calculation of gross working capital and permanent investment to arrive at total assets. They also include current and long term liabilities and the various components of the subsidiaries' equity capital. It is possible to then estimate the return on assets and on equity for the period.

An additional series of "performance controls" reports provide more detail so that the variances in sales and exports can be isolated for examination as well as the variances from standard costs. Selling and administrative expenses are similarly detailed for comparison to previous periods and to the current projection.

From these reports, International Harvester management calculates several ratios both as they were planned and as they actually turn out. For example: current asset ratio, quick asset ratio, return on assets, return on equity, ratio of equity to liabilities, the ratio of net income to net sales, selling and administrative expenses as compared to net sales, income taxes to net sales, the ratios of receivables turnover, of inventory turnover, of user financing receivables, and "devaluation exposure."

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