

Societies and Inflation

With Particular Relation to Profits

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In order to understand the impact of inflation on business operations one must initially be bold enough to attempt to define in simple language what the word "inflation" really means and how it occurs.

There are many people who will say that rising prices cause inflation. There are those who will diagnose the cause to be wage increases. Some will advance the argument that the real worth of wealth produced has been overstated by the measurement factor - money.

Meaning of Inflation

I would contend that rising prices and increasing wages are the results of inflation because the value of money in relation to other commodities has fallen. Unit costs of production have risen when measured by rate of output and are not therefore competitive; and for numerous reasons the money supply has been allowed to become excessive in relation to the value of those productions.

Thus we have an equation which is out of balance. Money, which is the manager's and the accountant's yardstick of measurement and also the means of recording business activities, has become unstable and unreliable. Unless corrective measures are taken, this out-of-balance situation accelerates, and the rapidly reducing value of money, when placed in the time-scale of production, wholesaling and retailing, aggravates the problem of asset replacement at higher costs which are not supported by real profitability. Hence we refer to paper profits, inadequate cash flow and illiquidity.

If we attempt to reduce the situation to simple proportions so far as the retailer is concerned, it could be suggested that the essence of the problem lies in the relationship of prices and gross profits (sales), wages and other expenses (costs) and net earnings (cash).

Increased prices should increase sales if we only remain static in market penetration. Increased wages and other expenses may or may not increase the rate of cost dependent as these factors are on the level of sales achieved and the amount of wage increases and other expenses borne.

Importance of Rates

Net profit will, however, be real to the extent that its rate is not allowed to fall when expressed as a percentage of the sales achieved. It is assumed, of course, that gross profit rates do not vary materially in the short term. If they decline then obviously a greater volume of sales will be required to balance the equation.

The most important point to note is that we are dealing with rates, not amounts. The rate of net profit should become the insurance policy to cover the inflationary element included in sales.

Inflation in sales must be reflected in inflation in net profits if we maintain balance because the value of money has fallen in each part of the equation. In other words, the rate of net profit may be maintained but the amount of net profit must increase.

If we fail to achieve this position of "status quo" then we make less real money and we have less to spend. Real net profit and cash flow are obviously inseparable so far as management is concerned.

Under inflationary conditions, however, profits should be regarded as real only to the extent that they are net after depreciation at replacement cost of fixed assets and after allowing for appreciation in current assets - stocks, etc.

This does not mean that we need to change accountancy procedures fundamentally in order to record replacement values. We should provide at trading account level for outstanding costs as in the past at the level of prices and charges appertaining at the balance sheet date. We should, of course, anticipate all contingencies on a prudent basis as in previous years but there is no need to adjust asset values or amend depreciation rates at this juncture beyond those required to amortise the historical cost over the expected life of the asset concerned.

The purpose of the accounts at this stage is to record accurately what we have expended on current and fixed assets, what we have received from sales, what we have achieved at gross margin level, what we have spent on wages and other expenses, and what we have left as trading profit and assets, including cash, to start the next accounting period.

Replacing Stock and Assets

Inflation is, however, the danger signal which informs us that to replace our stock and to replace our fixed assets will require more money. We should, of course, already have an extra amount in cash or bank balances if our rate of net profit has been maintained and if we have not been obliged to suffer exceptionally heavy capital expenditure. We should, therefore, allocate from our net profit (cash resources) sufficient sums to build up replacement funds and if possible invest these sums outside the business in order to finance the increased costs of asset replacement - the sinking fund method of internal financing. These adjustments or allocations of surplus are best implemented after arriving at the trade account profit.

So far as taxation is concerned we must abide by the rules and regulations of the game. It has recently been stated that stock appreciations will be allowed for in computing taxable profit. This is not an absolute allowance because it only amounts to a deferred tax liability and upon withdrawal of the allowance a tax payment could occur. In

other words, we should regard this concession only as a temporary aid to cash flow - we are allowed to defer payment of tax according to the formula employed.

The basic ingredient of the profit game which is causing the "paper profit" and cash flow problems is obviously money. Both as a measure of value and as a medium of exchange it has become a most unreliable commodity. At any one particular time it may adversely affect consumer spending because prices may rise faster than wages or it may generate spending because wages increase faster than prices. Whatever situation occurs a strain is placed upon the normal activities of retailers in their efforts to balance the equation to make real net profit supported by adequate cash flow.

It is beyond dispute, however, that the retailer who acquires adequate cash surplus from his operations, whatever the value of money, must provide himself with a power to spend and thus to develop his assets for future profit growth. The retailer who generates cash flow acknowledges the reducing value of money and at least maintains his rate of net trade earnings.

If we adopt this realistic attitude to a declining money value we obviously upgrade figures and downgrade money in our current operations and future development plans - we also control cash flow. The relationships (rate) should remain reasonably constant whilst all the figures will increase in amount - sales down to net.

Stock relationships, pension fund liabilities, members' capital balances, etc., all fall into the same category. All should rise as the value of money falls. To the extent that they do not, then we must retain from current earnings to maintain liquidity.

In the case of pension funds it must not be overlooked that here again there is a rate relationship. If wages increase then the contributions made by employees and employers will rise in amount because both are calculated on a rate basis.

If the general levels of interest rates increase then the interest to be charged to the Society and credited to the fund should also be increased.

Investment Outside the Society?

The investment of funds outside the Society raises quite a different problem. The falling values of equities and gilts pose serious problems. In the long term one would expect them to recover and capital losses should be recouped. On the other hand, the security of the fund could be threatened if inflation gets completely out of control. Caution should be exercised in the placing of funds outside the Society, especially in equities - there is an element of risk which appears to grow daily. Any deficiency arising from quinquennial valuations will normally require an addition to the annual special contribution. Here again, all things being equal, the original annual special contribution in amount has lost value. It will need to be increased at least to an extent to take care of inflation. The equation must balance because the base ingredient - money - has lost value. Obviously, these simple rules of procedure call for sophisticated analysis by actuaries because the wages upon which contributions are based will not be the wages upon which pensions will eventually be calculated. The principle, however, is not thereby invalidated which is to establish a rate of growth of the fund which will at least meet the deficiency arising from reduced money values.

What we must ensure is that we reflect the falling value of the pound sterling in the records we keep in order that we do not understate our liabilities and hence produce paper profits unsupported by adequate cash flow.

The adjustments and retentions we make are part of the re-alignments needed by allocation of earned surplus on current costs to meet the increased costs (money-wise) of the future. Most of these adjustments should be made after completing the trading account. They are allocations or provisions in a general sense caused by the reducing value of money.

The effects of inflation upon the nation's welfare and the adverse effects upon standards of living are, of course, quite different subjects. Indeed, the manner in which we allocate earnings, whatever their level, to the agents of production is significant, but does not affect the general case outlined so far as retailing and inflation are concerned. Even subsidies have to be paid for by somebody - they do not solve the overall problem of inflation - they merely alleviate burdens in selected areas and transfer the cost elsewhere. They may have social and moral justification but they cannot enhance wealth production upon which all economies must depend in the long term for standards of welfare.

The General Need

Until we produce wealth at a competitive cost and until we cease to print pound notes to balance our deficiencies, we must learn to live with inflation. If we accept that more money will buy less so long as inflation continues, then we must manage our affairs on a rate basis as opposed to an amount basis and thus generate more liquidity to meet the increasing costs of the future. In this way we will produce real profits, record our results correctly in our accounts, and generate sufficient cash flow to support the increasing costs of working capital and to finance future development plans.