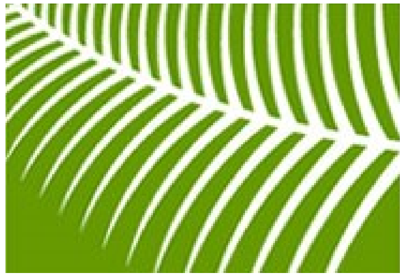

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WITHDRAWN
JUN 4 1981

Managing Agribusiness Firms in an Inflationary Economy

Gary T. Devino*

Coping with the inflation which has occurred in the last several years has been difficult for agribusiness managers. Price increases on goods and services have not all been at the same rate. This has caused problems in pricing and maintaining margins. Information available from financial statements has been distorted due to inventory "profits", depreciation based on historic cost, and changes in the purchasing power of assets.(1) Management decisions on asset replacement, expansion, and dividend policy are suspect because of the information sources on which they are based.

The vulnerability of individual firms to inflation has varied. Principal causes of differences include:

1. The Firm's Net Monetary Position

   Firms hold some assets in dollars - cash, checking accounts, and some investments. Accounts receivable are stated in dollars which are due the firm. Assets held in this form lose purchasing power when inflation exists. A firm also has the potential to gain from inflation. Dollars which are owed to someone else - accounts payable, notes, mortgages, etc. - are paid back in cheap dollars. To the extent that interest costs do not fully reflect the credit supplier's loss in purchasing power, a gain is realized.

2. Inventory Turnover

   Inventory which is turned over quickly ties up less money for shorter time periods than a slow-turnover inventory. There is less time for the purchasing power of the inventory to deteriorate.

3. Cost Structure

   Firms differ in the proportion of their operating costs which

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(1) A study of 106 locally owned farm supply/grain cooperatives in Missouri concluded that nearly 67 percent of the reported improvement in earnings during the 1978-79 period was associated with inflation.

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are fixed.[2] Firms with a high proportion of their costs in the fixed category have high break-even points. When inflation pressures build, dollar sales volume may change dramatically. Maintaining a profitable operation is more difficult for a high fixed cost firm than for a firm which has more flexibility in its cost/volume relationship.

4. Age of Facilities

When inflation is being experienced, the cash flow from depreciation on old equipment and buildings is not sufficient to purchase replacements. If the firm does not replace old items it may experience a cost disadvantage relative to its competition. If it does replace, financing may be a problem.

Management Practices

Depending upon the nature of inflation's impact on a firm, a number of alternative management practices may help minimize future effects.

Adjust Financial Records for Price Level Changes

The reported financial records of very large firms must contain both historic and price adjusted information.[3] Price level adjustments can have benefits for firms of all size. The position or progress of the firm is stated in dollars of constant purchasing power. If, for example, the value of all assets is adjusted to reflect prices which prevail today rather than the price level which existed when the asset was purchased, a much clearer picture may be obtained of the "real" changes taking place.

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(2) Fixed costs are items that remain relatively constant during a time period regardless of volume handled. Depreciation, interest, property taxes, and administrative salaries are typically fixed costs.

(3) Statement 33 of the Financial Accounting Standards Board specifies the information which must be included.

Price level adjustments may be made to bring the value of all past transactions up to today's price level (the Financial Accounting Standards Board approach). Each year's records reflect the price level prevailing at the time of the adjustment. Another alternative is to use a base index period and restate each year's figures in the constant dollars of the base year.(4) With this process the financial information will show what the firm's position would be if no inflation took place.

Whichever method is used is not critical. What is important is that the result of the price level adjustment process will be to let management see what is happening to the firm in real terms rather than in dollars which reflect conditions which no longer exist. Dividend, asset replacement, and pricing practices can be seen more realistically.

Reducing Net Monetary Losses

Idle cash or excessive accounts receivable are expecially costly when the dollars in these accounts are losing purchasing power. Efforts need to be increased to reduce this type of asset. Cash which is needed for the future operations of the firm can be invested in safe, short term instruments. Credit policy can be reviewed and revised as needed. Careful monitoring of accounts receivable will help assure timely collections. You cannot afford to become the banker for your customers.

Interest compensates a lender for (1) giving up current consumption, (2) uncertainty, and (3) inflation. Market rates of interest often do not fully reflect the rate of inflation. While prudent management would hold some borrowing capacity in reserve, borrowing in anticipation of higher levels of inflation could result in gains in "real" terms for a firm.

Increase Inventory Turnover and Change Inventory Accounting

As suggested earlier, faster inventory turnover will help reduce inflation effects. Management may also wish to change their inventory accounting procedure if they are using a First-In, First Out (FIFO) method. With FIFO the cost of goods reflects the Value of of the oldest inventory. When prices have risen, this may result in a cost of goods which does not

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(4) For a discussion of the procedure see: Devino, Gary. "Measuring the Impace of Inflation on Agribusiness Firms," The Cooperative Accountant, Summer, 1980, pp. 39-50

reflect today's value. The consequence is higher profits and higher taxes. This effect can be minimized by going to a Last-In, First-Out (LIFO) method.

Replace Fixed Assets More Frequently

Timely replacement of buildings and equipment may benefit a company in several ways. First it may allow them to become more competitive by reducing costs. Secondly there are tax advantages including additional first year depreciation, accelerated depreciation, and investment credit which may reduce a firm's tax obligation in the first years of an asset's life. By using accelerated depreciation, the after tax cash flow may be improved. Financial statements of the firm will more accuratey portray the firm's performance and progress.

Summary

The practices suggested won't make inflation go away. They should, however, give management a clearer picture of where the firm is going and the best way to get there.