A MARK OF ACHIEVEMENT

OR

A CAUSE FOR CENSURE ?

THE good balance sheets appearing in recent months have revived a hardy perennial, which, though it may at times lie down, stubbornly refuses to die. This is the attitude, apparently ingrained among some Australians, that there is something morally wrong, even sinister, in good company profits. That a healthy level of profits may provide strong evidence of all-round economic prosperity apparently never occurs to those who are stung to self-righteous wrath by the sight of a good balance sheet. Sometimes the wrath may be feigned, especially when to enter the ranks of the critics may be good politics (even though it is bad economics). But frequently the hostility to profits arises from a prejudice founded in plain economic ignorance. Aggregate profits, the figures headlined in the press, with the adjective "record" often attached, usually form the basis of the layman's judgment. It doesn't matter that figures of aggregate profit are by themselves meaningless. To some a profit of £1 million or over would be reprehensible even if the invested capital on which it was earned were £100 million.

There are two important points about the profits of 1953/54. First, the sharp rises that have occurred in some industries, for instance textiles and retailing, have taken place against a background of relatively depressed business following the slump in wool prices during 1951 and the subsequent balance of payments crisis. *The higher aggregate earnings — before tax — are thus due almost entirely to higher turnovers, not to any general increase in profit margins.* The second point is that in 1953/54 company taxes were reduced by about 2/- in the £. This has helped companies to show an increase in profits after providing for taxation.

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IT is singularly unfortunate that the Tariff Board, which has built up a well-deserved reputation in economic matters for balance and reliability (and which cannot be accused of playing politics or of financial naivety) has seen fit to rebuke businessmen for the latest financial results being reported. In paragraph 17 of its Annual Report issued on 27th August, 1954, the Board states:—

> "The response of proprietors of industry to suggestions that profit margins be controlled in the interests of a stable economy has been negligible. The Board's comment in this respect is based not upon the accounts submitted by applicants for protection but upon reports of trading results appearing in newspapers and financial journals."

This lapse from the Board's customary meticulous standards of observation and analysis is difficult to understand. Companies rarely publish their margin of profit on sales and it is therefore not possible for the Tariff Board to tell from the profit figures in the newspapers whether or not profit margins have increased. If the Board's statement is meant to imply that the greater profits earned in the last financial year are in the main the outcome of higher margins per £ of sales then it is demonstrably incorrect. All the relevant statistics such as aggregate figures of retail sales, comprising in the main home manufactured goods, and estimates of rises in manufacturing output suggest that greater turnovers played a very large part in the increases in profits which have occurred in 1953/54. Although, for instance, retail sales rose by 9% and estimated manufacturing output by 10%, estimated profits in manufacturing (before tax) increased by only 7%. This data, while it does not prove conclusively that there was no movement in profit margins nevertheless heavily discounts the likelihood of any increase.

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To obtain a proper perspective on aggregate company profits — including the multitude of proprietary and small public companies whose annual accounts do not hit the headlines — the National Income Estimates compiled by the Commonwealth Statistician is the only place to turn. Here are the figures for the last pre-war year and all post-war years:

	Total Company Profits (before tax)* £m.
1938/39	84
1946/47	163
1947/48	191
1948/49	213
1949/50	253
1950/51	386
1951/52	381
1952/53	383
1953/54	415

* Excludes profits of banks.

In order to assess fairly the trend of profits in 1953/54 this data must be viewed in conjunction with other economic indicators. For a start, retail prices, as measured by the "C" Series Index, have increased by 38% since the last peak year — 1950/51. When allowance is made for this increase, profits in real purchasing power are over 20% lower today than in 1950/51. Also during this period the population increased by over half a million people and private firms invested an additional £1,000 million in new fixed capital equipment to meet the expanding demand for goods and services. The volume of factory production (in physical quantities, not values) itself rose by about 10% between 1950/51 and 1953/54. *But despite this increased activity and the much greater capital investment, aggregate company profits (in comparative £'s) dropped by over 20%.*

The table on the next page attempts to relate company profits to the level of economic activity by expressing them as a percentage of gross national product. The division of company income into taxes, dividends and undistributed profits is also shown:

CONSTITUENT ELEMENTS OF COMPANY INCOME AS % OF GROSS NATIONAL PRODUCT

	Company taxes Paid	Dividends Paid	Undistributed Profits *	Company Income
1938/39	1.7	3.7	4.1	9.5
1946/47	3.3	2.9	4.0	10.2
1947/48	3.5	2.8	3.4	9.7
1948/49	3.2	2.8	3.5	9.5
1949/50	3.1	2.8	3.6	9.5
1950/51	2.8	2.5	5.6	10.9
1951/52	3.9	2.6	3.6	10.1
1952/53	4.0	2.4	2.9	9.3
1953/54	3.2	2.7	4.2	10.1

Note — This table includes banks.

* Includes provisions for taxes on current year's operations payable in subsequent income year. This reduces the amount available for re-investment, particularly when profits are rising.

Because of the heavy increase in company taxes, the proportion of company income available for dividends to shareholders and for financing expansion and development is now much lower than pre-war. While company taxes remain high, this situation cannot be rectified unless company profits increase. Whatever may be the position with dividends, there is the strongest of cases for increasing that part of profits ploughed back into the development and expansion of industrial plant and other productive facilities.

The Tariff Board, for example, would no doubt highly commend profits used for this purpose. In paragraph 20 of its latest Report, the Board points out that "compared with American experience Australia's horsepower in relation to man-power is very low". *Because of the lower level of profits here, Australian public companies are able to reinvest only about one-quarter of their profits after tax compared with about two-thirds in the United States.* The rate of company earnings during 1953/54 is nowhere near great enough for such a goal to be attained in Australia.

RATE OF PROFIT ON SALES AND RETURN ON SHAREHOLDERS' FUNDS

In considering the profitability of a business, the two main tests applied by financial experts are the rate of profit on sales and the return on shareholders' funds. The trend of profits and dividends on shareholders' funds, before and after allowance for the fall in the value of money, is set out on the next page:

	Dividends	Net Profits (After Tax)	Dividends	Net Profits (After Tax)
	On Shareholders' Funds (Book Values)		On Shareholders' Funds (Adjusted for Price Changes)	
	%	%	%	%
1937	5.5	7.1	5.5	7.1
1947	5.3	7.4	4.0	5.6
1948	5.6	8.0	4.0	5.7
1949	5.6	8.2	3.8	5.5
1950	5.7	9.1	3.6	5.7
1951	6.0	9.9	3.4	5.5
1952	5.5	8.7	2.8	4.4
1953	5.4	8.1	2.7	4.0

Source: Commonwealth Bank Statistical Bulletin.

Note:

The number of companies in the analysis compiled by the Commonwealth Bank changes from year to year. However, the figures for the previous year, are in each case adjusted to bring them back to a comparable basis with the subsequent year. By applying the percentage increases in shareholders' funds thus shown it is possible to secure figures of shareholders' funds which may be taken as broadly applicable to the same companies over the period 1937 to 1953. The shareholders' funds of each year are revalued in terms of the price level ruling in that year. As the 'C" Series Index used to adjust the value of shareholders' funds each year generally understates the rise in value of properties held by companies the general trend is not materially affected because some companies may have already revalued their assets..

Net profits expressed as a percentage of shareholders' funds (book values) are slightly higher than before the war. Dividend rates have kept much the same. But what if allowance is made for the current value of funds employed? It is hardly fair, for example, to relate 1953 money profits and dividends to funds which have been, for the most part, invested at a time when the £ had a much greater purchasing power. Occasionally companies have revalued their assets and transferred any surplus to reserves in order to reveal their true earning capacity. But in the great majority of cases, assets and consequently shareholders' funds remain in the books at levels well below their real worth. As a consequence, the percentage profit and dividend figures — particularly in the last few years — shown in the tabulations of the Commonwealth Bank do not give a true picture of the trend of profits. When shareholders' funds are adjusted to money values appropriate to the year in which profits are earned or dividends paid, these percentages are sharply reduced. While the figures should not be taken in any precise sense, it is clear that the return today on a comparable "amount" of capital is on average much lower than before the war.

PROFIT MARGINS

Statistics culled from published returns and data compiled by the National City Bank of New York do not suggest that companies here are overcharging the Australian public by comparison with their highly competitive counterparts in the United States. Striking an average of the latest available three years this is what we find:

Industry	Australian Company	Profits (After Tax) % on sales Aust.	U.S.A. (All cos.)
Sugar	Colonial Sugar Refining	1.6	4.3
Cotton goods	Davies Coop	3.2	4.0
Hosiery & Knitted Goods	Holeproof (N.S.W.)	3.2*	3.8
Paper and pulp	Aust. Paper Mnfrs.	6.0	7.6
Glass	Aust. Consolidated Inds.	4.9*	6.9
Chemicals	I.C.I.A.N.Z.	4.7	8.4

* Latest year.

Source: Monthly letter — National City Bank of New York; company annual reports.

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MISUNDERSTANDING about company profits (for which business itself is partly responsible) inevitably results in a climate of opinion unfavourable to the pursuit of progressive economic policies. The obstinate retention of price controls by State Governments and discrimination against particular sectors of private enterprise are founded ultimately on an ingrained public hostility to profits as such. There have been glaring instances, notably bacon and petrol, where reductions in prices have been forced on producers and distributors already earning below-average profits. Authorities in the building industry insist that the failure of the State Government to allow adequate margins of profit is the principal factor behind the reluctance to expand capacity and thus the current shortage of building materials.

The fundamental point that seems to be overlooked by those who criticise profits is their key function in stimulating efficiency. A good profit earned through efficient operation is clearly much more to the advantage of the community than a poor profit resulting from waste and inefficiency. But which is the more likely to be the subject of criticism?

If it is politically unwise to reap greater profits where then is the inducement to strive for higher productivity? It is surely far better to pay a profit of 10% to a well managed company than one of 5% to a badly run concern compensating for inefficiency by high prices.

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THE world has changed. Today the capital of industry is supplied by hundreds of thousands of people, most of moderate means, instead of by a limited monied class. Employee shareholdings have become almost a commonplace. Institutional investments in public companies by life insurance societies, pension funds and charitable bodies bring great numbers of wage-earners within the circle of beneficiaries from profits. Taxation has been vastly increased — both on profits and high incomes. The annual wealth production of the community is much more evenly divided. Modern business recognises social responsibilities so that the profits of companies are becoming as much a means to an end as an end in themselves.

Where, then is the point in general attacks on earnings which are distributed among such a large proportion of the community and which provide the essential incentive to enterprise and efficiency and a broadly shared progress? In this new social setting would it not be to our advantage to regard good profits as a mark of achievement rather than a cause for censure?

Efficiency in British Industry in the Post War Years

by

Sir Charles Renold

Sir Charles Renold, a leading British industrialist, is Chairman of Renold Chains Limited, Birmingham. He is Vice-President of the British Institute of Management and has been a leading spirit in the development of this body to its present influential position.

At our invitation, he has written this article for "Review" tracing the efforts that Britain has made since the war to raise the productive efficiency of her industries.

WHAT steps are being taken to improve the efficiency of British Industry and what success is being achieved? Those are the questions that have been put to me and this article is an attempt to answer them.

For practical purposes the most generally accepted measure of industrial efficiency is the "productivity" of the labour employed, expressed in terms of production per man year. Our enquiry must start therefore by setting out the facts in this respect.

Before the war the productivity of British Industry taken as a whole was increasing by about 1½% per annum and this rate of increase had held for half a century or more. Al-