Financial, Legal & Tax Advisory

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The Impact of Inflation

What exactly is inflation? Inflation is the overall rise in the prices of goods and services over time. The rising of prices leads to a reduction of purchasing power. The rise in the general level of prices often expressed as a percentage, means that the dollar buys less than it used to in prior periods. As mentioned before, inflation can have a positive impact on the economy. In fact, the Federal Reserve sets an inflation target. They want a healthy core inflation rate of 2%, which takes out the effect of food and energy prices. The central bank wants a little inflation, which also leads consumers to believe prices will continue rising. When inflation rises faster than expected, problems can arise.

Now how does inflation impact business owners? Naturally, with inflation costs will rise, putting pressure on gross and net profits. However, the impact of rising prices will vary for different cost types. The rising cost of raw materials will erode gross margins if sales prices are not increased. Keep in mind, the reduction in gross margins may not be immediately apparent. This is because an existing stock that was purchased at lower prices will be used first. However, that inventory will eventually need replenishment. It is best recommended to use the current or predicted cost of raw materials when making pricing decisions when inflation is high. An important note about inflation is that it varies by region and country.

It may be possible for a business to source materials from regions where inflation is lower. When the prices of energy are affected by inflation, distribution costs will likely increase. Such rising costs will impact both shipments to customers and suppliers. While service providers may be able to avoid certain negative impacts, they will experience an increase in the cost of travel. As expected, all overhead costs will rise under high inflation periods. These rising prices will begin to eat into net profit that is already being impacted by raw material and distribution costs. While it will take longer for inflation to increase the cost of long-term fixed-price contracts (rent, maintenance contracts, etc.), you could see significant annual increases in these costs if inflation remains high for an extended period.

With the impact of rising inflation on businesses, consumers will begin feeling the effect as well. This can lead to pressure from employees to increase wages and salaries. Businesses that do not adjust pay in line with inflation often risk losing workers. When the employee turnover rate is high, recruitment and training costs will be incurred and a drop in productivity will often occur. This encourages businesses to increase wages and salaries in order to retain employees. An erosion of spending power will affect both businesses and consumers alike. B2B (business-to-business) and B2C (business-to-consumer) companies could very well experience a drop in demand.

The degree of the drop in demand will depend on the sector of products or services. Demand for luxury and non-essential products will tail off quickly and demand for low-cost alternatives could rise. As inflation grows higher, so will interest rates. Consequently, servicing existing debts will become more expensive. It very well may become a challenge to obtain new financing. Additionally, inflation devalues money. As a result, you will be repaying the capital element of loans at face value with money worth less than when you took out the loan. Along with this, businesses will likely see a rise in overdue accounts receivable (AR).

Customers will have less money to pay their bills and will try to manage their limited available cash. The effects of this will be high collection costs, a squeeze in cash flow, and possibly the need for increased borrowing. As a result, there could be higher bad-debt risks. High inflation certainly presents challenges to businesses. However, the effects of rising prices can be managed. If costs are controlled, cutbacks are made when needed, and sales price increases are made in a timely manner, margins can be maintained. For any questions about how to prepare yourself or your business for rising inflation, do not hesitate to reach out to the professionals at The Center for Financial, Legal, and Tax Planning, Inc at our website, www.taxplanning.com or by phone at (618) 997-3436.

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