Oxford Economic Research Group. **Confidential**

5/1/7 (Visit of Mr. H. F. Scott. Stokes on 31.1.36.

Mr. Scott. Stokes began by giving a description of his business (of which he is joint managing director).

Structure of business

The total capital of his business stands at c £150.000; [I infer that this includes the bank overdraft] the shares are one half preference and one half ordinary.

His turnover is c. £140.000 a year.

A large stock is carried consisting of from £80.000 to £100.000 of raw sheep-skins. This is due to the fact that they can only be purchased at a certain time of the year.

Manufacture is entirely for stock and consequently stocks of finished goods rise if trade unexpectedly deteriorates and vice versa.

c. ⅔rds of finished goods sold are sheepskin rugs and slippers and c ⅓rd perambulator rugs and canopies. There is convenient seasonal dovetailing between the perambulator and the other business. Processed sheepskins are also sold to competing manufacturers.

History of business, 1925 – 1935.

The business is an old family (Quaker) one. It was formed into a company in 1925 when £40.000 7% preference shares were issued. Another £10.000 preference shares were issued in 1930.

A clear profit of £6/10 thousand p.a. ~~after payment of preference shares~~ was normally made ~~between~~ before 1930, allowing a dividend of from 8% to 10% on ordinary shares. The bank overdraft was usually large (£30.000 or more).

By 1930 a reserve of £15.000 had been built up together with an equalization reserve of £5.000. There was a rule that the ordinary dividend should not exceed 10% until a reserve of £30.000 had been achieved.

Directors are paid out of profit after distribution has been made to preference share holders. They have received nothing since ~~1930~~ 1929.

In 1930 there was a loss of c £20.000 on the year's trading. This was largely due to the loss of almost the whole continental market, mainly German, for the artificial fur collars, worth £50.000 – £60.000

In 1931 cuts of from 6½% to 10% were made in wages and salaries. Overheads, which had stood at just over £10.000 p.a. were reduced by c. £5.000. A loss of something under £5.000 was made.

In 1932 overheads were reduced by another £3/4.000 down to c £40.000. The depreciation allowance was cut severely. Before the slump it stood at c. £4.000, which was well in excess of the income tax allowance [but in another place I have a note that the depreciation allowance was c £5/6.000], and this was cut to c. £2.000.

Overheads include everything except raw materials and wage earners up to £3 per week.

In 1933 prices firmed up owing to the rise in price of raw wool. A profit of c £16.000 was earned and preference shareholders were paid arrears from the previous year.

In 1934 business went on merrily. But the warm December proved a disaster utterly destroying the market for sheepskin slippers. At the same time the wool market crashed again and prices reached a low level not previously attained. A profit of c. £4.000 was made.

In 1935 the business further improved, although large stocks of slippers were carried over and of processed sheepskins which competing firms, who had met with a similar reverse in the preceding December, would not buy.

Consequently profit was only c. £2.500 although the turnover was c £130.000.

In 1935-5 home sales steadily increased. The volume was increased by 30%. [I am not clear whether this figure

Profit
Referred to 1933-5 as to 1935 only.] ~~The profit~~ and turnover suffered from low prices.

Causes of fluctuation.

The business is subject to great fluctuation for two reasons. (i) It is near the raw material market, and is strongly affected by the fluctuations of prices there in. (ii) It has to carry enormous stocks. Variations in the value of these are included in the trading profit (or loss) for the year.

At the top the overhead was c £55 thousand. [This was subsequently reduced but not to low ~~to~~ £40.000 (v'd. sup.)].

When turnover is £200.000 (as at the top) gross gross profit is c £90, i.e. 45%. When turnover is down to £130.000 gross gross profit is c £60.000, i.e. still about 45%. But in the latter case not much is available for profit, i.e. it is mostly swallowed up in overheads.

Thus in 1930 the two losses were mainly due to depreciation of stocks (cf. cause of fluctuation (ii) sup.). But in 1935 the trouble was due to bad turnover, despite ~~of~~ increased the value of this suffering, despite of an increase of volume, from the low prices in the woolen market.

(Sales are made direct to the retailers at the cost of 2/- per £1 of sales; and it is found that these do in fact pass on the cuts in prices to the consumer.)

The business has an effective monopoly in its particular corner of the market. When changes in price are made, competing firms follow suit at a somewhat lower level for somewhat inferior goods).

Overhead costs.

Mr. Scott Stokes then explained the principles by which prices were fixed.

Direct costs consist of wages and raw materials.

Overheads are divided into two parts, room charges and dead charges. Room charges are those particularly connected with the productive process, dead charges with sales.

It must not be supposed, however, that room charges vary much with the volume of output.

At the end of the year, room charges and wages paid in the previous year are computed.

In pricing next year, on the ~~cost~~ costs of a dead article in terms of raw materials and wages are computed; an addition is then made equal to $\frac{\text{total room charges of previous year}}{\text{total wages paid in previous year}} \times$ direct wages cost of the article. This gives the cost in the factory. To this is added 50% for dead charges to make the sales price. Thus the overheads connected with production are assumed to bear the same relation to ~~wages~~ direct wage costs that they bore in the previous year. While ~~sales~~ overheads connected with sales are assumed to bear a constant ratio to total other costs.

In reply to questions Mr. Scott Stokes admitted that the latter assumption was unjustified in fact, since dead charges might not fluctuate in proportion to the fluctuation in total other costs, when the latter was largely due to changes in the prices of raw materials. In his opinion, this formula had led to a reduction of sales prices in the slump, which was bound to cause trouble.

This formula for making a price was adopted as a fairly rigid rule.

Cost and demand.

When questioned as to the propriety of taking into account the ~~effect of~~ a change in demand when fixing a price, Mr. Scott Stokes referred to prevalence of the principle, especially among Quaker producers, that the price should have some direct relation to the cost and be based upon a common form.

When questioned as to the effect of competitive offers, he explained that this chiefly affected them in the case of miscellaneous articles. Any difficulty that arose for this reason would be met not by departing from the formula in making a price to meet competition, but by altering quality so that ~~competitive~~ saleable goods might be produced at a competitive price in accordance with the formula. A price was never quoted regardless of cost.

He explained that competition was keener in the case of cheaper goods than in that of the more expensive; he admitted that they might occasionally squeeze the price at the bottom (viz. for the cheaper qualities) and stick somewhat on at the top, thus departing from the formula.

While this might be done to meet competition, the point that the demand might respond to a lower price was not taken into account at all.

Prices were almost always fixed for the whole year unless something catastrophic happened.

In making a charging out price the average of the cost of raw materials in the previous year was taken, again except again in the case of a catastrophic slump.

Questioned as to the prudence of following the formula so implicitly in making a price, Mr. Swift-Stokes referred to the age (about 70) of the head of the business.

Further questioned as to demand, he explained that at the cheaper end it was affected by weather conditions. He held that at the luxury end it was absolutely inelastic.

Demand was primarily taken into account in the thinking out of new lines, which was pursued vigorously.

Mr. Swift-Stokes then addressed himself to answering the questions on the paper. The second sheet was taken first.

1. Straight ways were common to form a smaller proportion of costs. Business was getting more complicated. The increase of education was a factor. Salaries had more than doubled and far more people were being paid them. Sales costs had also risen. When questioned, he admitted the analogy of an armaments race.

2-4 already answered.

5. In fashion lines demand was not responsive to price changes. While asserting this categorically, he could not be driven to admit that price had much effect on demand at all or anyhow that such effect would be taken

into account.

This firm did not undercut. They did not use cutting mass production methods. They had the reputation for supplying the best quality and endeavoured to maintain it.

(At this point he explained in a digression that his firm guaranteed employment, standing the men off in rotation and making up unemployment benefit to the standard wage. Once an employee reached the age of 17 he was regarded as permanent.)

6. They did not produce to order. Price lists were revised annually.

7. Replacement cost was not taken into account in making prices.

Sheet I

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1. It was true that firms were careful not to raise dividends if they did not think they could be maintained. But when bumper years occurred they always thought the good times would last. They invested they were merely reaping the fruits which their enterprise had all along deserved.

The amount set aside for reserve would depend upon circumstances; e.g. in early years firms might set themselves a definite figure to work to. In no case would the half and half formula be adopted.

Firms would not be afraid that high dividends would suggest to customers that they were being swindled. Customers liked to see high dividends as, treating them as a symptom that the business was well run and its products likely to be sound.

2. Having a "slump during great overdraft" they would use undistributed profit to effect its reduction. They followed the general principle of providing the fluctuating part of their capital by overdraft.

Mr. Scott. Stated that he referred to a neighbouring firm which had in the past ploughed a great part of its profit back into the business and avoided any new issues, so that its share capital was extremely small in relation to the value of its assets. It had ultimately

been driven by this policy into building houses for its employees. Conceivably it had been able to continue paying good dividends in the slump.

The answer to the last question in this section was emphatically ~~(yes)~~ no.

(In a digression at this point, Mr. Scott-Stokes explained, though he did not recant, his unwillingness to believe that demand was much affected by price; he said he liked to think that the increasing volume of sales in recent years was due not to the fall in prices, but to the improving quality of his goods.)

3 (i) No.

(ii) During bad trade the overdraft was reduced. [M.D. Mr. Scott-Stokes was not questioned on the apparent inconsistency that the overdraft would be reduced in times of good trade as a way of disposing of undistributed profit and in terms of bad trade owing to the smaller need for one. When is it increased?]

At this point Mr. Scott-Stokes referred to the fact that his firm had recently taken to bills owing to the good terms offered by a broker. His bank was shocked at this, on the alleged ground that the bills were unsecured and the business therefore improper. It was true that by a different arrangement the bills might have been secured on the stocks purchased, but this would have meant a large departure from existing practice by which the overdraft was obtained in respect of the stocks and any attempt to put the bank to ~~this change~~ agree to this change might have led to ~~trouble~~ further protest. The business with the bill-broker was, however, duly maintained.

(iii) Certainly not in any ordinary prudent business.

4. If you finish the year well, you take an optimistic view on the value of stocks in hand, and vice versa.

Hidden reserves are formed in almost any way you please.

Plant may be extended out of the repairs fund.

The most common practice is to make a very low valuation

of stock in trade.

No auditor would allow the writing up of stock that had already been written down. But if the content of the stock in trade had changed, the matter would be different. It is very difficult for an auditor to detect what is actually happening to stocks.

In the slump he had changed his method of valuation. He regarded it as a precise object of policy so to arrange matters, that heavy trading losses should not again occur as a result of the fall in the value of stock during the year. To this end he was attempting to write down the value of stocks as low as possible. Formerly they had been valued at cost. It was possible to value stocks at the lowest price at which such goods had been marketed within the memory of man.

In particular he was engaged in policy the overhead cost of stocks. Formerly finished goods had been valued at the sales price in accordance with the formula.

5. Mr. Scott. Stokes was not quite clear as to the nature of what was meant by obsolescence. He had in mind the Inland Revenue definition. He said that it was a small item in comparison with depreciation. Depreciation was fairly large.

6. The main object in issuing bonus shares was to keep money in the business.

7. Changes in bank rate may affect the fortunes of a firm with a large overdraft, but they have no effect whatever on policy, in the sense of making it act differently from what it otherwise would.

When pressed on the subject of the long-term rate, Mr. Scott. Stokes admitted that it might in principle influence plant extension, but he was extremely sceptical about it and disinclined to make any admission.

In conclusion he enlarged on the effect of the slump in making the firm much more conservative in its valuation of assets, with a view to the avoidance of trading losses from this cause on future occasions.

Early