SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
(202) 755-4846

FOR RELEASE: 1 P.M., Tuesday, December 13, 1977

INFLATION, CORPORATE FINANCIAL REPORTING, AND ECONOMIC REALITY

An Address by Harold M. Williams, Chairman
Securities and Exchange Commission

The Conference Board
New York, New York
December 13, 1977

One of the most important challenges facing business today flows from the language through which it communicates, not only to shareholders and analysts, but to society at large. The failure of conventional financial reporting to reflect the impact of inflation on corporate earnings contributes to an increasingly widespread misunderstanding of both the function and the level, in real terms, of corporate profits and cash flow. That failure obscures the fact that business is simply not accumulating and retaining the resources required to meet the challenges facing it. Put differently, it contributes to misleading the American public into believing that corporate earnings are so thoroughly adequate for all legitimate corporate purposes as to justify substantial additional reallocation of a portion of those earnings to social purposes. Indeed, in the judgment of some opinion leaders, corporate earnings are "obscene," "a rip off," etc.

For that reason, I was especially pleased to accept the Conference Board's invitation to be part of today's program on inflation and corporate management. The subject is an important one; in fact, inflation may well be the most serious economic problem facing our country. I would like to trace briefly the consequences which flow from the gap inflation opens between reported measures of financial performance and economic reality, and to sketch the outlines of some of the responses to that gap which are beginning to take shape in the financial reporting process.

The Problem: Inflation and Economic Reality

Corporate earnings are regarded as the most basic numerical measure of business success, and, in the aggregate, of the success of the business sector as a whole. Investment decisions, executive promotions, public attitudes toward business, tax policy, the implementation of social programs, and a host of other judgments rest largely on the number which appears on "the bottom line."

Because, I suppose, of the precision which numbers imply, it is easy to lose sight of the fact that corporate profits, like any measurement, are no more reliable than the assumptions on which they rest. Financial reporting depends on a wide variety of assumptions and conventions -- the use of historical costs, the various methods of Depreciation, the criteria for distinguishing between capital expenditures and expenses, and many others. While I am not disputing the logic of those principles, in my view, the resulting corporate earnings figures should never have been treated as precise; business earnings would more meaningfully be reported or interpreted as a range rather than a single figure, exact down to the penny when reported in the form of earnings per share.

In an event, whatever the significance of corporate profit figures in an inflation-free economy, the impact of inflation has compelled a re-examination of the meaning of the portrait of corporate earnings which traditional financial reporting paints. Increasingly, we are becoming aware that the consequences of reliance exclusively on a measure which distorts the economic contours of business performance are felt throughout the economy -- from the overall capital formation process to the day-to-day managerial decisionmaking in each firm. More broadly, if our ability to judge and report the economic performance of business is skewed, then both the public and its elected representatives are unable meaningfully and accurately to analyze the contribution which business is making in our society.

During the past 10 or 15 years, the public has come to demand more and more that business discharge obligations which might, in some sense, be thought of as social rather than purely economic -- the protection of the air, water, and the other facets of the natural environment; the promotion of occupational safety; the implementation of the national policy of equality of employment opportunity; and similar objectives might fall in this category. In the long run, of course, it may be difficult or impossible meaningfully to separate the economic components of each from the social components. In any event, these new factors are now as real a part of the equation of business responsibility as are the more traditional goals of providing employment and a source of livelihood for our workforce and of producing the goods and services necessary to satisfy a rising level of expectations with respect to the standard of living.

Thus, as a society, we are placing increased demands on our private enterprise system. The problem of marshalling sufficient capital in order that business may discharge its role in accomplishing these goals is a serious one. Unfortunately, however, the effects of inflation upon the present methods of reporting business performance obscure the increasingly pressing need to bring forth additional capital and, indeed, may lull us -- as government policy-makers, as decisionmakers in private business, and as individual citizens -- into a belief that corporations are generating more than adequate funds to satisfy our demands for capital.

The public perception seems increasingly to be that American business profits -- particularly those of the largest firms, those most able and most responsible for aiding in accomplishing our national objectives--are huge, growing larger, and accruing exclusively to the benefit of a small and select group of wealthy individuals. This mis-impression leads inevitably to demands that the government take steps--often through tax policy--to moderate those profits and to divert them to the common weal.

In my judgment, American corporations, as a whole, rather than generating shockingly high profits, are earning at dangerously low levels, if they are to discharge the responsibilities we expect them to shoulder. Further, profit trends--especially as they affect cash flow available to replenish, modernize, and expand assets and to pay dividends--are probably the most important factors in evaluating common stocks in the marketplace. Despite their importance, however, I believe that the function and level of corporate earnings and cash flow are seriously misunderstood.

It is common-place to read in the press that particular well-known corporations have reported "record" or "all-time high" earnings. In terms of the absolute number of dollars involved, these statements are, of course, true. It is, however, useful and important to put those figures in perspective. And when the perspective is comparative earnings over time, their "real" value, and business's ability to generate required new capital, then what are reported as "record" earnings may prove to be distressingly low.

How can corporate profits be low in any sense when reported after-tax earnings hit a record $77 billion last year? One striking element is the consistent, substantial understatement of depreciation in an inflationary environment. This is, however, by no means the only way in which accounting based on historical costs distorts corporate profit. Valuation methods which do not exclude illusory, inflation-generated inventory profits also overstate income. Both of these problems erode the value of reported earnings while often adding to tax liabilities--liabilities which may, in fact, be paid out of capital. As long as reported earnings continue to fail to take into account an accurate assessment of the economic costs of using and replacing the assets, both current and fixed, which produce those earnings, investors, managers, government policy-makers, and the general public will all necessarily remain uncertain of the level, expected growth, and rate of change of profits.

In outlining on several recent occasions what I believe to be amore accurate--and sobering—perspective on the profitability of American business, I have referred to economist George Terborgh's study prepared under the auspices of the Machinery and Allied Products Institute. Without necessarily adopting precisely either his conclusions or methodology, I find his approach thought-provoking and his findings disturbing. Terborgh's analysis deals statistically with corporate profits, the impact of inflation on those profits, and the ability of earnings to generate the new capital required by industry. Take as an example the $77 billion in after-tax earnings for 1976 which I mentioned a moment ago. Terborgh performed two adjustments in order to reach a figure which, he believes, more closely represents the real purchasing power of those earnings. First, he recomputed depreciation based on the current-cost, double-declining balance method. The objective of this step was to charge against revenues a sum which, in his view, more accurately reflected both the manner in which capital equipment was consumed and the cost, in inflated, current dollars, of replacing it. Second, he endeavored to convert inventory consumption charges, as reflected in the cost of goods sold, from historical to current costs. Net of these adjustments, 1976 after-tax profits shrank to $43 billion, only a little more than half the $77 billion figure reported. By comparison, in 1966, the year in which the market peaked, reported after-tax earnings were $40 billion--about half of the 1976 figure--while inflation--adjusted profits were $39 billion--only 10% below after-tax earnings a decade later.

Terborgh also directed his attention to the share of its profits which business retains after dividends as a source of capital for re-investment. He found that annual retained earnings, adjusted as described above and converted to constant 1972 dollars, fell from $28 billion in 1966 to $7.9 billion in 1976 -- a drop of around 70%. Terborgh's analysis produces a $13.3 billion dollar <u>deficit</u> after dividends for 1974 alone. His study also suggests that, while there were net additions to adjusted retained earnings in 1975 and 1976, those additions were insufficient to offset the 1974 deficit. Thus, over the most recent 3-year period for which figures are available--1974 to 1976--business has, in effect, apparently paid its dividends out of capital.

The effect of this effort to adjust corporate earnings for inflation is even more startling from the perspective of federal tax policy. During the past 11 years the effective tax rate on reported corporate earnings has generally hovered around 42 percent. However, if actual tax liability is compared to pre-tax profits adjusted for inflation-based under-depreciation and inventory gains, a much different picture emerges: In 1966, the effective rate on adjusted earnings was quite close to the 42% rate on reported income. In 1976, the effective tax was 56%, while in 1974 it was an amazing 80%. Thus, Terborgh's approach suggests that inflation, and the failure of the tax system to recognize its distortions, increased the rate of corporate taxation over 1966 from one-third to 90 percent depending upon the year--all without Congressional action of any sort, and without the debate that would occur if such a tax increase were formally proposed.

Indeed, Terborgh's figures make a case for the proposition that meaningful decisions to reduce the legal rate of taxation in order to stimulate business are almost impossible unless coupled to a recognition of the impact of inflation.

The Impact on Public Confidence in Business

If the validity of this general type of analysis is accepted, it seems clear that we are caught in a dilemma. On one hand, much of the public perception--encouraged by traditional methods of financial reporting--is that business profits are already too large and still growing. At the same time, the economic reality is that American business overall is not generating and retaining funds adequate even to replace existing capacity and continue operations at present levels; on the contrary, some businesses may actually be distributing their capital and be in the process of unconscious liquidation.

It is difficult to overstate the importance of a better public grasp of the size, in real terms, of corporate income. Public unease with the perceived level of corporate profits and disbelief of claims that earnings are insufficient to meet capital needs are only elements in a larger erosion of confidence in business. In recent years, public trust and confidence in the private enterprise system have been severely shaken for a variety of reasons. A restoration of confidence in the institutions of private capital depends in no small measure on a restoration of confidence in their financial reporting.

The implications of constant reports of "record" corporate earnings make a solution to that problem, at minimum, more complex. Published earnings reports lead the public to perceive business profits as inordinate or "obscene." At the same time, however, businessmen are pleading the case for tax and other incentives to stimulate capital spending. The net result is often both a further decline in the credibility of business and government action--or inaction--which is destructive of the effectiveness of our economic system. Enhancement of the public's confusion concerning profits--and the manifestations of that confusion in governmental responses--is perhaps the most profound and serious consequence of financial reporting which does not compel reconciliation with economic realities.

The Impact on Capital Formation

As each dollar of corporate income becomes less potent in terms of real purchasing power, business profits dwindle in their ability to meet capital requirements. Simultaneously, current corporate reporting practices, particularly with regard to depreciation, induce a false sense of security regarding investment needs. The tax system, in turn, re-enforces these misperceptions, and the net result is likely to be overtaxation, skewed balance sheets, and ultimately a handicapping of the corporate sector's ability to raise the capital which it must have to play the role we demand of it. If we are to meet our need for adequate new investment, the disclosure and taxation systems must be converted into tools which will aid the effort rather than obstacles which frustrate it.

In 1976, the Department of Commerce prepared one of the most detailed and comprehensive discussions of the problem of investment requirements. In "A Study of Fixed Capital Requirements of the U.S. Business Economy, 1971 to 1980," the Department's Bureau of Economic Analysis looked at capital needs on an industry-by-industry basis. The purpose of this study was to estimate the amount of investment necessary, through 1980, in order to have an economy capable of meeting three objectives--reasonably full employment; a national program of environmental protection; and decreased dependence on potentially unstable foreign energy resources. The Bureau found that real capital investment--that is, non-residential fixed investment--must average about 11.4 percent of Gross National Product. Capital spending has, however, not led the economic recovery, averaging less than 10 percent for the recovery period. In fact, the Department predicted last week that the rate of real capital spending during 1977 would be only 8 percent and would be lower still in 1978, running at half the figure which the Administration had targeted as necessary to reduce unemployment.

The Department's 1976 study also contains interesting findings with respect to the uses to which new investment would be put. First, the study estimates that only about 3 percent of total projected investment requirements are needed for environmental expenditures. Second, slightly less than half of required investment will provide for expansion of productive capacity. In other words, the majority of projected national investment through 1980 would be employed simply to keep us from slipping below present levels.

An example from a particular industry may make these figures more concrete. A recent investment research study concluded that an average annual outlay of $3.2 billion would be required just to hold steel manufacturing capacity at present levels. This is more than twice the cash flow available in 1976, after dividends, in that industry, so at least $1.5 billion of additional annual borrowings would be needed--or else dividends would have to be drastically cut--if capacity is to be maintained. If existing production capacity were maintained through borrowing and without reducing shareholder dividends, then debt would come to represent about 60 percent of the industry's capital--a figure which probably would not be tolerable either to lenders or to investors. To the extent that this analysis is correct, it suggests that the steel industry faces two choices: Either continue the de facto liquidation which the analyst concludes is presently underway, or undertake substantial alterations in the capital structure and the dividend policy of the industry.

This picture of our capital needs suggests that, to the extent that traditional financial reporting hampers capital formation, it threatens to have a very real impact on our economic future. On the individual investor level, for example, the perception that profit figures--without the benefit of some guide to the impact of inflation--are undependable subtly affects investor confidence in the securities markets. To the extent that reported earnings do not reflect economic reality, the investor will be less confident in his investment judgments and less likely to discern any rational basis for movements in stock prices. Institutional investors may have access to data which permits them to compensate. But, when reported financial data is not a reliable guide to the issuer's economic position, the small, private investor may be reluctant to participate in the equity markets.

For that reason, I do not share the view that explicit recognition of the impact of inflation on corporate earnings would impair the ability to raise capital. On the contrary, even apart from the enhancement of credibility, there is a growing body of research suggesting that, through the abilities of the sophisticated investors, the stock market is already more efficient in reflecting economic realities than had traditionally been assumed. Consider, for example, that the current average price/earnings ratio of the companies composing the Dow Jones industrial average is around 10. A recent study by one investment research organization indicates, however, that, if depreciation based on replacement cost is considered in computing earnings, the aggregate P/E ratio of the Dow rises to almost 34. It might be argued from this that the market, in pricing securities, reflects the magnitude of corporate profits in terms of real purchasing power to a considerable degree. Considerations such as these lead me to believe that claims that the disclosure of the impact of inflation will impair the ability of those in a given industry to raise capital are overstated.

In that connection, perhaps another question to ask is whether, if traditional methods of reporting earnings persist, price/earnings ratios will survive as a meaningful tool for evaluating securities. In an earlier era, a healthy balance sheet was thought to be the first characteristic of a sound investment, and book value per share was in vogue as an analytical tool. Later, as securities analysis evolved, attention shifted to the income statement, and the concepts of earnings per share and earnings multiples attained their popularity. With the utility of reported earnings now being seriously questioned, we lack a meaningful measure to rationalize the marketplace. The development of a readily available and widely accepted yardstick of that character may be a prerequisite for rekindling investor interest in corporate equities. In the future, perhaps a measure more closely tied to inflation-adjusted earnings, or to cash flow relative to the cost of asset replacement, will become the chief instrument for securities analysts. In my judgment, such an index would do much to dispel existing confusion regarding corporate profitability.

The Impact on Corporate Decisionmaking

Financial reporting which ignores the impact of inflation also has important implications in business decisionmaking. For example, corporate directors and managers, in estimating their capital needs, the internally-generated capital available, and the projected returns from proposed investments are relying in large part on an information system which depends on historical costs and ignores the present--and future--impacts of inflation. Where the defects in available information are perceived, but more realistic substitutes are not available, decisionmakers may resort to informal judgments, intuition, or guesses in an effort to allow for prive-level changes. To the extent, however, that corporate decisions are made on the basis of incomplete information, the risk of a venture may not be accurately gauged, and resources may be allocated inefficiently.

Further, disregard for the impact of inflation on the adequacy of earnings distorts pricing decisions. If corporate profits are insufficient to generate the capital necessary to maintain existing capacity, a part of the reason may be that the goods and services which the firm sells are priced unrealistically relative to their true costs of production. It may be difficult for one business to correct under-pricing if its competitors chose to ignore the problem. Eventually, of course, both those who recognize that they are eroding their capital and those who do not will have to come to grips with the truth. Thus, financial reporting which obscures or ignores the impact of inflation impedes efforts to identify and deal with emerging problems until they become crises. For example, during the ‘60’s the steel industry stopped using accelerated depreciation for financial reporting purposes. In the short run, the effect was to improve earnings and, I suppose, once a few firms had taken the step, those who competed with them for capital felt compelled to follow suit. As I mentioned a moment ago, however, the unavoidable economic realities of the steel business are beginning to surface; in effect, the industry is undergoing a partial liquidation. Without being simplistic about a complex problem, if a short-term increase in reported profits had not been bought at the expense of sound financial reporting, perhaps the problems which the industry is facing might have been dealt with earlier.

Finally, present financial reporting principles may be having consequences for the way in which corporate managers are evaluated and rewarded. Even in firms with sophisticated, inflation-oriented, capital budgeting techniques, executive compensation may be tied to the bottom line on a conventional income statement. There undoubtedly are managers who are being awarded enhanced compensation and promoted up the executive ladder in return for increased reported earnings when in reality they are running an operation which, in real terms, is dissipating its capital. Financial data which is developed both for external reporting and internal corporate functions such as budgeting, performance evaluation, management compensation, and investment, must reflect variations in the purchasing power of the dollar, if rational decision-making is to result.

Interestingly, labor unions may be the one element on the economic scene which have most clearly perceived the impact of inflation. Unions typically approach the bargaining table with wage demands which explicitly take into account the dilution--past and future--in the buying power of their members’ wages. At the same time, however, labor’s negotiators can point, with little resistance from management, to the increasing level of the employer’s reported profits--“profits” which, if the analysis I have outlined earlier is correct, may actually represent decreases in the after-tax spending power of business income. Corporate managers, in sensitizing themselves to the impact of inflation on capital needs, might do well to emulate labor's focus on price-level changes.

Solutions

For the reasons I have outlined this afternoon, I believe that those who foresee inflation accounting as a passing fad are wholly mistaken. In my judgment, the need for disclosure of the impact of inflation on corporate performance is simply no longer open to serious debate. The question is not whether it should be disclosed, but how.

At least two institutional thrusts will support this effort. First, the Financial Accounting Standards Board is presently engaged in the project of developing a conceptual framework for accounting. I believe it imperative that that framework allow for the recognition of the true costs of business operations. It is not necessary that the FASB discard the principle of valuation based on historical costs. In fact, I have considerable discomfort about the added judgmental aspects of financial reporting which would be implicit in the abandonment of accounting methods dependent on actual costs. The conceptual framework should, however, mandate disclosure of the impact of inflation on financial statements. Such disclosure would include the current cost of assets as well as the current cost of using those assets. Once the principle that the effects of inflation must be recognized is accepted, the methodology can evolve and develop in the same manner as have other innovations in financial reporting.

Second, as I imagine most in this room are well-aware, in 1976 the Commission adopted Accounting Series Release No. 190 requiring major companies to disclose the impact of inflation on inventories, productive capacity, and cost of sales. I recognize that many corporate managers have greeted the opportunity which ASR 190 affords them to provide a perspective on reported earnings with something less than enthusiasm. In a recent article in the Harvard Business Review, Thomas D. Flynn captured what may be the essence of much of the hostility to replacement cost and other inflation-based techniques. He observed:

> "U.S. businessmen are somewhat like football players who have learned to do very well indeed under the existing rules. To change
>
> the dimensions of the playing field significantly would introduce uncertainty and make most players apprehensive of how they personally would fare on the radically new field. By and large, American businessmen have been satisfied with the financial system under which they have grown up. They do not wish to have newfangled ideas introduced unless they can clearly perceive the practical advantages of such changes."

This analogy may well explain why some segments of the business community view inflation accounting less than enthusiastically. As I have tried, however, to point out this afternoon, financial reporting must aid investors, business managers, politicians, and the general public in realistically evaluating the performance and capabilities of private enterprise. This is not a theoretical or abstract problem. It impacts directly on the capital formation process and on society's attitudes toward the effectiveness of the private enterprise system.

My purpose today is not to defend the methodology of the current replacement cost rules, and, in fact, the Commission recently issued a release requesting comments on any problems which companies have encountered in providing replacement cost data pursuant to ASR 190. The Commission's ultimate decision as to any changes resulting from that review will depend on the comments and, in part, on the direction of the FASB's conceptual framework project. As I mentioned a moment ago, however, I do not foresee an end to inflation accounting as a possible outcome of the Commission's review.

Although I am mindful of the expense which developing replacement cost data has entailed, this area is, I believe, one in which the cost of compliance with government regulation will prove to be far outweighed by the benefits. Accordingly, I hope that those in this room will not write off ASR 190 as another example of bureaucracy in action but rather will work with the Commission by affording us the benefits of your thoughts and insights on how the users of financial information can be given a meaningful picture of the impact of inflation on reported corporate earnings. The resulting benefits in more rational corporate tax policy, improved investor confidence in business, and better understanding by companies of their own strengths and weaknesses will, in my view, repay the costs of developing such a disclosure system many times over.

Conclusion

While inflation has subsided from its peak during the mid-70's, it has also demonstrated a remarkable ability to resist both fiscal and monetary solutions. One of the most important challenges facing business is to come to grips with the implications of life in an environment in which annual inflation of 6% or more is conceivable--an environment in which costs double every 12 years, and triple every 19. A basic consequence of that environment is the fact that the traditional income statement, by itself, no longer serves to portray the full economic realities of business operations. To the extent that that fact is not grasped, or is ignored, it will have radiations which seriously, and perhaps permanently, jeopardize public confidence in private enterprise. In addition, capital formation will be hobbled and managerial decisionmaking clouded.

As I mentioned earlier, one of the most familiar consequences of the failure to evaluate reported profits and cash flow in terms of what they represent as a real source of capital is that the public is exposed to a constant stream of reports of "record" corporate earnings. Those reports, in turn, often are cited in rebuttal to claims that tax or other incentives are necessary in order to encourage investment, and thus serve to obscure to problems and importance of capital formation. Corrective measures are necessary, I believe, both to recognize inflation explicitly in the financial reporting process and to raise the public and political level of understanding concerning the significance and magnitude of inflation and its effects on corporate earnings. Whether such steps will be taken is a question with which all of us who believe in the effectiveness and survival of our economic system should be deeply concerned.