



## SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

February 2, 1976

Honorable Carl Albert  
 The Speaker's Room  
 U.S. House of Representatives  
 Washington, D.C. 20515

Dear Congressman Albert:

I have been asked to comment on a letter which was sent to you by Mr. Ivan Owen, Senior Vice President of Lucky Stores. In his letter Mr. Owen objects to a proposal that we are currently considering which would require companies such as Lucky Stores to provide shareholders information regarding the impact of inflation and other forces which have caused price increases. An essentially identical letter was sent to many other legislators.

Companies that have purchased inventories, buildings and equipment in periods when prices were lower may be currently reporting illusory profits. To illustrate by way of simplistic and possibly extreme example, assume a retail distributor of oil purchases one barrel of oil for \$5 at a time when the distributor will be able to sell that same barrel to his customers for \$6, resulting in a \$1 profit for his distribution efforts. Next assume that between the time the distributor purchases the barrel of oil and the time it is sold, the cost to replace it increases to \$12 and can be sold for \$13, still a margin of \$1. Under conventional accounting the distributor will report a profit of \$8: the sales price of the barrel (\$13) less the original cost to buy it (\$5). However \$7 of that so-called profit is directly attributable to an increase (or inflation) in the price of oil between the time it was purchased and the time it was sold and only \$1 is attributable to distribution efforts.

In order for a profit to be "real" in a going concern it should represent an increase in cash to the distributor after the replacement of the inventory sold. However that's not the case in our example:

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	<u>Cash</u>	<u>Inventory</u>	
		<u>Barrels</u>	<u>Amount</u>
The distributor starts his business by investing \$5	\$ 5		
The distributor purchases one barrel of oil and is now in the oil distribution business	\$-5	+1	+\$ 5
Starting balance	-	1	\$ 5
The distributor sells the oil for cash	\$ 13	-1	-\$ 5
And buys another barrel of oil	-12	+1	+\$12
Ending balance	\$ 1 =====	1 =====	\$12 =====

At the start of business, the distributor had \$0 cash and 1 barrel of oil; at the end of one complete business cycle he has \$1 and 1 barrel of oil--a gain (or profit) of \$1.

An investor looking at the financial statements of this oil distributor might assume that next year the distributor will probably earn the same \$8 profit as this year. However that can only happen if (1) the price of oil again increases by \$7 a barrel, (2) the distributor's volume of sales increases seven-fold, or (3) a combination of (1) and (2). Stated differently, the \$8 profit may not be a reliable indicator of the distributors ongoing ability to operate profitably.

The same problem exists with depreciable assets. If ten years ago a business purchased a \$1,000,000 building that had an economic life of 40 years, annual depreciation expense would be 1/40th of the cost or \$25,000. However, with the price increases (inflation) that exist in the construction industry, that same building might cost \$3,000,000 today and the attendant annual depreciation expense would be \$75,000. In this situation companies with older properties will report lower depreciation expense and higher profits. In order to compare the profitability of various companies and to assess the impact upon future earnings from replacing old, low cost assets with new, higher cost assets, investors should be provided with the relevant data.

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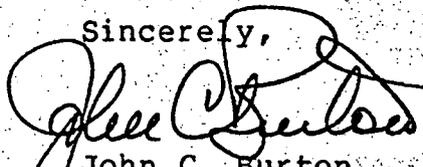
A great number of companies are reporting very high (and possibly one-time) profits as a result of the inflationary phenomena described above. In the interest of maximizing capital efficiency in our economy, it is important for investors to be able to estimate that portion of a company's profit which is attributable to management skill and that portion which is merely attributable to increase in prices.

During 1974 and 1975, many companies voluntarily attempted to remove some of the impact of inflation from their financial statements by adopting an inventory technique (LIFO) which is similar in many respects to our proposal (which calls for replacement cost). Safeway Stores, for example, reduced pre-tax profits from \$227,000,000 to \$141,000,000 by changing to LIFO thereby eliminating certain inflationary affects.

We are proposing that companies provide their shareholders with information as to the cost of replacing their inventories and depreciable properties and certain income statement information on a replacement cost basis. These data will be meaningful and useful to investors in assessing the impact of inflation on business enterprises and the benefits derived will clearly exceed the costs incurred.

Should you have further questions I will be pleased to respond.

Sincerely,

  
John C. Burton  
Chief Accountant

Enclosure:  
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