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Remarks by

Henry C. and Mable I. Wallich

at the
Meeting of the American Statistical Association

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The Statler Hilton, New York

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"Profits Distortion in an Age of Inflation --
Implications for Taxation and Accounting"

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THE ECONOMIST'S VIEWPOINT ON ACCOUNTING DURING INFLATION

Our purpose here today is to discuss the impact of inflation on corporate profit accounting from an economist's point of view. We would like to make quite clear at the outset that, whether these effects turn out to be favorable or unfavorable in a narrow sense, we regard inflation as a serious evil. The remedy for inflation is to eliminate it, not to find ways of living with it.

The means of analyzing the effects of inflation on corporate accounts are no secret. There is a substantial literature, going back at least to the writings of Franz Schmidt following the German inflation after World War I. Very possibly accountants examined the

1/Member, Board of Governors of the Federal Reserve System; I should emphasize that in these comments I speak only for myself and not for my colleagues on the Board.

probl in the wake of John Law's manipulation of the French note issue ome 250 years ago, but we have found no record of this work. Statement (3) of the Accounting Principles Board of June 1969 develops a generally plausible though certainly not uniquely valid approach. The problem is how to bring the distortions caused by inflation and the means of diagnosing them to the attention of businessmen and the general public. Today it is generally thought that workers and savers are trying to obtain some adjustments for inflation through higher wage increases and higher interest rates. Their "money illusion" has largely disappeared. It is not quite sure that one can say the same thing about businessmen, given the facts that we are about to summarize.

The Effect of Inflation on Corporate Accounts

A simple way of looking at some of these facts is to look at particular items on corporate balance sheets. Perhaps the most striking effect concerns inventory. The inventory valuation adjustment computed by the Department of Commerce for 1973 amounts to $17.3 billion. This is the amount of inventory profits of those non-financial corporations that were not on a LIFO basis.

To the extent that the price of inventories rises with the general price level, inventories do not produce profits in the sense of Statement (3). Even if the particular assets held in inventory do rise faster, these profits are of very little value to the corporation. They yield no cash flow, they do raise tax liabilities, and at least to the extent of the amount absorbed by taxes they must be financed. The taxes paid on inventory profits, which would have been avoidable under LIFO, may be estimated at not much less than one-half of the inventory valuation adjustment. In the unincorporated sector of the economy inflation no doubt has produced similar results on a smaller scale.

Let us turn next to plant and equipment. The Department of Commerce from time to time estimates the extent to which depreciation allowances fall short of or exceed replacement cost. The Department makes alternative assumptions as to replacement costs, the difference, however, being small. The Department computes depreciation alternatively on a straight line and on a double declining balance basis, with alternative percentages of Bulletin F useful lives running from 75 per cent to 100 per cent. Using the Department's data with double declining balance and 85 per cent of Bulleting F useful lives, underdepreciation in 1973 may be estimated at about $7.5 billion. In a period of inflation, in other words, the accelerated methods, far from constituting a "gift" to business, are not even sufficient to meet replacement needs.

During 1973 American business discovered to its surprise that productive capacity in industry was not nearly as great as had been believed. Numerous industries bumped and some still are bumping their capacity ceilings. One is bound to wonder whether the inadequacies of depreciation and profits accounting under conditions of inflation have had something to do with this.

If we put together inventory profits and underdepreciation, we find that corporate profits in 1973 were overstated by close to \$25 billion. This would put them at little more than \$100 billion before taxes instead of \$126.4 billion, as reported. If we carry the deduction all the way down to retained profits of \$42.7 billion, the corrected figure for retained profits becomes about \$18 billion. Of course, this is only a first approximation, because inflation gains and losses resulting from the balance of monetary assets and monetary liabilities are not included, nor is a correction for capital gains which at a time of inflation is also required.

We do not have data on the net balance of monetary assets and liabilities. Obviously it is likely to vary greatly among different industries. Nor can we speak in a quantitative way about capital gains, but a matter of general principle can be stated. It is obvious that, in a time such as now, capital gains contain a large inflation component. Clearly a capital gain does not constitute a profit in the true sense of the word to the extent that it merely compensates for the rise in prices. One could argue that there are other components in capital gains which do not constitute profits or income in an economic sense, such as changes in asset values due to changes in interest rates. The problem of the appropriate treatment of capital gains in a time of inflation, which has been argued extensively before the Ways and Means Committee, is a matter of concern primarily to individual taxpayers. But it has relevance also for corporations.

As still another instance of the impact of inflation on corporate balance sheets, we would like to point to the wide fluctuations in foreign currencies, which in part at least are the result of inflation both here and abroad. With American business owning some $100 billion of assets abroad, this is not a small matter.

What are Business and Others Doing About Inflation?

Having examined the economic impact of inflation on certain corporate accounts -- by no means its much broader impact on sales, costs, and profit margins -- we would now like to examine some of the actions that business and others are taking to defend themselves. The first point to be made is that if business and the public were doing more about the root of the problem, i.e., if they were acting more effectively to stop inflation, the problem itself might disappear. Finding ways of adjusting to inflation is no substitute.

Looking again first at inventories, it is surprising that there seems to be no general trend so far to convert to LIFO accounting.

According to the survey made annually by the American Institute of Certified Public Accountants, roughly one-quarter of the 600 large corporations surveyed is on LIFO. For some years prior to 1972, the trend had been declining. Shifting to LIFO of course reduces stated profits, since reports to stockholders must be on the same inventory accounting basis as returns for tax purposes. Management may fear the stock market consequences of such a shift. But since a shift to LIFO also reduces taxes, there is no question that the firm is better off in fact if not in appearance. Research has indeed made fairly plausible that the market sees through accounting techniques of this type. It has been shown, for instance, that the stock of companies shifting to LIFO was not adversely affected. It would be very helpful if more detailed information could be made available by corporations on the differences that would result in their accounts from shifting between LIFO and other methods.

It should be clear that LIFO is only a makeshift device for dealing with the impact of inflation on inventories. It is by no means general price level accounting. It merely postpones the payment of the inflation gains on inventory until the hypothetical day when the business is wound up. In fact days of reckoning may come much earlier. Reductions in total inventories, or possibly in particular inventory pools, may compel a firm to peel off older layers of inventory and eventually reach back to the bottom of the barrel where the cheapest inventory usually has accumulated, in a financial rather than a physical sense.

With respect to depreciable assets, business does seem to be taking fuller advantage of the opportunities permitted by the tax law, reflecting the permissible difference between statements for book and for tax. Accelerated depreciation and the interest savings resulting from it can make up for the shortfall of total depreciation allowances below replacement costs under our system of original cost depreciation. But at higher rates of inflation increasingly accelerated methods would be required to achieve this result.

An increased debt burden may have been one of the defenses that business has thrown up against inflation. One cannot be sure that inflation was the cause of mounting debt/equity ratios, however, since the tax system and other factors also favor debt financing. The buyer of corporate bonds certainly has protected himself to some extent by charging rates that include a substantial inflation premium. In some credit contracts, inflation has led to adjustable interest rates. It should be noted, however, that only tax exempt investors get the full benefit of the inflation premiums. Needless to say, high interest rates as a means of coping with inflationary conditions are dangerous to the borrower unless protected by a call feature.

Looking farther afield, business is "adjusting" to inflation, under the pressure of collective bargaining, by paying very much higher wage increases than productivity gains would permit or by embodying escalator clauses in wage contracts. The government itself has in effect built an escalator into Social Security payments. And the personal income tax system has been adjusted by the Congress, through successive tax cuts in 1964, 1969, and after, in such a manner that the effects of inflation in pushing taxpayers into higher income brackets have been almost exactly offset by rate cuts. The effective rate of the personal income tax has remained roughly constant.

General Price Level Accounting

It is important to distinguish sharply between general price level accounting and the indexing of contracts. Price level accounting eliminates the distorting effects of inflation from corporate statements. It does not alter the value of legal obligations, wages, interest rates, taxes, and all the rest. Indexing seeks to do precisely the latter. Price level accounting is a means of supplying information about the true facts. Indexing seeks to change the facts themselves. Since we hear a good deal about indexing these days from Brazil, from Germany, and even here at home, we would like to point up some of its dangers.

The crude argument that indexing makes it possible to ignore inflation is unsustainable. Some things cannot in a practical sense be indexed, among them money and profits. An economy in which everything else is indexed except these two important ingredients runs the risk of becoming an economy where nobody wants to hold money and where profits are being squeezed out. To suggest that total indexing provides a way of living with inflation validates the dictum that indexing means throwing in the towel against inflation.

A more subtle argument used by the proponents of indexing is that it can be turned into a means of ending inflation. High interest rates and fixed wage contracts, the proponents say, impede the rapid ending of inflation. Unsustainable conditions would arise and perhaps a recession provoked if inflation were to be slowed sharply while business was still tied to very high wage increases and interest rates. If these were indexed, so the argument goes, inflation could be halted more quickly with no adverse consequences on production and employment.

This argument overlooks some of the fundamentals of inflation. Inflation essentially is a means, however defective, of reconciling social claims. If the demands that labor, business, and government make upon the GNP add up to 105 per cent of that GNP, a 5 per cent price increase is the means of reconciling them. A confrontation over income shares in real terms is thus avoided. If wages, interest, and taxes were all indexed, there would be a confrontation of irreconcilable demands. The result might be severe social and political pressures, or possibly a rapid acceleration of inflation.

There is no good substitute for ending inflation. The job has to be done. Part of that job is to get to know the effects of inflation. Accountants have an important role to play in enlightening us.