

TESTIMONY OF  
THE HONORABLE HAROLD M. WILLIAMS, CHAIRMAN  
SECURITIES & EXCHANGE COMMISSION  
before the  
JOINT ECONOMIC COMMITTEE

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Mr. Chairman and Members of the Committee:

I appreciate this opportunity to testify concerning inflation accounting, which is intended to reflect the impact of inflation and changing prices on the financial condition of individual companies. As the Committee may be aware, the Commission has been a strong advocate of inflation accounting as a means to provide investors with financial information material to their investment decisions. It has been our belief that financial information prepared according to inflation accounting principles enables investors to obtain more relevant information about the current economics of a business enterprise which has experienced significant inflation than do financial statements prepared on the basis of historical cost.

Thus, the Commission was pleased when, last September, the Financial Accounting Standards Board issued its Statement of Financial Accounting Standards No. 33, requiring the reports of certain large, publicly-held companies to disclose financial information prepared according to two accounting methods designed to communicate the

effects of inflation. The first -- constant dollar accounting -- generally translates traditional historical-cost financial reports according to general price increases. The second method -- called current cost accounting -- is based on the replacement cost of the specific company's assets and expenses.

Statement No. 33 represents an extraordinary milestone for the accounting profession -- and not merely because it departs from the profession's exclusive reliance on historical-cost based accounting. Rather, its greatest importance may be in its message of the profession's willingness to address difficult issues in an innovative, conceptual mode. Statement No. 33 is not held out as a definitive standard on inflation accounting. Instead, it recognizes that the state of the art does not permit a definitive standard, that a degree of experimentation is called for, and that such important issues cannot await formulation of a perfect solution. However, while there may prove to be a need to further perfect the methodologies of inflation accounting, the present standards are well enough developed -- and are much more informative and accurate for these purposes -- to justify confidence in their use for establishing orders of magnitude. This is particularly true because, in addition to providing minimum standards for disclosure, Statement No. 33 urges all companies to provide whatever additional information would make the financial information more meaningful in relation to their specific situations.

It is my understanding that, in his testimony today, Donald Kirk of the Financial Accounting Standards Board will discuss the technical aspects of Statement No. 33. I will, therefore, devote the balance of my statement to the important -- and disquieting -- picture of the economic health of American industry that has been revealed by applying

inflation accounting methods to financial reporting, as well as some ramifications of that condition.

The press, financial analysts and others have been analyzing the data reported by American business for the year 1979. A national accounting firm -- whose chairman, Joseph Connor, will also testify before this Committee today -- recently released its analysis of these inflation-adjusted financial reports for a significant number of the Nation's largest companies.<sup>\*/</sup> The study, which is the broadest-based yet released, provides a composite perspective of American industry significantly different than that provided by historical cost accounting procedures. It shows that inflation-adjusted corporate income among the industrial companies included in the analysis is only 60 percent of the figure that had been reported, under traditional accounting methods, to represent corporate income. And, the 40 percent disparity would have been even greater except that it excludes companies for which the adjustment results in a loss.

Since corporate income is substantially lower than previously perceived, distribution is a much higher percentage of income than traditional measures and rules of thumb have reflected. For example, it was widely noted that corporations are taxed at an effective corporate tax rate of 39 percent, as contrasted to a 48 percent theoretical tax rate. In fact, inflation accounting methods reveal that the composite of industrial corporations pay a significantly higher, 53 percent, real tax rate. Similarly, the general assumption, using historical cost accounting, had been that cash dividend payments on common stock are about one-third of corporate aftertax income, when in reality they are double -- two-thirds of inflation-adjusted income after taxes.

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<sup>\*/</sup> Price Waterhouse & Co., Disclosure of the Effects of Inflation: An Analysis (May 1980).

Most disturbing, however, is that the aggregate of those composite figures for taxes and dividends paid on an inflation-adjusted basis approaches -- and in some industries exceeds -- corporate income. That means that much of the corporate community is distributing more than its real income in taxes and dividends. These figures indicate that portions of the industrial sector must be paying their taxes and dividends out of capital resources. That, for all practical purposes, means that a substantial part of American industry -- the historic keystone of our prosperity -- has begun to liquidate.

For years we have been warned of such hidden costs of inflation. Statement No. 33 has revealed these costs and, in my opinion, they may be more than our economy can reasonably be expected to bear. Indeed, these figures show that so-called record -- some say "obscene" -- levels of profit, in real terms, fall far short of meeting the ongoing capital requirements of this Nation and, indeed, represent the partial liquidation of our corporate sector.

This disparity between perceived and real profit levels exists because, under historical cost accounting, figures thought to represent profit are swollen by including inventory appreciation -- even when the inventory necessarily must be replaced -- and by depreciating fixed assets based on original prices -- even when the replacement costs are much greater. In short, under inflationary conditions, the conventional measures of profits and profitability have proven grossly misleading.

However, the capital markets -- to which corporations essentially deprived of real retained earnings must turn for capital -- cannot rationally allocate resources on the basis of misleading financial information, such as characterizing payouts of capital as

dividends from profits. And, any misallocation is particularly critical because, in inflationary times, investment capital becomes unusually scarce as the erosion of wealth and decreasing real income squeezes savings and frustrates equity investing.

I do not think it is necessary to elaborate at length on the economic and social price which we would pay over time for inadequate or irrational capital allocation. The ability of U.S. products to compete in world markets depends on our ability to develop new technology -- and to minimize the growth in unit labor costs -- all of which depend on capital investment.

Another major issue which these trends raise is whether the U.S. economy will grow in the coming decade at a rate sufficient to absorb new entrants into the labor force. Unemployment and underemployment are directly related to capital investment.

Similarly, the productivity of U.S. industry depends on the growth of capital per worker. Increases in employee compensation -- whether in wages or benefits -- are inflationary if unmatched by increased productivity; thus further squeezing profits and increasing inflationary pressures.

Moreover, the capital shortage problem is particularly serious for growth companies. The strength and vitality of growing companies -- large and small -- are key to the future of our country; they are the source of much of our technological innovation, the nucleus of new industries, and the major creator of new jobs on which both our economic and social future depend.

Finally, the capital squeeze not only impairs investments in plants and equipment, but it also generates a conservatism on the part of management which adversely affects

investment spending in research and development for new products, processes and services.

While the urgency of this crisis was not fully documented previously and not understood by many, I believe that sophisticated market professionals and investors have instinctively understood the reality and acted to mitigate the misleading of the capital markets. As an illustration, the reason, in my opinion, that some capital intensive industries are selling at extraordinarily low price-earnings ratios is not because of erroneous undervaluations. After all, stock investments are, in reality, a risk purchase of a share in a corporation's future income stream. These low price-earning ratios appear to reflect a skepticism of the adequacy of the future dividend potential of much of American industry to provide an appropriate and competitive aftertax return for that risk. They recognize its current inability to recapitalize adequately to assure its ability to be competitive in the future. Indeed, this appreciation that inflation has particularly severe consequences on certain industries argues the greater relevance of current cost accounting -- which discloses the effects of inflation on each corporation -- compared to constant dollar accounting -- which merely reflects across-the-board price increases that may not fully communicate the condition of the specific corporation or industry.

While providing such inflation-adjusted financial information to investors is the Commission's primary interest in encouraging the development of these accounting methods, inflation accounting also provides a more informed basis for other economic decisionmaking. For example, it is particularly urgent that business adopt inflation-adjusted internal accounting practices -- and I understand that a number of companies are already doing so. In many cases, inflation-adjusted information will have a significant

impact on intelligently assessing and controlling corporate costs -- such as the relation of increasing labor costs, which are often influenced in their negotiation by overstated profit figures, to real productivity. And, accurate inflation-adjusted information is necessary for realistic pricing, as well as for a rational level of dividend payouts based on real corporate profits. Of course, in other instances, these figures will reveal that some lines of business are no longer viable in inflationary times and should not consume valuable capital resources.

The availability of inflation-adjusted financial information also should precipitate a reassessment of governmental policies towards business -- particularly, regulatory and tax policies, both of which are now tied to erroneous perceptions and obsolete accounting methods which distort what our economic system can afford. Although government policies, particularly tax policies, are generally thought to involve the transfer of income to finance social responsibilities and goals, we are now aware that much of business is in the dangerous process of liquidating its capital, in large part, to comply and pay its tax bills. It is, therefore, urgent that we consciously consider whether this situation represents the best possible balance between, on the one hand, the public's need to finance programs directed to critical social problems and, on the other, our interest in facilitating the healthy and profitable private sector that generates the real wealth which could resolve many of these problems.

Finally, I should emphasize that, even with the widespread application of inflation accounting principles to accurately communicate the condition of economic entities and to provide for more rational decisionmaking, we must not avoid confronting the underlying economic problem, which is the sustained existence of inflation. Indeed, one

of the most important aspects of inflation accounting is that it documents to national policymakers the already heavy punishment which our industrial capabilities have sustained from a period of continuing inflationary pressures. But current financial reports, as disquieting as they are, can only suggest the terrible consequences that await this Nation if this trend continues and accelerates. We have been provided with a warning which we must not ignore: Controlling inflation must be the first priority of our Nation's economic policy.