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THE INFLATION THAT WON'T GO A WAY AND HOW TO ACCOUNT FOR IT

by
Dr. Sidney Davidson
Chief Counsel
Internal Revenue Service
November 5, 1979



[Introductory Note: Sidney Davidson is Arthur Young Professor of Accounting, Graduate School of Business, the University of Chicago. He has been on the Graduate School of Business faculty since 1958 and has occupied the Arthur Young Chair since its establishment in 1962. Also in 1962, he helped establish the Institute of Professional Accounting at the school and headed it until mid-1969, when he became dean of the school. He served as dean until June 1974. During the 1974-75 academic year he was on leave as a Fellow of the Center for Advanced Study in the Behavioral Sciences.

He was president of the American Accounting Association in 1968-69 and served as its Distinguished International Lecturer in 1978. He was a member of the Accounting Principles Board from 1965 to 1970 and was a member of the American Institute of CPA's study group that issued the statement on "Objectives of Financial Statements" in 1973.

Professor Davidson is a CPA and earned the AB, MBA and PhD degrees at the University of Michigan. He taught economics and accounting at Michigan and at Johns Hopkins from 1946 to 1958; in 1955-57 he was director of research for the American Accounting Association, and in 1956-57 was a Guggenheim Fellow in England. He has been a visiting professor at numerous universities throughout the world.

He is the author or editor of thirteen books and a large number of articles in journals on accounting, economics and finance. Professor Davidson has served as consultant to a number of business firms and government agencies, including consulting with the U.S. Treasury Department from 1961 to 1969 and the SEC in 1976 and 1977.]

I'm very pleased to be here, to be delivering the first of the Emanuel Saxe lectures in the 1979-80 year, and of course, I'm delighted to have Dean Saxe present. I'm also especially pleased to be here at Baruch College this evening where my good friends and former colleagues Joel Segall and David Green have some sort of a position. I am flattered that they, knowing me as they do have invited me nevertheless. It is pleasant to realize that I am speaking at the home base of Abe Briloff. I have always greatly admired the work of Abe Briloff, at least until he asks the first question tonight. And Abe, I promise I will turn to you for the first question.

All of us here have weathered the decade of the 1970's, a decade that has been marked by chronic inflation. What I would like to talk about this evening is that inflation, and accounting's efforts to portray it realistically. I suggest that today's inflation is a new and different phenomenon, an inflation that won't go away, and one for which we must be preparing in accounting to work toward long-run solutions; long-run solutions to presenting, in a realistic fashion, the effects of inflation.

This inflation is likely to persist, despite the widespread public opinion that it must be halted. We know

that there are substantial real costs to a rapidly and a radically rising price level, that the accompanying uncertainty is bad for both capital investment and long-term planning; income and wealth get redistributed in a way that makes no sense at all, and most of us do not like a situation in which the big rewards go to speculation, and not to the things that we specialize in, skill and hard work. As Bob Solow of M.I.T. has suggested, those who gain from rising prices, and there are some, do not thank the inflation; they attribute that gain to their own efforts, whereas those of us who lose in inflation blame the loss on inflation, so nobody feels that they gain from it. But despite this widespread concern and anxiety it seems to me that the best we can do despite the efforts of Mr. Volcker and even President Carter, is to slow down, maybe to moderate the inflation; you know the hopes are that maybe we'll be able to get away from double digit inflation in 1980. But it remains, it seems to me, an inflation that won't go away, and accounting must learn to adapt to it.

One way to get some feeling for the special nature of this inflation can be seen if we take a brief retrospective look. And in this retrospective glance, I will be looking at measures of the consumer price level going back almost two centuries. Obviously few of the things that consumers buy today were purchased back then. But, as a rough measure of the value of the dollar, the consumer price level will have to do. All of the consumer price index numbers that I am going to be citing have the year 1967 as a base; that is 1967 equals 100.

Inflation Measures

Table I
U.S. Consumer Price Index (1967 = 100)

Year	Index	Year	Index
1800	51	1920	60
1810	47	1925	52
1814	63	1930	50
1820	42	1935	41
1840	30	1940	42
1860	27	1950	72
1864	47	1960	89
1870	38	1965	94
1880	29	1970	116
1890	27	1973	133
1900	25	1975	161
1910	28	1976	170
1919	51	1977	182
		1978	198

TABLE II
Average Annual Rate of Change
in the Consumer Price Index

1920 - 1929	-1.8%
1930 - 1939	-0.6%
1940 - 1949	4.2%
1950 - 1959	2.2%
1960 - 1969	2.4%
1970 - 1978	6.7%

Another way of emphasizing the difference between this inflation and other inflations, would come if we look at Table III and say, "What's happened to post-war events?" Traditionally, war years have been years of inflation, followed, to some extent by a subsequent decline. If we look at our history of wars, we can see that following the War of 1812 prices did advance, but then within five years prices had fallen by some 27% after the end of the War of 1812's peak. When we come along to the Civil War, again, five years after the end of the Civil War prices had fallen by some 17%. After World War I, prices again fell after the peaks that they had reached. During World War II prices did rise modestly because of the institution of price controls.

It is difficult to believe, looking at Table I the information that's shown there, that in the year 1919 the general price level was precisely at the same point that it was in the year 1800; that over that 120 year period, prices remained relatively stable. In fact, the entire nineteenth century was a period of falling prices, punctuated only by an upward movement associated with the War of 1812 and the War Between the States, as I have learned to call it on the South Side of Chicago. In fact, in 1900, the Consumer's Price Index hit an all time low of 25. Surprisingly, perhaps, to some of us who are nurtured by current thoughts, the nineteenth century was one, as I say, of falling prices, but also of rising real income on a per-capita basis.

The twentieth century, however has been a period of rising prices but we can divide that century into two parts, the first 65 years of the twentieth and the last 15. From 1900 to 1965 the average price increase was only about 2% a year. In fact, if we start with 1920, the average increase in prices from 1920 to 1965 was less than 1% per year. All of this, though, changed with the guns and butter view of the Johnson administration, in financing the Viet Nam conflict. Since 1965, prices have been rising at more than a 5% annual rate with the upward movement accelerating in the later years.

From 1970 to 1978, as Table II shows prices have been rising at almost a 7% rate. If we include 1979, the average increase in prices during the decade of the 70's has been over 8%.

Table III
Percent Change in Consumer Price Index
War-Related Peak to Five Years Later

Period	Conflict	Percent Change
1814 - 1819	War of 1812	- 27%
1865 - 1870	Civil War	- 17%

1920- 1925	World War I	- 12%
1948 - 1953	World War II	+ 11%
1953 - 1958	Korea	+ 8%
1970 - 1975	Viet Nam	+ 68%

Even after the Korean conflict in the early 1950's, prices rose only moderately. But if we look at where we stood five years after the end of Viet Nam, prices were 68% higher than before that conflict.

Nor is this inflation only a local phenomenon as Table IV shows, it has infected all of the Western industrialized nations.

Table IV
Percentage Increase in Consumer Prices, 1967- 1977

West Germany	58%
United States	86%
France	122%
Japan	145%
Italy	172%
United Kingdom	203%

In fact, aside from West Germany, the U.S. made out somewhat better than the rest of the world. During the recent ten-year period our prices rose by some 80%, those in the U.K. by over 200%, with Italy and France moderately higher. The position of Japan is perhaps a little unusual in that, in that period after 1977, its position, as compared with the U.S., changed. In 1978, for example, our prices rose 9%, those in Japan just 3.5%. What we must recognize is that the inflation problem is endemic and all countries are struggling to cope with it, and are seeking a way to show its effects in financial statements.

Now, unfortunately for this audience, my competence does not extend to explaining the causes or prescribing the cures for this inflation. Indeed it would be interesting to find a speaker who could both explain the causes and, more interestingly, prescribe the cures, although there are many who are willing to try. My effort is designed merely to emphasize again that this is an inflation that won't go away. We could ask ourselves, wherein does this inflation differ from all other inflations, as the primary question rather than the first of four. What we must answer is, that this inflation differs in that it's an inflation that won't go away. And we must find ways to show, realistically, yet simply as possible, the effects of inflation on our financial statements and in our financial reporting. Up until now, we in the accounting profession have been inclined to say that if we wait long enough things will right themselves and no accounting action will be necessary. But we are dealing with an inflation that won't go away and answers must be found.

Two general approaches to the accounting problem of inflation have been put forth. They are, as you know, constant dollar accounting and current cost accounting. Those who favor the constant dollar approach are inclined to put it this way. They say suppose there were a firm that had three plants, one in the U.K., one in the U.S. and one in West Germany. And if the plant in the U.K. cost £ 100,000, the one in the U.S. cost \$200,000, and the one in Germany cost 300,000 deutschmarks, it's clear that you could

say you had 600,000 of plant. And of course everyone scoffs at this and says oh no, you can't add together pounds and dollars and deutschmarks and come up with any meaningful answer. But then the constant dollar people would say, but don't you know that the dollar of 1965 has an economic significance that differs from the dollar of 1979 by more than the difference between the significance of the pound or the deutschmark to the dollar. That both of those, the pound a little less than two dollars, the deutschmark running in around 50 cents, have a closer affinity to the dollar today than does the dollar of 1965 which is worth about \$2.25 in terms of today's dollars. And the constant dollar people say, what you've got to do, just as you translate pounds and deutschmarks into dollars, what you've got to do is convert '65 dollars and '73 dollars into '79 dollars to get a common measuring unit. They say you need to express all items in this constant measuring unit, dollars of some constant purchasing power.

The other approach, the current cost approach, says that all items on both the balance sheet and the income statement should be stated in terms of current cost, of current values. That the really significant factor is what is the present economic meaning of these items, irrespective of what they may have cost whenever they were acquired, no matter how far back. So we've had these two views, and it might be useful to trace rather briefly the history of these two views in the United States, at least with regard to authoritative pronouncements,

As you know, the Financial Accounting Standards Board issued an Exposure Draft in 1974, which provided that by the end of 1976, firms would be reporting in terms of what they described as purchasing power units, that they now describe as constant dollars. That document provided for several major adjustments; if we focus on the income statement, the primary adjustments were three in number. (I) Since the statement was to be expressed in year-end dollars, firms would have to restate sales, and all other items that occurred roughly in mid-year, by a half-year adjustment into year-end dollars. (2) The cost of goods sold would focus on that date when the goods that were sold were purchased and convert those to year-end dollars. There would be an even more substantial adjustment with regard to depreciation. That may be illustrated if you want to turn to Table V, where the middle column there reflects, very largely much of the data that was going to be required by the FASB Exposure Draft of 1974.

Table V INCOME STATEMENTS EXCERPTS FOR GENERAL ELECTRIC YEAR ENDED 12/31/1978 AS CONVENTIONALLY REQUIRED AND AS ESTIMATED DISCLOSURE FOLLOWS THE FASB REQUIREMENT			
Amounts in Millions			
	Historical Cost / Nominal Dollars (Conventional GAAP as Reported) (I)	Historical Cost / Constant Dollars 7/01/1978 Units (II)	Current Cost/ (III)
Sales and Other Revenue	\$19995.5	* 19995.5	* 19995.5
Equity Method Revenue	77.3	45.8	77.3

Total Revenues	\$20072.8	* 20041.3	* 20072.8
Cost of Goods Sold (Excl. Depreciation)	\$13915.1	* 13898.4	* 14000.0
Depreciation	576.4	885.4	890.0
Other Expenses Except Fed. & For. Taxes	3258.9	3258.9	3258.9
Interest Expense	224.4	224.4	224.4
Federal & Foreign Taxes	868.3	868.3	868.3
Expenses	\$18843.1	* 19135.5	* 19241.6
Income from Continuing Operations	\$1229.7	* 905.8	* 831.2
Unreal. H. G. on Inventory and Plant	_____	_____	* 876.0
Real H. G. on Inventory and Plant	_____	_____	* 398.5
Holding Gains, Gross	_____	_____	* 1274.5
Less: Inflation Component of H. G	_____	_____	-975.3
Net Holding Gains on Inventory and Plant	_____	_____	*299.2
Purchasing Power Gain (Loss) on:			
Domestic Monetary Items	_____	* 42.1	*42.1
Foreign Monetary Items	_____	* -33.4	* -33.4
Total Purchasing Power Gain (Loss)	_____	* 8.7	* 8.7
Extra. Items & Disc. Ops. (Net of Taxes)	\$ 0.0	_____	_____

\$ = Nominal dollars: in Column (III) \$ are approximately the same as *

* = Dollars of mid-year purchasing power.

Multiplier to convert to 1967 dollars: 0.493

There is this one difference that this middle column, as you can see, is headed 'Historical Cost/Constant Dollars -- 7/1/1978 Units', and the original Exposure Draft called for this to be expressed in year-end units, so that if you look across you can see that sales, and interest expense and federal taxes, are the same in the middle column which is historical cost/constant dollars, as they are in the first column, historical cost/nominal dollars, Back in the '74 requirement, those items that occurred roughly mid-year would have had a half-year adjustment. Cost of goods sold has a relatively small adjustment since General Electric is on LIFO. Depreciation, on the other hand, grows very substantially from \$576 to \$885. (Dollar amounts are in millions.)

(3) The other major adjustment that was called for in the 1974 Exposure Draft was one which went by the name of "Gain or Loss on Monetary Items" and which is now described as purchasing power gain or loss, or inflation gain or loss by the FASB. That simply made the point, how would you feel if you held a large number of dollars during the year in which the price level was advancing rapidly. The answer is, you wouldn't feel very well at all. You would recognize that those dollars, and claims to dollars like receivables, have a far less significant purchasing power at the end of the year than they did at the start. But conversely, the dollars that you owe could be repaid at the end of the year with cheaper dollars, and you would have a gain. When you put these two together, you ask what is the net monetary position of monetary assets, claims to dollars, against monetary liabilities, obligations in dollars. If you had a favorable monetary position, that is monetary assets in excess of monetary liabilities you would suffer a loss. If you had an excess of monetary liabilities over monetary assets, you'd have a gain. As you can see, looking at the bottom item in Table V, GE had a monetary gain of \$8.7 million in 1978.

The data in Table V are the estimates for General Electric for 1978 using an estimating technique that my colleague at the University of Chicago, Roman Weil, and I developed as part of a research effort funded by the National Science Foundation, to whom we give thanks. As part of the research effort, we estimated what the common dollar results would have been for each of the years from 1975 to 1978, for the thirty companies in the Dow Jones Industrial Index. Every one of those companies had an excess of monetary liabilities over monetary assets, so every one of them shows a gain on monetary items. The gain shown for GE is relatively small. We also looked at a group of public utilities, and they had very substantial monetary gains. In fact, in the year 1975, when your own favorite utility here in New York, Consolidated Edison was stopping its dividend payments, we did a calculation which indicated that if you added the purchasing power gain into the calculation of income, 1975 would have been a year of one of the highest incomes in the history of Consolidated Edison. In commenting on the FASB proposal, Forbes magazine ran an interesting article which talked about these monetary gains, and they picked up our information about Con Ed, and they presented a dramatic cartoon which showed a black sea of bankruptcy and Con Ed sinking into the sea, but as it was going down it was holding up its hand in a victory sign, to indicate that this was one of their most profitable years as they were going bankrupt.

For a variety of reasons, the FASB proposal of 1974 never became effective. Probably, the most important reason resulted from the actions of the SEC. Those could have been forecast by the comments of the then Chief Accountant of the SEC, Sandy Burton, who, commenting that the board was talking about accounting in purchasing power units, PPU, made the comment that whatever their skill in accounting, they were rather poor in spelling and that really, their proposal instead of PPU accounting, ought to be described as P U P U accounting, for the reason that adjusting things by a general price index for all firms just didn't make sense. That to say that the same adjustments should be applied to the inventories of Texas Instruments, whose prices were falling rapidly as should be applied to the inventories of Exxon, whose prices were rising very rapidly in his view did not reflect economic reality. That was a foretaste of what was to come, and in March 1976, the FASB issued Accounting Series Release 190, which called for major firms with plant, equipment and inventories of over \$100 million, to reveal replacement cost data with regard to depreciation, cost of goods sold, and the balance sheet amounts for inventory and plant. This information was to be disclosed in a footnote to the Form 10-K, that the corporation submitted to the Commission.

Earlier on I told you of what a poor prognosticator I was in terms of predicting what was going to

happen to inflation. In early 1975, a group of us at the University of Chicago thought that it was important, even though we didn't agree with general price level adjustments, for the world to understand about them, so we prepared a little book on that subject that went off to the publisher in the Fall of 1975. It takes a while for the book to come out, and just by an unhappy coincidence it was released by the publisher on March 23, 1976, the same day that the SEC issued Accounting Series Release 190. Our little book was called *Inflation Accounting: A Guide to General Price Level Adjustments for the Accountant and the Financial Analyst*. Sandy Burton is a good friend of ours so we sent him an inscribed copy. The inscription said, we thought that economic events might make this description of general price level adjustment accounting out of date after a period of years, but we never thought it would become obsolete on the day it was published. Well, it turns out, it's really not obsolete because the kinds of price level adjustments that are described there with regard to the general price level, also have meaning for specific price level adjustments. The book still does have some abiding value, the title is *Inflation Accounting*, it's published by McGraw-Hill, and lots of copies are still available in the bookstores.

When the SEC issued Accounting Series Release 190, this led, at least, to a slowing down of the efforts of the FASB in pushing for purchasing power units, for pushing for constant dollars, and firms in 1976, 1977 and 1978 had to report the replacement cost data. And the third column in Table V is an illustration of what an income statement would look like using the SEC mandated replacement cost data, for 1978 for GE. That is the cost of goods sold and the depreciation are the numbers that are shown in the footnotes to the form 10-K of GE in their 1978 submission.

Our experience in the U.S., this experience where we have the official accounting professional organization recommending general price level adjusted historical cost, and then in effect, being overruled by some governmentally organized group, like the SEC, is not an unusual one. In almost every English speaking nation, there first came a recommendation from the professional accounting organization that there be general price level adjustments. And it's easy to see why general price level adjustments are appealing to us accountants. You start with the historical cost data; these data have many infirmities, but at least we've grown accustomed to them. You take the customary historical cost data, and you apply a single governmentally supplied index to them, and everyone comes up with the same answer. And it is an answer, that in a sense, is objective, that is verifiable, that is auditable. It possesses all the virtues that are appealing to us accountants. The only trouble is that there's always some nagging soul, some terrible person, who says, but are they meaningful? Now, that's a thought that rarely occurs to us. And, so, you look into this question of whether adjusting by a single common index the affairs of all firms in the same way, produces meaningful results. We come up with the conclusions that were so well put in an article by your own Vice President, here at Baruch, David Green writing with Clyde Stickney, in an article in the CPA Journal which points out that these are really not economically significant numbers. The meaningful ones come in terms of the current cost data.

The Financial Accounting Standards Board continued to pursue their efforts on this subject diligently, and as Professor Mellman in his introduction, has pointed out, just a few weeks ago, they came out with Financial Accounting Standards Board Statement #33, that prescribes for all firms with plant and equipment and inventories of over \$125 million, or any firm with assets in excess of \$1 billion, that those firms must, in their 1979 financial statements, report the data that are spelled out here in Table V. The current cost data can be delayed for one year, but must be shown in a comparative fashion in 1980. The SEC has indicated that ASR 190 will prevail, unless a firm shows the current cost data for '79 so one way or another, these current cost data for '79 will be available either in the financial statements as mandated by the FASB, in supplementary form, of course, or in the 10-K's submitted by the firms. You can get some feeling, if we focus on just the top part, the income from continuing operations. You can get some feeling for what's happening to the price movements as they relate to these firms. Notice that if we look on the depreciation line, there's only a slight difference between the constant dollar and the current cost numbers, but that slight difference indicated that the current cost of GE's plant is rising more rapidly than is the general price level, and so as a result, the current cost column shows a higher number. That same thing is true of the cost of goods sold, which again seems to indicate that the price

of GE's products is rising slightly more rapidly than the general price level. Both the historical cost constant dollars, and the current cost columns wind up with income from continuing operations, a figure that some of us have been inclined to describe as "distributable income," the amount the firm could distribute, while maintaining its productive capacity.

Also required by the FASB, in 33, down there at the bottom, is our old friend the purchasing power gain or loss which, as I pointed out, was some \$8 million for GE in 1978. The third requirement is to indicate on the current cost basis, what had been, what I described as holding gains. The Board has backed away from that title in favor of some phrase like "current cost of inventory and plant in excess of historic cost." There are two kinds of such gains. One gain, the realized gain, we have some folks from the Board here and I hope they will pardon me if I do insist upon calling it what it is, and that is, a holding gain, that the realized gain on inventory and plant, you can see, is \$398. Don't bother to check me, but let me tell you, that that's equal to the difference between historic cost depreciation and current cost depreciation plus the difference between historic cost-cost of goods sold and current cost-cost of goods sold. If you take the differences between those two sets of numbers you'll see that the realized holding gain is \$398. In addition to that, there's an unrealized holding gain of the increase in current cost of the plant and inventory, above the cost that's shown on the balance sheet in historic cost terms. Putting these two together we can see that GE had, in the year 1978, holding gains of \$1,274, a substantial amount that is not included in income from continuing operations. But the Board says, are those holding gains real, or are they nominal? And so they say, if the inventories and plant had been revalued on a constant dollar basis, how much would those holding gains have been? And the answer turns out to \$975 million. And so we can say that the \$299 million ($\$1,274 - \975) represents a, if you like, real holding gain, an indication that GE's prices have risen more rapidly than the general price level. The Board does not suggest adding together these three numbers, the purchasing power gain, the real holding gain, and income from continuing operations. But there are many of us who would say, yes, the sum of those three represents the economic income of the firm for the year 1978.

The one thing we can be sure of is that we are going to be presented with substantially more information about America's largest firms than we've ever had before. The financial statements in 1979 are going to be rich with information for analysis by any who are interested in the firm. One of the things that is almost certain to emerge, judging by some of the past data that is commented upon by the Wall Street Journal last week, is that firms are going to be demonstrated to be paying dividends out of real capital. That is, a substantial number of these 1,300 firms that are reporting to the FASB are going to report dividends in excess of income from continuing operations. In a small sample, it appears that about half of the firms were doing that in 1978. That is, if we view income from continuing operations as being a clue to real distributable income, then we're discovering that the dividend distribution exceeds the distributable income, which is another way of saying that dividends are coming, at least in part, out of real capital.

We're going to have a large mass of other information available. There are already research studies under way which seek to discover whether security price movements in the last three years been better correlated with income as recorded in the financial statements, column I, or income as reported by constant dollars, column II, or income on current cost basis, column III? Much of that study is being done, I must confess, in Chicago, and the preliminary results seem to indicate, that a closer correlation exists between security price movements and current cost results. The one thing that I can promise you is that these next few years are going to be very interesting ones for accountants who seek to struggle with providing current cost information, and for financial analysts who seek to draw interpretations from them. And I really must close with the strongest possible sort of commendation for the Financial Accounting Standards Board for stepping up and being willing to issue a statement which calls for information that is sorely needed if we are to portray in a realistic fashion, the effects of that inflation that won't go away. Thank you.

QUESTIONS AND ANSWERS

Question - Abraham J. Briloff:

Sid, we're friends now for over a score of years, and you know I love you dearly. We've been friends for over a score of years, so that you'll understand that if my question is particularly pointed you'll realize that it's nothing personal.

Davidson:

I would expect nothing else from you Abe, I must confess.

Briloff:

I appreciate the fact that you describe the way in which Sandy Burton referred to constant dollar accounting, namely as "PuPu" accounting and I believe it was President Carter who described current cost accounting as "baloney" accounting, and I appreciate that reference. I would not feel quite as intensely about this particular issue, Sid, if I didn't feel very, very keenly that this represents a critical, social problem, a matter that will involve, very critically, the allocation of resources throughout our entire society. You alluded to the fact that it may impact on the amount of dividends that corporations may determine to pay because of the way in which the numbers might read. I believe you've also read the statements of Chairman Williams and Chairman Burns of the Federal Reserve and Chairman Kirk of the even more awesome Financial Accounting Standards Board, that governmental policy and tax policy will be very importantly impacted by these data. What do I mean by that? Looking at your data on General Electric, and you look at that hodge-podge statement in Statement 33 of the FASB. You can see that on an historical cost basis, income \$9,000; on the basis of constant dollar there's a loss of \$2,000; on the basis of current cost there's a loss of about 6 or \$ 7,000, I forget the amount. As a consequence, the corporations will turn to the tax collector and say, we need more relief, we need more surcease from taxation. And why? Because the accountants have toted up these numbers, and look what it is that they have done, look what it is that they are showing to you; we have losses, not profits, therefore we want tax rebates. I hope you realize, Sid, that as a result of doing that, the very problem that you describe is exacerbated. Budgetary deficits will be increased because corporate taxes will be reduced. Furthermore, to the extent that the corporations, like with their advertisements and advocacy advertising, would be able to demonstrate that they're losing money, while garnering enormous resources, will then be able to rationalize yet further price increases, thereby intensifying the very pressures of inflation which won't go away. We see it in the way in which the oil companies are rationalizing their price increases. So that if it were merely an accounting, mathematical mirage, I couldn't give two figs for the problem but it's because of the fact that it does involve a matter of social and economic redistribution that I speak in these strident terms. You've described the way in which PuPu accounting data are meaningless. The same is true of what you call current cost accounting. First, the current cost is a hoax. There is no current cost. The firm has not involved itself in any transaction involving that current cost, hence it is a hoax to describe it as such. If they wanted to say it's a hypothetical replacement cost based upon some cockamamie fantasized numbers, I might be able to go along with it. Furthermore, what they're doing is factoring in these numbers. You read 33, you helped to prepare it. If you go back to paragraph 2 it says it will give the reader a better understanding of cash flows. What nonsense! What a monstrous misrepresentation! This depreciation, as you know better than anyone, doesn't involve cash out-flow at all! We know that the only cash outflow that may have affected depreciation at any time was the original cost which may still be imbedded in the form of some indebtedness. This future cost that might conceivably be incurred if they were to replace, might not involve the cash outflow at all. It might be a leased property. It might be one that was funded entirely by debt. Consequently, it has nothing whatsoever to do with cash flow at all, and to be calling it a better statement of cash flow is, to my mind again the perpetration of a hoax. And that we in academe, we in the profession of accounting proceed to somehow or another feed these data into our corporate financial statements, and give them a degree of legitimacy which is unwarranted, is to my mind a most disparing phenomenon. Just one more observation (my class doesn't begin till eight). If, as Chairman Williams said, there is a capital formation crisis in America, poor corporations, they just can't fund enough to meet their plant and equipment replacements. I might understand it, we must do something in order to

maintain the sinews of America to keep us strong. But, look at the now of funds statements, and we find that the cash now from operations is just about equal to the investment in plant and equipment, and when we read Business Week of just about a year ago, September of '78, the caption of the article, as I recall it, is that the corporations or the major corporations are saturated with liquidity, and they don't know what to do with it excepting to go out and buy other corporations for billions of dollars. Sid, we are perpetrating a hoax.

Answer:

I guess that was a question. My response goes along these lines, Abe. In my very first remarks I commented that I was pleased to be here at Baruch, in part, because Baruch College had nurtured you in expressing your very honest views with respect to accounting. And I think the underlying essence of your views, as I understood them, at least until now, was what we should seek in accounting was truthful and realistic portrayal of economic events irrespective of who it helped or who it harmed. That what we sought was truth in accounting, that what we were seeking to do was express realistically what was going on in the affairs of these firms, irrespective of whether that harmed management or helped them, irrespective of other considerations. And so with regard to your first comments, I would simply say that what we should seek to do in our efforts to portray the effects of inflation, is to seek that which you have always sought, this realistic, this truthful portrayal of economic events. And if it affects the tax system, so be it. If it affects prices, so be it. It is not up to us as accountants to be attempting to set national policy, but only to seek to demonstrate that which you sought for so long the truthful, realistic, meaningful portrayal of economic events. I think you put your finger on it when you said the important thing is, how will this affect resource allocation? The important thing in allocating resources is not what something cost in classical antiquity. What's really important is what is its current cost today? Should the steel companies be investing additional funds, should resources be allocated toward them or should they be allocated toward other industries that are, in current cost terms, more profitable? That if we do believe in a system of market allocation, the only thing that counts is really future costs, but the best we can usually do to predict them is to focus on current cost. And not to reveal the information on current cost to the investing public, is I think, to run exactly counter, Abe, to what you've stood for and what I've admired for so many years. Now, with regard to taxes, again, it seems to me that the important question is getting an appropriate, a meaningful definition of current taxable income. We can alter tax rates, we can change things around in many different ways, to produce the kinds of fiscal results that we seek. But the important thing, the essential thing is to say, let's tax those who are making real profits. There is the additional question of what we ought to do with the realized holding gains and the unrealized holding gains, notice the numbers for GE on income from continuing operations exclude the realized holding gains, and in any meaningful tax system, they'd be likely to be picked up in some fashion or other. I must confess one point, tough, and that is despite my avowed preference for current cost, it seems to me that a constant dollar approach is necessary for taxes. The current cost numbers are too subjective for this purpose. They are prepared by the corporation relying on judgment. In almost all cases, I assume the judgments will be honestly based, but nevertheless I can't see the tax authorities accepting them. So if we're to do anything in the way of taxes, and you know that financial income and taxable income need not coincide, I think it would have to be in terms of the constant dollars.

Basically my answer to you, very regretfully, is that I'm concerned that you've in some degree abandoned all that you've stood for so long. The goal of our accounting has to be a realistic portrayal of economic events, as you have urged for these many years. I continue to hold to that view. I hope you are not abandoning it.

Question - Dean Saxe:

Professor Davidson, you stated that using current costs, they indicate the distributions made by the corporations, might result in an invasion of 'real' capital. My question is, whose capital? In the usual situation, large investments in fixed assets are financed very much by persons who lend money to the corporations. And yet, no adjustment is made in this respect, with respect to depreciation, and the result is that the corporation under this plan will get the benefit of both the increment that it itself had investment as well as the increment that doesn't belong to it, it was furnished by the lender, What is

your reaction to that?

Answer:

My reaction is that you have put your finger on one of the things that troubles me about FASB statement #33. You recall, I suggested that the purchasing power gain really was a reflection of the amount that the firm had benefitted, in a sense, at the expense of bond -- holders, and that therefore, it probably should be added, in my view, to income from continuing operations. Well, let me tell you one important qualification on that, that if we take a firm that's borrowing today, and borrowing at say 15% rates, that really what that represents is 11 or 12% inflation expectation, and a 3 or 4% real interest rate. And so, to say that the firm gains from this monetary position, these bonds being outstanding, may be to misstate the case, that really, that purchasing power gain ought to be viewed as an offset to the interest expense where it represents the effect of inflation expectations on interest rates. Only when inflation is not expected by lenders will the firm gain. But whichever way we do it, I think that purchasing power gain ought to be included with income from continuing operations. So, I agree with you, but I would suggest that those data are available and those who share your opinion and mine would simply, in terms of this GE report, add that \$8.7 that's shown there for purchasing power gains, in with the income from continuing operations of \$831 and wind up with \$840, as a number that really represents distributable income.

In concluding let me say again that I think the action of the FASB in issuing Statement #33 was great. That doesn't mean that if they'd only let me write it, I wouldn't have made it different in many ways, but the important thing is that we're now getting most of the information that is essential for understanding the financial implications of the inflation that won't go away.

