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Washington, D. C. 20549
(202) 272-2650

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An Address by Chairman Harold M. Williams
Securities and Exchange Commission
before the
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The primary matter I want to talk about this afternoon is how the corporation deals with reporting the impact of inflation, but the underlying theme is the role and responsibility of the private sector when it comes to an issue of significance to the future of the private sector, and where can we hope or expect the private sector leadership to come from in addressing that issue. When I think about inflation, I think about corporate reporting. More fundamentally, as far as I am concerned, we are talking about the impact of inflation on American business -- on the American economy, if you will -- for that is where the base of the economy is created. It is not created by the government -- government can influence it by incentives and disincentives and by redistribution, primary through tax policy. It tends to redistribute it based on the sense that, or to the degree that, the public and its elected officials perceive or misperceive or arrive at certain judgments about corporate profitability and corporate concern for the public interest. For example, whether corporate profits are "too high" and whether corporate America is responsive to the "public interest." In any event, the government clearly does not create economic wealth or economic profits.

The failure of corporate reporting to reflect the impact of inflation on corporate earnings, I submit to you, plays a very significant role in creating the problem of misperception. We hear and read daily, reports of new record corporate profits. You may recall the bruhaha early this year that surrounded the record corporate earnings reported for 1978. The Wall Street Journal reported that corporate earnings were up 9.7 percent. The New York Times, if I recall correctly, reported that earnings were up 28 percent. The Washington Post had them up 44 percent. They were all right and they were all wrong. The most interesting observation that followed from it was the reaction of the White House and Fred Kahn about the excessiveness of corporate profits, using more or less generous or thoughtful terms.

What can we conclude about corporate profits and what impact does this have on public pressure for income redistribution through tax and other government policy? What does it do when we create a set of circumstances that either permit or encourage characterizations of profits as "obscene" or by other similar terms? What does it do to our credibility when on the same day that the financial pages of the press report record corporate earnings, some of us are up on the Hill talking about the inadequacy of corporate capital and the need for corporate tax relief? Where is the credibility? Where is the consistency? If we conclude that the reports on economic performance of business are askew, then both the public and the politician are unable to accurately perceive the profits that business is making or how they relate to the needs of business. Or, to put it differently, if one can misperceive, then the business community is a participant and indeed a leader in providing the basis for that misperception. We continue to leave the impression that corporations are generating more than enough profits to satisfy their capital needs. But more importantly, we cannot blame the conditions leading to the misapprehension or misunderstanding of corporate profits in this Country on either the lack of economic education of public or elected officials or on some anti-business attitude or ideology. The blame has to rest first with the corporate community and with the accounting community, and with the articulation of corporate profits in both earnings reports of American corporations and in the supplemental public and press articulations of American business.

We must correct the message, and we cannot do so by talking among ourselves about the issue. We must talk to shareholders, to employees -- particularly those who are unionized -- to the public and to the politicians.

A lot of work done on over a decade on the question of how to quantify the magnitude of the gap between real and reported earnings. It would tell us, among other things, the difference in impact on earnings between depreciation based on cost, and depreciation of corporate assets that would reflect the current value of utilizing those assets -- what it would cost to replace them rather than what they cost when they were purchased 15 or 20 years ago. One way to approach this would be to compare book depreciation with income tax accelerated depreciation which comes closer to replacement cost. While all through the '60s and through 1972 the correlation between corporate depreciation and income tax depreciation was close, the situation changed beginning in 1973, to where by 1978, tax depreciation exceeded book depreciation by some $18 billion, and by an aggregate of $63 billion since 1973. Inventory valuation and the impact of inflation on corporate inventories is a second area of concern. Again, while through the '60s and the early part of the '70s there was only a modest amount of so-called inventory profit created by inflation, it began to explode in the early '70s, hit a high of $40 billion in 1974, and was in excess of $24 billion in 1978. For 1973 to 1978 it aggregated $125 billion.

When a profit on sale of inventory is caused by inflation and is not real, it nevertheless incurs tax liability. The company pays income tax on it, and then needs to replace the cash paid out in taxes in order to replace the inventory at the higher cost. That $24 billion in overstatement of inventory profits in 1978 due to inflation required American business to use up in tax payments at least $10 billion of either internally-generated cash flow or borrowings which did not further the needs of the economy, of the company or the Country.

What is the impact of these numbers on corporate profits? In 1978, real corporate profits, i.e., corporate profits as reported and adjusted only for the two factors just articulated, dropped from $98 billion after tax, as reported, to $56 billion.

At the same time, many corporate leaders and investors work from a rule of thumb that calls for the payment of dividends based on some percentage relationship to reported earnings, not distinguishing whether they are real or not. Particularly with price/earnings ratios depressed and the concern over unfriendly tenders, pressure exists to increase dividends so as to increase the yield and place a floor under the market value of the stock. While dividends in 1978 of $45 billion were just under 50 percent of the $96 billion of reported earnings, in line with the traditional rules of thumb, they were 80 percent of real corporate profits of $56 billion. At this level, it is clear that there are many companies in this Country today which are in the process of liquidation which they do not advertise and may not even realize, for realistically they are paying dividends out of capital rather than out of earnings. At an 80 percent rate, with only 20 percent left over, where will the money come from to be reinvested in American business to provide upgraded plant and equipment, to enhance productivity, to provide jobs, to keep us competitive in world markets, etc.? What we are finding is that much of what the corporate community articulates as profits are not profits and what is left over in the corporate coffers after the impact of inflation and after the impact of paying taxes and dividends is far from adequate for the recapitalization and the growth of the American economy.

That is where the future of the economic growth of this Country falls out of bed. And that is the story that needs to be told by the corporate community and is just not being told at all.

What it also tells us is that the effective corporate tax rate, which for years we have thought of as 42 percent, which it was in the '60s, is realistically around 55 percent today. Where else in the history of American tax policy have we had a 30 percent tax increase without at least some discussion in Congress? It is true also that individual taxes have increased as inflation pushed income into higher brackets and I am not insensitive to the problems that are posed for the American public by the impact of inflation. But, frankly, I am more concerned about the impact on business to which we must look to build the future economic strength of this Country. Business is not going to be able to obtain the changes in tax policy necessary to assure a more appropriate and adequate flow of capital -- nor will we be able to move the Country from its orientation on consumption to providing incentives for investment, until we understand the reality of corporate profits.

Why is it that so little has happened to cause the reported corporate earnings, or the facts if you will, to to be more clearly articulated? The key is that there is no focal point in the private sector whose overriding interests are clearly identified with telling the story or who are willing to subordinate their own interests to doing so. The accounting profession is a very powerful force that prefers to keep things reported as they are. Whether it is the comfort of tradition and consistency, whether it is easier to audit because the conventions are now all based on historic cost, whether it is concern over the increased liability that might be imposed because of the relative "softness" of replacement cost, there is very little thrust or momentum from the accounting community to address the problems. In the corporate community we experience the same resistance -- greater difficulty in managing a pattern of earnings growth as one moves away from historic cost, a less favorable earnings picture which in turn places management's performance and its incentive compensation based on earnings improvements and compensation tied to stock market performance -- in a less favorable light. This is not to say that there are people in both categories who are concerned and who are suggesting alternatives. But there is no place that I can turn to in the private sector where I can find an able band of people who are concerned about the long-term impact of inflation on the future of the private sector and who are willing to put those concerns above short-term interests -- where we can look in the private sector for a sense that recognizes we face certain issues that will over any time period determine not only the profitability but indeed the future of the private enterprise system.

When I was invited to become Chairman of the Commission, it appeared to me that there were two different kinds of issues that the Commission would be facing. One relates to the on-going assurance of the integrity of securities and securities markets which is the historic and important role of the Commission and one that is very important to me to be involved with. The other one is that the Commission touches upon issues that are not only involved with the day-to-day integrity of the securities markets, but with the future of the system. These issues require us to grapple not only with substantive issues such as the impact of inflation, but also with political process issues so vital to the future of our society such as the role of the Commission, and much more importantly, the role and responsibility of the private sector, other than to be critical of government and to react belatedly and negatively.

Let us use inflation as an example. The SEC has taken certain actions -- to enhance relevant financial information about the impact of inflation -- ASR 190. I am optimistic that the FASB will assume the initiative this year for further and timely progress. But it has taken far too long for this to happen. Leadership on the part of the private sector, both accounting firms and the corporate community, to deal with the problem has been lacking. Leadership does not emerge out of consensus. By the time a consensus emerges, the problem -- and perhaps even its solutions, are generally apparent -- and the damage has been done. Where does the leadership come from? I am confident that it should not come from government. Not only does government lack the wisdom, it does not have an appropriate way of making or implementing decisions that will impact fairly or appropriately in the myriad of diverse circumstances -- since it can be implemented only at the macro level. But it also tends to deal with problems only when they have become crises, deal with them simplistically, often with a politically-based bias, and most importantly, again transfers the decision-making to Washington.

We must change the momentum. The initiative has to come from the private sector. It ought not to come out of government.

Under the '75 Act Amendments, the Commission is charged with developing a national market system. Why is the Commission charged with developing a national market system? In part, because the securities industry did not respond to the obvious writing on the wall early enough to maintain the initiative for itself and prevent the government from assuming it.

What about the Foreign Corrupt Practices Act? Another example.

The accounting profession should not be federally-regulated, but whether it will be or not will depend essentially on the ability of the accounting profession itself to take the substantive measures necessary to develop and implement a program of self-regulation that is effective and is perceived that way.

The Commission has dealt with a number of issues involving application of Rule 2(e) to attorneys. Part of the question underlying the Commission's need to discipline lawyers who practice before it revolves around the adequacy of the conduct and disciplinary processes of the bar.

Corporate accountability. I do not insist that you accept my definition of an ideal board. What I do care about is that the board is independent and functions as a board of directors is supposed to function, not because I say so, not because the SEC says so, but because that is the way the system is designed to work. If the board is not working the way it is supposed to work, its members are perverting the private enterprise system. The future of the system is being determined, consciously or unconsciously in the board rooms of America every day, and you are there. I am not. That is where the momentum has got to turn. That is where things have to happen, not at the SEC.

How do we galvanize the private sector, individually and collectively, to assume the leadership role that it must take in order to assure the system is preserved because it works well, rather than being part of the drift through which it will be converted into something else?

This is probably as good a place as any to stop and express to you my appreciation for having me here and to answer any questions you might have.