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# CORPORATE PROFITS: Illusion and Reality

AN ADDRESS BY

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I would like to share with you this evening some observations concerning corporate profits, public and corporate perceptions of the profitability of American business, and the impact which the financial press has on those perceptions. The subject is, I believe, both important and highly relevant to this group, since it is largely through the information gathered and disseminated by the press that we form our conclusions concerning the functioning of our economic system. My theme is a simple one: The widespread failure to understand both the function and the level, in real terms, of corporate profits and cash flow is, in my judgment, blinding many to the fact that business is simply not accumulating and retaining the resources required to meet the challenges facing it.

As a society, we are placing increased demands on our private enterprise system, particularly in reaching national objectives which are as important and as diverse as full employment, energy independence, and environmental protection. The problem of marshalling sufficient capital in order that business may discharge its role in accomplishing these goals is a serious one. Unfortunately, however, the effects of inflation, coupled with the present methods of reporting business performance, obscure the increasingly pressing need to bring forth additional capital and, indeed, may lull us — as government

policy-makers, as decision-makers in private business, and as individual citizens — into a belief that corporations are generating more than adequate funds to satisfy our demands for capital.

The public perception seems increasingly to be that American business profits — particularly those of the largest firms, those most able and most responsible for aiding in accomplishing our national objectives — are huge, growing larger, and accruing exclusively to the benefit of a small and select group of wealthy individuals. This mis-impression leads inevitably to demands that the government take steps — often through tax policy — to moderate those profits and to divert them to the common weal.

In my judgment, American corporations, as a whole, are — rather than generating shockingly high profits — earning at dangerously low levels, if they are to discharge the responsibilities we expect them to shoulder. Further, profit trends — especially as they affect cash flow available to replenish, modernize, and expand assets and to pay dividends — are probably the most important set of factors in evaluating a stock in the market place. Despite their importance, however, I believe that the function and level of corporate earnings and cash flow are seriously misunderstood.

Public Perceptions of Corporate Profits

It is common-place to read in the press that particular well-known corporations have reported "record" or "all-time high" earnings. In terms of the absolute number of dollars involved, these statements are, of course, true. It is, however, useful and important to put those figures in perspective. And when the perspective is business's ability to generate required new capital, "record" earnings figures may, in my judgment, prove to be distressingly low.

In 1974, economist George Terborgh wrote an interesting article which appeared in the Financial Analyst Journal, and which forcefully illustrates this point. Terborgh studied corporate profits, the impact of inflation on those profits, and the ability of corporate earnings to generate the capital required by industry. The year to which he directed his attention was 1973. That year saw the highest corporate earnings in history, as of that time — reported after-tax profits of $50 billion. Terborgh noted that this compared with $38 billion in 1965, an increase of about 32% over a period of 8 years.

Terborgh performed two adjustments in order to transform the $50 billion of 1973 reported profits into a figure more closely representing the costs and revenues, in terms of real purchasing power, resulting from business operations. First, he recomputed earnings based on current-cost, double-declining balance depreciation. The objective of this step was to charge against earnings a figure which more accurately reflects both the manner in which

capital equipment is consumed and the cost — in inflated, current dollars — of replacing it. Second, he converted inventory consumption charges, as reflected in the cost of goods sold, from historical to current cost. In both cases, then, the adjustments were designed to produce an income figure which reflected current, inflation enhanced costs of doing business rather than the historical costs on which traditional accounting methods rely. Adjusting for the effects of underdepreciation and one time inventory profits, Terborgh found that 1973 after-tax profits were $23 billion, less than half as large the $50 billion figure on a reported basis. Profits for 1965 comparably adjusted were $36 billion. This converted a reported 32% increase between 1965 and 1973 to a 30% decrease. Finally, adjusting for inflation by converting earnings to 1965 constant dollars resulted in a decline in profits from $36 billion in 1965 to $18 billion on a comparable basis in 1973.

Terborgh also directed his attention to the share of its profits which business retains as a source of capital for re-investment. He found that retained earnings comparably adjusted fell from $19 billion in 1965 to $2 billion in 1973, a drop of 90%. Business had, in effect, paid its dividends and taxes out of capital. During the same period GNP grew 88%.

The effect of adjusting corporate earnings to allow for inflation is equally startling from the perspective of federal

tax policy. In 1965, after tax profits, both as reported and as adjusted by Terborgh, were nearly identical. By the mid-1970's, however, reported after-tax profits were just about double the figures adjusted for under-depreciation and inventory gains. Naturally, this has led to higher and higher effective tax rates on the profits that remain. As pointed out by Terborgh, the effective tax rate on "real" earnings has risen from a little more than 43% in the mid-1960's to almost 66% in the mid-1970's. Thus, inflation, and the failure of the tax system to recognize its distortion of corporate profits, have resulted, in effect, in a 50% tax increase over the last decade. This increase has, of course, been accomplished without congressional action of any sort and, consequently, with no opportunity for debate over the effects on capital formation — a debate which would certainly occur if a legislative increase of 50% in the corporate tax rate were proposed.

As each dollar of corporate income or in the corporate stream of cash flow becomes less potent in terms of real purchasing power, business profits — which the man in the street, with the acquiescence of the news media, may perceive as astronomical — dwindle in terms of their ability to meet capital needs. The distortions in financial reporting which inflation spawns are not, of course, confined to income statements. Balance sheets which reflect the historical costs of corporate assets are similarly

unrealistic, both because they reflect assets at figures which may far understate current values and, correspondingly, because the equity side of balance sheet omits any recognition of the impact on retained earnings which results from inflation-induced changes in depreciation levels and asset values. Without attempting to challenge the underlying assumptions with which accountants have traditionally dealt, I would suggest that a balance sheet which was "up-graded" to reflect replacement value of assets would look considerably different than do the statements which capital-intensive industries are today disseminating.

The most unfortunate consequence, in my view, of current corporate disclosure practices, particularly with regard to depreciation, is that those practices lull both policy makers and the public — and perhaps more importantly corporate managers — into a false sense of security regarding investment needs. The tax system, in turn, re-enforces these misperceptions, and the net result is likely to be overtaxation, skewed balance sheets, and ultimately, a handicapping of the corporate sector's ability to raise the capital which it must have to play the role we demand of it. In my judgment, if we are to meet our need for adequate new investment, the disclosure and taxation systems must be converted into tools which will aid the effort rather than obstacles which frustrate it.

Profits and Capital Formation

It might at this point reasonably be asked whether these issues are actually of much significance to the general public or whether questions of inflation accounting and capital formation are best relegated to the domain of accountants, economists, and those of similar bent. I believe, however, that a grasp of the interplay between capital formation and business profits is critical to anyone with a serious interest in our national economic future. It is from after-tax corporate profits that business is expected to make the investment necessary to eliminate shortages, to improve productivity, to resolve the energy crisis, and pay for an ever expanding social program. In my view, studies like Terborgh's illustrate that, if business were to develop financial reporting which reflected the economic realities of operations, the conclusion would be inevitable that private enterprise is not presently generating adequate cash in terms of real spending power for the formation of necessary new capital, and that profits need to be higher rather than lower.

In 1976, the Department of Commerce prepared one of the most detailed and comprehensive discussions of the problem of investment requirements. In "A Study of Fixed Capital Requirements of the U.S. Business Economy, 1971 to 1980," the Department's Bureau of Economic Analysis looked at capital needs on an industry-by-industry basis. The purpose of this study was to estimate the amount

of investment necessary, through 1980, in order to have an economy capable of meeting three objectives — reasonably full employment; a national program of environmental protection; and decreased dependence on potentially unstable foreign energy resources. While the methodology of that study is complex, and undoubtedly open to debate amoung those steeped in such matters, the general findings of the report helpfully quantify the dimensions of our potential problem. The Bureau found that capital investment — that is, non-residential fixed investment — must average about 11.4% of Gross National Product in the coming years.

The Commerce Department's study also contains some interesting findings with respect to the uses to which new investment would be put. First, the Bureau estimates that only about 3% of total projected investment requirements are needed for pollution abatement expenditures. Secondly, less than half, or 45% of required investment, will provide for expansion of productive capacity. Finally, over half, or about 52% of capital needs, will be for the replacement of aged, obsolescent, and inefficient productive capacity. In other words, the majority of the Department's projected national investment needs during the coming years would be employed simply to keep us from slipping below present levels. I think that this finding is a reflection of our chronically low rate of capital formation in the last decade, and that it has

disturbing implications for our industrial future, especially if capital formation, in real terms, does not match the requirements which the Department's study identifies.

An example from a particular industry may be held to make these figures more concrete. A recent study by a Wall Street security analyst, as reported in the Wall Street Journal, concluded that the average cost of replacing a ton of steel manufacturing capacity works out to $805 a ton. At that level of replacement cost, an average annual outlay of $3.2 billion would be required just to hold capacity at present levels. This is more than twice the cash flow available, after dividends, in 1976 for the steel industry, so that at least $1.5 billion of additional annual borrowings would be needed — or else dividends would have to be eliminated — if capacity is to be maintained. If existing production capacity is maintained through borrowing and without reducing shareholder dividends, then debt will have to come to represent about 60 percent of the industry's capital — a figure which probably would not be tolerable either to management or to investors. To the extent that this analysis is correct, it suggests one of two things: Either, as the author concludes, a "defacto" liquidation of part of the industry is underway, or the capital structure and the dividend policy of the industry will need to change substantially.

A review of capital formation trends in the economies of our major trading partners also demonstrates the significance of the rate of domestic investment. Statistics developed by the Organization for Economic Cooperation and Development indicate that, in its 24 member countries, gross fixed capital formation in recent years, as a percentage of gross national product, has averaged nearly half again that of the United States. Meanwhile, Japan's capital share of GNP is almost double ours. In light of these facts, coupled with the analysis I mentioned a moment ago concerning capital replacement in the industry, I do not find it surprising that domestic steel producers, for example, may have a problem remaining competitive internationally. Indeed, those whose concern is focused on the very real plight of the unemployed American steel worker might be well-advised to consider the implications of these figures.

The problem of inadequate investment capital can also be viewed from the standpoint of the fiscal policies which the federal government would have to pursue in order to plug the "capital gap." A Brookings Institution report, issued in 1975, entitled "Capital Needs in the 70's" by Bosworth, Deusenberry, and Carron, concludes that we "can just barely afford the future." But if one studies the report, one finds that even that rather unsettling conclusion is based on several very optimistic assumptions. One is that during each year in the period 1974-1980 the federal government will run

an average surplus of $11 1/2 billion. In contrast, the Congressional Budget Office estimates that, in fiscal year 1978 alone, we will in fact experience a deficit of $60 billion.

The second assumption underlying the Brookings study is that, by 1980, we will have reduced unemployment to 4%. That may be achievable, but it is, I fear, also quite unlikely. Finally, in reaching the conclusion that we can supply our capital needs, given the two assumptions I have referred to, the authors of the Brookings study point out that there will be little money for sweeping new federal programs since opportunities for new programs will be severely constrained by the limited availability of resources. They conclude that the combination of some tax reduction and a system of national health care insurance would exhaust available resources unless other programs were correspondingly pared down.

Investment capital, like other commodities, is, of course, subject to the laws of supply and demand, and thus capital will always be available to those businesses which can pay its price. But all of society's investment demands are not purely "economic" in the sense that we may be sanguine about permitting the free play of the market place to determine which will be satisfied in light of a severe capital shortage as compared to our national aspirations. Pollution abatement, for example, is basically a social rather than a business goal. Similarly, the move towards greater energy independence is at least partially a political decision. In fact, in

striving to achieve full-employment — however that term may be defined — we are pursuing objectives which are social and political as well as economic. All this is to say that, while questions of capital formation may seem at first blush to be arcane and theoretical, those issues have a very real impact on our ability to meet the goals that we as a nation have set for ourselves.

## The Role of the Press

I want to conclude by relating my theme briefly to those whose profession it is to inform the public concerning the business and economic environment. As I have explained already, I believe that, as long as reported earnings continue to fail to take into account an accurate assessment of the impact of inflation, investors, managers, government policy-makers, and the general public will all necessarily remain uncertain of the level, expected growth, and rate of change in profits. The press has, I believe, an important role to play in correcting this situation.

The consequences of this uncertainty on the formation of capital are, in my judgment, far-reaching and poorly understood. For example, the undependable nature of reported earnings subtly affects confidence in the securities markets. To the extent that the investor doubts the relevance of reported earnings, he will be less willing to hold corporate shares and less willing to acquire

new equity issues. To put it simply, if reported earnings fail accurately to reflect economic and financial realities, investor confidence is eroded.

The effect of traditional methods of financial disclosure on the securities markets can also be viewed from another perspective. The current average price-earnings ratio of the companies composing the Dow Jones industrial average is around 10. A recent study by one investment research organization indicates, however, that, if depreciation based on replacement cost is taken into account in computing earnings, the over-all average P/E ratio rises to almost 34. It might, I suppose, be argued from this that the market as a whole does take the effects of inflation into account in pricing securities to a greater degree than is generally assumed. Indeed, a P/E ratio of 34 would suggest that — rather than being depressed — the stock market is, at present, unrealistically high.

The investor is not the only one who lacks the requisite data for decisionmaking. Corporate managers themselves, in estimating their capital needs, the internally generated capital available, and the projected returns from proposed investments, may be relying on information systems which depend on historical costs and ignore the past — and future — effects of inflation. Where the defects in available information are perceived, but more realistic substitutes are not available, decisionmakers may resort to informal judgments, intuition, or guesses in an effort to allow for price-level changes.

To the extent, however, that corporate decisions are made on the basis of second-best information, the riskiness of a venture may not be truly appreciated, and resources may be allocated inefficiently.

Interestingly, labor unions may be the one element on the economic scene which has most clearly perceived and exploited the impact of inflation. Unions typically approach the bargaining table with wage demands which explicitedly take into account the erosion — past and future — in the buying power of their members' wages. At the same time, however, labor's negotiators can point, with little resistance from management, to the increasing magnitude of the employer's profits — "profits" which, if the analysis I have outlined earlier is correct, may actually represent decreases in the after-tax spending power of business income. Corporate managers, in sensitizing themselves to the impact of inflation capital needs, might do well to emulate labor's focus on price-level changes.

Finally, as I mentioned earlier, one of the most familiar consequences of the failure to evaluate reported profits and cash flow in terms of what they represent as a real source of capital is that the public is exposed to a constant stream of reports of "record" corporate earnings -reports which often are cited in rebuttal to claims that tax or other incentives are necessary in order to encourage investment, and which, in any event, serve to obscure the problems and importance of capital formation. These reports would take on a different cast, however, if it were borne

in mind that, for example, a 6% increase in earnings or in sales revenues during a period of, say, 8% inflation means that the corporation has actually decreased its profitability or its sales in real terms — and, with respect to earnings, this is so even without converting depreciation to a current cost basis.

In the long run, the solutions to the problems which stem from the failure to recognize the inflation components in corporate profits lie, I suppose, primarily with those who establish accounting principles, disclosure requirements, and — perhaps most importantly — federal tax policy. I believe, however, that the press also has an important role to play in helping the public and businessmen themselves to understand the function of corporate earnings in our society, and the importance — not simply, or even primarily, to stockholders but to all of us - of profits which are adequate to permit investment in our industrial future.

While the magnitude of reported corporate earnings may be newsworthy, I would urge that consideration also be given to focusing and reporting on the uses to which those earnings and the related cash flow generated are being put. Is productive capacity expanding in a given industry? Are new sources of raw materials being sought out? Do retained earnings form an important source of funds for pollution abatement and other capital expenditures? Or, on the other hand, is a particular corporation diverting its earnings into

dividends or expenditures which fail to take into account capital formation needs? These are, I believe, issues which should be of greater interest and importance to the public in following business and economic trends than is the issue of the size in dollars of reported profits alone.

Conclusion

It is, of course, within neither my function nor my expertise to instruct business journalists on what to report or how to perform their jobs. I do believe, however, that both the public and much of the business community are at present seriously confused about the level and role of corporate profits. And, if this country is to maintain its existing industrial resources — to say nothing of expanding productive capacity and accomplishing goals such as full employment, environmental protection, and others — a considerably increased level of capital formation will be necessary, much of which must be generated by corporate earnings.

The New York Times recently editorialized that:

> "Profits can be measured in many ways; economists quarrel over the details. But most now believe that business simply became less profitable starting in the mid-1960's. Investments no longer pay off as well as they used to for companies and stockholders. This is a much more objective reason for the reluctance to invest and may explain some of the hedging on outlays during the current expansion."

This type of journalism is a valuable step in the right direction. The other pieces of the picture are, however, the role of inflation in causing this decline and the impact which it threatens to have on capital formation and on our economic future generally.

At the present, however, the effects of inflation, both on our systems of corporate taxation and of financial reporting, inhibit solutions to the problem of generating adequate cash for necessary capital formation and, in fact, serve to conceal its existence. I would urge only that those with the power and the opportunity to help foster public understanding of this problem be sensitive to its existence and its importance, in the long run, to our Nation.