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What Profits?

The Commerce Department recently reported that pre-tax corporate profits had soared at a 40-percent annual rate (to $140 billion) in the first quarter of the year, following strong gains in the 1971-72 period and a whopping 29-percent increase in 1973. However, the news generated few smiles in corporate boardrooms, partly because the gains were very uneven among industries, and for other reasons as well. Profits typically rise sharply during business expansions (and fall sharply in recessions), in contrast to the relatively steady long-term uptrend in wages. Moreover, recent statistics may not be as strong as they appear; many analysts, in fact, now question the "quality" of the profits data reported by corporations, claiming that they are overstated by one-fourth or more because of their inflation-swollen inventory component and insufficient write-offs for older plant and equipment.

The situation disturbs corporate treasurers because they foresee the need for a continued high level of profits in the years ahead to supply investable funds for the nation's myriad needs, such as breaking capacity bottlenecks, developing new energy sources, and cleaning up the environment. However, inventory profits don't provide a reliable source of investment funds, and neither do the profits derived from the underdepreciation of existing capital assets. Corporations thus are under growing pressure, not only to improve their earnings position but also to make reported profits a more accurate and economically meaningful measure.

Poor accounting

Inventory profits in the first quarter of 1974 amounted to a massive $31 billion (annual rate)—more than one fifth of total earnings—as successive price increases added retroactively to the value of goods in stock. Even so, a large share of that total resulted simply from the choice of accounting system made by most firms. Especially during an inflation period, the size of reported profits is strongly influenced by the accounting method chosen—last-in first-out (LIFO), first-in first-out (FIFO) or whatever.

The LIFO method, in which the inventories that are sold or otherwise used up are charged with the cost of the most recently acquired stocks, works to reduce reported profits when prices are rising. It does so because recently purchased goods are usually higher priced than earlier acquisitions. But only about one-fourth of all major corporations utilize LIFO, and most use other accounting methods that tend to overstate profits. The widely-used FIFO method suffers from this failing because it includes in reported profits a sizable amount of what essentially are capital gains on inventories—and by enlarging profits in this way, it also expands tax liabilities, leaving smaller amounts available for future investment.

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The same type of exaggeration results from the impact of inflation on depreciation allowances. Accounting tradition and tax law both favor the use of original-cost depreciation, even though use of that method could lead to the understatement of the value of business capital (and therefore of depreciation) in inflationary periods such as today. The situation has been helped only partially by the legislative liberalization of depreciation allowances in 1954, 1962 and 1971. By failing to take full advantage of methods appropriate to an inflationary period—such as accelerated depreciation—nonfinancial corporations may have under-depreciated their plant and equipment by as much as $7 billion in 1973.

Poor record

Beyond the problem of measurement, there stands the basic question of the adequacy of profits for motivating—and financing—the necessary expansion of productive investment. Increasing doubts are surfacing on this score, although few observers would yet agree with the perennial pessimist, George Terborgh, who recently said, "The reinvestment of corporate earnings, realistically measured, has almost ceased."

A straw in the wind is the growing tendency for internally generated funds (retained profits and depreciation allowances) to fall short of corporate spending for plant, equipment and inventories. During the 1971-73 expansion, internal funds fell 30 percent short of such expenditures. In contrast, the shortfall amounted to only 14 percent and 3 percent, respectively, in the comparable business expansions of the mid-1950's and early 1960's. The problem was attributable not to depreciation but rather to retained earnings, which amounted to only 9½ percent of net funds raised by corporations in the 1971-73 expansion, compared with a 20-percent contribution in each of the earlier expansions.

Poor future?

Thus, no matter how well corporations counteract the effects of inflation by adopting LIFO accounting and accelerated depreciation methods—and they have a long way to go in this respect—they still may not be generating a sufficient flow of earnings to meet essential investment needs of the coming decade. In past periods, the relative shares of capital and labor in the national income tended towards long-term stability, with the real return to each of those factors of production rising

about 3 or 4 percent a year. But although the capital (profits) share rose in 1973 for the third year in a row—to 11.7 percent of gross corporate product—it still remained lower than at any other time since World War II. The capital share lagged behind its pre-1970 performance even with the inclusion in that measure of net interest, a return to capital whose importance has risen sharply in the past decade.

A number of reasons could be cited for this apparent decline in the return to capital. One hypothesis, advanced by Alan Greenspan, is that the labor-management balance has shifted in favor of labor in the postwar period. According to this view, the wage-bargaining process now generates a higher average wage than formerly because of the decreasing incidence of actual hardship during unemployment periods, what with the availability of such income supplements as unemployment compensation, welfare payments and food stamps. Another argument suggests that profits have been hurt by the changing legal environment surrounding business activity, because of the substantial cost increases generated by environmental, consumer, factory-safety and equal-opportunity legislation.

An alternative explanation, developed by Albert Burger, relates the low profit share in the early 1970's to the length of the previous business expansion. During the prolonged period of growth of the 1960's, total spending (and prices) accelerated, giving firms a strong incentive to expand their capital stock. Further incentive came from the liberalization of asset depreciation rules and the several changes in investment tax credits.

The resulting increases in capacity which came on line in the late 1960's and early 1970's were not fully utilized. Consequently, the average cost of production rose and the profit rate fell. But this depressing factor may have been overcome during the strong 1972-73 expansion, with firms experiencing a rise in output per person and a consequent improvement in profits, as would be expected as they moved down along their average cost curve.

No one knows how well corporate profit margins—and the profit share of income—will hold up in the face of all the diverse factors noted above. Suffice it to say that the task will remain difficult as long as the economy remains distorted by inflation, with its resultant misallocation of resources.

William Burke