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The Meaning of Depreciation

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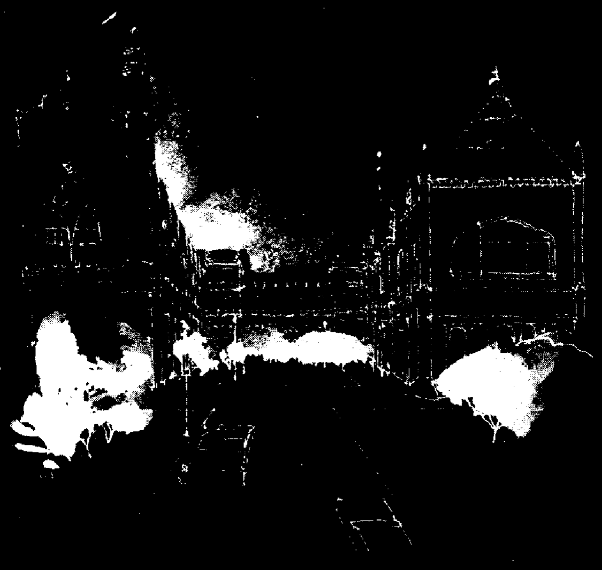

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The Meaning of Depreciation

The topic of depreciation is one of the most disputed in all the relationships between accounting and business. And, of course, optimum practices and policies with regard to depreciation are still far from settled.

More than a quarter-century ago, Henry Rand Hatfield, the second Dean of the Business School, wrote a very entertaining essay on the subject, “What They Say about Depreciation,” in which he pointed out some thirty-six different approaches or procedures to be used in connection with the depreciation question. The quarter-century which has passed since that time has resulted not in consolidation of ideas but rather in a multiplication of approaches, so that this whole question of what depreciation is, what it means, what should be done with regard to it is one that is subject to a good bit of controversy.

One of the things that has certainly helped to heighten the controversy in this area is the important place that depreciation plays in income-tax calculations, especially when income taxes reach a 52 per cent rate.

As far as the general nature of depreciation is concerned, there can really be no question. Depreciation is-and must be recognized as being-a cost of doing business, one that nobody can deny. The cost of a boiler is as much a cost of doing business as the cost of the coal. It is true that plant expenditures may be more sporadic; nevertheless, these expenditures have to be made. We all know that these facilities are used up in the carrying-on of the firm's activities. Therefore, as you can readily see, depreciation is a cost of doing business that nobody can deny.

However, depreciation is a joint cost par excellence. It is joint with respect to the several time periods during which a plant asset is used. It is joint with respect to the products that are turned out utilizing any piece of equipment. It is joint with respect to the individual units of production that are turned out during any given time period. Economic theory suggests to us that joint costs cannot be allocated satisfactorily. Yet in a variety of circumstances we are faced with the problem of allocating these joint costs-costs which are joint to an extent unmatched by almost any other kind of cost.

The problem is complicated by the fact that the period of usefulness of most plant assets-the period over which this allocation is made-is usually relatively long. Changes in the economic significance of the units that we use to measure the expenditures that we have made can come about fairly readily and, in fact, frequently do.

The depreciation problem, in essence, boils down to three questions.

The first is: What kind of base should we use in measuring depreciation? Should it be related to the historic dollars that have been expended, or should it approximate some measure of the current cost of assets that have been utilized?

Second, over how long a time period should we attempt to allocate these costs? What is the service life of the asset?

Third, what pattern of charge-off over this service life should we use?

With this background for the problem and the uncertainty about depreciation, what does depreciation mean to the business firm and to the economy as a whole?

We can say that to the individual firm depreciation means a tax deduction, a factor in the preparation of external reports, and an ingredient in internal analysis.

To the economy as a whole, depreciation is a factor in determining the base for income tax. The procedure with regard to depreciation in the legally defined notions of taxable income has had considerable effect upon the equity of the income-tax law and upon the rate and structure of economic growth within the economy.

Let us start with what depreciation means to the business firm. Here let us turn to one area where, I think, we can speak with a relative degree of confidence, with relative assurance. This, of course, is the area of depreciation as a tax deduction for the business firm.

Within this area it seems clear to me that the goal of the firm should be to maximize the present value of the reductions in tax pay ments from claiming depreciation. In a flat-rate tax situation this is the same as saying we want to maximize the present value of depreciation deductions. Of course, we can always deduct the cost of the asset over its life, but the earlier deductions are worth more in this cash-hungry world than the later ones. Therefore, our goal should be to maximize the present value of this stream of depreciation deductions and with this to minimize the present value of the stream of tax out-payments.

Congress has presented business firms with several permissible alternatives to follow in determining the amount of depreciation to be charged off each year. The pattern of depreciation charges is to at least some degree within the control of the business firm. It seems clear that the firm should choose that alternative which meets the general goal that we have set forth-to pay the least amount of tax as late as possible.

We can put this more strongly by saying that management has an affirmative obligation in our economy to carry on operations and activities so as to minimize all costs-to minimize the present value of these costs over the long run. This is an obligation of management to the stockholders and, indeed, to the competitive system, because to fail to minimize costs is to put a roadblock in the wonderfully effective system of allocating resources by market processes. This applies to tax costs as well as all other costs, and, except in a highly unusual circumstance, tax costs are minimized by taking depreciation as rapidly as legally permissible.

Any management that fails to take depreciation as rapidly as legally permissible to minimize the present value of tax payments is remiss in its responsibility to stockholders. This is something that must be done, and, in fact, I would say that any management that does not seek to maximize the present value of this stream of depreciation deductions is suspect in a sense and that we must look for the exceptional circumstances that justify this sort of procedure. In this connection, one of our Ph.D. candidates is writing a dissertation which is an effort to analyze firms that do not take rapid depreciation for tax purposes to see what the unusual circumstances are which explain their failure to do so. There is the question of what procedure does minimize the present value of tax payments. The tax law spells out three general types of procedures-the straight-line method, the sum of the year's digits, and something described as double-declining balance. It is clear that either of the two latter, the sum of the year's digits or double-declining year balance, will, almost without exception, give a more rapid rate of charge-off than the straight-line method. However, the choice between these two, the SYD or double-declining balance, is dependent upon several rather specific circumstances, such as the estimated service life of the assets, the discount rates that are appropriate for the firm and the salvage value of the assets. Several of us worked up a paper last year on the selection of the optimal depreciation method in a capital-budgeting situation. This appeared in the October Journal of Business.

Is there a danger that these goals of the least and latest tax payments may conflict? For instance, in taking depreciation deductions early, may we be faced by the problem of increasing our tax payments in a later period by a greater amount? You see, if we take more depreciation now, then in a simple situation we will have less to take later. If tax rates should turn out to be higher later, when our taxable income would be higher, we would have a larger total tax bill.

This might be the case if we were considering a single-asset firm, although even here the interest saved from postponing tax payments might very well offset the higher payments later. However, if we move from a firm that has only a single asset to the more realistic situation of a balanced firm, the higher depreciation on new assets that are acquired regularly will serve to complement the lower depreciation on the older assets, with the result there can be every expectation that the tax savings in the earlier years will not be offset by higher taxes in the latter years. Indeed, if the firm is a growing one, there will be more newer assets than older ones, with the result that, rather than having repayments of the earlier tax savings, we will have increasing tax savings year after year.

If we turn from the notion of depreciation as a tax deduction to depreciation as a factor in external reporting, we are up against a different sort of problem. In the tax situation the regulations are prescribed by the Internal Revenue Code. However, the place of depreciation in the external reports is prescribed by generally accepted accounting principles.

The goal in the tax case is to minimize the outflow of funds. The goal in the external reporting case is to seek a statement of income which is realistic in measuring the consumption of plant assets-one which is rational or accurate in the measurement of the expiration of the plant assets. The only trouble is that no one knows how plant assets depreciate realistically, rationally, or accurately. In this calculation we are faced with a multiplicity of subjective estimates. How long will the asset last? What is the pattern of its expiration of useful life? What will be its salvage value?

Arthur Hadley, former president of Yale University and a noted transportation economist, once said, "God Almighty does not know the cost of hauling a ton of freight from New York to Boston." The same thing might be said with respect to what the realistic, the accurate, depreciation charges are in any given year. However, it does seem to me that there are some that are more realistic, more accurate than others.

Recognizing that there has to be a considerable band of skepticism about any measurement of annual depreciation, yet we see some reason for feeling that depreciation should be tied in with the capital-budgeting estimates made when we decided to buy the asset. We have another Ph.D. dissertation in process which seeks to analyze and describe the procedure of basing depreciation charges on capital-budgeting estimates of cash inflows. Whatever specific procedures are used in measuring depreciation, our goal in external reporting should be to state, as realistically as possible, the amount of the expiration of cost of the assets used in operation.

What if this realistic estimate of expiration of costs differs from this maximum charge-off that we seek under the tax laws? What if the charge-offs for tax purposes do not coincide with what we think is appropriate for external reporting purposes? There is some tendency here, I believe, to let tax rules be controlling and allow the possibility for more meaningful income reporting and more meaningful asset valuation to go by the board-to accept the tax-depreciation charges. There is some element of clerical convenience in doing this, but this impresses me as a minor advantage.

Far better, it seems to me, is to report in the financial statements the depreciation charges in line with the best estimates of expiration that we can make, based on generally accepted accounting principles, and simply allow this figure to differ from the one shown in the tax return. Since generally accepted accounting principles do limit depreciation to cost and since we try to charge that cost off as rapidly as we can for tax purposes, it is likely that the external reporting of depreciation charges is going to be lower than those shown for tax-reporting purposes. Therefore, we are likely to show a greater income on our financial reports than we show on our tax returns.

This, it seems, is an altogether appropriate, permissible, legal, moral thing to do. Many of my colleagues in the accounting profession say that taking higher deductions for tax purposes today than we take on our financial reports means that in the future tax charges will be based on a higher income figure than that shown on the financial statement. In some future years, taxes will run more than 52 per cent of reported financial income because in those years there will be smaller depreciation deductions to be taken, and so taxable income will run higher than reported financial income. This means, they say, that we have borrowed tax deductions from the future and that we should recognize something described as a deferred tax liability.

I disagree emphatically with this view, but my protests have had no effect. The American Institute of Certified Public Accountants and the Securities and Exchange Commission now virtually require all firms, except some public utilities, to recognize a deferred tax liability if they claim depreciation deductions more rapidly on tax returns than in financial statements.

What is the nature of this deferred tax liability? Will it require the expenditure of corporate funds at some future date, or is it, for all practical purposes, part of the stockholders' equity?

If a firm continues replacing assets, there will always be as large a deduction on the tax return as in the financial records, with the result that the deferred tax liability will never have to be paid. I have searched hundreds of balance sheets for evidence of payment of this deferred tax liability, and I have found none for the firms that have remained on an accelerated depreciation basis for tax purposes. I am not saying that there are no cases. It is just that after hunting through a few hundred published balance sheets, covering a seven-year period, I have not found any case where this deferred tax liability is drawn down, where the depreciation deductions on the tax return are less than they are on the published statements. The reason, of course, is simply that this will come about only in the case of a declining firm and one which is declining in that happy state where its profits are remaining undisturbed through the liquidation period; this is somewhat hard to visualize.

Finally, what about depreciation in internal analysis? There are a multitude of problems here we could discuss, but we will skip over all but a few.

As far as investment decisions-certainly one of the central problems in internal analysis-are concerned, what part does depreciation play in the decision to purchase new equipment? It seems to me that, here again, this decision is affected only in terms of reducing cash outflow for taxes.

There is the myth that depreciation provides funds for the replacement or expansion of capital assets. If depreciation is viewed as providing funds, it ought to be sued for non-support as Charles Gaa says-there are no evidences that it is a good provider. The only way that funds are provided is by making sales to customers. Depreciation simply gives us a tax shield so that less of the funds received from the customers need be turned over to the government. Unfortunately, no amount of accounting legerdemain can produce funds. It would be wonderful for accountants if it were the other way, if somehow by making a few marks on our books we could bring a substantial flow of funds into the firm. However, the only way funds can be provided is by finding customers willing to purchase our products.

The central question regarding investment acquisition decisions is whether the after-tax cash flow is sufficiently high to enable us to recover the cost of the investment plus a reasonable profit. The effect of depreciation is simply one of cutting down the tax out-payments. This increases the rate of return; it increases the excess present value; it shortens the pay-back period. Whatever test is used for investment analysis purposes, the reduction of tax flow benefits it. That is the effect of depreciation in this capital investment area as measurable solely in terms of the improvement in the amount of cash inflow that remains from sales to customers.

This is a point that has great relevance when we come to consider, as we will in a few moments, how changes in tax laws affect the volume of capital formation in the economy.

One other place in internal analysis where depreciation has an important and growing significance is in measuring divisional performance. In this question of decentralized operations, which seems to appeal to people these days (and with good reason, I believe), the question of depreciation and asset measurements plays a central role. One general approach to decentralized operations is to say that each division should show a satisfactory rate of return; that we are willing to set the division managers up in almost a separate business if they will show a satisfactory rate of return. This of course has to be a rate of return based on some figure. The amount of assets turned over to the division is the denominator of the rate of return calculation; the income that the division earns is, of course, the numerator. Depreciation figures in the calculation of both the income and the asset base.

Most firms that I have been able to survey follow an arrangement that is similar to the duPont procedure, in which, as I understand it, the denominator is the original, undepreciated cost of the assets and depreciation charges are taken as some percentage of this original undepreciated cost. A composite depreciation rate is applied to this original undepreciated cost. When we retire asset, no gain or loss is recognized. We simply reduce the asset total that is being charged off.

It seems to me that this approach, despite its success, has several shortcomings. It gives a powerful incentive to retire assets prematurely because retiring an asset reduces the denominator. There is no point in keeping standby equipment even though it may have potential usefulness. As a matter of fact, this kind of notion would say that, if we bought a piece of equipment last year for $100,000 which we thought would have a twenty-year life and now this year a new piece of equipment comes along that will save us $1,000 a year, we ought to junk the old $100,000 piece of equipment and buy the new one because by decreasing operating costs by $1,000 it will increase the income numerator and will have no effect on the denominator, since both old and new equipment are carried at the original cost terms. Obviously, no division manager is going to do anything quite as flagrant as this. However, the plain fact is that this type of depreciation and asset valuation approach may very well serve to make the division manager's interests incompatible with those of the firm as a whole.

An alternative treatment would be to recognize losses on retirement of assets within the division. Of course, this tends to have the exactly opposite effect of making us unwilling to bring about retirements, even though they would pay off in the long run. In the long run, of course, the division manager hopes he is going to be holding another job, and what he is going to be judged on are the profits of this year and the next.

What we need is a different approach, one which admittedly is followed by a great many firms, where what we do is to set up assets for the divisions in terms of net book values-where we attempt an appraisal of the assets in terms of their economic significance and then keep the record at cost from then on, with a revaluation every time we get a new division manager. We would use composite depreciation with no gain or loss recognized on disposition of assets. This method also has shortcomings; however, the fact is that there is no ideal method of charging depreciation in a decentralized operation so that the division manager's goals and the goals of the firm can be made to dovetail-all of such plans do have certain drawbacks. However, it does seem to me that using depreciated economic values as a base, with a composite rate of depreciation, is probably the best way out of this difficult situation.

What is the meaning of depreciation for the economy as a whole? Here, **it seems to me, its** entire meaning is tied in with the tax laws. Depreciation has had a checkered history here. In the first English temporary income-tax law of 1842, which has had its one hundred and twentieth renewal this year, depreciation was not permitted as a deduction. **In one of the** renewals of the temporary law, that of 1878, provision was made for permitting depreciation of equipment and machinery.

Our own 1894 law, which was ruled unconstitutional for other reasons, specifically disallowed depreciation as an income-tax deduction. Almost all the twentieth-century laws, including our own, have contained a provision which does permit depreciation as a tax deduction. The idea has been that this is necessary in order to get an equitable measurement of income and also that it does have an effect upon economic growth.

Since World War II, almost every country has tinkered with the depreciation provisions of its income-tax laws in an effort either to make the laws more equitable or to stimulate economic growth. Of course, it is difficult to separate the two because any changes made in the name of improving equity usually speed up the rate of depreciation deductions for tax purposes. This simply frees funds and makes investments that much more profitable, even though it is done in the name of equity rather than in the name of economic growth.

However, one thing we have discovered is that it is far easier to get tax changes through if they are offered in the name of equity than if they are put forth with the suggestion of securing a greater rate of economic growth. Indeed, within the next month or two, the Treasury Department will issue what amounts to a revision of Bulletin F, which sets forth estimated service lives of assets generally. The amendment will shorten by some 20 or 25 per cent the service lives over which depreciation can be taken for tax purposes. This is a measure that is likely to win almost unanimous approval because, by and large, it is done to make the tax law more realistic, more equitable.

It is estimated that this will cost about a billion and a half dollars in tax revenues in the next fiscal year, but, because this is done in the name of equity, everyone is pleased and happy with it. Similarly, the 1954 provision for acceleration of depreciation was offered largely in the name of equity and, as a result, met fairly general approval.

When we turn to the question of depreciation deductions for tax purposes as a means of stimulating economic growth, it seems to me that we run into a greater controversy. Our earlier analysis in this area still holds-the only way that depreciation can stimulate economic growth is by altering the time pattern of tax charges by permitting the firms to defer, in most cases indefinitely, a substantial amount in tax payments. This has the effect both of making the firm more liquid-therefore better able to carry on investments-and of making individual investments that much more profitable. It increases both the desire and the ability to carry on capital formation.

To this end, the President has, within the last year, put forth a proposal for investment credits-a proposal that firms be permitted a credit of 7 per cent of their investment in eligible assets against their income-tax payments. The original proposal was 15 per cent, with some adjustments. Then it was reduced to 8 per cent. Finally, we now have it down to a tax credit of 7 per cent of the amount of eligible investments.

In explaining the tax credit proposed, Secretary Dillon said:

"As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind. . . . In the last five years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 per cent in the 50's. Clearly, we must improve our performance, otherwise we cannot maintain our national security, we cannot maintain our position of leadership in the eyes of the world and we cannot achieve our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.

"I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal. . . . I think it important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances and investment credits."

The Secretary says that the way to get the more rapid rate of economic growth that we want is through this expanded scheme of tax credits.

Now, in considering depreciation reform for growth purposes, I think there are several questions we want to ask.

The first of these is: Should we tamper with the "natural" rate and the structure of growth that is produced by market forces?

Then, if, through the orderly operation of market forces, we are growing at a 3 or 3 1/2 per cent rate, should we, by means of a depreciation device, tamper with this natural rate of growth?

Further, if we do tamper with it, will depreciation reform give us more capital investment and, therefore, more growth?

Finally, if depreciation reform increases growth, is the investment credit proposal now before Congress the most efficient way of achieving the growth? Can we get more growth per dollar of tax revenue foregone by this device than any other?

I am willing to confess that my general answer to all of these questions is "Yes."

I think that the question of what a natural growth rate is depends to some extent upon what we have said about depreciation deductions in the tax law-that our natural growth rate of 3 1/2 per cent over the last decade or so has been related to the way firms have had cash taken from them through taxes, which was affected by the depreciation pattern permitted by the tax laws. However, I am not about to say that a 7 per cent investment credit is the kind of natural force that would emerge if we sought a realistic measure of depreciation. It does seem to me that there is a sound basis for feeling that a more rapid rate of growth is desirable and possible, that positive government efforts to help secure it are appropriate, and that this can probably be achieved as readily through depreciation reforms as through any other means.

If the way to get a more rapid rate of growth is to increase and to modernize productive facilities, depreciation reform has the virtue of singling out this area of growth, this particular area of expenditure, for special treatment, with the result that we do minimize tax loss in arriving at this growth area.

This may bring about some distortions within the economy. Dean Wallis, in a recent speech on automation, pointed out that structural unemployment may result from using tax gimmicks to stimulate new investments before they are called for by relative wage rates; that the effect of cheapening capital (which is what this tax gimmick does) is to stimulate the use of capital in place of labor, which may cause some unemployment. There is no way to deny the logic of this argument. The only question is: Is this a sufficiently small price to pay to get a more rapid rate of growth?

What about investment credit as a device for bringing about growth at a minimum cost -a minimum cost to the Treasury? By this device we are focusing not only on capital formation but also on the effects in the first year. The investment credit says that in the year of acquisition we get a credit amounting to 7 per cent of the cost of the asset. Now, if we were to spread this out over a period of years, it would mean that the amount of savings to the firm would have to be substantially greater in order to secure this same effect. In any system where money has a positive time value, the more of the special deduction we can put in the first year, the greater its effect is going to be. Further, the only way that depreciation affects the capital investment decision is by affecting the cash outflow; if we can affect the first-year flow, we will get a maximum result.

It is true that the investment credit for the first time provides for a breach in the tax principle which says that depreciation, as in fact all expenses, is limited to the amount of dollars expended. The investment credit is in addition to regular depreciation so that you can get 100 per cent of the cost of the asset charged as a tax expense over the years and, in addition, get the 7 per cent tax credit. I must confess that I have some misgivings about this aspect. However, in comparing it with the alternative that would produce about the same amount of tax savings, a 40 per cent charge-off in the first year, it seems to me that there is much to be said for it. To summarize, my feeling is that depreciation reform can be made a part of an appropriate policy to increase the rate of economic growth. Depreciation has a significance to the firm in terms of its cash flows and to the economy as a whole in terms of affecting the rate of growth.

Thank you very much.

DEAN WALLIS: Mr. Davidson has promised to deal with questions, and, of course, while everything he says always sounds completely lucid and sweetly reasonable to me, I do find that it often starts a riot among people who know something about the subject. Therefore, let us see who has the first question.

QUESTION: Professor, you said something at the outset that interested me. You said that depreciation did not provide cash for future purchases. However, in the light of what you said later, I do not think you meant that exactly as it sounded.

You know, of course, that a banker always looks at cash flow. When a banker makes a loan, he lumps the net profits after taxes and the depreciation to show the cash that would be available to repay his loan.

I am now thinking of a case where a cosmetic company was purchased for $5 million with no cash equity whatsoever-it was all done on borrowed funds. However, the company was able to depreciate its patents and copyrights at rates of $78,000 a month, resulting in profits the first year of $1.8 million. Therefore, in three years enough cash accumulated to pay off the loans made on behalf of the company.

Would you care to comment on that?

MR. DAVIDSON: The whole secret is that the company was doing something besides charging depreciation. I would suggest to you that they would not have been able to pay anything off to anybody if they had not been out there on the street selling cosmetics to ladies.

QUESTION: Well, they made $1.8 million the first year-but then a million of that was depreciation.

MR. DAVIDSON: Indeed, the significant thing about depreciation is its effect on taxes. The company must have made $4,600,000 before taxes and depreciation. By virtue of the fact that they could charge a million dollars to depreciation, their income before taxes was $3.6 million. Therefore, they only had $1.8 million of taxes, and the rest was cash flow.

All that I am saying is that you can get cash in this way. In order to do this, you do not need to hire the best accountant in the world to set up a scheme of depreciation for you. The way to get the cash is to sell the cosmetics. The only way that depreciation helps you in this area is by reducing your cash outflow for taxes. We accountants, and financial analysts as well, have contributed to the confusion about cash-flow procedure that you suggest, by adding depreciation charges to net income in our statements of funds.

Far more satisfactory would be a procedure where we deduct the expenses that use cash from the amount of revenue from customers and show cash flow the way we really get it. Unfortunately, however, most fund statements are not presented in this fashion.

QUESTION: I believe you talked about depreciation for tax purposes and for income purposes as well as depreciation for the growth of the economy. What depreciation would you recommend using, first, in establishing prices, if you can establish them; second, in determining whether a particular commodity or service is profitable; and, third, in what you pay out to security holders based on depreciation of original costs-which factor would you use in those cases?

MR. DAVIDSON: The question is: How does depreciation figure with regard to the setting of price for the product, in determining profitability of a product line, and, finally, in relation to dividend policy.

Well, with the exception of the public utilities that are here represented, it does not seem to me that depreciation plays much of a part at all in the setting of prices.

When the plant is acquired, you make certain assumptions about what your total output will be over the life of the plant. You make certain assumptions about what your incremental operating costs are going to be. You likewise make certain assumptions about what your unit sales are going to be and price is set on a long-run basis.

If market forces permit you to charge this kind of price, that is one thing. However, once you have made the investment, all the calculations are meaningless. Then what you want to do is to get as much as you can from the equipment without regard to what your depreciation charges are. If, in order to get rid of the product, you have to sell it so that you make only a very minor contribution to the covering of this fixed cost, you will do it-at least you ought to do it.

There are some horrible examples you hear of, like the ice-cream manufacturer who had an enormous warehouse empty during most of the winter months. Someone wanted to rent his cold-storage facilities for storing turkeys for Christmas. He decided that, although there was almost zero incremental cost in renting the facilities, he would not rent unless the tenant agreed to pay the full depreciation charges. The deal fell through. The ice-cream man lost a fine chance to augment his income. This I think is the heart of the relationship of depreciation to the whole pricing problem: Except for the regulated industries, depreciation, I feel, probably plays virtually no part in the pricing decision.

Now, of course, if you are in a semiregulated industry, such as steel, the question of cost justification enters. However, where you do not have to justify costs to an outside agency, I think it plays no part.

Insofar as individual product profitability is concerned, here again we must decide whether to go into the manufacture of this product and purchase a large amount of equipment. Once the equipment is committed, again it seems to me that it is the direct costs that are the all-important ones. Probably, in determining product profitability, we will include a depreciation charge; however, I favor including it below the line, where the line represents contribution toward the meeting of depreciation and contribution toward profit of the firm.

With respect to the dividend question, here, I think, depreciation may play a greater part. Legally, of course, we are estopped in almost every jurisdiction from declaring dividends unless we do have some income, and this income is income after maintaining capital and after charging depreciation. In this sense we may get some cash contribution through the depreciation charge because it keeps us from declaring as much in the way of dividends as we might otherwise declare.

QUESTION: I detected something in your remarks that indicates that you have the traditional accountant's viewpoint: There is a little bit of sin in recouping more than the original cost value in depreciation, in spite of the fact that we have been in continuous process of inflation.

MR. DAVIDSON: The question is whether there is something sinful in recouping (and I assume you mean for tax purposes) more than the original cost in the depreciation process.

Well, again, what you recoup depends upon how much you can get your customers to pay. In determining the prices that you charge for your products, it would seem to me that the competitive society could not function well if you did not take into account current replacement costs. The depreciation question merely asks how much of what we get for selling cosmetics is going to be reported as depreciation and how much as income.

Now, with regard to the tax situation, this is a very real problem because how much you report as depreciation and how much you report as income is going to affect the amount of taxes you pay.

There has been, as I am sure you are all well aware, a great deal of controversy about taking current-cost depreciation rather than historical depreciation on tax returns. Congress, very wisely-at least in my opinion-has stuck to the historic cost limitations in depreciation deductions. However, if price-level movements should become more violent, then we might adopt a current-cost depreciation deduction. This should be done not only with respect to depreciation but also with respect to all items of income. That is, the interest received should be adjusted in terms of the relationship of the purchasing power of the interest received compared with what was promised. Further, in all aspects of income we ought to go on to a current-cost basis. Until we permit current-cost adjustments for all items, it might be more equitable not to permit current-cost depreciation.

As far as financial reporting is concerned, there is a whole host of problems involved in charging current-cost depreciation, including the same question of the kind of mixture of measuring units that should be used in the entire accounting system. If we are going to say that our unit of account should be some quantity of purchasing power for all items, I would be much more sympathetic.

QUESTION: Basically, there is a lot of concern today about reporting to stockholders on the basis of current-cost depreciation and paying taxes on the other basis because management does want to be honest with stockholders. Therefore, if it is honest as far as stockholders are concerned, then it is likewise honest as far as earnings are concerned. Would you care to comment upon that?

MR. DAVIDSON: This reporting of depreciation on a current-cost basis is more commonly found in the President's letter than in the formal statement of accounts.

QUESTION: Do you mean they lie a little?

MR. DAVIDSON: No, I do not mean **that** at all. I am just saying that generally accepted accounting procedures do not permit you to take depreciation on anything but an original cost basis, so the published financial statements will in every case carry an exception if current-cost depreciation is used. However, the President in his letter may very well say something else.

QUESTION: Do you refer to a separate reserve item?

MR. DAVIDSON: Yes.

I do not, I confess, feel that we would increase the over-all equity or effectiveness of the income-tax law by permitting depreciation in terms of replacement costs while denying it in other areas. However, this is not an opinion that is universally held.

QUESTION: I believe you indicated that the Secretary of the Treasury said that the reason for this change in depreciation policy was primarily to help stimulate our economic growth by modernizing our plants so that we can compete in foreign countries and with foreign competitors. What I object to is this indirect approach we are using.

After all, Uncle Sam is now the greatest stockholder we have in connection with any corporation. He receives 52 per cent of the profits. Now, then, we have through our tax structure taken 52 per cent of these profits and subsidized certain parties in various countries. We have put ourselves in this competitive position. The question I am raising is: Why do we use the indirect approach of saying that depreciation reform will stimulate economic growth? Why do we not use the positive approach? Why do we not reduce taxes from the 52 per cent rate to the 40 per cent rate so that our cost of operations can be lowered; so that the steel companies can compete with foreign companies? Is this not a direct approach?

MR. DAVIDSON: Of course. It is almost too direct, and that is the trouble.

We also have the problem of somehow financing government activity without bringing about too great an excess of expenditures over receipts and thereby contributing to an inflationary process. It seems to me that what we have to do is to ask how we can get growth; how we can get modernization; how we can get new capital formation with a minimal loss of revenue to the Treasury.

Now, then, the main fact is that, if we were to cut income-tax rates instead of giving an investment credit, it would take, in terms of effect on investment decisions, about a 14 or 15 per cent cut in the tax rate, for an asset with a service life of fifteen years, to equal the investment credit. That is, we would have to cut taxes back to 38 per cent before it would be as profitable for a firm to buy a new asset as it would be if we gave them a 7 per cent tax credit. The main fact is, in my opinion, we just plain cannot afford a 14 per cent reduction in the corporate tax rate. Therefore, what we want to do is get as much of increase in capital formation as we can with a minimum loss of revenue to the Treasury.

What I would dearly love would be to see someone come up with an arrangement where we could say that only investments that would not be made without some form of investment credit would receive the credit. Unfortunately, however, nobody will confess that his is an investment he would have made even if there were not an investment credit. As you will recall, the Administration had the notion of saying that only investments in excess of depreciation allowances would qualify to get a whopping big credit in order to stimulate growth. However, there were sufficient difficulties involved so that the Administration finally withdrew the plan.

QUESTION: A month or so ago, in this same club, David Bell, in an informal talk, commented on stimulating growth. However, his approach involved not only stimulating growth but controlling growth. If we get into stimulating growth through tax credits and through changes in depreciation rates, I wonder whether the next step will be to use this as a means of controlling growth when it seems to be going too fast to suit the director of the budget.

MR. DAVIDSON: Or to please the Congress, really, because it is they who must enact the legislation. However, you are right-the history of depreciation reform has seen these ups and downs. As a matter of fact, each year in the renewals of the temporary income tax law in England, they do lay down different depreciation regulations, depending upon the amount of growth that is sought for that year. Further, Sweden had 100 per cent write-off for more than a decade and a half, until Sweden decided this was giving the country too much growth and inflation, so this sort of thing was cut back.

You are also right in saying that this is a policy that can be used, I think, both to stimulate and to control growth and like any governmental policy which seeks to depart from natural economic forces, it does confer on political authorities some degree of control over important economic questions.