

BUSINESS INCOME DURING THE INFLATION IN JAPAN

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I. *Chronic Downward Trend in the Value of the Yen*

In his book, *Money Illusion* (New York, 1928, p. 4), the following view was developed by Irving Fisher:

“We simply take it for granted that all money is stable, just as centuries ago, before Copernicus, people took it for granted that this earth was stationary, that there was really such a fact as a sunrise or a sunset. We know now that sunrise and sunset are illusions produced by the rotation of the earth around its axis, and yet we still speak of, and even think of, the sun as rising and setting! We need a somewhat similar change of ideas in thinking about money”.

Another concept was pointed out by the American Institute of Accountants, *Changing Concept of Business Income: Report of Study Group on Business Income* (New York, 1952, p. 20).

“The postulate that fluctuations in the value of the monetary unit may be ignored is probably the longest established of the three mentioned. From which it follows that income or profit in a given year may arise in part from manufacture or trading, and in part from changes in the value of the monetary unit during the period. The significance of the two types of profit is by no means the same for purposes for which determinations of income or profit are most commonly made”.

The above two views stated by Americans are more characteristic for Japan than for the United States of America. The problem of ‘Fluctuating Price Levels in Relation to Accounts’, brought up for discussion at the Sixth International Accounting Conference held in London on June 1952, is very important and deserves to be considered in business accounting especially in Japan.

Japan has suffered acutely from the vicious inflation during four years succeeding to the termination of World War II, when the Yen depreciated drastically. But, even in former times, we experienced chronic inflation

for the past seventy or eighty years, not comparable with those in the United States and England. However, business accounting in Japan, adhering to the maintenance of nominal monetary capital, has been for a long time based on the premise that the value of the Yen as a calculating measure remained as 'unchanged', as the Ptolemaic theory before Copernicus. The expressions that "income or profit in a given year may arise in part from manufacture or trading and in part from changes in the value of the monetary unit during the period. The significance of the two types of profit is by no means the same for purposes for which determinations of income or profit are most commonly made" can be very well applied to the yen-accounting, not merely during the recent inflation period after the War, but also to the long period back to the early Meiji era and lasting still to the present.

Wholesale Prices Index in Japan

1873 (Meiji 6)	100	1903 (Meiji 36)	199
1874 (" 7)	108	1904 (" 37)	209
1875 (" 8)	113	1905 (" 38)	224
1876 (" 9)	108	1906 (" 39)	231
1877 (" 10)	111	1907 (" 40)	249
1878 (" 11)	117	1908 (" 41)	240
1879 (" 12)	128	1909 (" 42)	229
1880 (" 13)	146	1910 (" 43)	232
1881 (" 14)	162	1911 (" 44)	240
1882 (" 15)	156	1912 (Taisho 1)	255
1883 (" 16)	126	1913 (" 2)	253
1884 (" 17)	110	1914 (" 3)	243
1885 (" 18)	112	1915 (" 4)	246
1886 (" 19)	104	1916 (" 5)	298
1887 (" 20)	108	1917 (" 6)	375
1888 (" 21)	113	1918 (" 7)	491
1889 (" 22)	118	1919 (" 8)	601
1890 (" 23)	124	1920 (" 9)	661
1891 (" 24)	115	1921 (" 10)	511
1892 (" 25)	112	1922 (" 11)	499
1893 (" 26)	126	1923 (" 12)	508
1894 (" 27)	133	1924 (" 13)	526
1895 (" 28)	143	1925 (" 14)	514
1896 (" 29)	153	1926 (Showa 1)	456
1897 (" 30)	170	1927 (" 2)	433
1898 (" 31)	180	1928 (" 3)	436
1899 (" 32)	181	1929 (" 4)	424
1900 (" 33)	194	1930 (" 5)	349
1901 (" 34)	185	1931 (" 6)	295
1902 (" 35)	187	1932 (" 7)	327

1933 (Showa 8)	375	1943 (Showa18)	806
1934 (" 9)	382	1944 (" 19)	914
1935 (" 10)	392	1945 (" 20)	1,380
1936 (" 11)	408	1946 (" 21)	6,411
1937 (" 12)	496	1947 (" 22)	18,972
1938 (" 13)	523	1948 (" 23)	50,403
1939 (" 14)	578	1949 (" 24)	82,253
1940 (" 15)	647	1950 (" 25)	97,242
1941 (" 16)	693	1951 (" 26)	134,957
1942 (" 17)	753	1952 (" 27)	137,650

The same is, of course, the case for the dollar-accounting in the United States and for the pound-accounting in England, though not at the same degree. But from the long-term point of view, the internal value of the Dollar and Pound has shown rhythmical fluctuation, like a pendulum which oscillates regularly, while for the Japanese Yen, the amplitude of pendulum-movements, even before the World War II, greatly deviated from its centre. Since the early Meiji period, the Japanese Yen has followed a long term downward trend of consistent depreciation, accompanied by short waves of upswings and downswings.

In American or English business enterprises, one may possibly compare figures of financial statements or cost reports at the end of the year 1952 with corresponding figures at the end of 1900, without any serious misconception; but in the case of Japanese ones such a comparison would be nonsense at all.

The accounting postulate of the constant value of money means that the accounting is established on the assumption that the value measure of money as a calculating unit is single. Therefore, wherever the actual value of money moves rhythmically up and down, its value measure from the long-term point of view is consistent, even if temporarily not so. On the contrary, wherever it fluctuates one-sidedly, the value measure must in the long run be inconsistent, and will present a problem which runs counter the postulate of the constant value of money upon which the accounting is established.

The determination of business income which are based on historical costs, in accordance with the postulate of the constant value of money, is now actively being discussed in the United States, England and other countries, because of fluctuating price levels. In Japan where the change in the value of the Yen shows a downward trend, not rhythmical but one-sided, the important affects of changing price levels on business accounting should be more deeply impressed on our minds than in the United States, England and the other countries.

II. *Post-War Vicious Inflation and Its Effects on Business Accounting*

Long-term fluctuations in the value of the Japanese Yen may roughly be classified in three stages: first, the period from the early Meiji era to the close of World War II, when the Yen showed, in general, a trend toward gradual depreciation, sometimes accompanied by wavelike ups and downs (from 1873 to the middle of 1945); second, the period of violent inflation for several years after the war (from the middle of 1945 to 1949); and third, the subsequent period of alleviated but still persisting depreciation (since 1950 —).

Not mentioning the pre-war situation, I shall content myself by stating some chief problems of income determination in business accounting of recent years subsequent to the postwar inflation, because the present accounting procedures in Japan retain evils caused by the postwar inflation.

Through the postwar inflation period, the Japanese government consistently adopted the official-price policy based on actual cost method. The prices of commodities were officially fixed by the actual costs spent on production plus an adequate profit, and when the official price could no longer be maintained, it was revised on the basis of new actual costs, following the blackmarket price. From the viewpoint of business accounting, income was computed on historical costs basis which rested on the postulate of the constant value of the monetary unit, in spite of the greatly depreciated currency.

In these circumstances, whenever prices of productive factors, especially raw materials and labour, advanced, they were immediately woven into selling costs of a product and reflected themselves upon the official price. Although the actual costs of materials and labour included in selling costs were covered in the sale of products, it usually costed more for a manufacturer to replace materials and labour required for current production. Accordingly, some amount corresponding to the increased cost of raw materials and labour had to be appropriated out of a calculated net profit. The same applied also to the depreciation charges of fixed assets included in the cost of production. Since depreciation charges were computed according to the rate prescribed in the tax law and on the basis of actual costs entered when the price level was lower. As regards obsolete assets, the amount covered by depreciation was only a fraction of the replacement value of the assets.

In the income determination of a business enterprise, the principle of constant value of the monetary unit has been consistently sustained, not only from the national economic viewpoint of price policy, but also in the tax legislation. Therefore, the increment of inventory price raised by the revision of official price was taken as 'profit' and taxed when this 'profit'

was realized through sale. Hence, most corporations, even if they showed a book profit, were actually barely able to maintain their business through increasing their capital or borrowing. The present capital composition in most Japanese corporations' balance-sheets, in general, shows a remarkable excess of the liabilities to owned capital, which is due borrowings to meet the money shortage during the recent inflation period brought about as above stated.

III. *Revaluation of Fixed Assets*

After the cessation of the post-war vicious inflation, the revaluation of fixed assets, mainly from the standpoint of the tax law, has been carried out three times, the first in 1950, the second in 1951, whilst the third is now in course of execution.

The economic significance of the revaluation of assets lies, needless to say, in the fact that it is supposed to eliminate the effects of the deteriorated value of money upon depreciation charge as a part of costs and to maintain the capital of the enterprise. It was obviously the idea of the *Report on Japanese Taxation by the Shoup Mission* (1949), the forerunner of the *Law on Revaluation of Assets* (1950), which suggested the use of the general price index as the base for revaluation.

“Even were there no practical difficulties in using specific indices and even though such indices were not affected by temporary disturbances, it would still be preferable on theoretical grounds to use a general index. For we are not trying to exempt from tax all gains, but only those gains that do not represent a real increase in purchasing power”.

In other words, Professor Shoup's suggestion, intended to repair the damaged parts of the groundwork of depreciation in Japanese corporations, from the viewpoint of the national economy, by means of the method of Stabilized Accounting. I think, it was, of course, the ought-to-be of revaluation of assets that, according to this idea, it should be compulsory uniform to all corporations and should be carried out to a full extent, its appraisal basis being the index of general purchasing power of the Yen.

Through the inflationary period, the income determination in the enterprise rested consistently on the principle of the constant value of the monetary unit, from the viewpoint of national economic policy, and corporations generally had to incur immense debt in order to meet the depletion of their capital. This was the reason why for the Japanese economy, which was meager in economic resources and had been isolated from the world economy, there was no other way but to depend upon drastic control of goods, services and prices, so that the people could overcome the poverty and inflation caused by war.

If Japan had abundant economic resources, as the Soviet Union after World War I, isolated even from the world economy, or if it had been jointed to the world economy through free trade and free exchange as Germany after World War I, we might have adopted the method of Stabilized Accounting for all sectors of economy, namely for the personal, business and public sectors with good effects, as it had proved in the above stated countries.¹

Aside from these considerations, Prof. Shoup's suggestion of compulsory revaluation based on the idea of the adjustment of the monetary unit as a calculating measure was not in accord with the line of the voluntary revaluation advocated by the industrial circles, and the *Assets Revaluation Law* (April 25, 1950) resulted in a way acknowledging the voluntary revaluation for which the general price index (the wholesale price index of the Bank of Japan) was applied as basis. According to this law, corporations were free to revalue their assets or not, and they were allowed to determine adequate amounts within the legal margin.

In carrying out the first and second revaluation, corporations took the following three points into consideration: first, increased depreciation charges due to the raised book-values resulting from revaluation and a decreased rate in the corporate tax caused by it; second, the imposition of a tax of 6 per cent on Revaluation Reserve, the difference of the book value and the reappraisal value; and third, a probable increase of dividend outlays rising by the transfer of revaluation reserve to capital stock.

Under this manner, corporations used to revalue their assets at an amount most favorable to themselves. Accordingly, both the first (1950) and second (1951) revaluations can not be said to have met with satisfactory results. Corporations which carried out the first revaluation numbered about 30,000, revaluation values being 4,200 million yen against 700 million yen of book-value. The second revaluation was carried out by 4,600 corporations, of which 2,500 had also gone through the first revaluation, fixed assets of 60 billion (1,000,000,000) yen of book-value being revalued to 160 billion yen. Thus, the total number of corporations which carried out both the first and second revaluations was merely 16 per cent of all corporations, although major corporations mostly did not fail to do so. Details are shown on p.104.

In accordance with the above mentioned reappraisal policy, the revaluation of fixed assets was based on, and computed from, the possible earning capacity of each corporation. Thus, the revaluation was diametrically reversed from the original aim to revise the distortions which the drastic changes in the general purchasing power of money brought about on depreciation. It resulted in the appraisal of fixed assets based on the accounting postulate of the constant value of money unit. If the revaluation had been

¹ For details of the inflation accounting in Germany and the Soviet Union after World War I, see I. Katano: *Stabilized Accounting*. Tokyo, 1949.

Combined Results of First and Second Revaluations

Capital Amount	Book-values of total assets of corporation which filed return	Total revaluation differences	Total revaluation values
(1,000 yen)	(1,000,000 yen)	(1,000,000 yen)	(1,000,000 yen)
Less than 200	11,263	10,584	21,847
" 500	12,435	7,464	19,899
" 1,000	23,169	14,959	38,128
" 2,000	16,074	13,921	30,016
" 3,000	13,551	9,689	23,240
" 5,000	15,664	14,319	29,983
" 10,000	8,255	24,160	42,415
" 50,000	24,977	53,110	78,087
" 100,000	19,625	41,101	66,326
over 100,000	92,687	535,906	628,593
Total or Average	247,720	725,813	973,533

applied to the full extent and uniformly as a compulsory measure along the line of Prof. Shoup's suggestion, the disorders in the business accounting, deeply rooted by the long-term chronic depreciation of money since the early Meiji period and the serious inflation after the war, might have recovered at once, and the business accounting in Japan, in the national economic scale, could have started afresh with the homogeneous figures.

As for the reasons, why the voluntary revaluations, both first and second, ended in insufficient results, we are faced with two major facts. The imposition of 6 per cent tax upon the revaluation reserve constituted no doubt the chief reason. Another reason, in my view, is the exchange rate which has been fixed to the dollar at 360 yen — this rate is now said to deviate about 120 or 130 yen for the general price level in Japan. In fact, it was a leading aim of the reappraisal policy for Japanese industries that they, highly related to export, should make profitable export prices based on the fixed exchange rate and thus should calculate a most favorable reappraisal value of fixed assets based on the cost of export goods.

The revaluation of fixed assets offers a good chance to correct the confusion in business accounting caused by the drastic depreciation of the Yen and restore the process of capital formation to a normal track. However, checked by the 6 per cent tax on revaluation reserves and the fixed exchange rate of 360 yen, most corporations are still not situated to grasp this possible best chance to correct the mistaken income determination practice which must result in the depletion of capital.

IV. *Limit of Capital Maintaining Function of LIFO Method*

Business accounting in Japan has been influenced by the continued downward trend in the value of the monetary unit following the post-war vicious inflation, even after the first and second revaluation of fixed assets. This is especially marked in enterprises where fixed asset revaluation was insufficient carried out or not at all. Japanese business men must more deeply keep in their mind the fact that an important factor in the present shortage of working funds is the outflow of imaginary profits resulting from a decline in currency value.

Meanwhile, the last-in-first-out valuation method adopted in the Revised Corporate Tax Law of 1950 appeared as an important measure of income determination to meet fluctuations in the value of the monetary unit. This regulation concerning inventory valuation in the tax law concerns the valuation for inventories outstanding at the end of an accounting period, but not the valuation of costing of inventories. However, control over the valuation of inventories outstanding at the end of an accounting period will eventually regulate the costing of inventories.

The LIFO method of costing inventories is to determine the inventory at acquisition cost most recently purchased, and its fundamental object is to charge current costs with current sales. In short, this method is to determine inventory costs in harmony with price fluctuations, thus reducing over-estimation of income in a period of rising prices and under-estimation in a period of declining prices and making it possible to level income in the long run.

This method has been adopted in the tax laws of the United States and has been considered practical for many years especially in a period of rising prices, as it prevents the shortage of stock of inventories necessary for the maintenance of reproduction in enterprises.

It is true that the LIFO method prevents to a certain extent the shortage of material capital caused by an outflow of income in the form of taxes and dividends through reducing the over-estimation of income in a period of rising prices. However, the income determination through this method is based on historical costs on the assumption of the stability of the monetary unit, so, from a long-term viewpoint, taxes which are reduced in a period of rising prices will become irksome in a period of declining prices. The absolute amount of taxes as a whole, therefore, will not be different from that of the FIFO (first-in-first-out) method. The LIFO method has only a meaning in the business financial policy, because the levelling of income and taxes has important effects on the manipulation of working funds in enterprises.

Special attention should be given to the following points: the effectiveness of the LIFO method in the determination of income as a measure of capital maintenance to meet fluctuations in the value of the monetary unit will mostly be found when economic conditions are as in the United States where its fluctuation is moderate and rhythmical; under the conditions which exist in Japan where the value of the Yen has continued to decline during a long time, though with rhythmical fluctuations in short period, the function of maintaining capital by this method is effective only for short periods and temporarily, and this method cannot be regarded as guaranteeing the capital maintenance of continuing enterprises.

In connection with the LIFO method of costing inventories, the problem of '*inventory profits and their nature of non-realized profits*' have recently often been discussed in Japan by those who advocate this method. My opinion on this problem is mentioned briefly hereunder.

The advocates of the LIFO method of costing inventories assert that on the assumption of maintaining normal amount of inventories, if this method is adopted, the book value of inventories at the end of an accounting period will be higher than at the beginning of the period when prices show a rising trend; the difference is a non-realized profit, because profits from an inventory are realized when the replacement of the said inventory is completed or secured, but not realized by the completion of sales; in short, so far as the continuance of the enterprise is concerned, it is correct to assert that profits are realized only through the cycle of purchase—manufacturing—sale—replacement; consequently, in the case when the value of the normal amount of inventories at the end of an accounting period is higher than at the beginning of the period due to a price advance, income in the said period involves a non-realized one which is equivalent to the difference of the inventory value.

According to my opinion, these advocates primarily take the attitude to maintain money capital by determining the business income based on historical costs on the accrued basis, and, within this concept, further to maintain material capital through a broader interpretation of the realization principle. This is advocated as a background to the LIFO method in the determination of income. But, this assertion will be admissible only from the stand point of a financial policy that the appropriation of income should be limited to the line which will guarantee the reproduction of continuing enterprises. The LIFO method may be advocated more positively in practical accounting in Japan as actual manifestation of the 'going concern' principle. However, the conception of 'inventory profits' must be rejected, so long as business income is based on the maintenance of money capital. It is self-evident that when prices of materials are higher at the end of an accounting period than at the beginning, larger funds will be necessary to secure a constant stock of goods. It is the problem whether the source of

these funds shall depend on capital subscription, or on borrowings, or on retained profits, and it is not proper to base it on the determination of income for the said period. Further, the idea that the difference in inventory values at the beginning and at the end of a period shall be regarded as nominal book profit cannot be considered, if the attitude is taken to regulate the concept of business income on the basis of maintaining money capital on the postulate of the constant value of money unit.

*V. Tax Assessment on Income under Inflation
and Maintenance of Capital*

—An example appeared in Judicial Case—

The traditional practice of taxable income determination based on historical costs on the premise of the constant value of money unit, which was adhered during the inflation after the Pacific war, tended to fatally affect Japanese enterprises through a heavy tax burden. A typical example in the docket is mentioned below (No. 9 of an administrative case in 1951, Tokyo Local Court).

A steel-frame builder evaluated 1389.81 tons of rolled steel the cost of which had to be considered in the determination of taxable income for the fiscal year 1949 (accounting for more than 90 % of the total rolled steel utilized in the said year) at ¥12,000 per ton, slightly lower than the controlled market price of ¥15,000 for the fiscal year 1949, instead of the book value of ¥2,000 (which was the controlled price prevailing in March 1946 when returns of the property tax was made out). The taxation authorities refused this valuation and decided the income on the basis of ¥2,000 per ton, the book value. There was a difference of ¥10,000 per ton or a total of ¥1,389,810 in the determination of taxable income between the calculation of the taxpayer and taxation authorities. The taxpayer considered this decision unreasonable and instituted a suit at the Tokyo Local Court against the Tokyo National Tax Bureau for annulment of the administrative decision, stating that:

“The object of the Income Tax Law (which was effective before the revision made on March 31, 1950) to authorize a deduction of purchase costs as necessary expenses from revenues is to make possible the recovery of capital for the smooth continuance of business —, therefore, the interpretation of costs in case of the fluctuation of currency value shall be in harmony with the spirit of legislation”.

Against this, the Tokyo National Tax Bureau made the plea that:

“The cost of purchase stipulated in Clause 2, Article 10 of the old Income Tax Law was codified, following the original cost principle in

the theory of accounting; the law rejected appropriating profits through appraisal in case of a price advance, and adopted the realization principle that a appreciation of assets is not a profit and that the profit is realized only when sales are effected. Needless to say, there is a serious question that the tax assessment on profits from the sale of assets during the inflation would result in taxing on nominal income. As the Income Tax Law adheres to the original cost principle, legislative steps to revise this principle in the Income Tax Law are necessary, if the taxpayer was to be relieved from tax assessment on nominal income during inflation. However, such relief regulations were not inserted in the Income Tax Law from the viewpoints of tax assessment technique and national revenue. —Therefore, the original cost principle has not been changed at all as regards purchased goods and raw materials provided in Clause 2, Article 10 of the old Income Tax Law. Moreover, it is implied in the Income Tax Law that tax assessment on nominal income is inevitable. For these reasons, the tax assessment in this case could not be considered illegal”.

The case was decided against the plaintiff on the following grounds:

“The plaintiff insists that steel frame materials used in 1949 were purchased in 1944, before the termination of the war, at ¥300 per ton, and evaluated at ¥2,000 per ton in the property tax returns of March 1946, the same value as the controlled price prevailing at that time; as the controlled price of steel frame materials in the fiscal year 1949 was ¥15,000, the cost of materials provided in Clause 2, Article 10 of the old Income Tax Law (effective before the revision of March 31, 1950) does not imply the price prevailing at the time when the property tax return was submitted in 1946, but must be the controlled price, ¥15,000 which was revised in the fiscal year 1949, following a decline in the currency value; consequently, ¥12,000 per ton which the plaintiff charged against the said steel frame materials should be deducted from sales revenue as purchase cost (some reduction being made from the controlled price of ¥15,000 because these steel materials were stocks on hand).

The advance in the controlled price of steel frame materials from ¥2,000 in 1946 to ¥15,000 in 1949 was attributed to a decline in the currency value due to inflation, and the increase of the controlled price is not considered to have been greater than the depreciated rate of money. Therefore, the owner of goods could not be said to have obtained a substantial profit from the price advance of goods in his possession (underlined by the writer). The plaintiff's stock, which was held from 1946 when it was quoted at ¥2,000, was delivered at ¥12,000 in 1949. The difference ¥10,000 per ton was caused by the price advance due to a decline in the currency value and must be regarded as nominal income but not as substantial income. From this point of view, the tax assessment on such nominal income seems to be unreasonable.

However, 'cost of purchased goods' stipulated in Clause 2, Article 10 of the old Income Tax Law means the original cost, and it cannot be considered that an advance in prices of the goods in possession, which is due to a decline in currency value, naturally brings about a revision of costs. The law adopts the principle that profits from a price advance are not the object of taxation, but taxes are assessed on profits which are realized through the sale of goods. Consequently, the above difference of ¥10,000 resulting from the delivery of steel frame materials at ¥12,000 per ton must be regarded as income provided in Article 10 and No. 9, Clause 1, Article 9 of the old Income Tax Law. Originally, the reason for the authorization in the law of deducting original cost from revenue as necessary expenses is that the deduction of purchase costs is regarded as proper in the determination of profits. Needless to say, the law did not take into consideration the estimated purchase cost in future. Consequently, the plaintiff should not confound purchase cost with prices necessary to replace the same commodity. The difference ¥10,000 may be considered as nominal profit, and tax assessment on such profit could not be the object of the law. However, the law could not foresee that the original cost would be revised following a decline in currency value especially in abnormal inflation.

As a legislative measure to remedy the above difficulty resulting from inflation, there was the Assets Revaluation Law which aimed at the revaluation of fixed assets. But the movables as merchandise, raw materials, etc. have been placed outside this law, as these movables are usually transacted during a short period, contrary to fixed assets, the difficulty arising from tax assessment on their nominal profits is comparatively small, even though the taxable relief through revaluation is not granted to them. Moreover, the revaluation of movables is nearly impossible due to technical difficulties (underlined by the writer). Therefore, although the Assets Revaluation Law was enacted, it is not proper to consider that the Income Tax Law grants the same relief as regards merchandise, raw materials, etc. too, even if legislative measures to meet abnormal conditions are not taken, and to conclude that the meaning of 'cost' in Clause 2, Article 10 of the old Income Tax Law shall be revised, following inflation, in conformity with market prices or controlled prices prevailing at the time when revenue is realized.

It is undeniable that tax assessment in this case is extended over nominal income, but it is not illegal, though unreasonable."

The judgement is clear in its statement and involves no doubt. The decision explains that "it is undeniable that tax assessment in this case is extended over nominal income, but it is not illegal, though unreasonable", because the cost of inventories in the old Income Tax Law means the actual purchase cost and no legal measures have been taken to remedy the effects

of a depreciated currency on inventory costs in the determination of income.

Two points may be mentioned from the theoretical standpoint of the accounting, however, as regards the opinion of the court concerning the business income during the inflation. These points have been underlined as above by the writer. The one is that "the advance in the controlled price was attributed to a decline in the currency value due to inflation and the increase of the controlled price is not considered to have been greater than the rate of decline in currency value. Therefore, the owner of goods cannot be said to have obtained a substantial profit from the price advance of goods in his possession". From this short phrase, it can be understood that, apart from the interpretation of the text of the law, the court conscientiously distinguished *stabilized cost*, that is the original cost adjusted by the general price index, from *replacement cost*, and supported the principle of maintenance of money capital on the theoretical basis of Stabilized Accounting, according to which, unless replacement cost is larger than stabilized cost, the excess part of replacement cost over original cost does not constitute profit.

The other point is the court's opinion that "as merchandise, raw materials, etc. are usually transacted during a short period, contrary to fixed assets, the difficulty arising from tax assessment on their nominal profits is comparatively small, even though the taxable relief through revaluation is not granted to them." This is an important point which is liable to lead to misunderstanding as regards the formation of imaginary profits causing by inflation. Several words will, therefore, be given below.

When an enterprise prepares a profit and loss account in a period of inflation on the basis of historical costs on the postulate of constant value of money unit, imaginary profits will arise from the depreciation charges of fixed assets, inventory charges and wages paid and other cost factors. In this case, the degree of imaginary profits is different according to the ratio of cost factors in total cost of finished goods in normal years when prices are stable. Generally speaking, in commerce and in manufacturing industries, the ratio of depreciation charges of fixed assets to total cost of finished goods is rather small, whilst inventories turn over several times during one accounting year, involving each time imaginary profits, which reach a heavy sum at the end of the year. The same applies to imaginary profits from labour charges. Under the post-war inflation in Japan, imaginary profits in large-scale enterprises employing large number of workers seem to have been most pronounced through frequent increase of wages. Enterprises where imaginary profits arising from fixed assets occupied a leading position were limited, I think, to several industries such as electric power and railway transportation.

Since the revaluation of fixed assets became an important problem after the violent inflation, as seen in the above legal case, the insufficient depreciation of fixed assets is often considered as the largest factor of the depletion

of capital caused by tax assessment on imaginary income. But according to my opinion, this view is not right in full sense. Although imaginary profits arising from other cost factors disappeared or declined following the stabilization of prices, depreciation alone remained to produce imaginary profits; under this circumstance, in order to lighten the burden of tax on business income, the fixed assets revaluation has been authorized by the tax law.

Tax assessment on imaginary profits in the above legal case is a typical example of economic suffering which was to be shared by all Japanese industries under the inflation after the War II, from the national standpoint. But it is undeniable that in the above judicial case the tax assessment had destructive effects upon the business of the taxpayer.

—Written in Oct., 1953—