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Editorial

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EDITORIAL

Compensation for Exhaustion Based on Present Value

The supreme court, in its recent decision in the case of the United Railways & Electric Company of Baltimore, handed down as we go to press, has accepted a logical corollary to its former decisions. It has long been clear that in determining whether or not a given rate structure is confiscatory the test is to compare the probable yield thereunder with the aggregate of three things:

(1) The amounts necessarily expended for supplies consumed, wages and salaries paid and expenses incurred in rendering the service;
(2) Compensation for the partial exhaustion of the property used in rendering service;
(3) A return at a reasonable rate on the value of the property necessarily employed in rendering the service.

In previous cases the court had held consistently that the third element must be computed upon the present values of the property, and it is entirely logical that it should now apply the same ruling to the second element in the computation. Any doubts as to the soundness of this decision must be based on practical considerations. The difficulties inherent in such a method of determination are dwelt upon by Mr. Justice Brandeis in a long dissenting opinion. To the accountant, much of this opinion will probably seem persuasive, though it is lengthened and weakened by references to industrial practices which seem irrelevant to the present discussion. Industrial precedents are not valid, because cost is the foundation of industrial accounting

just as surely as present value has become the basis of rate regulation through the decisions of the court.

Decision Favors the Engineer

Viewed from the professional standpoint, the decision unfortunately seems to imply a further enhancement of the importance of the engineer and a corresponding diminution of the part to be played by the accountant. The question whether rates are or are not confiscatory will become more and more an engineering question. Up to the present, the practical application of the test above-mentioned has been based mainly on cost of reproduction, which is comparatively easy of ascertainment; but the next logical step would seem to be to base the determination on a consideration of the cost and the rate of exhaustion of an ideal plant capable of rendering the same service. If the value of the property employed or exhausted is to be the test, that value is no greater because the plant rendering the service is expensive and subject to rapid depreciation than it would be if the same service were being rendered by a different type of plant, cheaper to construct and subject to less depreciation. If this view is correct, the determinations of the courts in future cases may become more and more speculative and the practical outcome depend largely on the skill of the professional advisors to the two sides of the controversy. Our engineering friends are to be congratulated on the prospect thus opening up and we have no doubt the utilities, with their aid, will fare well in the courts. For the present, and until the price curve turns downward or new inventions render existing plants obsolete, the public may expect to bear not only the cost of higher compensation to the utilities but the higher cost of securing that compensation.

Public-utility Rates Are Reasonable

Of course, there is another side of the picture. The courts have always insisted that rates must be reasonable and may not be increased, even if they are not fully compensatory, if an increase would make them unreasonable. While this limitation is itself difficult of enforcement, the American public by and large gets its service from the utilities at reasonable prices. Perhaps, therefore, there will be no general complaint if a part of the skill and resourcefulness which is constantly being devoted

to reducing the cost of operation is diverted to the task of increasing the limit of gross revenues. Furthermore a meed of praise should be accorded to those who presented to the court in the Baltimore case a record which forced the court to the conclusion that a return of 6.26 per cent certainly was not, and a return of 7.44 might not be, sufficient to attract capital into the street-railway field.

Treatment of Stock Dividends

There is no question at present before the accountant which excites keener interest than the recipient's treatment of stock dividends, and this condition will continue while there is the least uncertainty as to the proper classification of such distributions—or perhaps until the current practice of giving stockholders more stock is superseded by some other plan as yet unknown. THE JOURNAL OF ACCOUNTANCY has expressed the belief that the decisions of the courts in certain cases involving income taxation have clearly shown that a stock dividend is not income while it remains a stock dividend. The well-known argument that increasing the number of pieces of paper indicating ownership in an asset or group of assets does not increase the value of the owner's holdings seems to us quite sound in almost all cases. There are instances wherein the distribution of a stock dividend does not flatten the price of the stock and the new shares have an immediate value in and of themselves without taking anything from the value of the older shares. But even in such circumstances we can not bring ourselves to the belief that a stock dividend is really income until it has been converted into cash. Furthermore, as one correspondent asks, when the stock is sold why should not part or all of the proceeds be treated as a reduction of cost or book value of original holdings upon which the stock dividend was based? Let it be admitted for the sake of illustration that the new stock is easily salable —as it is, for example, in the case of the North American Company, which has been the topic of much discussion in these pages during recent years. It does not seem to us that the ability to realize profits is actual realization prior to sale. If a man who owns a piece of land which he purchased for $1,000 and has held during a time of rapid advance in values, now finds that his property can be sold whenever he desires to sell for $10,000—he has, let us say, a firm offer of that amount—has he re-

ceived a profit of $9,000 on his investment (omitting all question of interest, taxes and other carrying charges) or has he merely an opportunity to make a profit if he cares to do so? The courts hold that there is no profit "until realized," or, in other words, cash is the determining factor. Comments which appeared in THE JOURNAL OF ACCOUNTANCY for November, 1929, on the general subject of stock dividends have been criticized both favorably and adversely. Some accountants incline to the opinion that any attempt to differentiate between stock dividends which increase one's wealth and those which simply alter the form of evidence of wealth is fraught with too much difficulty and doubt to be worth while. They prefer to cling to the dicta of the courts that nothing is income until it becomes tangible. Other accountants are convinced that dividends in stock, such as those of the North American Company, which are paid regularly in lieu of distributions of surplus, can be taken as true income and should be treated by the recipient precisely as he would treat cash. These readers are not afraid to attempt to classify stock dividends as either income or mere transformation. They would base their decision largely upon market values; and some go so far as to say that stock dividends may be entered in the books of the stockholder at the market price prevailing on the day of receipt, whatever be the state of the market—whether quotations are sane or as unreasonably high as they were before the collapse of last October.

The Opinions of a Correspondent

From the letters received we select the following:

"I have read with considerable interest the recent editorial section in THE JOURNAL OF ACCOUNTANCY relating to stock dividends. Almost immediately thereafter came the bulletin of the American Institute of Accountants, dealing with the same subject. The latter naturally deals with the subject more fully and it seemed to me that your briefer editorial notes might lead some accountants who did not consider all the facts of the case into an untenable position.

"I refer more particularly to your caption 'Stock Dividends Are Not Income in Law.' This is surely misleading, as the case quoted in support of this point of view was a tax case, which must be construed strictly in favor of the taxpayer, and each decision is only given on the facts before the court and, naturally, facts relating to every stock dividend could not have been before the court in the particular case decided: actually the case involved an unusual distribution of a 50% stock dividend.

"In these days when many companies have made a regular practice of distributing a portion of their current earnings in the form of stock dividends, in order to strengthen their cash position, though desiring to distribute a reasonable portion of their current earnings, it is surely optional to the recipient of such dividend whether he sells it, and thereby converts it into a cash income without reducing the book value of his actual original investment in the company, or whether he increases his investment in the company as compared with a year ago, by holding it. The latter course would be identical with an investor in a company distributing cash dividends who, not requiring the cash, invested his dividend in additional stock in the same company.

"It is respectfully submitted that there is not the clear-cut distinction that there should be between a stock dividend made as part of the regular distribution out of regular earnings, such, for example, as the distributions of the Electric Bond & Share Company and Sears, Roebuck & Company, and substantial stock distributions amounting to as high as 100% or even more, where the desire presumably is to keep the stock of the corporation in question to reasonable limits for the average investor.

"Another angle of the discussion seems to have been entirely overlooked, namely, the apportionment of stock dividends received by a decedent's estate and its distribution between life-tenant and corpus. There, of course, the situation is covered by the state law and not the federal law and, to the writer it seems very properly, several of the important states have laid down rules legally to determine what portion of a stock dividend should be paid to the life-tenant as being income indisputably. In those states that still keep the old rule, apparently inherited from or adopted from the English law, that stock dividends are accruals of capital, apparently the testator, if he wishes his life-tenant to receive the entire income of the estate or trust fund, and any of his investments are in companies that make periodical small stock dividends as part of their system of distribution of current earnings, should insert a special clause in his will to deal with the matter.

"Whilst it is realized that your editorial in particular seems to have in mind principally the numerous investment trust corporations, to which it especially refers, it perhaps generalizes too much not to be somewhat misleading.

"Yours truly,

"J. H. STAGG."

When Does a Dividend Become Income?

These comments by Mr. Stagg are welcome. They express what seems to be a common conception of the nature of stock dividends. There is, however, nothing in this letter which necessarily conflicts with the opinions published in these pages.

The difference seems to be chiefly due to misunderstanding of the premises. The caption to which our correspondent refers is not misleading if it is wholly true, and that it is true is admitted. The reasons for declaring stock dividends in place of ordinary cash payments are not now at issue. If that were the only bone of contention there would be perfect peace. THE JOURNAL OF ACCOUNTANCY's opinion of the stock-dividend policy of the North American Company is evident in the editorial notes which appeared in May, 1928. The question which is now of interest is the treatment of stock dividends when received, not the theory which is back of their distribution, and we cannot see the slightest justification for taking into the books of the recipient, whether corporate or individual, a right to profits before that right has been exercised. Someone may say that it is splitting hairs to accept as income the payment received for stock sold and to reject the stock which can be sold for cash at a moment's notice. But the truth is that the market value of stock may change in a moment and a right to sell not exercised may fade away as quickly as any other intangible item. Let us suppose that there are two stockholders, A and B, each of whom received a stock dividend October 1, 1929. The market price of the stock on that day was, perhaps, $100. The stockholder whom we call A felt that his dividend would be more acceptable in the form of cash and, accordingly, his share of stock was sold for $100. B believed that the prospects of an advance in value made it desirable to hold his share. On October 31st the market had gone to the devil and the stock was then sold at, say, $10 a share. Does anyone contend that the two men received the same amount of income? It may be constructive to inquire what effect would have followed a decision by both A and B to enter their stock dividends in their books at the market value of October 1st.

Stock Dividends in Decedents' Estates

The apportionment of stock dividends received by a decedent's estate to life-tenant and remainderman is, as Mr. Stagg justly points out, a matter of importance and no little difficulty. When state statutes provide a method it is, of course, perfectly simple to make a division, but even in such cases there may be serious injustice, or at least interference with disposition of the estate according to the wishes of the testator. A company, which has never paid a dividend, may have been regarded by the

testator as a remote source of profit and he may have felt that his share in the company should go over to the corpus of the estate after death of all life-tenants. Shortly after his own death the company may adopt the policy of distributing stock dividends, with consequent reduction in the value of the original stock. If stock dividends were income in such a case the corpus of the estate might receive practically nothing and the life-tenants practically all—and that in direct opposition to the intentions of the testator. Or a company, which had always paid dividends in cash, may have been regarded by the owner as a source of immediate returns and he may have willed his interest in it so that a life-tenant would receive the proceeds. Then the company may have changed its policy and stock dividends may have taken the place of cash. If these dividends are not income and were not converted into cash the life-tenant would not gain and the remainderman would receive all. The whole question of the rights of legatees has always been full of fine legal problems, and there have been comparatively few estates in which bequests to life-tenants have been included that have not led to a great deal of dispute. Quite often the purpose of the testator has been entirely frustrated. It is not astonishing, therefore, to find that the stock dividend of the present-day vogue is confusing to the administrator of estates. It would be unwise to expect anything else. But that does not seem to affect the vital consideration. It does not change the nature of a stock dividend to pay it to the estate of a decedent. As Mr. Stagg suggests, the course of wisdom is to make specific provisions in wills that stock dividends shall be regarded as income or as principal. Then there should be no complications. If no provision of that kind is in the will the life-tenant may be unfortunate, but that will be due to circumstances over which he can have no control. Because an administrator believes that distributions should be made available to life-tenants is not sufficient reason for departing from the established principles of law. Mr. Stagg is partly correct in assuming that the notes to which he refers were concerned with investment trusts. They were directly relative to all holding companies and to the stock dividends received by such companies from other companies. The chief peril in the entry of stock dividends at market value on the date of payment is the tendency to gross inflation of apparent profits and the consequent effect upon the dividends, either cash or stock, to be distributed by the recipient companies. Upon

that point most accountants seem to agree. We can not for the life of us see how a method of valuation of stock dividends which is unsound and dangerous in the case of a corporation can become sane and safe in the case of any other stockholder.

Sprats to Catch Mackerel

At a recent meeting of a state society of accountants a speaker referred to the custom of charging low fees for professional services when the client to whom such special consideration was accorded might be expected to call upon the accountant for more important services in the future. The question was not discussed at any length and there may have been wide differences of opinion as to the propriety or impropriety of allowing the potential to influence the actual. The comments which were heard seemed to be in opposition to allowing future relationship to affect the amount of fees for past labor. The subject is one that is elusive and not readily defined. Nearly every mortal is inclined to let the possible effects sway him in the determination of policy or even principle, and it is a counsel of perfection to urge that one hew to the line, let the chips fly where they may. Now and then arises a citizen whose indifference to the throng about him makes him conspicuous; but most of us in our calm moments —there are still a few calm moments in the lives of the majority— prefer to ponder over intentions before they become facts. It is manifestly quite wrong to base a professional fee upon the ability of the client to produce later fees. Indeed, it savors a little of a contingent basis for fees when the element of possible repetition is allowed to prevail. But it is folly to ignore all save the absolutely righteous, and even accountants may be conceded a few human frailties. There may be many accountants who could be induced to charge a merely nominal fee for a casual service to a great corporation whose appreciation might take the form of an annual audit. So much may be admitted. That differs, however, rather sharply from the utterly reprehensible practice of charging what one might call sprat fees—bait for mackerel. They might also be called gratitude fees, on the theory that gratitude, as Sir Robert Walpole said long ago, is a lively sense of future favors. We have heard of firms which have been so lost to decency that they have offered to undertake accounting work for a song—often out of tune—in the confident assurance that the establishment of temporary association with a client would lead

to permanent retention in a professional capacity. Generally such magnanimous offers are addressed to clients of other accountants. The short-sightedness of the business man who will accept something for nothing more tangible than prospective emolument is not the point at present. Such a man is not to be pitied when he finds that too often the something which he expected for nothing turns out to be precisely equal in value to the fee. One usually gets about what he pays for, and most bargains are expensive. There is, however, record of a few cases in which an accountant has rendered good service at a loss to attract clients, and in such cases it is the state of the accountant rather than the fate of the client which is of interest.

Free Service Often Worthless

There is no law nor rule of conduct which forbids an accountant to work without fee. An old legend describes the strange history of a lawyer who neglected his fees, but he lived, if the story is true, in a far country and at a remote time. There was, too, some reason to doubt his sanity. There is nothing written for the guidance of the practice of law which makes imperative the marriage of service and fee. In fact, there seems to be no specific requirement that a fee shall be charged or collected by any professional man; and the accountant is, therefore, within his rights if he waives the fee. A wise client, however, will look askance at the over-benevolent accountant and will suspect that there may be implications not nominated in the bond. Some clients, alas, are not wise. Some will take what they think to be advantage of special introductory prices, as they say in the advertisements of cosmetics. It is a grave question whether the accountant whose fees are only partly in cash and chiefly in goodwill is foolish or worse. The objections to contingent fees are almost as potent where gratuitous services are concerned, except, of course, when services are rendered as an act of pure charity or public spirit. For those there can be only praise. If an accountant's work is worth anything at all it is worth as much in one instance as in another, provided the service is the same in both. It is not fair to the accountant to spend himself without immediate reward. Every laborer in the vineyard of the professions is worthy of his hire. It is not reasonable to expect that a man who works for nothing except goodwill will be impartial and judicial. A fee contingent upon the results of a case is con-

demned principally because the very fact of contingency almost precludes unprejudiced opinion. Only the super-man can rise above the miasma of personal interest. When the accountant voluntarily sacrifices his fees or sets them below compensation he indicates instantly that his interest is primarily in the results of his ostensible generosity to the client. Can he be expected to exercise that cold, dispassionate judgment which is equally ready to damn or to commend—that detached impartiality which is the essence of the professional obligation—when what he seeks is the friendship of the client? His insufficient fee is an incontrovertible proof of his purpose. There is also this further thought concerning the expectant practitioner and his feeble fees: he may acknowledge that his charges are intentionally inadequate for purposes of magnetism; but does he know that it is more difficult to rise to fair levels from the depths than it is to start aright without preliminary descent? That transforms the question to one of simple expediency, which may be more convincing than any argument on purely ethical theses will be to these mackerel fishers.

Matters of Form

Observant readers of THE JOURNAL OF ACCOUNTANCY will detect in this issue of the magazine several changes in form and arrangement. To begin with, the editorial notes, which for many years have sheltered between the contributed articles on specific accounting subjects and the regular "departments," as they have been called, now come into the leading position on the first and succeeding pages. This change is made in response to many requests—based perhaps upon the notion that the thorough reader can tackle them with unwearied intellect and, having passed them by, can then refresh himself at the fountain of purer wisdom which contributors supply. Another change, which we effect with genuine regret, is the omission of a special section devoted to consideration of the questions of income-tax law and its administration. Ever since 1913, when income in this country became a sort of partnership affair, in which the federal government insisted on participating, we have published narrative and analytical comments upon the tax statutes and the incidence of taxation. Now Stephen G. Rusk, who has served most recently as editor of the tax department, has asked to be relieved of the responsibility, and his request has been reluctantly granted. In view of the gradual approach to standards in the

execution of tax laws and the apparently lessening interest of the accountant in tax cases, it seems unnecessary to allot each month a portion of the magazine to the subject. Instead we shall attempt to present summaries of the most important enactments or rulings as they appear. In addition to what may be called news of taxation, we intend to assign from time to time whatever space may be required to a brief synopsis of really important current events which may affect the interests of all who profess and call themselves accountants. Much of the matter which will appear will be summarized from full reports published in the *Bulletin* of the American Institute of Accountants. The *Bulletin* is to continue as before—and in passing it may be noted that the *Bulletin* evidently meets a demand for a detailed chronicle of contemporary affairs—but the outstanding events which are recorded there and elsewhere will be brought directly to the attention of readers of THE JOURNAL OF ACCOUNTANCY. Laws relative to the certification of accountants, significant court decisions, regulations affecting corporate procedure and similar matters will be mentioned. Other plans for the future construction of THE JOURNAL OF ACCOUNTANCY are under consideration and, if found desirable, will be introduced. Accountancy is changing almost daily and its spread now carries it into the fields of finance, economics, civics, sociology and the like. It can no longer be restricted by the old boundaries of debit and credit. The growth of professional accountancy is a constant marvel to the old fellows and a spur to the imagination of the young—sometimes too sharp a spur.