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Accounting Questions

[The questions and answers which appear in this section of THE JOURNAL OF ACCOUNTANCY have been received from the bureau of information conducted by the American Institute of Accountants. The questions have been asked and answered by members of the American Institute of Accountants who are practising accountants and are published here for general information. The executive committee of the American Institute of Accountants, in authorizing the publication of this matter, distinctly disclaims any responsibility for the views expressed. The answers given by those who reply are purely personal opinions. They are not in any sense an expression of the Institute nor of any committee of the Institute, but they are of value because they indicate the opinions held by competent members of the profession. The fact that many differences of opinion are expressed indicates the personal nature of the answers. The questions and answers selected for publication are those believed to be of general interest.—EDITOR.]

DEPRECIATION ALLOWANCE FOR AN ELECTRIC LIGHT COMPANY

Question: The X Electric Light Company with both common and preferred stock and an issue of bonds has a capital surplus of \$1,000,000, due to revaluation of fixed assets, and an earned surplus of \$500,000 at the end of 1932. It has been deducting 3 per cent. for depreciation, that being the amount fixed by the public service commission for rate-making purposes.

The company learns that higher rates of depreciation are being allowed by the income-tax department on similar properties and employs an accountant to obtain a refund. The accountant goes back in his refund claims as far as the statutory limitations will permit and obtains a substantial refund, using 5 per cent. rate of depreciation instead of the 3 per cent. permitted by the public service commission.

Jones is a bondholder and has access to the company's books. He finds that if the 5 per cent. rate of depreciation be carried back in the books for eight or ten years, and the necessary adjustment made in the surplus and the reserve for depreciation, by transferring from the former to the latter, the difference between 3 per cent. and 5 per cent. depreciation during those years, earned surplus will be wiped out altogether and a deficit shown amounting to \$350,000.

He warns the management that it can not continue to declare dividends as the capital has been impaired, but the management claims that the rate of depreciation claimed for income-tax purposes is not important and that the governing rate is the 3 per cent. fixed by the public service commission. It calls upon its accountant to support that contention. Can he support it, or must he admit that the company's net income available for dividends is that arrived at after deducting the rate of depreciation claimed in the claims for refund, and that therefore there is no balance of earned surplus?

What would his answer have to be if the company claimed that it could pay dividends from the capital surplus?

Answer No. 1: We are inclined to agree with the management that the deductions for depreciation allowed by the internal revenue department in arriving at taxable income would not be the deciding factor in determining the deductions for depreciation in the calculation of surplus available for dividends. We believe it is quite a common practice among public utilities to make claims for depreciation for tax purposes greater than the amounts provided on the books and in the accounts.

The whole question of depreciation and retirement accounting of public utilities is at present in a state of some confusion owing to the differing opinions and rulings of the courts, public service commissions, and the internal revenue bureau. Until these inconsistencies are adjusted, it would seem that if any dispute between shareholders and bondholders with regard to depreciation provisions reached the courts, it would be settled upon its merits, quite apart from the rulings of either the commissions or the internal revenue bureau. However, the decisions of the commissions would probably have greater weight than those of the tax authorities, inasmuch as the depreciation allowances fixed by the commissions are used in determining the rates for service and the rate of return on capital investment. It should be borne in mind, of course, that the depreciation allowances granted by public service commissions are based on property valuations fixed by the commissions for rate-making purposes, or the "rate base," while allowances by the internal revenue bureau are based on the cost of the depreciable assets, neither of which necessarily corresponds with book values. For accounting and financial purposes provision should be made out of earnings for depreciation on the book values of the depreciable property. It might be pointed out also that quite often bond trust deeds contain provisions with regard to depreciation and maintenance charges. In such a case these requirements would be the governing factor from a bondholder's point of view. As there is no reference to this point in the present inquiry, it is assumed that there are no specific provisions in the trust deed in this respect.

With regard to the payment of dividends out of capital surplus arising from appreciation of fixed assets, the question is a legal rather than an accounting one and the answer would depend somewhat upon the laws of the state in which the company was incorporated. For example, the New York state corporation law provides that no dividends shall be paid unless the "value" of the assets of the company exceeds its liabilities and capital stock, which would appear to permit of a valuation of the properties of a company on other than a cost basis for the purpose of determining the surplus available for dividends. However, from a financial or an accounting point of view, it is our opinion that there is no justification for the payment of dividends out of unrealized surplus arising from appreciation of capital assets.

Answer No. 2: In our opinion, based upon the facts as presented, the earned surplus of the company need not be charged with the additional depreciation claimed for income-tax purposes. We think it is generally recognized that the depreciation claimed for income-tax purposes may properly be more or less than that taken into the general accounts for the purpose of determining actual income and earned surplus. The important consideration, as far as the general accounts are concerned, is whether or not the depreciation provided is adequate to amortize the investment in capital assets over the life of such assets or to provide from earnings a fund with which to replace the assets when necessary.

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It is stated that depreciation has been computed at 3 per cent. for general accounting purposes and 5 per cent. for income-tax purposes. Presumably these rates apply to the cost of the property, since depreciation will not be allowed for income-tax purposes on any valuation in excess of cost. The question naturally arises, therefore, as to whether depreciation ought not to be based on the book value of the property, including the appreciation of \$1,000,000 resting in the capital surplus account. If that were done, it might be proper to charge that part of the depreciation which applies to the excess of the book value of the property over cost to the capital surplus account. We regard with disfavor payment of dividends from capital surplus representing revaluation of property, but the same purpose might be accomplished by charging part of the depreciation against the capital surplus. Our opinion previously given presumes, of course, that the depreciation provided by the company is adequate, whether based upon the cost or appreciated book value of the property.

Answer No. 3: May we say at the outset that a matter of this sort requires for its proper treatment a full understanding of all the facts, and not merely the formulation of certain of the salient features such as are embodied in the question. With this observation, we trust the following comment will at least indicate the required solution.

It would seem that the contrasting rates of 5 per cent. and 3 per cent., respectively, have different bases inasmuch as the resultant amounts, however computed, are intended to measure within reasonable limits the amount to be provided and allowed as an element of the cost of the service.

Now, if the depreciation in both cases is calculated on the same base, it seems evident that if 3 per cent., the rate allowed by the public service commission is adequate then, *prima facie*, the rate of 5 per cent. allowed for income-tax purposes is in excess of the requirement. We are inclined to think that at bottom there is really no such variance, and this phase of the question leads us to suggest that the commission's rate of 3 per cent. is probably based on the amount of the total capital assets, while the treasury department allows the higher rate, 5 per cent., on depreciable assets only.

Then again the commission has probably allowed for rate-making purposes the appraised value of the capital assets, while for income-tax purposes the basis for depreciation, we take it, is cost, which, according to the question, is \$1,000,000 less than the appraised value.

Further, it would seem from the question that operations have been charged with depreciation on the appraised value, but the so-called capital surplus, the increase on appraisal, \$1,000,000, has continued unimpaired instead of being reduced each accounting period by transfers to earned surplus of the proportionate amount realized through operations.

To sum the matter up, the provision for depreciation is, in the nature of the case, largely a matter of judgment and estimate, and in the final outcome it is immaterial how the reserve is computed. The question of importance is whether the provision is adequate for the designated purpose as far as informed judgment can determine.

Putting the matter more concretely, 3 per cent. on appraised value including, possibly, non-depreciable and intangible assets, may possibly be considered adequate, and if this be the case then the amount computed on any other base, 5 per cent. on cost of depreciable assets, for example, should be substantially

the same—with this proviso, that on the one hand we may with propriety provide what is considered sufficient but, on the other, we may, on the ground of conservatism and prudence, make a more liberal provision. Moreover, consideration of functional depreciation, as distinct from physical depreciation, may account for a distinct variance in the reserve provided by operations.

Thus in a given case there may be legitimate differences of opinion as to the depreciation reserve, inasmuch as a good deal depends on individual interpretation of the particular facts—always subject of course to the controlling rule of reason. At the same time the data of experience are available as a standard of reference, and we believe that the rates established in comparable plants may be applied to the case under consideration, making such revision as is necessary to meet the circumstances. In this way the adequacy, or otherwise, of the provision can be measured within reasonable limits, even though those limits do not admit of precise measurement.

Of course 3 per cent. of a given sum is obviously much less than 5 per cent. of the same sum and it would strain the probabilities to endeavor to reconcile, under anything like normal conditions, so wide a variation in dealing with equipment of standard type such as that to which the question refers. We are inclined to think, therefore, that, as we have said, the treasury department and the public service commission have taken different bases, or, it may be, functional depreciation may have been considered in one case but not in the other, or, still further, both factors may be operative.

We, therefore, suggest that, as a necessary preliminary, the whole question be reconsidered in the light of the foregoing comment.

Dealing now with the further question: "What would his (the accountant's) answer have to be if the company claimed that it could pay dividends from the capital surplus" (i.e., surplus arising from the revaluation of the fixed assets)? It is well established, certainly as a matter of sound accounting, that no such distribution can properly be made in cash inasmuch as unrealized increment on revaluation does not constitute profits or surplus available for distribution in cash.

Answer No. 4: It is the duty of the accountant to use the rate of depreciation that he considers adequate, even although a different rate has been fixed by the public utility commission or by the internal revenue bureau. The accountant is a professional man who is supposed to have his own opinion on a matter of this sort. Obviously, the accountant may accept for his own opinion a rate fixed by a state regulatory body or a rate fixed by the internal revenue bureau or a rate prescribed by a trust deed under which the bonds were issued, if such a rate is so prescribed, but the opinion of the accountant is his own opinion, on his own responsibility.

In no circumstances, should the accountant prepare the answer to the bondholder, as the questions raised by the bondholder are questions of legal construction as to the rights of bondholders and stockholders and such questions should be answered by competent legal counsel.

Answer No. 5: In our opinion the question is one of fact and public service commission regulations in the state where the company is organized. The mere allowance of a five per cent. rate for income-tax purposes does not in itself determine the amount of real earned surplus and consequently does not determine the amount available for dividends. If in the judgment of the direc-

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tors a three per cent. rate is sufficient to provide for the renewal of fixed capital, then we believe that the surplus predicated on such a rate is properly available for dividends irrespective of income-tax depreciation. Of course, the payment of such dividends on the theory that the three per cent. rate is sound reacts against the good faith of the claim of five per cent. sworn to by the officers of the company for the purpose of establishing their income tax.

If the bondholder in question should invoke court proceedings, the officers would be in a very embarrassing position in claiming that what they had sworn to for income-tax purposes was in fact not true.

In respect to the second portion of the question as to the availability of capital surplus for dividends, there is no question that paying dividends on such surplus is quite improper, though in some states it appears to be legal.