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Percival F. Brundage

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The Illinois Bell Telephone Company Case

BY PERCIVAL F. BRUNDAGE

The recent decision of the supreme court of the United States in the Illinois Bell Telephone Company case is so important in respect to much debated depreciation questions for rate purposes that a resumé should be of interest to all accountants.

Justice Butler in a concurring opinion took the definite position that straight-line depreciation is not acceptable for rate purposes. He said: "Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life can not be accepted as legitimate additions to operating expenses."

The opinion of the court delivered by Chief Justice Hughes did not go so far as this but decided the issue rather upon the particular facts disclosed. After explaining that the company had used the straight-line method of computing depreciation, "a method approved by the interstate commerce commission," the court held that, "the point is as to the necessity for the annual charges for depreciation, as made or claimed by the company, in order to avoid confiscation through the rates in suit. . . . The questionable amounts annually charged to operating expenses for depreciation are large enough to destroy any basis for holding that it has been convincingly shown that the reduction in income through the rates in suit would produce confiscation."

In previous decisions, the supreme court has held that the rate base on which a fair return is to be computed is "the present value" and not the original cost of the property used in the service rendered. In the United Railways & Electric Co. case (280 U. S. Pur 1930 A), the supreme court sustained the court of appeals of Maryland in holding that the allowance for annual depreciation should also be based upon "present value." In the Illinois Bell Telephone Company case the court holds that the computation of the annual depreciation provision is not independent of the rate base. Furthermore, after this decision, it is difficult to see how straight-line depreciation can ever be sustained as a charge to operating expenses in determining whether a rate is compensatory or confiscatory. The decision, it is true, was based upon the facts of the particular case, but a similar relation between the amount

of accumulated reserves and the observed depreciation for any company that has been in business for a substantial number of years would of necessity seem to exist in all cases in which the straight-line method has been employed. This is of particular interest in New York state where the public service commission has recently prescribed straight-line depreciation as an accounting requirement for all utilities in the state.

The facts of the Illinois Bell Telephone Company case were briefly as follows. The Illinois commerce commission on August 16, 1923, reduced rates applicable to part of the intrastate business of the Illinois Bell Telephone Company effective October 1, 1923. In September, 1923, the telephone company obtained an interlocutory injunction restraining the commission from enforcing the rate reduction on the condition that, if the injunction were dissolved, the company would refund the amounts charged in excess of the challenged rates. It was the second time that this case had been before the supreme court, and that court in its decision of April 30, 1934, reversed the decree of the district court, dissolved the injunction and required the company to refund the amounts charged in excess of the rates in this suit during the whole period up to that date, amounting to approximately a million and a half dollars a year.

The company in presenting its case had endeavored to sustain two contentions, which the court held to be contradictory, (1) that the depreciation charge against earnings on a straight-line basis was no more than was required in order to provide for the accruing loss of useful value during the period, and (2) that the property had been maintained in the best possible condition, was modern in every respect and that "the existing depreciation in the property, physical and functional, did not exceed 9 per cent. in the years 1923 to 1928 and 8 per cent. thereafter," while the depreciation reserve accumulated on the straight-line basis had reached an amount in excess of 25 per cent. of the cost of the property. Chief Justice Hughes in dismissing the injunction said: "The company has had abundant opportunity to establish its contentions. In seeking to do so, the company has submitted elaborate estimates and computations, but these have overshot the mark. Proving too much, they fail of the intended effect."

The court defines depreciation as follows:

"Broadly speaking, depreciation is the loss, not restored by current maintenance, which is due to all the factors causing the ulti-

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mate retirement of the property. These factors embrace wear and tear, decay, inadequacy, and obsolescence. Annual depreciation is the loss which takes place in a year. In determining reasonable rates for supplying public service, it is proper to include in the operating expenses, that is, in the cost of producing service, an allowance for consumption of capital in order to maintain the integrity of the investment in the service rendered. The amount necessary to be provided annually for this purpose is the subject of estimate and computation. In this instance, the company has used the 'straight line' method of computation, a method approved by the interstate commerce commission."

The following discussion of the depreciation charge and comparison of the accumulated balance of the reserve with the observed depreciation of the engineer's estimate is very concise and constitutes the clearest statement on this point that has appeared in any court decision.

"Confiscation being the issue, the company had the burden of making a convincing showing that the amounts it has charged to operating expenses for depreciation have not been excessive. That burden is not sustained by proof that its general accounting system has been correct. The calculations are mathematical but the predictions underlying them are essentially matters of opinion. They proceed from studies of the 'behavior of large groups' of items. These studies are beset with a host of perplexing problems. Their determination involves the examination of many variable elements and opportunities for excessive allowances, even under a correct system of accounting, are always present. The necessity of checking the results is not questioned. The predictions must meet the controlling test of experience.

"In this instance, the evidence of expert computations of the amounts required for annual allowances does not stand alone. In striking contrast is the proof of the actual condition of the plant as maintained—proof which the company strongly emphasizes is complete and indisputable in its sharp criticism of the amount of accrued depreciation found by the district court in valuing the property. The company insists that 'the existing depreciation in the property, physical and functional, does not exceed 9 per cent. in the years 1923 to 1928 and 8 per cent. thereafter.' The existing depreciation as thus asserted by the company, and the amounts it shows as the depreciation reserve allocated to the intrastate business in Chicago (taking in each case the average amounts per year) are as follows:

"Years	Existing depreciation	Depreciation reserved
1923.....	\$11,992,000	\$26,797,000
1924.....	12,865,000	29,316,000
1925.....	13,775,000	32,155,000

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1926.....	\$14,621,000	\$35,572,000
1927.....	15,360,000	39,352,000
1928.....	16,241,000	42,769,000
1929.....	15,300,000	44,515,000
1930.....	15,863,000	45,829,000
1931.....	15,828,000	48,362,000”

Too little attention has been given by many utilities heretofore to the interrelation of the rate base and the depreciation charge. Telephone companies generally have been willing to compute the annual depreciation charge on a straight-line basis as approved by the interstate commerce commission, relying on several supreme court decisions that the rate of return must be calculated on present value of the plant and not on original cost less computed depreciation. The case of the company as summarized by the supreme court appears to bring out the conflict of bases in a very direct way, and that court has now definitely indicated that a company can not eat its cake if it wishes to have it for a consumer's party.

On the one hand is the argument that the depreciation charge is correct and computed in accordance with the requirements of the interstate commerce commission. On the other hand is the statement that the plant “was not functionally deficient, in any practical sense.” Although the balance of the depreciation reserve increased between two and three million dollars a year during this period, the company's counsel stated that:

“The percentage of depreciation in the various classes of plant did not vary materially during the period, with the exception of three classes, namely, central office equipment, private branch exchanges and booths and special fittings. In the case of central office equipment, there were large installations of new equipment in 1929 which had the effect of raising the per cent. condition for the entire class from 92 per cent. for prior years to 93 per cent. for 1929 and subsequent years. In the case of private branch exchanges, the percentage condition improved gradually from 88 per cent. in 1923 to 94 per cent. in 1930 due to the large proportion of new installations and correspondingly large retirements of the old. In the case of booths and special fittings, the percentage condition gradually improved from 78 per cent. in 1923 to 85 per cent. at the end of the period, in this case also because of abnormally large changes of booths at pay stations. These are the changes which in the main account for the fact that the overall condition of the plant rose from 91 per cent. for the years 1923-1928 to 92 per cent. thereafter.”

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In view of the definiteness of the above statements, it is not perhaps surprising that the court held that the burden of proof that the depreciation charges included in operating expenses were fair and reasonable had not been sustained.

“In the light of the evidence as to the expenditures for current maintenance and the proved condition of the property—in the face of the disparity between the actual extent of depreciation, as ascertained according to the comprehensive standards used by the company’s witnesses and the amount of the depreciation reserve—it cannot be said that the company has established that the reserve merely represents the consumption of capital in the service rendered. Rather it appears that the depreciation reserve to a large extent represents provision for capital additions, over and above the amount required to cover capital consumption. This excess in the balance of the reserve account has been built up by excessive annual allowances for depreciation charged to operating expenses.”

The court’s reference to maintenance as related to the depreciation charge is also interesting:

“In the process of current maintenance, ‘new parts’ are ‘installed to replace old parts’ in units of property not retired. Such ‘substitutions or repairs’ are separate from the amounts which figure in the depreciation reserve. The distinction between expenses for current maintenance and depreciation is theoretically clear. Depreciation is defined as the expense occasioned by the using up of physical property employed as fixed capital; current maintenance, as the expense occasioned in keeping the physical property in the condition required for continued use during its service life. But it is evident that the distinction is a difficult one to observe in practice with scientific precision, and that outlays for maintenance charged to current expenses may involve many substitutions of new for old parts which tend to keep down the accrued depreciation.”

As already pointed out, Justice Butler goes even further than the court in taking a definite position against straight-line depreciation. He gives a number of tables and statistics in support of the court’s decision and then concludes as follows:

“From the foregoing it justly may be inferred that charges made according to the principle followed by the company create reserves much in excess of what is needed for maintenance. The balances carried by the company include large amounts that never can be used for the purposes for which the reserve was created. In the long run the amounts thus unnecessarily taken from revenue will reach about one-half the total cost of all depreciable

parts of the plant. The only legitimate purpose of the reserve is to equalize expenditures for maintenance so as to take from the revenue earned in each year its fair share of the burden. To the extent that the annual charges include amounts that will not be required for that purpose, the account misrepresents the cost of the service.

"The company's properties constitute a complex and highly developed instrumentality containing many classes of items that require renewal from time to time. But, taken as a whole, the plant must be deemed to be permanent. It never was intended to be new in all its parts. It would be impossible to make it so. Expenditures in an attempt to accomplish that would be wasteful. Amounts sufficient to create a reserve balance that is the same percentage of total cost of depreciable items as their age is of their total service life can not be accepted as legitimate additions to operating expenses. In the absence of proof definitely establishing what annual deductions from revenue were necessary for adequate maintenance of the property, the company is not entitled to have the rate order set aside as confiscatory."

If this had been the opinion of the court, the situation today would at least be clearer than it actually is. However, accountants must realize too well the necessity of deciding cases as they arise to have any just cause for complaint at the unwillingness of the court to go further than deciding the case immediately before it.