1928

Before depreciation

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Recommended Citation

Haskins & Sells Bulletin, Vol. 11, no. 10 (1928 October), p. 75-77

Such consideration of this matter leads one to the conclusion that it would be better, if expression must be given at all to increased values of assets, to take up the complement to the increase in a reserve account. Under such treatment, there would be no misapprehension as to the significance, no possibility of confusing it with earned surplus, no chance of making improper charges against it on misconceived theories, and no necessity of disillusioning stockholders with respect to the amount available for cash dividends, or as to the value of their stock. Such are some of the practical considerations.

From the theoretical point of view, it is interesting to see what may happen if estimated increases in the value of assets not subject to depreciation or amortization are set up as capital surplus, properly segregated from earned surplus. These increases have not been realized, they may never be realized, and perhaps they may not represent even hope or expectancy. It seems absurd, therefore, to charge against such surplus anything other than adjustments in asset values from which the theoretical surplus was derived, or a stock dividend if such action is taken.

A suggestion, for example, to charge against capital surplus so created unamortized discount on a bond issue meets with instant objection. Such procedure would be inherently wrong, first, because the charge is unrelated in character to the capital surplus; second, because the effect would be to charge a known loss against an estimated or theoretical increase in value. Further, with respect to bond discount, it is improper to relieve the earnings of a charge which increases the nominal rate of interest and should be included therewith in order to show the true cost of utilizing the borrowed capital and to protect bondholders against the payment of excessive dividends.

This illustration shows clearly the fallacy of charging a known loss, or expense, or similar item against a surplus the basis of which is an estimate of increase in value. To use again the familiar homely expression, "No company makes money doing business with itself."

Before Depreciation

THE idea that net earnings before depreciation and Federal income tax indicate the ability of a corporation to cover the interest requirements of its capital obligations has come to be generally accepted by those who have to consider the handling of interest-bearing securities. This idea is predicated on the theory that the amount of income tax payable cannot be determined until after interest has been deducted, and that depreciation is a "bookkeeping matter" which does not involve the disbursement of cash.

The difficulty for the accountant in assenting readily to this theory lies in the fact that readers of financial statements to which he attaches his name do not always differentiate the bondholder from the shareholder. The bondholder is concerned with the remainder of earnings available to satisfy his rights with respect to interest. The stockholder inquires as to the residue of earnings out of which he may receive dividends.

Full consideration of the question of depreciation must be based on a view which comprehends bondholders as a class and over the life of the bonds. Bondholder "A" may figure that he will invest for a relatively short term, during which time the net earnings probably will take care of his interest and before the expiration of which the depreciated value of the property securing his obligation will not have become a matter for practical consideration. But Bondholder "B" may not have been so farsighted and may come into the situation in time to be caught with impaired earnings as the result of a decrepit plant, and suffer a loss in his capital investment because the property in which his funds are invested has to be disposed of at a capital loss.

A hotel, perhaps, offers as good an opportunity for illustration as any which might be selected. Depreciation in this case may not appear to be a practical matter. But depreciation slowly and surely evidences itself in the shabby and passé appearance of the buildings, equipment, and furnishings, which no amount or kind of service can long overcome. Patronage passes to newer and more modern hostelries, with the resulting decrease in earnings, or the substitution of constantly declining rates, in keeping with the ability to pay of a cheaper class of guests, cuts into the receipts. If a hotel were a temporary venture, bondholders as a class might be satisfied to ignore depreciation with the idea of selling the property before being overtaken by a capital loss. As an institution to be continued, the ultimate loss with respect to the capital investment in hotel property is inevitable, unless provision is made concurrently out of income to compensate therefor.

Depreciation is difficult to measure, but that is not a reason why it should be ignored. Any representation with respect to the earning power of a corporation possessed of property is incomplete if provision is not made for depreciation in a measure which is believed to be adequate. Perhaps no human being is competent to guarantee the accuracy of depreciation charges. There is sufficient depreciation experience available from which to make estimates that are sufficiently accurate for practical purposes.

One might as well prepare a balance sheet and leave out part of the liabilities, capital stock, and surplus as to make an operating statement and leave out some of the charges that reduce the net earnings and net profits. The current advertising of a leading appraisal company announces that "to state earnings only before depreciation is as confusing as to state them before deducting cost of raw materials."

An article in *The Investment and Business Forecast* offers the following illustration which is particularly appropriate to a discussion of depreciation:

"Take the case of a company that pays $1,000,000 for a new steamship through the sale of $500,000 worth of 1st mortgage 6% 20-year, bonds at par; and 5,000 shares of common stock at $100 a share. If the boat earns $130,000 per annum with no charge for depreciation, this would leave a net of $20 per share after bond interest. It would thus seem conservative to pay dividends of $10 a year. After 20 years, however, there would be an accumulated surplus of only $1,000,000—and no other assets—from which to pay off the bond issue, and buy a new boat. On the other hand, had an annual charge of 5% of the cost of the vessel been made to a depreciation reserve account, the common would have earned $10, could have paid $5; and the company would have accumulated, after 20 years, a depreciation reserve of $1,000,000 for replacement of the vessel, and a surplus of $500,000 to meet the bonds at maturity. This would leave the common stock with a book value of $200 a share, and no senior securities ahead of it. Under the no-depreciation-charge plan, the stock would face a $100 assessment to keep the company in business."

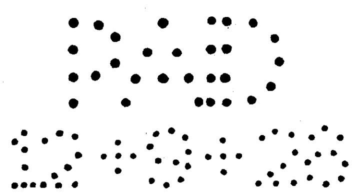
Instead of omitting depreciation and Federal income tax from a statement designed to show earnings available for interest, it would be more logical to first deduct depreciation and income taxes, inasmuch as depreciation usually is regarded as an operating expense, and income taxes have a claim on earnings prior to any interest. If depreciation and Federal income tax were taken into consideration oftener, bond issues would be smaller in amount and frequently more nearly consistent with the earning power of the corporations involved.

The Perforation of Checks By Banks

By R. S. Johns, Newark Office

Styles in the perforation of checks by banks, perhaps at first thought a rather trivial matter, may at times become a factor of considerable importance. In connection with the audit of cash, it is sometimes necessary to examine the bank's perforation of a check as evidence of the date on which the amount of the check had been charged to the bank account in question.

The customary method of indicating that a check has been paid by the bank on which drawn is to perforate the check in somewhat the following fashion:



There is a tendency, however, to perforate checks by code so that one cannot determine at a glance just what date the check cleared through the bank. This is more true of the larger banks than the smaller ones where the volume of checks to be cancelled is not so great. The basis of the code is to have the holes representing the numerical equivalent of the month, day, or year, perforated on the following scheme:

1 2 3	● ● ●
4 5 6	● ● ●
7 8 9	● ● ●

Three such blocks are employed to indicate, respectively, the month, day, and year. These blocks are separated by a series of holes to avoid confusion between blocks. For example, August 16, 1928, would be represented in the following manner (those not punched are shown solid for purposes of illustration):

● ● ● ○ ○ ● ● ○ ● ○ ●
● ● ● ○ ● ● ○ ○ ● ● ●
● ○ ● ○ ● ● ● ○ ● ○ ●

It is evident that some additional provision must be made for such numbers as 11, 22, etc., for numbers containing a cipher, such as 10, 20, etc., and also to distinguish between 12 and 21, 13 and 31, etc. Two additional holes for each block are provided for these purposes, as illustrated by the letters "A" and "B":

A B
● ● ●
● ● ●
● ● ●

"A" is used to indicate that a cipher should follow the numeral punched in the regular block. "B" means that the numeral indicated should be taken twice. October 11, 1928, would be represented in the following manner:

○ ● ● ○ ● ●
○ ● ● ○ ○ ● ● ○ ● ○ ●
● ● ● ○ ● ● ● ○ ● ● ●
● ● ● ○ ● ● ● ○ ● ○ ●

Twelve and thirteen are distinguished from twenty-one and thirty-one, respectively, by punching "A" when the numerals should be taken in reverse order. It should be noted, perhaps, that the use