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Appreciation From the Point of View of the Certified Public Accountant

By John R. Wildman

Address Delivered at a Meeting of the American Association of University Instructors in Accounting, Chicago, December 27, 1928

THE certified public accountant's interest in the subject of appreciation is a practical one. He is forced to consider the matter in connection with his review of accounting and his certification of financial statements.

The facts are, whether or not such procedure is justifiable, that physical property and intangible assets frequently are revalued by, or at the instance of, the owners of such possessions who attempt, in various ways, to give expression to the estimated increases in value. The certified public accountant, therefore, is confronted primarily with a condition; not a theory.

The authority for the restated value may be either a report of independent appraisers or a resolution of corporation directors.

Inasmuch as the certified public accountant does not attempt to act as an appraiser, to pass judgment on the work of such persons, or to assume responsibility for the values which they fix, he accepts their judgment and qualifies his statements accordingly.

Inasmuch as corporation directors, in some jurisdictions, are empowered by statutes to fix values, and even though not specifically so empowered are within their corporate rights in so doing, the accountant usually takes the position that he must accept their judgment when they revalue assets, provided there is no fraud involved and they officially record such acts in the corporate minutes. In such cases the accountant places the responsibility on the directors by proper explanation in his statements.

The occasions for revaluations which give rise to estimated increases in values are various. One corporation may wish to bring out a bond issue. Another corporation may wish to offer an issue of preferred stock. Still another company may see in the procedure an opportunity to overcome a deficit in capital, thus preparing the way for future declarations of dividends payable in cash. A fourth concern may wish to use the restated value as a basis for depreciation and thus increase the charge for depreciation against earnings.

In one particular case, a company owning city realty considered using an appraised valuation for the purpose of restating its land and building values, crediting the estimated increment in land values to surplus available for cash dividends. This was done on the theory of equalizing the increase in value among the stockholders over a period of years, rather than giving the benefit of large profits to the shareholders at some future time when, and if, the profit might be realized.

In another case, a company having on its balance sheet a large amount of deferred charges which had accumulated as the result of numerous refinancings, caused certain intangibles to be revalued, credited the amount of the increase to capital surplus, and wrote off the deferred charges against such surplus.

Cases, illustrating the use which is made of asset revaluation in order to take advantage of an estimated increase in the value of such assets, might be continued at length. It is doubtful, however, if a continuation would develop uses substantially different from those already described.

The principle is well settled, and is specifically exemplified in cases such as the one involving the directors of the American Malting Company (65 N. J. Equity 375), that anticipated profits may not be made the basis of dividends payable in cash. In that case, quoting from the opinion written by Judge Clarke, "These contracts were to deliver at a future time a product not yet

made from raw material, not yet purchased, with the aid of labor not yet expended. The price agreed to be paid at that future time had to cover all the possible contingencies of the market in the meanwhile, and might show a profit, and ran the chance of showing a loss. When the sales actually took place they were entered in the books. But to calculate months in advance on the results of future transactions, and on such calculations to declare dividends, was to base such dividends on paper profits—hoped for profits, future profits—and not upon the surplus or net profits required by law. It does not seem to me that you can 'divide,' that is, make a dividend of a hope based on an expectation of a future delivery at a favorable price of what is not yet in existence, under the statute."

The principle is generally accepted, and is supported by Jennery *v.* Olmstead (36 Hun 536), that a rise in market prices over the cost of commodities carried as current assets does not justify a credit to profit and loss, or an increase in earned surplus. In the case of Jennery *v.* Olmstead, the court had to pass on the question of whether an increase in the market value of United States bonds, than which nothing could be more marketable, was a proper credit to profit and loss. The court held that it was not.

In further support of the principle that unrealized increment does not constitute a profit distributable in the form of cash dividends, might be cited Marks *v.* Monroe County Permanent Savings and Loan Association (52 N. Y. St. Rep. 451, 22 N. Y. Supp. 589) in which it was held that unearned discount was not so distributable.

The statutes of Ohio (General Corporation Law of 1927, Section 8623-38) require that "Cash dividends shall not be paid out of surplus due to or arising from (a) unrealized appreciation in value of or a revaluation of fixed assets * * * ."

In the outstanding case of Eisner *v.* Macomber (252 U. S. 189) the United States Supreme Court held that in order to be subject to taxation, income must be shown to have been "derived" from capital, and not merely a "growth or increment of value in the investment." * * * "Enrichment through increase in value of capital investment is not income in any proper meaning of the term." This case, of course, will be remembered as the one in which stock dividends were declared by the Supreme Court to be non-taxable.

In another case which arose in connection with the Profits Tax Laws, the United States Supreme Court held in the case of La Belle Iron Works *v.* United States (256 U. S. 377) that appreciation could not be included in invested capital.

If contractual rights to receive in the future, amounts in excess of cost, or an opportunity to realize profit through resort to a ready market, do not warrant the recognition of increased asset value, it does not seem that any opinion expressed by, or in behalf of, the owner of property, can effectively increase the value of such property to the same owner.

The conclusion well may be reached, therefore, that an estimated increase in the value of assets, even if the estimated increase is recorded in the books of account of an enterprise, does not increase either actually, or constructively, the surplus available to that enterprise for distribution as cash dividends.

Exception to the foregoing conclusion possibly may be taken on the ground that it is not applicable in a case where one corporation owns all, or a sufficient amount of the stock of another corporation to direct the application of surplus profits, and periodically revalues its investment in the stock of the subsidiary company. Such circumstances seem not to indicate an exception to the rule which excludes appreciation from earned surplus. Revaluation on the basis of net asset values of subsidiaries, where warranted by circumstances of control, is but another way of giving expression to a result which would be achieved by consolidating the accounts of two companies. That this procedure may result in an amount of surplus greater

than that of the parent company alone, does not place the parent company in the position of having taken credit for unrealized appreciation.

The question may be raised, next, as to whether the procedure of increasing the book value of an asset, increases the capital account of an enterprise. The value of capital to an enterprise is determined by its earning power. Capital being but a collective term comprehending ownership of, or an equity in, the assets of an enterprise, the earning power inheres not in the capital account, but in the substance by which the capital is represented. To answer in the affirmative the question of whether increasing the book value of an asset increases capital, it must be shown that the asset which has been raised in value has increased earning power which justifies the value assigned to the asset.

Physical property in the form of buildings and equipment scarcely may be considered to be capable of producing any favorable effect on earnings. On the contrary, the older such property becomes, the greater, frequently, becomes the burden on earnings. Consequently, such property does not meet the test which justifies an increase in asset value and in capital.

Land, under certain circumstances of location and demand, may increase in value, but the increase is a theoretical one requiring an exchange in order to make it effectual. In the hands of the same owner and without improvement, usually it has no increased value in use.

Mineral deposits are analogous to land. Their value in use continues the same. Their value in exchange requires a transfer of ownership, before an increase in value may be recognized.

Values in ore bodies, or other natural resources, established by discovery and engineering appraisal, constitute an exception to the foregoing statement, in that they represent added wealth which finds its rational place in capital, and is justified by increased value in use, with the consequent effect on earnings.

Nature, also, is responsible at times for increment which it seems must be recognized. Probably no one would maintain that the natural increase in timber, livestock, or nursery-stock should be ignored in any attempt to portray, by means of accounting, conditions and operations of enterprises dealing in such resources. On the contrary, it seems but reasonable that the accretion should be admitted to a place in the inventory of assets, with the consequent effect, as the case may be, on capital, reserves for unrealized increment, or profits.

Coming finally to intangibles, it is apparent that some enterprises possessing rights under contracts which have been undervalued, or not previously valued, or having franchises, patents, trade-marks, copyrights, etc., acquired at nominal cost, may enjoy profits in excess of those which are normal for their particular line of business. Under such circumstances, it seems that the owner of such intangibles would be justified in attributing the excess profits to such assets, and in placing on them a value commensurate with their earning power. In cases where the increased earning power has been demonstrated to have continued over a reasonable period of time, and is sufficiently permanent to warrant it, it would not seem irrational to raise the book value of the asset and credit the amount of the increase to capital. The effect, incidentally, would be to adjust the future return on capital so that it would tend to conform to the rate assumed as the norm.

There are at times circumstances involving land which create a situation analogous to that in which the capitalization of intangibles is warranted. Where capital, represented by land at cost returns a profit substantially and continuously in excess of normal, it does not seem illogical to increase the land value and the capital so that the future percentage of return on the increased amount of capital will approximate a normal rate of return. This is not on the theory that the value of surrounding lands has increased and

created a possibility of sale at a profit, but that the owner, by reason of the increased earning power conferred on him by a fortunate purchase, is entitled to capitalize that increased earning power. Thus, it seems that the situation becomes analogous to that involving intangibles.

The preceding discussion of appreciation in its relation to capital seems to warrant the conclusion that an increase in the book value of an asset does not justify an increase in capital account unless the asset has increased value in use. Increased value in exchange does not constitute grounds for increasing capital.

Common law and specific statutes, in some jurisdictions, may deter those charged with the direction of corporate enterprises from paying cash dividends out of anticipated profits, or estimated surplus. There is little, if any, regulation, however, outside of that employed by the Interstate Commerce Commission and the various public service commissions, over the bookkeeping of corporations.

If a corporation desires to give expression to a theoretical increase in value of property, there is little an auditor can do to prevent such practice, except to inform himself thoroughly on the subject and exercise his logic and moral suasion in the premises. He can and should, however, refuse to certify to a statement in which the expression of increased value results in a misleading representation with regard to surplus, or to capital.

Justification of the practice of recognizing appreciation is attempted at times on the ground that the increase in value will be recovered out of future earnings through increased charges for depreciation.

This theory is fallacious, in that if the proportionate credit, representing a decline in unrealized appreciation, is properly applied, that is, as an offset to the depreciation charge, the net result will be the same as if depreciation had been taken on the property value before it was increased.

The effect of charging an increased amount of depreciation is to show the realization of a fictitious profit on property at the expense of future income. The result is doubly misleading. Net income from operations has not, in fact, been reduced; neither has a profit been realized through disposal of the property.

This argument is in no sense a criticism of the practice now prevalent of having property appraised by qualified appraisers. For purposes of insurance, appraisal is a proper procedure. For purposes of negotiation incident to a sale of property, or recapitalization involving the entry of new money into an enterprise, appraisal is pertinent and logical. For the purpose of creating a surplus to be distributed to shareholders in the form of cash dividends, appraisal is impertinent and unsound. If an appraisal *relating to property which is subject to depreciation*, is used to create a surplus which will be apportioned by means of a stock dividend, the procedure is not only unsound in that it erroneously assumes an increase in capital, but it is misleading in that it conceals the burden which is placed on future earnings through the increased depreciation charges which must follow.

The contention sometimes is made that the cost of replacing property having increased because of a rise in the general level of prices, property values should be marked up in order to protect invested capital against a sudden and unexpected charge in the event of severe property loss. Such procedure, being accompanied by an increase in the periodic charge for depreciation, has the advantage, it is claimed, of providing for the extinguishment of the property on the basis of replacement cost while protecting the original capital against impairment in case of extraordinary loss.

The fallacy in this theory, as it relates to capital, is that the property value will be extinguished with equal certainty on the basis of original cost and the corresponding periodic charge for depreciation, and capital will not become impaired. Depreciating property on the replacement basis is tantamount to anticipating an increase in surplus or in capital and attempt-

ing to make good the realization of the increase out of future earnings.

Directors who fear extraordinary property losses should arrange for insurance on the basis of replacement cost as long as such cost is above original cost. If directors consider it desirable to provide a reserve against extraordinary property losses, they should create it through a special charge against surplus, rather than misstate the net profits by excessive charges for depreciation.

If a corporation decides to increase its capital by means of an appraisal of property, perhaps no preventive can be imposed. Such steps should be taken, however, with the knowledge that if the property is of a depreciating character, the increased depreciation charge will result in decreased future net earnings in an amount equal to the depreciation on the appreciation. This effect is one especially worthy of consideration in its effect as between present and future shareholders. Those who buy shares, the capitalized value of which in part is based on appreciation of depreciating property, must expect to suffer the consequences of reduced future profits, and perhaps reduced dividends.

The power to prevent a corporation from writing up the value of its property, where prevention is desirable, obviously, is beyond the control of the accountant. But the right is his to determine the kind of financial statements to which he will attach his certification. It is his duty to refrain from certifying to financial statements which are misleading. Applying this formula, consideration may be given to the various treatments of appreciation in an attempt to discover what constitutes a misleading statement.

Property clearly described on the asset side of a balance sheet as being carried at appraised value should mislead no one. Intangibles so described should be equally clear. Earned surplus which contains an undisclosed element of appreciation is misleading, and the inclusion of appreciation under the general caption of surplus is a misrepresentation.

While it may seem sufficient in giving effect to appreciation to differentiate it from any earned surplus by showing it as "capital surplus," or "surplus arising from appreciation," all the reasoning heretofore applied seems to lead to the conclusion that appreciation does not, in fact, give rise to surplus of any kind. Under such circumstances, it appears that the credit for appreciation may not be described in any way on the balance sheet as surplus, without danger of misleading the reader.

Almost equally dangerous is the practice of including the credit for appreciation in the capital account, without disclosing the fact, in cases where corporations have shares of no par value. The implication exists, where such stock is involved, and there is no question of stated share value, that the capital account represents the amount of consideration received for the stock, plus such amounts as the directors have authorized to be transferred from surplus thereto. The inference may be drawn, therefore, that such capital is based on closed transactions, and is not dependent in any part upon future earnings for its establishment.

No one should be misled with respect to the credit for appreciation, in its relation to capital and surplus, if an amount equal to the estimated appreciation is placed in an account by itself, stated on the balance sheet in a separate caption above the capital stock, and appropriately described. A descriptive title which would be universally acceptable is difficult to find. Judging the matter from the standpoint of what must transpire if effect is to be given to appreciation, and it is to be treated correctly in its relation to the asset, to capital, to depreciation, to earnings, and to surplus, the element seems to stand out clearly as an estimated increase in value which has not been established by realization, or by earnings. Consequently, it may be described accurately as "Unrealized appreciation" or "Unearned appreciation."

The conclusions reached with respect to appreciation are as follows:

1. The recognition of appreciation in

accounts generally is unsound from the point of view of economics.*

2. Appreciation does not increase capital, except in cases of newly discovered value, and of increased intangible or other asset values which are supported by indisputable earning power.

3. Appreciation should not be recognized unless it is justified by newly discovered value, or by increased value in use. Value in exchange does not justify its recognition.

4. Appreciation is not recognized by the profit economy, which requires that there shall have been a closed transaction before gain or loss may be determined.

5. The recognition in accounts of appreciation as creating a realized and distributable asset value is contrary to common law, and to some statutory law.

6. Profits, ascribed to appreciation, are excluded from income which is subject to Federal taxation.

7. Appreciation does not give rise to surplus which may be distributed in the form of cash dividends.

8. Appreciation does not give rise to earned surplus.

9. Appreciation may not be shown as having given rise to surplus of any character, without danger of being misleading.

10. Appreciation should not be given effect in a balance sheet, except as an estimate of unrealized value, in the nature of a reserve which may be shown either on the side of the liabilities or as a deduction from the corresponding asset. If shown on the side of the liabilities, it should appear above the capital section of the balance sheet, and in any event should be described as "Unrealized appreciation," "Unearned appreciation," or by means of some caption equally clear and accurate.

11. The theory that appreciation may be recovered out of earnings by increasing the charge for depreciation is erroneous.

*A study of the subject of "Appreciation" by graduate students under Professor A. C. Littleton, in the College of Commerce and Business Administration, University of Illinois.

12. The amount corresponding to depreciation of appreciation periodically deducted from unrealized or unearned appreciation, in cases where effect has been given to appreciation, should be applied as an offset in reduction of the charge for depreciation, so that the effect on net profits will be the same as if the charge for depreciation had been based on the value of the property prior to the introduction of appreciation. Stated differently, depreciation of appreciation should be charged against "Unrealized appreciation."

Telephotographic Statement

OUR New York Broad Street office recently sent a financial statement by the telephotographic system of the American Telephone & Telegraph Company to our Los Angeles office. This statement was a schedule of securities held by a New York bank for the account of a certain corporation, giving the number and market values of the various securities held on each of three dates. It was of considerable size, covering slightly more than one ordinary working sheet. The time required was approximately one and one-half hours from the time the statement was placed in the hands of the transmitter until it was delivered to our Los Angeles office. The cost of sending it by telephotograph was considerably less than it would have been to have sent it by telegraph. Obviously, the result was much more satisfactory. The New York Broad Street office was enthusiastic over their first experience in using the telephotographic process.

News Items

Colonel Carter and Mr. Kracke recently returned from Europe on the S.S. *Majestic* of the White Star Line.

Colonel Carter was reëlected vice-president of *The Accountants Club of America,* at its annual meeting on November 19, 1928, at New York.