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Cost vs. Value in Depreciation Accounting for Public Utilities

By H. C. Hasbrouck

A quite common but unfortunate tendency to confuse the essentially different concepts of cost and value appears to the writer to be exemplified in the article appearing in THE JOURNAL OF ACCOUNTANCY (July, 1923) entitled *Amortization and Depreciation in Public Service Corporations.* The two ideas of cost and value are so related that it is very easy for most of us in dealing with them to shift our point of view from one conception to the other without realizing that we have changed it. This Mr. Johnson seems to have done to some extent and his discussion of the function of depreciation accounting for public utilities suffers accordingly.

In two places the article states that the fundamental purpose of depreciation accounting is to record the *value* of the permanent property.

> "* * * The fundamental purpose of depreciation accounting, viz., the maintenance of the property account as summarized on the balance-sheet, so that it will represent the approximate going value of the company's property and so serve as a basis for credit and the price of the company's securities, and also in the case of a public utility as a rate-base."

> "* * * The fundamental purpose of depreciation accounting is to prevent any wide and permanent gulf between the balance-sheet figures of fixed capital and the actual value of the property they represent."

The first of the two statements above quoted is qualified a sentence or two later by the remark: "There are, of course, different kinds of value and a digression into the discussion of their definitions would be out of place here." But is it not true that the only kind of value with which the accountant is primarily concerned is market value or value in exchange, the value, expressed in terms of money, at which a transfer of title can be effected, resulting in a transaction which it is the accountant's duty to record and to classify? And is it not also true that the accountant is concerned with that value only as at the instant of its establishment through a completed transaction? "Service value" and "value for rate-making purposes" are terms having more or less of technical and legal significance but they would

appear to be outside the accountant's sphere. "Exchange value at the instant of its determination," however, is nothing more nor less than cost—and that is the accountant's true concern.

In order to have an accurate record of the cost of permanent property, that is to say, a correct capital (or to use the phrase which has become pretty well established, at least in public-utility accounting, fixed-capital) account, the accountant need concern himself with only two transactions for each unit of property: the entry when the property is acquired and the entry when it is retired. If these two entries are correctly made as at the time of the respective occurrences to which they relate, the fixed capital account will be correct without regard to the "value" of the property or the amount of a depreciation reserve which may or may not have been accumulated.

The last sentence will undoubtedly sound like heresy to a good many accountants but the writer does not intend to deny the existence of depreciation nor to argue against its recognition in the accounts before it is actually realized at the time of retirement. The point is that the function of depreciation accounting is not "to represent the going value of the company's property" nor "to prevent any wide and permanent gulf between the balance-sheet figures of fixed capital and the actual value of the property they represent." The true function of depreciation accounting is to equalize the burden of retirement losses so that instead of being taken into the operating accounts when they are actually realized and definitely known they are anticipated to a greater or less extent and distributed with approximate equality throughout the service life of the property.

As a matter of cost accounting the relation between the fixed capital account and the depreciation reserve is of comparatively little significance, nor is it important whether the reserve was accumulated by the "straight-line" method, the sinking-fund method or on some other basis. If the periodic charge for depreciation seems reasonably certain to distribute retirement losses with approximate equality year by year the statement of operating costs will be (assuming, of course, that it is correct in other respects) as accurate as anyone can demand. Life tables and the statistics of average retirement losses have their usefulness, but they can never attain mathematical certainty and must be checked and modified by the experience of each individual enterprise. The

amount of depreciation reserve, the way in which it was accumulated (and especially whether or not it was set aside after the investors had had a reasonable return) and the method of its investment are, of course, of great importance in public-utility rate cases. But they are of legal and economic importance and should be carefully distinguished from the accountant's primary question which is not "What is the value of the property?" but "What is its cost to the present owners?"

This confusion of cost and value seems to the writer a fundamental and unfortunately too common misconception in depreciation accounting. Does it not make for clearer thinking to recognize that the value of fixed capital, in any true sense of the word, depends upon depreciation only as depreciation affects net income? After all, the value of the permanent investment in any enterprise is nothing but the capitalization of its expected earning capacity. The cost of the permanent assets of the business is another matter. Shall we not go further if we recognize that the depreciation reserve is not and cannot be a measure of loss in capital value at any given time? It is an accounting device for distributing retirement losses with greater regularity than would be the case if they were recognized only at the time of their actual occurrence.

Of course, it is almost a necessary corollary of this way of looking at the matter that the depreciation reserve should be shown among the liabilities rather than as a deduction from capital assets. Perhaps it does not make much practical difference which way the balance-sheet is set up in the case of ordinary manufacturing or commercial enterprises, provided the distinction between cost and value is always kept clearly in mind. However, it sometimes makes a tremendous amount of difference to a public utility whose balance-sheet is constantly under scrutiny by untrained, illogical and prejudiced minds not seeking for facts but for anything that will lend plausibility to their preconceived notion of the facts.

In the final paragraph of his paper Mr. Johnson suggests that revision from time to time of the balance-sheet figures for fixed capital "to represent actual values as shown by appraisements has much to recommend it," but he thinks that its disadvantages and dangers are so great that it is not likely to be systematically adopted. Nevertheless, he says, the expediency of revising the

books should be seriously considered whenever an appraisal shows that the "actual value" is materially different from the book value. It is not entirely clear what Mr. Johnson means here by "actual value." Presumably it is the hybrid "value for rate-making purposes" that has come to have such illogical importance in public-utility affairs because of the attempt of courts and commissions to adopt as a formula the phrase that happened to be used by the supreme court of the United States in the familiar *Smyth vs. Ames* case—"a fair return on fair value." "Fair value" is neither true value nor cost. It is nothing but a method of expressing someone's judgment as to what is a fair and just return at a particular time to the owners of a particular enterprise. The accountant very properly shrinks from confusing his records of facts by introducing such an anomalous element of opinion.

Nevertheless, there are practical reasons why ledger costs of fixed capital should sometimes be revised to correspond with appraisals. The first and most obvious case is where the appraisal is really an attempt to arrive at true cost and is a check on the books. If the results of the appraisal are widely different from the totals on the books, a careful analysis should be made to determine which is the more accurate, and, if it is evident that the books have been so kept as not to reflect true cost, they should be corrected. The most conservative accountant can hardly take exception to this.

In another type of case the revision of the books to correspond with the appraisal has more to recommend it on practical than on theoretical grounds. Suppose, for instance, that a public utility has had a "fair value" of its property for rate-making purposes fixed by a regulatory commission and has acquiesced in the decision. May it not be that in the circumstances which exist in that community it will be to the advantage of everyone concerned—the consumer, the public-utility investor and the regulatory or rate-making body—to accept the "value" so found as the starting point for a new set of capital accounts? Particularly if, as is usually the case with the older public utilities, there is no clear record on the books of the historical cost of the property to its present owners, the substitution, for vague and uncertain book figures, of values supported by a detailed inventory and appraisal has much to commend it even if the values are not the historical cost of the property. Here is a definite abandonment

of the strict theory of cost accounting. All general rules have their exceptions, however, and theory must sometimes be modified in practice. Nevertheless, the writer does not intend to argue here for this departure from the principle that capital accounts should represent costs rather than values. He merely suggests that it is a problem which accountants, particularly those who specialize in public-utility work, will have to consider very carefully.

Finally there is the situation, with which the whole economic world is faced in these days, of a changing standard in value. The dollar of today is not the dollar of yesterday and to assume that it is is often to work tremendous injustice. Such injustice is everywhere evident, the unfortunate — perhaps it may yet become the catastrophic — result of an imperfect economic and monetary system. Is the accountant bound to accept the dollar as the ultimate standard of value for his purpose or may he, at least in some circumstances, do what he can to correct the injustice arising from changes in the purchasing power of money by restating his costs in terms of equivalent dollars? To make the case a little more concrete, is an accountant ever justified in writing up the book costs of fixed capital to make them correspond to the costs of the same property in the present-day depreciated dollar?

This question also is asked rather than answered. The purpose of this paper is not to prove a thesis but to stimulate discussion on certain aspects of economic problems that deserve more attention from accountants than they have yet received.