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# Book Reviews

W. H. Lawton

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# Book Reviews

FEDERAL INCOME TAX, by GEORGE E. HOLMES. *Bobbs-Merrill Company*, Indianapolis. 1151 pp.
1921 SUPPLEMENT.

Mr. Holmes has presented a very comprehensive digest of the income-tax and excess-profits-tax laws written from the standpoint of the lawyer, but in language easily understood by the layman. The main volume published in 1920 deals with the laws and treasury rulings up to January 1, 1920, while the supplement is practically a transcription of the treasury decisions, rulings and opinions published during 1920 in the weekly income-tax bulletins issued by the treasury department. A feature of the most practical value in the latter volume is the reference by page to corresponding subjects in the original volume.

It is a well arranged and altogether admirable piece of work, but it reminds the reviewer of nothing so much as the perennial question involved in building battleships: they are hardly off the ways before they are obsolescent, and a new post-dreadnaught, post-Jutland, post-day-before-yesterday, must be laid down at once or the country will go to the demnition bow-wows! The amendments of 1921, which will probably be enacted before this goes to press, fill fourteen pages of double-column, and with the hundreds of treasury rulings during 1921 make Mr. Holmes' book, and all others of the same class, practically out-of-date. The only safety for the practising accountant lies in the up-to-date information of the tax department of THE JOURNAL OF ACCOUNTANCY or a good tax service and the weekly government bulletins.

W. H. LAWTON.

DEPRECIATION CHARGES OF RAILROADS AND PUBLIC UTILITIES, by ROBERT A. CARTER and WILLIAM L. RANSOM. *A. W. Stevens*, 300 Washington street, Brooklyn, N. Y. 110 pp.

This pamphlet is a letter to the Interstate Commerce Commission written by Robert A. Carter, chairman of the committee on rate fundamentals of the American Gas Association, and Wm. L. Ransom, of the New York bar, late counsel to the New York public service commission. It is a protest against allowing the railroads to include in their rates any charge for "theoretical depreciation" in spite of the mandatory provisions of section 20, paragraph 5, of the interstate commerce act, as amended. Not that the commission is asked to ignore the law, but a very strong and plausible attempt is made to show that the "depreciation" of the act is not the "theoretical depreciation" of engineers and accountants.

The gist of the argument of the pamphlet is as follows: "Theoretical depreciation" is any depreciation based upon "life tables" and accrued in advance. Such provision is "fanciful," "unsound," "silly," and "all to the end that through these accruals current passengers and shippers may be compelled to a piecemeal but surreptitious 'purchase' of the property" (p. 25). Taken as a whole no railroad system or utility suffers any depreciation at all, as the constant repairs to and replacements of units keep the property at its original value.

There may be depreciation due to obsolescence but no reserve should be accumulated for this element because no one can tell in advance when any given unit may become obsolete, and, anyhow, a replacement for this cause should be charged to future consumers.

Hence, it follows that only actual repairs and replacements should be charged in the operating expenses and included in the basis for rate-making. If a unit is retired to make way for a better one, in other words, for obsolescence, and the replacement charge seems too large to include in operating expenses for a single year, it may be spread over a few years at the discretion of the commission.

The conclusions of the authors are summed up (p. 104):

"We submit, on the basis of the general American experience:

"(1) That the setting up of 'depreciation reserves' based on 'life tables' leads inevitably to an unjust and burdensome inflation of the rate charged to patrons and to the accrual of reserves vastly greater than are actually necessary to make provision for the retirements of property as and when they occur.

"(2) That when reserves are set up and accrued on this basis, the amount of such reserves constitutes the minimum amount which is sooner or later deducted from the sum on which the company would otherwise have its fair return calculated and would in any event be deducted from the sum which the government would pay for the property upon any acquisition of the same.

"(3) That this deduction is made in complete disregard of the fact that even including the net balance in such reserves as a part of the sum earned by the enterprise over and above actual operating charges, the aggregate figures still constitute less than the fair return which the enterprise was constitutionally entitled to earn upon the fair value of its property.

"(4) That where the matter of retirement expense is treated in a sound way, on the basis of actual outlays therefor, charged against operating expenses, none of these confiscatory consequences rises up to plague the enterprise and deprive its investors of their constitutional rights."

We think we have stated the case of the authors fairly. Many of their arguments are fallacious and the constructions placed upon some of the court decisions on which they rely for support of their contentions are decidedly odd. For example, the Knoxville Water case has always been regarded as settling the status of accruing depreciation as an element of rate-making, but accountants will be surprised to learn that the supreme court meant something entirely different. After quoting the language of the court (with which accountants interested are acquainted, so we do not requote), the authors comment as follows:

"This does not mean that a reserve for 'accrued depreciation' based on theoretical age must be provided, if provision is made for meeting all withdrawals and replacements of property when and as the need arises. If proper provision is made in operating expenses for current replacements, and the property is kept in a high state of repair and efficiency . . . the investment remains unimpaired and subject to no deduction, and no 'reserve' need be set up to create a pretext for a reduction." (p. 46.)

The reason given by the authors for this construction is that the court referred to "making good depreciation" synonymously with

"replacing the parts of the property when they come to the end of their life." Apparently the authors overlooked the fact that in the same sentence the court remarked (also synonymously) that—

"Before coming to the question of profit at all the company is entitled to earn a sufficient sum annually to provide not only for current repairs but for making good the depreciation . . ."

If this does not mean the depreciation which is accruing annually we confess our inability to understand plain English. And it is equally plain that the court is referring to depreciation which is not made good by repairs.

Strained constructions are placed on the decision in the Minnesota rate case and in others; but this will suffice as an example. There are other cases wherein the argument is unfair and disingenuous, to say the least. Because old Roman aqueducts, old gas mains, dams, etc., show infinitesimally small depreciation, it does not follow that modern railroad and utility structures and equipment do not depreciate. In quoting *Bonbright vs. Geary,* it is asserted that the decision does not support "theoretical depreciation." Yet the extract quoted (pp. 68-69) shows that the court distinctly approved the accumulation of a reserve fund for replacements as "good business judgment." It doubted the reasonableness of the *amount* of depreciation found by the corporation commission, and it disapproved its failure to include the reserve fund in the valuation. Again, in the Medford Gas case (p. 99), the authors fail to notice that the New Jersey B. P. U. commissioners did deduct depreciation from the physical property, but restored it to the *intangible* value on the ground quoted, viz., that the previous net earnings had not been sufficient to provide for it together with a fair return. Nor did they notice the very significant fact that the new rate prescribed by the board provided for theoretical depreciation. Yet these cases and other similar ones are quoted in this pamphlet in an effort apparently to make the interstate commerce commissioners believe that courts and state commissioners are turning away from theoretical depreciation!

The Bonbright case brings up another point which is apparently overlooked by the authors, viz., that setting up a reserve for depreciation, while it lessens the value of the property so depreciated, does not lessen the value of the property as a whole. Correct setting up of the reserve concurrently creates a reserve fund in cash, and such reserve fund is certainly a part of the property "used and useful" to the public as long as it is maintained for the purpose of replacement; and therefore it should be added to the depreciated value of the plant in ascertaining the amount of the investment on which the fair return is to be earned. It is immaterial whether this amount is set aside in available funds or re-invested in the enterprise—that is a matter of policy for the management. If it is used in making extensions, it does not increase the total investment, since the reserve fund is correspondingly reduced. The total investment thus always remains at its original value.

The aim of theoretical depreciation is not, as the authors of this pamphlet mistakenly allege, to compel the consumer to "a piecemeal but surreptitious 'purchase' of the property," but on the contrary to insure its perpetual preservation for service. It means fair and level rates which will not be violently affected by heavy replacements in any one period. It means keeping the stockholders' investment intact. It means that profits will not be over-estimated, and money that should be retained for future replacements will not be paid away in unearned dividends. It means nothing more nor less than equalizing over a term of years in advance the expected loss to be incurred when a unit goes out of service. Repairs do not prevent the final "scrapping" of a unit, though they do prolong its serviceable life. The authors admit that spreading the cost of an actual replacement is allowable in certain instances. What is the difference in principle whether it be accrued in advance or amortized after the event? In practice, the amortization plan, which the authors advocate, would discriminate against future consumers since their increased rates would include not only ordinary repairs and renewals of their period but also the cost of making good the hidden depreciation caused by the use of the railroad property by present consumers. In any event the proposal to charge the cost of replacements to future consumers is impracticable. The constant fluctuation in rates would inevitably arouse the animosity of consumers who would be utterly unable to calculate their freight costs in advance. Such a policy on the part of the railroads would lead to an overwhelming demand for government ownership.

Admitting that some rates of depreciation assumed at present may be too high, thereby leading to the accumulation of excessive reserves, that is not to say that they may not be reduced to proper proportions as experience may show. The commission will attend to that. Present rates are based on such experience as we have had, but it must be remembered that it is only within a comparatively few years that railroads and other utilities have given any serious attention to the subject. As experience widens the base it will be an easy matter to obtain life-tables as trustworthy as those of life insurance companies. That there are such things as concrete water-pipes and earth dams which are so long-lived as to be practically out of the field of depreciation may be cheerfully admitted (though one may remark that even the "eternal mountains" are slowly but surely wearing away); but that is not to say that a railroad should make no provision to replace a freight-car whose life has been ascertained to be, say, twenty years on the average.

One more claim remains for consideration: that, taken *as a whole* railroad systems of any size do not depreciate in value because their units are so many that their replacement cost becomes a uniform charge year by year. That is half true. A point is reached when the depreciation charge in the rate is practically equaled every year by the actual cost of renewals and replacements. When that time comes,

of course, the reserve remains at the same approximate amount year after year, and is of no practical use except as a concrete reminder that the railroad property ***subject to depreciation has depreciated fifty per cent.*** But it will be a long time before that point is reached in American railroading or in other utilities. As long as additions and extensions are made, so long will the day of perfect equilibrium be postponed. When the day comes that we have all the railroads we can possibly use, and no improvements can be made in equipment, it will be time enough to discuss the question of dispensing with the reserves and the provisions in the rates for them. At that time also directors whose hearts are wrung at the picture of consumers required to pay for depreciation incurred in their behalf may turn these reserves over to the stockholders in part return of their investment and make new rates based on the lessened (depreciated) value of their property. These new rates will then of necessity contain a provision for actual renewals and replacements only. But not before. Meanwhile the railroads should be allowed to make provision in advance for inevitable future replacements not only as a matter of "good business judgment," as Judge Morrow said, but also in order that they may maintain good service for the public.

We must apologize to our readers for dealing at such length with this survival of the dark ages of accounting, but, when names of such standing are appended to an attack on depreciation as an element of cost at this late day, it behooves us to take notice. Depreciation is a fact with which we must reckon, and a proposal to allow the largest industry in America to dispense with proper provision for it should be strenuously opposed by all advocates of honest and scientific accounting.

W. H. Lawton.

EXCESS-PROFITS DUTY AND CORPORATION PROFITS TAX, by Roger N. Carter. *Gee & Company,* London. 138 pp.

Part of this book is taken from the author's larger work, *Guide to Income-tax Practice,* and it includes the new tax of 1920 on corporation profits. The purpose is to bring the practice and procedure up to date in view of the changes in the laws in the annual finance acts, and we assume the author also refers to the constructions placed on obscure or ambiguous clauses of the laws by the courts. Most of the contents are citations from court decisions.

Of course, the book is mainly for English accountants, but it will be useful to American firms with foreign offices, and also it should be valuable in furnishing citations from English decisions in cases arising under our own excess-profits-tax laws which are very similar to the English.

Full sections of the acts relating to the excess-profits duty and corporation-profits tax are given, and there is a good index.

W. H. Lawton.

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