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By Earl A. Saliers

Electric railway men have numerous problems pressing upon them for solution, and more should not be added unnecessarily. The increased price of all that enters into cost of service is probably permanent. Price levels are higher because money is more abundant. Those who have been unable correspondingly to increase revenues are seriously handicapped. We may feel that present evils are sufficient and that to look into the future is courting trouble. But it is always best to plan a lasting success, and doing so requires sound business foresight.

The events of the future are at best uncertain, but not altogether so. Economic events follow each other in a kind of rhythm. We know this from observation of past events. We know that periods of prosperity are followed by periods of depression; that during the past one hundred and fifty years these manifestations have seemed to obey a kind of law comparable to the swing of a pendulum; and that their recurrence has continued under changing conditions of government and finance. Many explanations have been suggested by students. W. S. Jevons, the well-known English economist, attempted to show that a certain relationship exists between these depressions and the spots on the sun, which pass through cycles of ten or eleven years, reaching the points of maximum and minimum density within each cycle. Professor H. L. Moore of Columbia University has written a book on economic

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cycles in which he attempts to show the connection between rainfall and prosperity.

At any rate, the fact remains that the business world passes through cycles marked by alternate periods of activity and depression. The theories which ascribe mathematical precision have, I think, been largely discredited by facts. As more accurate statistics are now compiled of the output of mines, factories and farms, also of foreign trade and credit, we may expect these to yield information to the future inquirer.

Most of us can recall the hard times of 1893-1896, and the disturbances following the outbreak of the European war are fresh in mind. Financial history describes similar and earlier troubles, such as the depressions which followed the panics of 1873 and 1837. Nevertheless business depressions are distinctly modern phenomena. Before the organization of business on the modern scale, there occurred extremes of scarcity and sometimes starvation in certain communities because of failure of local harvests, but these misfortunes bore none of the earmarks of business depressions. They resulted from failures in production due to natural causes. But the world is now unified—a great mart wherein occur interchanges of commodities between most distant parts. Harvest failures in one section are counterbalanced by successes elsewhere. The average productivity of the world does not vary greatly from year to year. Much of the raw material of industry is produced independent of the seasons. This is true of mineral and forest products, which alone constitute more than 60 per cent of the freight tonnage of railroads in the United States. In the organization of business, not in any known natural phenomena, do we find the best explanation of business depressions.

To consider in detail the causes to which these depressions have been attributed would be to fill a volume. Under the supervision of Carroll D. Wright, an investigation of the alleged causes of industrial depressions was carried out and the results were published in the first annual report of the commissioner of labor in 1886. So many possible causes of depressions were recorded therein that one writer has suggested that an attempt to find the true causes among such a number would be like hunting for a needle in a haystack. About one hundred were listed. Many of these can be eliminated, however, by a process of selection and the really important possible causes of depressions will be found to number not more than twenty, of which some of the most important are inflation, want of confidence, uneven production, extravagance and unemployment. I think that effect is often confused with cause. Thus it is conceivable that unemployment as a result might be mistaken as a cause of depressions.

Fortunately, however, we accountants can leave to the economists the further discussion of the causes of depressions, for we are more interested in the fact that they do occur than in their more or less remote origins. It is for us to do what we can to diminish the evil effects of depressions. By being beforehand we may help to diminish their severity and the spread of a knowledge of accounting principles will be a potent preventive of financial disturbance. But should the possibility of future business depressions influence our policies to any great degree? If so, are we to adopt distinct measures or merely shift our general policy to a somewhat more conservative basis?

Radical plans and revolutionary suggestions I shall not offer. The accountant's duties are constructive; nevertheless he is limited by existing conditions to more or less fixed methods of procedure.

The first noticeable effect of a depression on manufacturers is a falling off in orders; on transportation companies, a decline in revenues. This means less money with which to meet fixed charges, pay wages, make replacements of wornout machinery and disburse dividends. Retrenchment becomes necessary and the form which it takes determines whether or not the enterprise has good staying power. Some obligations must be met to avoid foreclosure and upon the payment of others current operations depend. There are also certain classes of repairs which cannot long be deferred without reducing the efficiency of the service.

A large proportion of the investment in electric railways is in the form of fixed assets. The term fixed assets is a misnomer, however, except in case of land which is for most purposes really a fixed asset. Many so-called fixed assets are wasting assets, differing, however, from materials currently consumed, such as fuel, oil, etc., in that they last a relatively long time and serve for the same purpose hundreds or even thousands of times. Now this investment in cars, track, buildings, etc., enters into the cost of service which an electric railway performs quite as truly as do wages paid to conductors, motormen and laborers or as does the money paid for coal used to generate power. But it differs from the investment in inventories of supplies and from wages, salaries and repairs, in that it is replacement, and consequently the actual disbursement of cash takes place at infrequent intervals. The length of these intervals corresponds to the useful lives of the assets. If, for example, steel rails will last thirty years, that part of the cost of service represented by the wear and tear of steel rails need give rise to cash disbursements only at the end of a thirty-year period. Much capital is so invested that replacements are necessary only after twenty or thirty years.

What I desire to emphasize is that, when funds have been tied up in constructions of permanent character, the wear and tear resulting from their use in giving service is an element in the cost of that service and should be reimbursed to the company in current charges for service. If this is not done the company will fail in the long run.

Assume the case of an electric railway corporation which constructs its plant at a cost of $10,000,000, this amount being spent to purchase rails, rolling stock, etc., which, let us further assume, have an average normal useful life of ten years. Of course in practice the replacement of the entire plant will not be made wholesale but piecemeal; yet this fact does not affect the general proposition that, on an average, in ten years the cost of the fixed assets is wholly consumed in giving service. There enters into cost of service each year about $1,000,000 of expense which is liable to be neglected in fixing a fair charge for that service, for the reason that it may be omitted for several years and the company will have enough revenue to meet current obligations nevertheless. I appreciate the practical difficulty of establishing an equitable charge, but that does not affect the principle at stake.

Carrying our illustration to its logical conclusion, let us assume that five years pass during which enough revenue is obtained each year to pay current obligations. No attention, however, is given to the fact that one-half of the average useful life of the fixed assets is past, except in so far as occasional renewals have become necessary. I contend that in failing to make a charge sufficient to cover not only current expenses but also the exhaustion of capital invested in fixed assets, the company has made a gratuity to the public in the form of service below cost; that this policy leads toward bankruptcy; and that it should be avoided, if possible, by making adequate charges from the beginning. If ten years pass before any charge is made for use of plant, it may be difficult to explain why rates should be increased although the increase is wholly justifiable.

One thing should be noted, namely, that to get back from the public during the next ten years what was given them during the first ten and at the same time make necessary replacements, the company will be compelled to charge twice the normal cost resulting from wear and tear on its plant; for, since it neglected in each year of the first ten to charge $1,000,000 for use of plant—a charge to which it was wholly entitled—it should with propriety be permitted to charge $2,000,000 each year for the next ten. This illustration may be extreme in its neglect of details, but it proves that nobody can be prosperous on an annual deficit.

I need not be specific about what should be done with the money collected each year of the ten when an adequate charge is made. That is a matter of practical finance to be determined by circumstances. If it is neither distributed as dividends nor otherwise improperly used it acts as a financial bulwark and does more than any other feasible thing to place the company on a basis that will enable it to weather future business depressions.

Let us see how this works out. Experience teaches us that we should expect a considerable depression at least once in twenty years and also that the duration of severe depressions is not ordinarily more than two or three years. Since the organization of our present government no period of twenty consecutive years can be selected which does not present evidences of depression in some part thereof. Perhaps the same might be said of shorter periods of time, but of that I am not certain. Once in twenty years is often enough. When past experience shows what we may reasonably expect in the future we ought to govern our acts accordingly.

How much a depression will reduce revenues is problematical. It differs with different industries, and public utilities are in some respects more fortunate than manufacturing concerns because of the very fundamental character of the service that they perform. Nevertheless, they cannot escape altogether. Where men are unemployed they do not ride daily to and from factories; moreover, freight and express shipments are diminished. Reduced revenues result; hence reduced disbursements. What, in these circumstances, is the difference in staying power of the company which has been adequately reimbursed for all costs of service and the company which has failed to secure a return of expired investment in plant?

The answer to the question rests partly with the disposition of capital thus returned, but if it is employed legitimately the company will benefit and the particular form which the funds assume is not vital. There will exist, either in distinct form or suffused through the volume of the assets, a quantity of wealth which will afford cash or the credit to secure cash when it is needed. This is true because funds destined for the replacement of fixed assets may be deviated from that purpose for a time without evil results. It may be that a portion of such funds can be permanently turned to other purposes.

Bankers are coming to depend more and more upon certified balance-sheets, and, being conservative men, they will not grant loans unless assured that balance-sheet values are real and not merely the reflection of values now extinct. We cannot hope to prevent our balance-sheets from becoming discreditable if we do not put back into property what we take out of it. All realize this so fully that I need not explain further.

Sometimes financial depressions are preceded by panics. Panics are more intimately related to the stock and money markets than are depressions, but they spring from the same general causes—over-speculation, over-expansion and over-confidence—and when such conditions are fundamental and widespread the resulting panic is pretty certain to be followed by depression. Panics aggravate the evil results of depressions by creating an artificial emphasis on the necessity of reducing credits, thus causing greater contraction than conditions warrant. However that may be, the contraction affects liquid funds and circulating capital more than it does invested capital, because income from capital permanently invested is oftentimes fixed by contract and because it cannot be immediately withdrawn to meet pressing demands elsewhere.

The income from some invested capital may increase, but it is generally diminished, and the need for funds to supplement this reduced income is above normal at a time when those who possess funds are least inclined to make loans.

Consequently we must study the amount and character of the current assets—not as abstract sums, but in the peculiar relationship which they bear to the current liabilities. In the long run the status of the current assets may be less vital than that of the fixed assets, but when sharp turns in prosperity occur, such as accompany severe panics, great embarrassment may occur when fundamental conditions are good. The fate of many enterprises is then quickly decided. The ones to be most severely tried are those which allow an insufficient margin of safety in providing for the liquidation of their current liabilities. Exactly what constitutes an adequate margin of safety depends upon various factors—chiefly the character of the business. Men familiar with the details in a given case are better fitted than I to say whether such a margin exists or not. I merely wish to emphasize as a matter of principle the necessity of having it. The electric railway business is a fundamental and stable one; hence the cost of an adequate margin of safety should not be burdensome. The financial world suffers first, and it takes time for the effects to be transmitted to all industry, during which time some opportunity is given to forestall its worst effects.

Every business has customary lines of discount and credit. These cannot be neglected without creating trouble at a time when credit is weak and cash at a. premium. Therefore, care must be taken that in normal times there shall exist a margin of current assets over current liabilities big enough to absorb the force of any sudden contraction, because contraction is accompanied by a scarcity of new credits, and, as the word itself signifies, is an attempt to reduce old credits. There are always some enterprises on the ragged edge of solvency, and if under stress they cannot secure help they fail. The more such failures there are, the more liable are stronger concerns to be carried down. No enterprise can perish without leaving a series of consequences that, like circles in water produced by a falling stone, diminish in intensity as they flow outward, but affect a continually increasing number of other organizations. The failures of weak concerns are cumulative in effect and have two possible results. Either their effects are neutralized through the absorption of their losses in the surpluses of strong companies or the strong ones are also destroyed or weakened so much that a long period of liquidation follows and then comes reconstruction on a more conservative basis.

We must provide business shock-absorbers in the form of reservations and margins. These raise a corporation above the dead level of existence. To the extent that we do this we place ourselves in a strategic position and accomplish most through the least sacrifice. Honest statesmanship sometimes prevents war at small cost. Conservative accounting procedure may conceivably prevent panics and depressions and will at least diminish their severity.

Spread of sound accounting practice has a beneficial effect cumulative in nature. Not only are those newly converted to its use directly benefitted, but others as well, because common losses are reduced. Correct accounting practice is a real factor in lasting prosperity.

The diseases of the business world resemble those which attack the living organisms. It has been said that the difference between a man and a clock is that when the clock runs down it stops, but that a man keeps going after he runs down. We are sometimes compelled to keep going when the logical thing to do is to stop, take stock of affairs, find the trouble and apply a specific remedy. But we need not shut off the power and stop the machinery if we act promptly, any more than a man needs ordinarily to enter a sanatorium if he looks diligently to his health before he loses it. A man is overworked when the vital forces are consumed faster than they are replenished. The same is true of a corporation—it cannot undergo continuous drain on its reserve forces without damage to itself.

The steps necessary to meet business depression are those which constitute conservative policy. We will all agree that those measures which can be taken as preventives are better than makeshift cures instituted at the last moment. A system of accounts has a purpose as well as a detailed procedure. Corporations are usually organized for an indefinite period of existence, and the accountant should shape his policy to meet the demands of tomorrow. He cannot do this unless he recognizes the true character of fixed assets and how they fit into and form part of invested capital. The plan of "service at cost," already adopted in several large cities, emphasizes the necessity of determining what the elements of cost are. L. R. Nash and others have shown that service is not "at cost" unless in cost there is included an adequate charge for use of fixed assets as well as current expense.

It has been and still is the belief on the part of many that all that can be accomplished by the measures which I have been considering can be equally well accomplished through a general surplus account to which there is carried each year part or all of the annual profit. Certainly there can be no objection to a surplus account, but we must keep distinctly in mind that no real surplus ever exists so long as invested capital expired is not returned through the rates. The surplus account when properly used is distinctly an excess account into which undistributed profits are collected. Ordinarily there is nothing to prevent the distribution as dividends of the entire surplus because it is in no way related to the problem of preservation of investments. Many so-called surpluses are in reality not surpluses at all, because all proper costs are not charged and the apparent profits exceed real profits by exactly the amount by which the company understates its cost of operation. A paper surplus is a delusion and tends to create a feeling of confidence not justified by the real condition of affairs. There are too many legal and business axioms covering this point to make further emphasis necessary.

What I have said is based on the assumption that revenues are adequate. That they are not always so I am fully aware. How to make them so is a topic now widely discussed in the daily press. This, however, is a matter affected by factors quite irrelevant to the present discussion. I mention it here because I am not unaware of the difficulties that usually have to be surmounted before effective things are accomplished.