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In regard to reserves for depreciation of plant it has been argued that in times of rising prices operating expense should be charged with the expected cost of renewals, regardless of the original cost of the property, in order to maintain the plant in its physical condition and capacity as a producing agent.

It is pointed out that at such times income feels the stimulating effect of rising prices before costs do, and that therefore the increase of profits is apparent rather than real because costs must ultimately be met.

The contention is that generally speaking the purpose of reserving from profits an amount sufficient to cover depreciation is to maintain the physical plant and keep up production without drawing upon capital funds.

This argument insists that the increase in cost of replacement over original cost should not be added to capital account; that the only way to withhold from earnings sufficient to cover renewal costs is to charge operating account, and, failing in this, the only recourse is to draw upon capital funds through the issuance of new securities, presumably bonds, and that interest on these bonds will be an added expense burden upon future operations; that to do otherwise in times of rising prices constitutes a waste of capital and consequent loss of earning power and that if in the future a dollar will possess only half its present purchasing power the future stockholders should be provided with two dollars in the place of one.

For the stockholders to exercise a restraint upon extravagance and reserve a portion of their profits so newly and so easily acquired against a day of reckoning is commendable, but why should they do this under the guise of a reserve for depreciation of something that is already written off the books and from the standpoint of pure bookkeeping no longer exists? To set up a replacement reserve or even an enlargement reserve by a debit to surplus and a credit to reserve would be permissible, but it would not be correct procedure to charge it to surplus via the operating route.

When prices are seen to be rising, prudent stockholders will, of course, reserve from earnings enough for replacement needs, but this should not all be charged to operation.

To charge operating with the expected cost of renewals, if that were greater than the original cost of the property consumed in service, would have the effect (a) of creating a reserve for depreciation larger than the property depreciated, (b) of affording the company a pretext for passing along to the consumer the cost of increasing the capital investment of the company in the form of a secret reserve, (c) of tempting future stockholders to reverse the whole procedure by reappraisement of the property by a debit to plant and a credit to surplus.

If a property which cost $5,000 and is estimated to last twenty years, is written off at the rate of 10 per cent per annum for twenty years, because it is expected that it will cost $10,000 to replace it at that time, the bookkeeping effect would be to show at the end of twenty years an asset of $5,000, and a reserve for depreciation of that identical asset of $10,000. Supposing the property to have actually worn out and disappeared, its place in the balance-sheet would have been filled by some other asset, probably of a very liquid nature, which the company could convert into another piece of property of double money worth if it wished. When purchased this would be charged to reserve account and cancel it, and the balance-sheet would still show an asset of $5,000, which actually cost $10,000.

There is a distinct difference between reserves for depreciation and reserves for renewals. The latter is a broader term; and while it does connote the same idea as the former up to a point where it equals the original cost, it connotes a very different idea after that point is passed.

If reserve is credited with $10,000 and replacement charged against it, the plant value stands on the balance-sheet unchanged at $5,000.

On the other hand, if reserve for depreciation is only $5,000, and if it is charged with $5,000 and plant is also charged with $5,000 at the time of replacement, the balance-sheet showing is then $10,000. An earning of 6 per cent on the former would be but 3 per cent on the latter. It is apparent therefore that the latter position holds the stronger justification for a request for increase of rates charged to the public.

In the former case the future stockholder would be in a position to ask for a return upon an investment of $5,000, and in the latter $10,000. The status of the future stockholder in the former case is that he has fallen heir to a property worth $10,000 stated on the books at $5,000, and he would be sure to request a reappraisement on actual replacement cost values with a corresponding credit to surplus and to request an adequate return upon the full amount. This would then operate actually to reverse the entry which charged operating and credited reserve for depreciation.

If the replacement cost of such a property advanced at the rate of 5 per cent a year there would be no harm in debiting plant and crediting reserve with that amount, provided this addition to capital were not included when writing off subsequent depreciation.

A company that finds that through its reserves it has saved only enough liquid assets with which to repurchase the equivalent in money of its worn-out plant, but that to replace the equivalent physical property will require double that amount, faces the need of finding more capital either in the other savings expressed in surplus account or in the issuance of additional securities, either stock or bonds.

It must be borne in mind, however, that borrowed capital is the same as invested capital. Interest on bonds, if capital is secured that way, is not an expense burden upon operation, but a division of profits with those who furnish it.

While there remains $5,000 of the original invested capital, even though that be mere money value and not plant value, it is an error to say that the stockholders have been living on capital instead of income.

To charge operating with that part of an expected replacement cost which exceeds actual cost would be to understate actual profits and would in all probability, in the case of a public utility, give great license to those who are permitted to estimate the expected increase not only to pass on to the consumer the cost of increasing the actual invested capital but allow a return, the purchasing power of which would be the same as in the days of lower prices. To permit this would be to put the stockholders of a company, which is thus able to pass along the burden to the consumer, in a position of great advantage over those whose investments did not permit of such a change, as, for instance, the widow who owns a 6 per cent mortgage or the owner of government bonds. To deduct the amount from income instead of from profit, would also give the possessor of such shares an unfair advantage in regard to income tax, for how could the widow maintain the purchasing power of her income and avoid a tax in any similar manner?

In other words, if the dollar has fallen in value, such people would have the advantage over those who are not able arbitrarily to increase the number of dollars of their investment and thus maintain an even purchasing power.

The iniquity of rising prices lies in the unevenness with which they rise. Those who are in a position to be the first to raise their prices thereby secure an advantage over others through the increase of purchasing power which it gives them. If all people were simultaneously to raise the prices of what they sell an equal percentage, no harm would result. The demand for war materials gave to certain manufacturers the opportunity not only to sell at higher prices but to sell materials which in ordinary times would be junk.

The demand for men in the army gave to the vendors of labor the next chance. Manufacturers were compelled to bid high for labor but saved themselves by passing the burden along (with a little added for their own comfort) to the consumer. When the laborer who thus received larger wages was the consumer no harm was done—the thing simply operated to tax him to pay himself. Those who were not in a position arbitrarily to increase their prices were the ones who paid the bill. The stockholders of companies which manufactured war supplies had the advantage over all others. The artisans in such factories had the advantage over other artisans who worked for the makers of "non-essentials." The artisan had the advantage over the office clerk, the school teacher and the widow with a small income and others not in a position arbitrarily to multiply the dollars of their invested capital.