Depreciation, Renewal and Replacement Accounts

Herbert G. Stockwell

Follow this and additional works at: https://egrove.olemiss.edu/jofa

Part of the Accounting Commons

Recommended Citation
Available at: https://egrove.olemiss.edu/jofa/vol9/iss2/2

This Article is brought to you for free and open access by the Archival Digital Accounting Collection at eGrove. It has been accepted for inclusion in Journal of Accountancy by an authorized editor of eGrove. For more information, please contact egrove@olemiss.edu.
Depreciation, Renewal and Replacement Accounts.*

By Herbert G. Stockwell, C. P. A.

Probably no department of accounting has given accountants so much trouble as that indicated in a general way by the subject assigned to me. Few of us would argue against showing in some way on the books of an operating business, the estimated amount of the depreciation of the plant. Some of us might not agree with any submitted scheme for such showing, but the idea that depreciation is going on further than can be offset by current repairs is too well fixed in our minds as a fact to admit of much dispute.

Backing away from the intricacies involved from a close examination of any particular kind of plant, and taking a broad view of the subject in general, there seem to be three points which project themselves into sufficient prominence for ordinary observation.

They are:

(a) Legal requirements.
(b) Various theories.
(c) Practical difficulties.

We accountants are placed in a difficult position in not having in our profession, a court of last resort. The opinion of one prominent expert accountant may conflict with that of another in a given set of facts. While this is equally true of lawyers' opinions, should their differences become important, they will, before the controversy has proceeded far, come into a court of law where the question may be decided one way or the other. If dissatisfied with the result of the court in which their case is heard, the losing side may appeal to a higher court, but sooner or later some court of law says in effect, to one attorney, "you are right," and to the other attorney, "you are wrong."

Having no court of the last resort of our own in which to decide disputed points of accounting practice, we must turn to the decisions of the courts of law for help in doubtful cases. This is quite a natural thing for us to do, for the reason that each and all points of accounting practice, where the interests involved are

---

* A paper read at the annual meeting of the American Association of Public Accountants at Denver, October 20, 1909. Abridged by the author.
The Journal of Accountancy.

of such a nature that litigation will result, must finally be brought to the law courts for determination. While there are many different ways in which questions involving our subject might be brought up, the most ordinary cases coming before the courts are those arising out of payment of dividends. These cases are brought into courts by creditors, receivers and shareholders of corporations, and are usually for the recovery from the directors or stockholders, the amount of dividends claimed to have been unlawfully paid.

Almost all of our state legislatures have enacted in their corporation laws, requirements that dividends shall not be paid except under certain conditions. While I have not examined the statutes of every state, extracts from a few will be sufficient to show the general condition of the laws, so far as the legislatures of the various states have passed on the matter of unlawful dividends.

In the following, selected as typical cases, I have quoted only so much of the acts as show the prohibition. The penalty usually is the recovery of the amounts unlawfully paid, from the directors voting or acquiescing in the dividend.

Extracts from State Statutes.

Delaware—"No corporation created under the provisions of this act, nor the directors thereof, shall make dividends except from the surplus or net profits arising from the business. Dividends may be paid in cash or capital stock at par, but otherwise the corporation shall not divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this act, etc."

Iowa—"If the directors or any other officers or agents of any corporation shall declare and pay any dividend when such corporation is known by them to be insolvent, or any dividend, the payment of which would render it insolvent or which would diminish the amount of its capital stock, etc."

Maine—"Corporations not created for literary, benevolent, or banking purposes, shall not divide any of their corporate property, as to reduce their stock below its par value, until all debts are paid, and then only for the purpose of closing their concerns, etc."

Massachusetts—"For declaring or assenting to a dividend if
Depreciation, Renewal and Replacement Accounts.

the corporation is, or thereby is rendered, bankrupt or insolvent, to the extent of such dividend, etc."

Nevada—"The directors of every corporation created under this act shall have power, after reserving over and above its capital stock paid in, such sum, if any, as shall have been fixed by the stockholders, to declare a dividend among its stockholders of the whole of its accumulated profits, in excess of the amount so reserved, and pay the same to such stockholders on demand, etc."

New Hampshire—"No dividend shall be made, and no part of the capital stock shall be withdrawn or refunded to any of the stockholders, when the property of the corporation is insufficient, or will thereby be rendered insufficient for the payment of all its debts, etc."

New Jersey—"The directors of a corporation shall not make dividends except from its surplus, or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders or any of them, any part of the capital stock of such corporation, or reduce its capital stock, except as authorized by law, etc."

New York—"The directors of a stock corporation shall not make dividends, except from the surplus profits arising from the business of such corporation, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital of such corporation, or reduce its capital stock, except as authorized by law, etc."

North Carolina—"No corporation shall declare and pay dividends except from the surplus or net profits arising from its business, nor when its debts, whether due or not, shall exceed two-thirds of its assets, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this chapter, etc."

West Virginia—"If the board declare a dividend by which the capital of the corporation shall be diminished, etc."

An analysis of the foregoing shows that the various legislatures have not all had the same object in mind, when the statutes from which these extracts were taken were formed.

Some states seem to regard insolvency as the test by which it may be determined whether or not dividends must be withheld. Others insist that dividends shall be paid only out of net
The Journal of Accountancy.

profits. Still others prohibit the payment out of the capital stock of the company.

I recommend a careful study of the acts of the various states, as the many questions concerning "net profits," and what constitutes impairment, will probably arise in states in which little if any thought has heretofore been given to them.

The charter and by-laws of a corporation form the law of that corporation, subject, of course, to the state and national laws. Within recent years the by-laws of some corporations contain clauses to the effect that dividends shall be paid out of net profits only. In some cases the method of determining what constitutes net profits is sufficiently described, so that it is comparatively easy for the accounting officer of the corporation to frame his accounts. Examination of the charter and by-laws of each corporation should be made by public accountants in connection with the financial accounts, to see if they throw any light on the subject of deductions from income.

**Decisions of the Courts.**

The decisions of the courts in the various states are by no means uniform, and one of the most difficult things to do is to draw some general rule from the decisions. It would seem that each one was decided on its own particular set of facts. The following language, taken from Morawetz, on "Private Corporations," seems to express the general view of a large number of cases decided both in England and the United States:

In determining whether a company is entitled to pay a dividend to its shareholders, the property acquired for permanent use in carrying on business may be valued at the price actually paid for it, although it could not be sold again except at a loss. And even although the business of the company should prove less profitable than was anticipated, and the value of the whole concern, and consequently of the shares representing it, should greatly depreciate in actual value, it would not be necessary to accumulate the profits until the depreciation had been made up and the value of the shares again raised to par. All that is required is, that the whole capital originally contributed by the shareholders, shall be put into the business and kept there; that no part of it shall be taken out again, directly or indirectly, and given back to the shareholders.

While there are some cases which would seem to indicate that dividends may be declared even though the ordinary repairs have not been made to the plant, it seems to have been held by
Depreciation, Renewal and Replacement Accounts.

the majority of the court decisions that so long as the actual things constituting the capital of the corporation be not paid out to the stockholders, and ordinary repairs are made so the plant is kept in good working condition, dividends may be paid, even though depreciation has not been taken care of. These courts seem to hold the view that the original cost of the plant is represented by certain items which must be kept intact, that is, not intact so far as depreciation is concerned, but intact so far as the actual thing is concerned. In other words, so long as the plant remains as a plant, with all the different parts present, the capital is said to have remained intact. If, for instance, the capital paid in to a corporation was $500,000, and consisted at the end of any given period of $500,000, including the manufacturing plant at its original figure, good book accounts and cash, after deducting liabilities, the capital would be intact. Any gains over and above that amount would be surplus assets not forming a part of the capital. The surplus would be available for dividends.

There are, however, here and there throughout the states, cases that seem to show that the courts have taken a more critical view of the subject of the depreciation of capital. In Richardson vs. Buhl, 77 Mich. 632 (1889), the court approved of the following statement:

“That the first thing to be done by any manufacturer, who would ascertain his net earnings during the preceding year, is to take a careful inventory of what he has left, including his plant and machinery, and then make just and full allowance for all losses and shrinkages of every kind that he has suffered in his property during the year, and for all expenses of every kind, ordinary or extraordinary, that have occurred during the year; and having made such inventory, and deducted such losses and shrinkages of every kind, his net earnings will be the difference between all his investments in his business and all his expenses of every kind on the one hand, and this new inventory, with the deductions properly made, and all that he has received of every kind on the other hand; and if his books are properly kept and proper deductions made, these net earnings will finally appear on the balance sheet, to the credit of the profit-and-loss account.”

The above case seems to express in very clear language just what ought to be done by a corporation before it declares divi-
The Journal of Accountancy.

dends, but it must be remembered that this is by no means a universal rule of law. On the contrary, the majority of the decisions which I have examined seem to make clear that if the original capital remains intact, so far as the thing itself is concerned, and has not become utterly worthless by depreciation, to the extent that it is known to be practically worthless, no deduction need be made from the profits to offset the depreciation before dividends may be declared and paid. The courts view differently, in many cases, suits by creditors or receivers to recover alleged illegal dividends from applications by stockholders themselves to restrain directors from paying dividends. In the former case, it must, as a rule, be clearly shown that the directors knew or ought to have known that the capital had been seriously impaired; and in the latter case, more consideration would be given to the physical condition of the plant as to its maintenance; but as a general proposition the courts have been inclined to leave the question of propriety of dividends to the judgment of the directors.

It must be remembered, however, that considerable change in method has manifested itself in the accounting departments of various public service, industrial and manufacturing corporations during the past few years. The tendency at the present time is along the lines of more study of the subject of depreciation, and its effect upon the plant values. It seems to me that the Michigan case referred to above, although decided in 1889, expresses what will eventually be the thoughts of the courts when the subject is properly presented before them. A number of the law book text-writers under the subject of dividends seem to recognize this as the correct principle, although they are forced to state that it is not universally maintained up to the present time.

State Railroad Commissions.

Many of the states have organized commissions for the supervision of railroads and other public service corporations. Inquiry of all the states produced replies so far, showing that in Idaho, New Mexico and Maryland, no railroad commissions have been formed. The railroad commissions of the following states have issued no orders regarding depreciation, renewals or replacements: Vermont, New Jersey, New Hampshire, Massachusetts,
Depreciation, Renewal and Replacement Accounts.


From correspondence and pamphlets received from the following states it would appear that the commissions have no special orders regarding the subject, but are inclined to follow the Interstate Commerce Commission's rulings in such cases as arise before them: Oregon, Minnesota, Kansas, Iowa, Illinois, Indiana, Arkansas, Texas, Pennsylvania, Georgia, Michigan, Virginia, Ohio.

Several of the states have given the subject considerable study and have issued orders directly bearing upon the subject, to various corporations coming under their control. From the pamphlets and orders received, it would seem as though the states of New York and Wisconsin have gone into the matter further than any of the other states, while the states of Oklahoma and Nebraska have taken up the subject, but in less detail. It will be seen that there is no uniformity in legislation on this subject in the states, and in many states no attention whatever has been paid to the subject, and in others the Interstate Commerce Commission's rulings are looked to for guidance in any special cases coming before the commissions. It is interesting to examine the orders issued by the four states referred to on these particular subjects, and all those desiring to obtain a clear understanding of the subject are advised to study them.

Of course these various state railroad and public service commissions have jurisdiction only over the corporations doing business in their respective states. In most of the states in which commissions have been formed, the jurisdiction has been assumed over railroad corporations only. Others have taken into their jurisdiction, other public service corporations, but in no case, so far as I have been able to see, has the state attempted to regulate the keeping of the accounts of manufacturing corporations of any class. Corporations coming within the description of common carriers are now under the jurisdiction, for certain purposes, of the Interstate Commerce Commission.

Interstate Commerce Commission Orders.

It has been seen that many of the state commissions, either public service or simply railroad commissions, have followed the
The Journal of Accountancy.

Interstate Commerce Commission's rulings, and even where the states have created their own commissions, in many of these the regulations regarding our subject have been copied either in full or in part from the Interstate Commerce Commission's regulations. It would, therefore, seem to be of considerable importance, in a consideration of this subject as applied to common carriers, to turn to the act to regulate commerce, and see what our national government has to say regarding the accounts. The authority to require accounts to be kept in certain form is contained in Section No. 20 in the Act to Regulate Commerce, as amended June 29, 1906, and April 13, 1908. Space here is too limited to permit of a copy of this section, which has often been published.

Briefly, the Act requires the amounts of railroads to be kept in a certain way, and numerous orders have been issued by the Commission, describing the accounts to be kept. In the "Classification of Operating Expenses," third revised issue, on page No. 10, Prof. Henry C. Adams, in charge of statistics and accounts, says as follows:

"Consideration of Depreciation—A number of points have been raised by correspondents relative to depreciation, that call for the following general statements, all of which bear upon the manner in which depreciation accounts should be treated:"

"1. The question of depreciation is fundamentally a question of value, and not a question of maintaining the original capacity, or a standard of operating efficiency, or of keeping full the numbers in equipment series.

"2. The depreciation rules may be worked either on the basis of the value of individual cars and locomotives, or on the basis of the value of series of cars and locomotives. On this point accounting officers are at liberty, until advised to the contrary, to follow whichever method seems to them the more appropriate.

"3. The basis of accumulation—that is to say, the amount to which the percentage rate is applied—ought, in strict theory, to be the original cost. For the current year, however, accounting officers are at liberty to accept original cost (estimated, if not known), record value, or purchase price. The term 'record value,' should not be interpreted to mean the value of the equipment as it stands in the capital account (unless that account represents the original value of the equipment on hand), but the actual
Depreciation, Renewal and Replacement Accounts.

cost or value of all equipment, regardless of where charged when purchased; and in case purchase price be accepted as the basis of the percentage charge to depreciation, the percentage rate should be limited to the rate required to replace the price paid. A second-hand locomotive, for example, is not called upon to provide for its replacement, when abandoned, by a new locomotive. As stated above, it is values and not locomotives with which depreciation charges deal.”

“4. The application of depreciation charges for the current year and subsequent years must not be influenced by the practice of years past. In case property has been appreciated by excessive charges to operating expenses in years past, the value thus placed in the property must be regarded as a permanent undivided asset to the stockholders. On the other hand, in case property has depreciated on account of insufficient charges to operating expenses in years past, this fact must not be permitted to influence the determination of the depreciation rate for the current year.”

A number of pamphlets have been issued by the Commission which contain interesting descriptions of accounts having to do with depreciation. One contains a form for balance sheet ordered to be put in effect July 1, 1909.

The reserves in which we are at the present time interested are contained under the general heading of account No. 44, “Operating Reserves.” The general description of the account is as follows:

“This account should include the ledger balances in the reserves created to cover past depreciation of property; reserves created since July 1, 1907, by charges to operating expenses to cover accrued depreciation of equipment and of way and structures when a plan for such purpose has been adopted by the carrier; reserves created by charges to operating revenues or to operating expenses to provide for overcharge, personal injury, insurance and other claims; and similar reserves. The credits in this account should be sub-divided as follows:

(a) Reserves for replacement of property.
(b) Reserves for other purposes.

By the new orders, the distinction between aditions and betterments has been abolished. The equipment accounts are divided into two general accounts: (1) Equipment to June 30, 1907. (2) Additions and betterments since June 30, 1909. No
additions and betterments may now be charged to profit and loss or income or any special fund. All such purchases must show on the balance sheet. In order to provide for the taking out of the income account any such expenditures charged there, an account is provided in the balance sheet on the liability side No. 48—"Additions to property through income since June 30, 1907." The description of the account is as follows:

“This account should include the cost of property acquired by expenditures of appropriations from income, since June 30, 1907, whether such expenditures are for new lines or for additions and betterments of existing lines. The amount standing to the credit of this account should be included in the amount reported under account No. 1-B, "Road and Equipment since June 30, 1907."

Equipment additions and betterments should now be charged not only with additional equipment purchased, but with equipment purchased to take the place of discarded equipment. In case of such replacements, the charge to the equipment account is the excess of the cost of the new equipment over and above the cost of replacing the old equipment with that of a similar kind and quality. The cost of such replacement in kind and quality is to be charged to operating expenses, and the excess added to the equipment account.

The new orders, effective July 1, 1909, also provide that the depreciation in the former orders regarding depreciation on Way and Structure may be met by the carriers who may open an account for such purposes after obtaining authority from the Commission.

In the opinion of the officers of some of the largest railroads in the country, the Interstate Commerce Commission has made a most serious mistake in its last orders regarding additions and betterments.

According to their views, railroad equipment should be kept up to a standard of efficiency, and the expense of so doing should be charged to operating. The maintenance of the equipment necessarily includes the purchase of new equipment to take the place of that worn out. If, for instance, a railroad has in use 100,000 freight cars, it should constantly keep the full number on hand, replacing discarded cars with new cars. The cost of the new cars should be charged to operating expenses. They say that
under the new orders, a dishonest management may allow these cars to run down to the lowest possible point and then discard them. A little later on they can purchase a lot of new cars and charge the cost to "Additions and Betterments," thus capitalizing what the honest managers would treat as operating expenses. The failure to make proper repairs at the last stage of the usefulness of the old cars would in effect increase the net earnings, and the day of reckoning, which under ordinary accounting, would come when the new equipment is purchased would, under the last orders of the Commission, never arrive, because the railroads are ordered to charge the new equipment to "Additions and Betterments."

The Commission consulted with the railway accountants before issuing the orders, but it is thought that it has been led into a position from which it will have to eventually recede. It is thought that many of the railroad accounting officers see in the new orders an opportunity to show better operating results, and consequently were heartily in favor of them, while the few railroads who oppose this plan constitute the conservative element in railroad circles, wherein it is a fixed belief that the management owes it to the public, the investors and to the stockholders, to maintain the equipment intact out of earnings. Furthermore, a question of law seems to have been raised in these orders. By directing that all new equipment shall be charged to Additions and Betterments and not to operating expenses, some railroad men think that the Commission has taken a more advanced position with regard to the actual management of railroads than it can successfully maintain. The Commission can undoubtedly prescribe the form in which accounts shall be kept, but they question whether it can interfere with the management of the road to the extent of directing just what is an operating expense and just what is a capital outlay.

If the question is seriously raised, the Commission will probably answer that all of the accounts prescribed should be correctly kept. If the depreciation charge to operating is calculated correctly, the charge to operating expenses for proper maintenance will not be omitted, but will appear in the accounts at the time when the depreciation actually occurs. Furthermore, if repairs and renewals are neglected, the omission in the reports
of charges for such expenses will invite attention to the bad management. The judgment of the directors of a railway does not seem to be affected when all of the accounts are taken into consideration. The charge for depreciation may be sufficiently large to produce an operating charge ample to enable the officers to maintain the road out of earnings.

The difference between the railroads and the Commission on this point seems to be a mere question of accounts. The railroad men think that the cash outlay is the important entry and the conservatives want to charge the actual outlay to operating; while the Commission apparently regards the depreciation account as the means by which the actual maintenance of the road can best be shown in a charge to operating expenses.

From my brief inspection of the new orders it appears to me that, so far as the particular point is concerned, the Commission is more in accord with correct accounting than those opposing the orders. "Cost," if used, should mean cost and nothing in the property accounts prefixed by that word should appear but cost.

In property, whether railroad or industrial, where it is possible to adjust the book values by means of inventories and appraisements it would be best to do so and then the balance sheet would represent "present value," a condition to be desired. But surely, in cases where such appraisements are impracticable, it is better to adhere to the definite tangible ascertainable fact, "cost."

When from this amount there is deducted the accumulation of estimated depreciation found in the reserve accounts, the balance if the accounts have been honestly kept, will show the original cost less the best calculation possible to obtain of the amount of the deterioration in value of the property form the original cost.

**Taxation.**

Besides the question of payment of dividends out of capital, is the other serious question of taxation. Some taxes on plants, manufacturing, industrial, public service and others are levied upon gross receipts, others upon valuations of property, and still others, upon value of the stock according to the books. Whatever taxes are levied upon gross receipts will not be affected by
Depreciation, Renewal and Replacement Accounts.

the book valuation of plants, but taxes levied upon the valuation of stock would be largely affected by the treatment on the books of depreciation. The book value of the stock would, of course, show in the excess of the assets over the liabilities. If that excess is reduced by a proper provision for depreciation, then the book value of the stock would be reduced, and the tax would be less to that extent. If the tax is levied upon the value of the real estate and improvements, without regard for the other items, then the proper reduction of the book value should represent as nearly as possible the true value of the plant, and would naturally affect the amount of the assessment. Almost all states require corporations to make reports of some kind to the state authorities for the purpose of levying taxes, and it would seem that all corporations should pay very careful attention to the matter of depreciation, in order that their taxes may be justly levied. If the depreciation exists, it should be shown, in order that the actual value of the property may form the basis of the taxation, instead of the original cost.

Corporation Tax Act.

The subject of depreciation will become very important at the end of the present calendar year, when corporations prepare their reports to the Internal Revenue Department, under the act of Congress passed August 5, 1909. By this act, “every corporation, joint stock company or association organized for profit and having a capital stock represented by shares, shall be subject to pay annually a special excise tax equivalent to one per centum upon the entire net income over and above $5,000, received by it from all sources during such year.”

In ascertaining the net income there may be deducted, among other things, a “reasonable allowance for depreciation, if any.”

While, as I have said, no regulations have been formulated, directing that the accounts of manufacturing corporations be kept in any specified way, the wide-reaching effect of this corporation income tax should cause an immediate consideration of the question of depreciation by all corporations, excepting the small concerns whose incomes do not reach $5,000 per year.

Heretofore the matter of depreciation has been thought to be largely a matter of a private nature, concerning no one outside of the corporate management. While there are now, and have
been, many officials who have given careful consideration to this subject, they are few in numbers compared to the immense aggregate of corporations whose officials have not treated the matter as one for serious thought.

But now, since the act of August 5, as soon as the management of corporations become aware that this is a matter of dollars and cents to them, great interest will be taken, and much discussion of all the depreciation theories and traditions will be started.

Of course the first thought of officers of corporations will be that the tax is unconstitutional, and it is more than probable that an attempt will be made to upset it, the preliminary step being taken by some large corporation, in the form of a petition to the court for an injunction restraining the local deputy collector of internal revenue from collecting the tax.

The large amount of the tax that will be collectible from some of our large corporations will be sufficient to create active interest in testing the constitutionality of the act. Whatever the final disposition of the act, it will not be safe for any corporation officer to rest upon the possibility that it may not ultimately affect his corporation. Even if the act should be declared unconstitutional the collection of tax on income may be delayed only a short time. Effort is now being made to have the state legislatures authorize a change in the national constitution, in order that there may be no question regarding the power of Congress to levy taxes on incomes.

The corporation officials will naturally turn to public accountants for advice regarding depreciation, in an effort to ascertain the proper amount that should be deducted from income, and the position of many of us will be reversed from that of urging a liberal amount of depreciation, to that of counselling a conservative calculation.

Taxes are dreaded by all classes of people, and corporation taxes are sought to be reduced or avoided by many corporations, as a matter of principle.

The act just passed will effect depreciation to the extent of $10 on each $1,000, so that it is not difficult to see that a liberal amount of depreciation will be shown in the reports of all corporations at the end of this and future years.

We shall have to take the subject up in all seriousness and
Depreciation, Renewal and Replacement Accounts.

attempt to so fit ourselves that we may give good counsel. Many of us will be called upon for the first time to certify to the deprec-
iation reductions from the income account for the current calendar year, only a little over two months from the time of this meet-
ing.

Summing up the law as bearing upon depreciation, it seems that:

(a) All railroads doing an interstate business must show depreciation charges in reports to the Interstate Commerce Com-
mision.

(b) In some states public service corporations must show depreciation in their reports to the state authorities.

(c) All corporations may show depreciation as deductions from income, in their reports to the Commissioner of Internal Revenue. While this is not obligatory, it is lawful to make reasonable deductions for depreciation, and will probably be attended to quite universally.

(d) Regarding dividends, as a general rule corporations may pay dividends without providing for depreciation unless it is well known and extensive enough to constitute utter disregard of the maintenance of the property, but caution should be exercised in such payment, for the reason that when such matter is brought into court from now on, the subject of depreciation and the directors' responsibility therefor is likely to be more intelligently presented to and considered by the court.

(To be continued)