

# THE YALE LAW JOURNAL

VOLUME 59

MARCH, 1950

NUMBER 4

## THE EFFECTS OF FEDERAL POWER COMMISSION ACCOUNTING ORDERS ON DIVIDEND LEGALITY

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ACCOUNTING reform has become a prominent feature of public utility regulation.<sup>1</sup> The Federal Power Commission, probably the acknowledged leader of enforced "accounting reform," recently stated:

"The importance of proper accounting in connection with the Federal Power Commission's regulatory work cannot be over-emphasized. Accounting may be said to be the backbone of utility regulation."<sup>2</sup>

In an attempt to achieve "proper accounting" the FPC has prescribed a uniform system of accounts for public utilities and licensees subject to its jurisdiction.<sup>3</sup> Imposition of this system has led to enforced reduction in balance sheet values of utility properties.

The direct result of such reductions is reflected only in the utility's financial statements.<sup>4</sup> Indirectly, however, balance sheet write-downs and administrative findings supporting them may have far-reaching substantive effects. For instance, they may adversely affect the rate base or decrease the depreciation recoverable as an operating expense, impair a company's ability to market securities<sup>5</sup> or obtain other credit, cause a decline in the value of outstanding securities, give rise to tax consequences, or restrict dividend payments. All of these possible ramifications merit careful study. This Article, however, is

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1. Towsley, Book Review, 49 *COL. L. REV.* 147, 149 (1949) suggests that regulation of accounting has in fact given way to regulation by accounting.

2. 26 *FPC ANN. REP.* 39 (1946).

3. *FPC, UNIFORM SYSTEM OF ACCOUNTS PRESCRIBED FOR PUBLIC UTILITIES AND LICENSEES SUBJECT TO THE PROVISIONS OF THE FEDERAL POWER ACT, EFFECTIVE JANUARY 3, 1937* (1936). See 12 *FED. REG.* 8503 *et seq.* (1947) for reprint incorporating later changes.

4. It is generally conceded that scribbles, unlike earthquakes or fires, do not cause a physical change in utility properties; nor can the enforced restatement of asset values be observed by the most delicate engineering instruments.

5. For example, FPC write-downs may affect the legality of utility stock for life insurance investment. See, generally, Comment, *Statutory Regulation of Life Insurance Investment*, 57 *YALE L.J.* 1256 (1948).

limited to problems arising out of the effect of FPC accounting orders on dividend legality.

The Federal Power Act, the Public Utilities Holding Company Act<sup>6</sup> and many state statutes<sup>7</sup> require, in effect, that permissible dividends be measured by surplus, *i.e.*, an amount equal to the total assets minus the sum of the liabilities and legal capital. Where one of these statutes is applicable, a write-off of asset values with no concomitant reduction in liabilities or capital stock, *i.e.*, a write-off against surplus, would reduce legally permissible dividends. FPC accounting orders often call for a revaluation of assets in this way. Since there is no *logical* bar to valuing assets by one method for FPC accounting purposes and by a different method for a determination of dividend legality, the issue is sharply presented as to whether the assets and surplus as reduced by the FPC, rather than the former higher values, will be taken as the dividend yardstick.

#### SUMMARY OF FPC ACCOUNTING PRACTICE

The Federal Power Commission's jurisdiction over accounting stems from Section 301 of the Federal Power Act<sup>8</sup> which provides that:

"Every licensee and public utility shall . . . keep . . . such accounts . . . as the Commission may . . . prescribe. . . . Provided, however, that nothing in this act shall relieve any public utility from keeping any accounts . . . which . . . may be required . . . under authority of the laws of any State. The Commission may prescribe a system of accounts to be kept by licensees and public utilities and may classify such licensees and public utilities and prescribe a system of accounts for each class. The Commission, after notice and opportunity for hearing, may determine by order the accounts in which particular outlays and receipts shall be entered, charged, or credited."

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6. Federal Power Act of 1935, § 305, 49 STAT. 856 (1935), 16 U.S.C. § 825d (1946) and Public Utility Holding Company Act, § 12(c), 49 STAT. 823 (1935), 15 U.S.C. § 791(c) (1946). The former applies only to public utilities, licensees being specifically omitted. (See notes 9 and 10 *infra*). See H. R. REP. No. 1903, 74th Cong., 1st Sess. 75 (1934). The latter encompasses utilities subject to the Holding Company Act. It is important to give § 305 of the Power Act operational significance because as § 11 proceedings under the Holding Company Act go forward, the SEC loses jurisdiction over many operating utilities. 13 SEC ANN. REP. 88 (1947); 27 FPC ANN. REP. 10 (1947).

7. It would seem to make little difference whether or not the federal and state law are identical, since dividend payments would presumably be restricted by the most stringent statute.

8. Part I of the Power Act was amended and Parts II and III added by Title II of the Public Utility Act of 1935, of which Title I is the Public Utility Holding Company Act. Under these statutes the FPC and SEC administer a comprehensive scheme of federal regulation over certain utility holding and operating companies.

For utilities also subject to the jurisdiction of the Securities Exchange Commission under the Public Utilities Holding Company Act, Section 301 has become operative only by virtue of Rule U-27 promulgated by the SEC. Section 318 of the Power Act provides that in case of joint jurisdiction of the SEC and FPC with respect to the method of keeping accounts, the SEC's jurisdiction, if exercised, is superior. By Rule U-27, the SEC has specifically exempted utilities from its own accounting jurisdiction where accounts are prescribed by the FPC or a state agency.

Pursuant to the authority thus granted, the FPC has prescribed for both licensees<sup>9</sup> and utilities<sup>10</sup> a uniform system of accounts. The noteworthy and most widely commented on feature of this system is its incorporation of the "original cost" concept of valuation,<sup>11</sup> which dictates, in general, that utilities should be permitted to show assets at no higher a dollar figure than the original cost to the first person

9. Part I of the Power Act relates to licensees including persons, municipalities and states required by § 23 to secure a license from the FPC. This encompasses, broadly speaking, hydroelectric generators on navigable interstate waterways or power developed on public lands and reservations. By § 4 the FPC is empowered to determine the "actual legitimate original cost of and the net investment in a licensed project." Net investment, defined in § 3(13), is more than a bookkeeping concept and is geared to operative provisions of the Act: It furnishes the basis for recapture price should the United States at the expiration of the license period exercise the right granted by § 14; it provides the basis under § 10(d) for the computation of excess earnings, a specified portion of which after 20 years of operation must be set aside in amortization reserves which in effect represent the government's equity in the licensed project; net investment by § 20 is the criterion for rate regulation subject to FPC jurisdiction.

In matters of rate regulation the FPC is subsidiary to state agencies: By § 19 intrastate rates may be fixed only when and so long as there is no local regulatory agency. Interstate rates are subject to FPC jurisdiction as provided in § 20 only when the state or states concerned have no regulatory agency or are unable to agree on rates through their properly constituted authority. Sections 19 and 20 refer to licensees, and FPC rate jurisdiction is expanded in Parts II and III of the Power Act which are concerned with licensees and "public utilities" as therein defined.

10. Part II of the Power Act relates to public utilities. Section 201(e) defines a public utility to mean any person except a governmental unit, who owns or operates facilities subject to the jurisdiction of the FPC under Part II. This jurisdiction extends to transmission of electric energy in interstate commerce and sale of electric energy at wholesale in interstate commerce. The Commission has power to set rates for sales of electricity within its jurisdiction, *i.e.*, sales at wholesale in interstate commerce. In addition the FPC may ascertain the "actual legitimate cost" of the property of every public utility. However, the pattern of federal regulation is in many ways subordinate to that of the states, as is explained in § 201(a) and illustrated by provisions giving the FPC jurisdiction over security issues only where there is no appropriate state agency.

11. The best and most dispassionate commentary is Kripke, *A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107*, 57 *HARV. L. REV.* 433, 693 (1944).

devoting the property to public service.<sup>12</sup> The difference between (1) what the accounting utility paid, or the par value of securities it issued for the asset and (2) original cost<sup>13</sup> is held to be an "inflation" or "intangible" and written-off.

In accommodating to the original cost concept, the FPC system uses chiefly three specialized accounts. Account 100.1, Electric Plant in Service, shows the original cost of electric plant.<sup>14</sup> Account 100.5, Electric Plant Acquisition Adjustments, shows, generally speaking, the amounts by which arms-length purchase price exceeded original cost. Account 107, Electric Plant Adjustments, is reserved for more illegitimate items representing a write-up or inflation. Together accounts 100.5 and 107 reflect the excess over original cost. While the line between these accounts may be shadowy,<sup>15</sup> a simple example may illustrate the distinction between the two accounts. Assume Parent Company in an arms-length transaction paid Vendee Utility \$800,000 for property which originally cost Vendor \$700,000 at the time of its dedication to public service. Parent subsequently transfers the property to Operating Subsidiary in exchange for securities with a par value of \$1,000,000, and the property is carried on Operating Subsidiary's books at \$1,000,000. In a reclassification of Subsidiary's Accounts the original cost of the property (Account 100.1) would appear as \$700,000; Account 100.5 would show \$100,000 and Account 107 would carry \$200,000.

Amortization policy with respect to adjustment accounts 100.5 and 107 is reported by the FPC to be as follows:

"Amounts classified . . . [in Account 100.5] may be disposed of by the companies through charges to earned surplus, or amortized over a reasonable period of years . . . to income. Amortization periods prescribed by the Commission have varied from one to fifteen years depending upon the fact of each case. Amortization charges are usually made to Account 537, Miscellaneous Amortization, although in a few instances Account 271, Earned Surplus, has been used upon the request of utilities. The disposition of write-

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12. In view of the clear statutory mandate and the well settled line of cases upholding prescribed uniform accounting for utilities, *e.g.*, *American Tel. & Tel. Co. v. United States*, 299 U.S. 232 (1936); *Norfolk & Western Ry. v. United States*, 287 U.S. 134 (1932), the Supreme Court had little difficulty sustaining the FPC accounting system, as such, *Northwestern Electric Co. v. FPC*, 321 U.S. 119 (1944), particularly since the doctrine of original cost as an accounting concept had received express judicial sanction in the *American Telephone & Telegraph* case.

13. Critics of "original" cost often term it "aboriginal" cost. See, *e.g.*, NASH, *THE ANATOMY OF DEPRECIATION* (1947).

14. Several other accounts also show original cost, but, for present purposes, are neglected.

15. See Kripke, *supra* note 11, at 693-703.

ups, etc., called electric plant adjustments [Account 107], has largely been affected by charges to earned or capital surplus."<sup>16</sup>

The FPC uniform system has been in operation for over a decade. Of the 195 reports examined by the FPC up to April 30, 1948, the amounts classified in Accounts 100.5 and 107 represented 21% of total utility plant and 27% over its original cost. Of the excess over original cost, the FPC classified two-thirds to Account 107 and the remainder to Account 100.5.<sup>17</sup> Thus under FPC accounting orders, more than 20% of former book carrying values of utility plants have been written-off against surplus. Furthermore, there are indications that the FPC will next focus attention on the utilities' depreciation policies,<sup>18</sup> and it is not unlikely that the equivalent of further write-downs will occur where depreciation reserves are found to be inadequate.

#### ASSET WRITEDOWNS AND DIVIDEND LEGALITY

##### *The Decisional Law*

The most authoritative pronouncement to date relating to the effect of FPC ordered write-offs on dividend legality is in *Northwestern Electric Company v. FPC*.<sup>19</sup> Shortly after its organization under Washington law in 1911, Northwestern issued all of its \$10,000,000 par value common stock to its promoters, charging "Land and Water Rights" and crediting "Common Capital Stock" on its books for \$10,000,000. In 1925 the American Power & Light Company purchased all of Northwestern's outstanding common stock for \$5,000,000. A year later Northwestern's assets were restated to reflect their purported fair value. A write-off of \$6,500,000 was made against reduction surplus arising when the par value of common stock was reduced from \$10,000,000 to \$3,500,000.<sup>20</sup>

In 1935 Northwestern became subject to FPC jurisdiction and was required to conform its accounts to the prescribed uniform system. The FPC had little difficulty finding a \$3,500,000 write-up on Northwestern's books representing the unwritten-off portion of the \$10,000,-

16. 27 FPC ANN. REP. 82 (1947).

17. MOODY'S PUBLIC UTILITIES a-14 (1948).

18. Cf. MOODY'S PUBLIC UTILITIES a-14 (1947); 27 FPC ANN. REP. 25 (1947).

19. 321 U.S. 119 (1944).

20. The restatement of Northwestern's assets was made pursuant to authority granted by the regulatory agencies of Washington and Oregon. The Oregon regulatory agency had not included any part of the \$10,000,000 in Northwestern's rate base. *Northwestern Electric Co.*, 3 P.U.R. (N.S.) 1 (Oregon Public Utilities Comm'r 1934). In approving the reduction of capital, the state regulatory agencies of both Oregon and Washington expressly stipulated that this was not recognition that the \$3,500,000 represented value. Transcript of Record pp. 580-1, *Northwestern Electric Co. v. United States*, 321 U.S. 119 (1944).

000 which originally had been entered shortly after Northwestern's organization. The \$3,500,000 was ordered transferred to Account 107, Electric Plant Adjustments. Amortization of Account 107 presented a knotty problem: the entire common stock equity was only \$4,500,000, \$3,500,000 of which represented par value stock and about \$1,000,000 earned surplus.<sup>21</sup> At the time, \$5,000,000 of preferred stock was outstanding, and most of the surplus was restricted against preferred dividend payments by a prior SEC order.<sup>22</sup> Moreover, the FPC felt that future dividend rights of the publicly-held preferred stock should be protected. These considerations led to an amortization order which required the company to apply its net income above preferred dividend requirements to writing off the \$3,500,000 in Account 107. The reasons for this order are given in the following extracts from the FPC opinions:

"Considering all relevant factors, we find that it is in the interest of consumers, investors, and the public to direct the disposition of the \$3,500,000 write-up by requiring the company to apply all net income above preferred stock dividend requirements to the disposition of the \$3,500,000 in Account 107. This disposition, assuming adequate earnings, is the equivalent of obtaining ultimately from the holders of common stock (the holding company) a consideration of \$3,500,000 worth of stock. Certainly dividends should not be paid on the common stock until it has the equivalent of a paid-in value."<sup>23</sup>

On rehearing:

"We were cognizant of the fact that the preferred stockholders had paid some \$4,800,000 into the company (in contrast to the common stockholders who had paid nothing into the company for the common stock) and some means, if possible, should be found to protect their interests. Our order, in effect, contemplates a charge, or series of charges, to earned surplus over a period of years in the future and thus avoids the creation of a present deficit."<sup>24</sup>

The FPC ruling was appealed to the Court of Appeals for the Ninth Circuit.<sup>25</sup> Northwestern contended that the FPC order deprived its common stockholder, American Power and Light Company, of dividends, hence property, without due process of law. Since the Northwestern common was not to receive dividends, it was inevitable that its market price would decline. The court might have ignored this argument, resting its decision on the ground that a stockholder is not entitled to dividends until declared, and therefore loses no property

21. MOODY'S PUBLIC UTILITIES 1840 (1941).

22. In the Matter of Northwestern Electric Co., 6 S.E.C. 57 (1939).

23. Northwestern Electric Co., 36 P.U.R. (N.S.) 202, 218 (FPC 1940).

24. Northwestern Electric Co., 43 P.U.R. (N.S.) 148, 151 (FPC 1942).

25. Northwestern Electric Co. v. FPC, 134 F.2d 740 (9th Cir. 1943).

by a dividend restriction. But the court chose to face the issue and upheld the order on the ground that it was reasonable as an accounting order *per se*, and could not be disturbed because of any indirect consequences it might have.<sup>26</sup> The court did not hold that the FPC order necessarily operated to restrict corporate dividends. It would only have this effect if state or federal regulatory authorities made FPC accounting procedures controlling for the purpose of determining dividend legality.

Northwestern had also attacked the legality of preferred stock dividends, presumably for the purpose of discrediting the amortization method adopted by the FPC. If the FPC was correct in its finding that the \$3,500,000 transferred to Account 107 was a write-up representing no value, argued Northwestern, then Northwestern's capital was impaired since the aggregate of assets, excluding the \$3,500,000, was less than the liabilities and capital stock. Under Washington law, which employs the capital impairment test, no dividend was permissible under these circumstances. Hence a preferred stock dividend could not legally be paid,<sup>27</sup> and the FPC's method was improper in so far as it provided for a payment to preferred stockholders while Account 107 had a balance of \$3,500,000.

The court ruled, however, that for purposes of the state dividend statute the FPC accounts might not be controlling and it was possible that assets might be taken at "fair value" (including the \$3,500,000) rather than "original cost" (excluding the \$3,500,000). However, the state courts might accept the FPC valuations without accepting the FPC declaration that those valuations should not operate to restrict preferred dividends. Then Northwestern would be precluded from declaring such dividends. But unless the state took such a position the FPC accounting determination and order had no effect on the legality of the preferred stock dividend.

Northwestern appealed to the Supreme Court contending that the order was in excess of the Commission's statutory power and in violation of the Fifth and Tenth Amendments. Its principal arguments were:

- (1) that the Commission was attempting to destroy substantive rights through the dogmatic application of its accounting principles;
- (2) that the order was substantially equivalent to a judgment against the present owner of Northwestern's common stock upon an unpaid stock subscription to a previous owner—a judicial question to be determined by the courts and laws of Washington. The determination of

26. This holding was based on the authority of *Kansas City Ry. v. United States*, 231 U.S. 423 (1913).

27. In spite of this contention, Northwestern had in fact continued to pay dividends on preferred stock. *MOODY'S PUBLIC UTILITIES* 156 (1945).

rights among shareholders was beyond the FPC accounting jurisdiction and rests with state law.

It also renewed its argument that the Commission's allowance of preferred stock dividend payments tacitly recognized that Northwestern's capital structure was not impaired.

It will be recalled that the FPC in its two opinions explained that the factor leading to the adoption of the particular method of write-off finally selected was the desire to protect the publicly-held preferred while forcing the common, which had contributed nothing, to "pay in" \$3,500,000 before it would receive any dividends. In its briefs in the *Northwestern* case, the FPC, perhaps with an eye on the court of appeals decision, argued that the order did not pertain to dividends at all. Contrast the above quoted excerpts from its two opinions with the following statements in its briefs:

"The corrective accounting prescribed by the Commission does not alter the company's existing capitalization and is in no way analogous to a corporate reorganization . . . [T]he order neither requires nor prohibits the payment of dividends but merely prescribes 'the accounts in which particular outlays and receipts shall be entered, charged, or credited.' " <sup>28</sup>

". . . [T]he order of the Power Commission did not purport to control the payment or non-payment of dividends. . . ." <sup>29</sup>

"Nothing in the Commission's orders directs whether or when dividends shall be paid; they leave the way open for payment of dividends if the company desires and is legally able to pay them." <sup>30</sup>

"The order of the Commission . . . does not attempt to determine or affect the status of the stock under Washington law. Its sole effect was to require that an item in the plant account found to be fictitious should be charged to surplus." <sup>31</sup>

The FPC concluded:

"The Commission has addressed itself solely to the removal of inflation from the plant accounts, a sound public utility accounting procedure, and what follows is merely one of the incidents [previously] noted by this court. . . ." <sup>32</sup>

28. Brief for Respondent in Opposition to Certiorari, p. 12.

29. *Id.* at 17.

30. Brief for Respondent, p. 61.

31. *Id.* at 66.

32. *Id.* at 72. Contrast *Arkansas Power and Light Co.*, 80 P.U.R. (N.S.) 193, 209-17 (FPC 1949).

The American Institute of Accountants also filed a brief which took no position on reversal or affirmance. It was directed solely at contesting the FPC assertion that the method prescribed for amortization of Account 107 was in accordance with "sound accounting principles." The Institute was concerned with the possibility of giving legal sanction to an accounting procedure which was probably ill-adapted to general usage in non-regulated industries.



Faced with arguments that did not meet on the basic issues, the Supreme Court in a unanimous decision upheld the order<sup>33</sup> but took an uneasy middle ground. Justice Roberts limited the issue in the case solely to the "question of proper accounting,"<sup>34</sup> and affirmed the Commission's authority to prescribe a uniform system of accounts for public utilities. The method of write-off adopted was upheld as not being arbitrary particularly since no alternative had been suggested by the company.

The Court tersely dismissed Northwestern's arguments. It stated that while the accounting method prescribed by the FPC interfered with the functions of management to some extent, such interference was "beside the point."<sup>35</sup> Whether the Court here recognized that the FPC method of amortization would prevent payment of common stock dividends, or whether it was referring merely to the fact that the accounts must show "original cost" rather than "fair value" for purposes disconnected with dividends, is not clear from the opinion.

The Court then stated that the FPC action in preventing the company from using fair valuation "takes nothing from the company or its stockholders."<sup>36</sup> Again, the Court's statement is ambiguous. It is impossible to tell whether the Court recognized that dividend restrictions must follow the FPC order but felt that the retained earnings resulting therefrom would inure to the common's ultimate benefit, or whether the Court meant that bookkeeping entries prescribed by the FPC would not affect dividend payments at all.

Finally, said the Court, "We are not called upon to make any decisions as to the ability of the company legally to declare and pay dividends."<sup>37</sup> Again questions arise: Is reference here made to the legality of preferred dividends? Or does the Court imply that common dividends may be paid notwithstanding the order, thus vitiating Northwestern's major objections as well as the moving purpose behind the FPC's prescribed method of amortization?<sup>38</sup>

33. *Northwestern Electric Co. v. FPC*, 321 U.S. 119 (1944).

34. *Id.* at 123.

35. *Id.* at 124.

36. *Ibid.*

37. 321 U.S. 119, 125.

38. The Court also stated: "Although if American had purchased the assets of Northwestern it might have been allowed to place among its assets on its own books the actual cost to it of the physical property to Northwestern, the fact is irrelevant upon the question whether Northwestern may carry a fictitious asset account representing estimated value of capital stock issued neither for money nor for property at exchange value." 321 U.S. 119, 124. One may agree that it is irrelevant as a matter of bookkeeping, but surely it is questionable whether the form in which the transaction was cast should control the substance of permissible dividend policy.

Further, said the Court, "Nothing in the statute or the order prevents Northwestern keeping other accounts if it so desires which will give information with regard to esti-

It is not surprising that the commentators have come to different conclusions as to the substantive effect of the accounting order in the *Northwestern* case. One commentator has interpreted the Supreme Court's holding as an affirmation of the FPC's power to restrict dividend payments through accounting orders.<sup>39</sup> Another has remarked that the case merely upholds "accounting requirements as a . . . scheme of notation without substantive consequences."<sup>40</sup>

*American Power & Light Co. v. SEC*,<sup>41</sup> which followed the *Northwestern* case, is of collateral importance.<sup>42</sup> The regulatory agency involved was the SEC which assumed jurisdiction under the Public Utilities Holding Company Act. The Florida Power and Light Company, conducting intrastate operations only, in a jurisdiction not prescribing an accounting system, was required by Rule U-27 of the SEC to adopt the FPC uniform system. Incompleted original cost studies indicated that about \$10,500,000 would be classifiable in Ac-

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dated present appreciated value of its assets." *Id.* at 124-5. If *Northwestern* keeps "other accounts," which set of books will control dividend payments under § 305a of the Federal Power Act? Under § 12(c) of the Holding Company Act? Under state law? Does it make any difference so long as dividends are not legal by any standard? Or should *books* (as distinct from *facts*) control dividend payments? Do they? See pages 609-12 *infra*, and *Arkansas Power and Light Co.*, *supra* note 32.

In connection with *Northwestern's* assumed freedom to keep other accounts it should be noted that under the Holding Company Act (to which *Northwestern* is subject by virtue of being a subsidiary of a registered holding company) the SEC has promulgated Rule U-28 providing that: "No registered holding company or subsidiary company thereof shall distribute to its security holders, or publish, any financial statements which are inconsistent with the book accounts of such company or financial statements filed with this Commission by, or on behalf of, such company." By Rule U-27, *Northwestern* is required to conform to the FPC system.

39. "In the [Federal Power] Commission's brief [in the *Northwestern* case] the method of disposition was presented as one which tempered sound accounting with mercy. Here again, there was perhaps an illustration of the unresponsiveness of the legal mind to accounting ideas. . . . The fact, immediately apparent to the accountant, is that the order was more punitive than an immediate charge and, indeed, the most punitive that could readily be conceived. Its effect was to prevent common-stock dividends being paid until \$3,500,000 of future surplus shall have been accumulated. An immediate charge would have required the accumulation of no more than \$2,500,000 of future surplus, since there already existed a surplus of \$1,000,000." May, *Accounting in the Light of Recent Supreme Court Decisions*, 77 J. ACCOUNTANCY 371, 372 (1944).

40. "Recent decisions like that in the *Northwestern Electric* case and the decisions therein relied on, which uphold accounting requirements as a mere scheme of notation without substantive consequences, might go far to remove these fears as to the financial consequences of an order which was limited by its terms to accounting only." Kripke, *A Case Study in the Relationship of Law and Accounting*, 57 HARV. L. REV. 433, 446 (1944).

41. 158 F.2d 771 (1st Cir. 1946).

42. Two circuit court cases following *Northwestern* affirmed FPC accounting orders on the authority of *Northwestern*, but they throw no further light on the dividend issue.

count 100.5, pending a final determination as to disposition. The SEC directed that \$700,000 be appropriated annually from earned surplus to a contingency reserve to provide for future amortization of Account 100.5. The SEC also directed that some \$1,800,000 appearing in Florida's surplus account, but really representing profits to affiliates, be deducted from Florida's earned surplus.

Both parts of the order were appealed by American Power and Light to the Court of Appeals for the First Circuit on the ground that as holder of all Florida's common stock it was being denied dividends due to the required write-offs of its subsidiary's surplus.<sup>43</sup>

In affirming the order the court gave three answers to the contention

Pacific Power and Light Co. v. FPC, 141 F.2d 602 (9th Cir. 1944) ; California Oregon Power Co. v. FPC, 150 F.2d 25 (9th Cir. 1945).

*Pacific Power and Light* presented the question whether amortization could be directed of an amount in Account 100.5. It was conceded by the Commission that the transactions giving rise to the 100.5 balance was arms-length and the payments bona fide. Accordingly it was labelled "an intangible" rather than a mere "write-up." Petitioner sought unsuccessfully to distinguish *Northwestern* on this ground. To the court, however, the question was much the same: "The present case, like that involving the Northwestern Electric Company, appears to us to present no more than a problem of proper accounting." 141 F.2d 602, 604. With this barrier hurdled, there was no difficulty in finding the order within the permissible scope of commission discretion. Pacific's objection that the elimination of intangibles from the "fundamental accounts" distorts its rate-base was dismissed with the observation that this was not a proceeding for rate-making. Furthermore the order did not prohibit the utility from keeping the now familiar "other accounts" to maintain a record of its intangibles.

The California Oregon Power Co. sought review of an FPC order directing the utility to amortize over 10 years \$800,000 includible in Account 100.5, and requiring a charge to surplus of \$600,000 representing profits to affiliates. The disposition of the 100.5 item was affirmed without discussion on the authority of *Pacific Power and Light Co.* In upholding the charge to surplus, the court analogized the licensee cases in which similar elements had been disallowed as part of "actual legitimate original cost" with concomitant accounting disposition. On the purpose and effect of FPC accounting orders (in this case for a utility) we have the following statement:

"The purpose of directing the ascertainment of legitimate cost was not merely to enable the Commission to compile and require the recording of informative data. The aim was to eliminate the padding from utility accounts. The provision has the broad purpose of protecting the public against artificially inflated investment costs on the basis of which utility companies assert the right to a return." 150 F.2d 25, 27-8.

43. The SEC first contested American's right to review, asserting that a stockholder is not a person aggrieved by an order restricting dividends. In *American Power & Light Co. v. SEC*, 143 F.2d 250 (1st Cir. 1944), the petition for review was dismissed for lack of jurisdiction since it was held that Florida, not American, was the proper party to contest the order. On appeal the Supreme Court reversed and held that American was entitled to review an order depriving it of potential dividends. 325 U.S. 385 (1945). The decision, however, is not strong authority for gaging the financial effect of accounting orders because the Court assumed, as did the briefs of both parties, that the order did operate to restrict dividends.

that the freezing of earned surplus in the contingency reserve prevented Florida from paying otherwise lawful dividends. First, said the court, the company failed to suggest any alternative source on which to draw for the contingency reserve. Second, prior years' dividends were undoubtedly enhanced by a failure to record losses properly. Finally, and somewhat ambiguously in view of the applicability of Section 12(c) of the Holding Company Act to the Florida Power & Light Company, the court said, "The state of Florida and not the SEC has jurisdiction to decide what funds are available for dividends. . . ." <sup>44</sup>

With reference to the effect on dividends of the \$1,800,000 write-off of surplus the opinion contains a like disclaimer: "[W]e are not now concerned with the legality of a dividend declaration. *Northwestern Electric Co. v. Federal Power Commission*. . . ." <sup>45</sup>

With the interpretation of *Northwestern Electric Co. v. FPC* as embracing the proposition that even SEC accounting orders do not in themselves determine dividend legality, the precise effect of prescribed accounting on dividend legality remains uncertain. The cases lead only to the conclusion that regulatory agencies may make original cost valuations for "accounting" purposes. An "accounting" purpose, however, is defined only by exclusion! It is neither a rate-base determination nor a dividend order. An "accounting" order, the cases say, is nothing more nor less than an "accounting" order.

### *The problem reconsidered*

Since the question is unsettled as to what weight the FPC accounts have with respect to the legality of dividends, it becomes relevant to make an examination of some of the factors which should influence the eventual resolution of the problem.

44. 158 F.2d 771, 784.

45. 158 F.2d 771, 785.

The court also held that the SEC could adopt original cost accounting and that the finding of probable inflation of \$10,500,000 was sufficient to support an order directing accumulation of a contingency reserve. *American*, echoing previous objections in FPC cases, contended that in application to 100.5 items, original cost accounting was so contrary to "sound accounting principles" as to be arbitrary and capricious. After a review of the accounting authorities, the court concluded: "Our analysis of the above authorities leads us to the conclusion that the substance of the objections [to original cost] relates to arbitrary dispositions of Account 100.5 regardless of value." 158 F.2d 771, 783. Since, under the FPC stipulation in *American Tel. & Tel. v. United States*, 299 U.S. 232 (1936) (quoted in full in *United States v. N.Y. Tel. & Tel. Co.*, 326 U.S. 638, 654 n.22 (1946)), which the court held binding on the SEC, arbitrary dispositions regardless of value would not be made, it was reasoned that petitioner's objection lacked substance. The opinion, however, does not attempt to give content to the words "arbitrary" and "value."

*Can the Power Act be construed to give the FPC accounts determinative weight in a dividend litigation?*

There would seem to be ample statutory mandate for an affirmative answer.<sup>46</sup> Section 301 of the Power Act gives the FPC jurisdiction to prescribe uniform accounting. Section 309 grants the Commission power to define accounting terms used in the Act. And under Section 305 it is unlawful for an officer or director to "participate in the making or paying of any dividend . . . from any funds properly includible in capital account." Moreover, one may argue by analogy from Section 302 which permits the FPC to determine rates of depreciation: Since one of the functions of depreciation accounting is the accumulation of funds, either liquid or otherwise, in advance of property retirement, it is to be assumed that the FPC must have the power to make this section operative by being able to restrict the distribution of assets to shareholders. The power to prescribe accounts would be relatively meaningless if the accountings prescribed were to have no operational significance.

*Could the conclusion logically be reached that the bookkeeping surplus appearing on the FPC accounts is the yardstick for permissible dividends?*

Within the limits of usual valuation concepts, this question must be answered in the negative. It will be remembered that in the *Northwestern* case the utility argued that once the \$3,500,000 in Account 107 was labelled inflation, even preferred stock dividends were illegal.<sup>47</sup> The company's position was that either Account 107 represented value for dividend purposes or it did not. If it did, then common dividends would be lawful; if it did not then capital was impaired and all dividends would be prohibited. In order to support what appears to be the FPC conclusion that preferred dividends are permissible while common dividends are not, one must say that Account 107 annually lost value in amount represented by that year's earnings attributable to the common. This conclusion seems difficult to justify by conventional concepts, and actually boils down to the proposition that Account 107 has a value for dividend purposes just equal to its unamortized balance for no reason other than that the books say so.

Another of the logical difficulties to be encountered in making FPC bookkeeping surplus the dividend measure is illustrated by *In re Niagara Falls Power Company*.<sup>48</sup> Can a company be in a sound dividend position at one moment and incapable of declaring a dividend

46. See *Arkansas Power and Light Co.*, 80 P.U.R. (N.S.) 193, 209-17 (FPC 1949).

47. See text accompanying note 27 *supra*.

48. SEC Holding Company Act Release No. 4911 (Feb. 28, 1944).

at the next, when only its book asset accounts—and not its physical properties—have been altered?

Niagara Falls Power Company, a licensee under the Power Act, had been directed by the FPC to eliminate about \$15,000,000 from its project account to reflect a determination of actual legitimate original cost.<sup>49</sup> The \$15,000,000 was to be written off against earned or capital surplus. Niagara had an earned surplus of \$5,000,000 but proposed to create a capital reduction surplus<sup>50</sup> sufficient to absorb the entire write-off, thus leaving earned surplus intact.

In its decision passing on the validity of this reduction, the SEC stated:

“The significant factor is the impact of the reduction of capital upon the right of the declarant to pay dividends both under State law and the provisions of Section 12(c) of the Act. . . . But for this reduction in common capital it would be necessary . . . [to retain] earnings and to use all the existing earned surplus before payment of common dividends. . . . This reduction, however, frees all further earnings for common dividends in addition to the existing earned surplus.”<sup>51</sup>

The declaration, however, was permitted to become effective because it was found not detrimental to the public interest.

The case is significant because of the SEC's flat assertion that, in absence of the capital reduction, dividends would be illegal. Prior to the FPC order and until 1942 Niagara had been paying regular dividends on common stock.<sup>52</sup> The factor intervening between 1942 and the SEC opinion was the FPC original cost determination and accounting order and this alone was deemed sufficient by the SEC to require a reduction in capital in order to permit resumption of dividends.<sup>53</sup> If as would appear to be true, the pre-1942 dividends were legal, we are forced to conclude that an FPC investigation, original cost determination, and accounting order affect dividend legality as far as the SEC is concerned. The physical properties remained unchanged; all that occurred was a substitution in method of book valuation. Dividend payment is presumably restricted the instant the FPC order becomes binding.<sup>54</sup>

49. Niagara Falls Power Co., 44 P.U.R. (N.S.) 291 (FPC 1942), *aff'd*, 137 F.2d 787 (2d Cir. 1943).

50. Par value of common stock to be reduced from \$36 million to \$21 million.

51. SEC Holding Company Act Release No. 4911, pp. 5-6 (Feb. 28, 1944).

52. MOODY'S PUBLIC UTILITIES 1321 (1946).

53. During the years 1943 and 1944 Niagara halted payment of dividends. *Ibid.*

54. While beyond the scope of this Article, it would seem that the SEC regards the FPC-prescribed accounting as “sound” and apparently bases its financial conclusions on it. See FPC Brief, Appendix D, *Northwestern Electric Co. v. FPC*, 321 U.S. 119, for

Making shifting bases of valuation operative for dividend purposes at the instant of shift, and not before, as was done in the *Northwestern* and *Niagara* cases, can best be rationalized by holding that a bookkeeping surplus, *per se*, measures the maximum legal dividend. Such a rationalization would have to be presumed on the theory that the bookkeeping surplus is the corporation's public representation of its dividend potential, and consequently the corporation is estopped from asserting a right to pay more. Thus, creditors and other interested parties may rely on a readily ascertainable figure. Consider, for example, a New York corporation showing a bookkeeping deficit. Under *Randall v. Bailey*,<sup>55</sup> if it possesses assets whose value, including unrealized appreciation, is sufficient to overcome the deficit, it may declare a dividend. But it is not unreasonable to argue that in absence of any bookkeeping adjustment to account for the appreciation, a dividend should not be permissible. This contention would be based not on grounds that it is inherently improper to increase a deficit by a dividend, but rather by reasoning that even parties having knowledge of the existing assets' values have a right to rely on the corporation's representation that it will pay no dividends. In other words, the corporation represents that it will retain a greater asset cushion than by law it must.<sup>56</sup> This precise question has never arisen because in the

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a letter to the Solicitor General from the Chairman of the SEC outlining SEC policy with respect to FPC accounting.

55. 23 N.Y.S.2d 173 (Sup. Ct. 1940), *aff'd*, 288 N.Y. 280, 43 N.E.2d 43 (1942) holding that present asset values including unrealized appreciation may be used to measure the fund for permissible dividend declarations.

56. The importance which may attach to public representations on financial statements was graphically illustrated when the certified public accounting firm of Arthur Andersen & Co. qualified their auditor's certificate in the E.I. du Pont de Nemours & Company 1943 Annual Report: "The company maintains a combined surplus, paid-in surplus, and surplus arising from revaluation of assets. In our opinion the respective amounts of these different classes of surplus should be stated separately.

"With the exception stated in the preceding paragraph, in our opinion, the accompanying consolidated balance-sheet and related statements of consolidated income and surplus present fairly the financial position of E.I. du Pont de Nemours & Company and its wholly owned subsidiary companies at December 31, 1943, and the results of their operations for the year ended that date, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year." E.I. DU PONT DE NEMOURS & COMPANY, 1943 ANNUAL REPORT, p. 32. Reprinted in 77 J. ACCOUNTANCY 333 (1941).

The 1943 du Pont report also contained a statement by the company's Committee on Audit concerning the exception in Arthur Andersen's certificate with respect to the surplus account. After reprinting the segregation proposed by the auditors and the reasons advanced therefor, the Committee on Audit concludes, "[O]ur observation has been that there does not exist sufficient uniformity or consistency of opinion among accountants with respect to the definition of the several classes into which it is suggested that surplus be divided or to the procedure which should be followed in the treatment of many

normal course of unregulated enterprise, a corporation can easily create a bookkeeping surplus by asset write-ups. The litigated cases involve an attempt to show that an existing bookkeeping surplus was in fact supported by asset values.<sup>57</sup> In the case of public utilities whose accounting is regulated, however, asset write-ups can be prevented and the corporation prohibited from changing its representation. Thus for dividend purposes, the "actual," "fair" or "real" value of assets would become immaterial, and the utilities would then be held to their enforced bookkeeping representations.

*What would be the financial consequences of using original cost  
for dividend purposes?*

Making the FPC accounts and original cost valuations controlling for dividend purposes would curtail permissible dividend payments

specific items to enable the company to make any segregation of the Surplus Account which would not be subject to question as to its accuracy.

"The amounts allocated to the respective classes of surplus by Arthur Andersen & Co. differed from those shown in a similar analysis attempted by another firm of independent public accountants who a number of years ago examined the company's accounts and certified to its financial statements.

"The committee on audit cannot accept the opinion of Arthur Andersen & Co. as being conclusive for the reason that it believes that certain of the items comprising the surplus account are not susceptible of such a segregation except on the basis of arbitrary assumptions or interpretation, and that the company can have no assurance that at some later date the accuracy of the segregation may not be questioned and if found inaccurate the company might not be deemed to have published erroneous information which had served to mislead the stockholders and the investing public.

"The company has been advised by counsel for years that, from the standpoint of dividend payments, the law of Delaware recognizes no distinction either in the status or in the availability of any separate parts of surplus. If in the future such a segregation should be required by statute or ruling of some official body, no doubt such action would be accompanied by such instructions as to procedure as will relieve the directors from the responsibility of making an arbitrary segregation.

"The company has consistently maintained the practice of describing in its annual reports the various changes in the surplus account as they occur, and we are of the opinion that such practice discloses the material facts." E.I. DU PONT DE NEMOURS & COMPANY, 1943 ANNUAL REPORT, pp. 34-5. Reprinted in 77 J. ACCOUNTANCY 334 (1944).

The 1946 du Pont report was certified by a different auditing firm. Their certificate reads in pertinent part: "The sources of surplus, as noted on the consolidated balance sheet, are 'earned, paid-in and arising from revaluation of assets,' but it has not been the practice of the Company to subdivide its surplus account. Lacking a definitive and authoritative basis upon which to predicate retrospective allocations of the various charges and credits which have been made to surplus since incorporation of the Company, we have not derived separate balances for the respective classes of surplus as of December 31, 1946," E.I. DU PONT DE NEMOURS & COMPANY, 1946 ANNUAL REPORT, p. 29.

57. *E.g.*, *Morris v. Standard Gas & Electric Co.*, 63 A.2d 577 (Del. Ch. 1949); *Berks Broadcasting Co. v. Craumer*, 356 Pa. 620, 52 A.2d 571 (1947). No case has been found where a corporation did not have a bookkeeping surplus (or apparent current earnings where permissible) at the time of a contested dividend.



and require a greater common stock investment than would be the case if conventional valuation techniques were employed. Restricting dividend payment is, in effect, a device for enforced corporate saving and results in what is conventionally labelled a "sunder" or more conservative capital structure. Stockholders supply more and creditors less of the enterprise's business capital.

As a consequence of this shift, senior securities become safer since there is a greater stock cushion to support them and absorb losses that may occur. The junior security holders do not lose their eventual claim to retained earnings since these earnings inure to the benefit of the common stock equity. What stockholders do lose is the right to withdraw funds, invest them elsewhere, and trade more heavily on the senior securities' equity.

Forced saving also bears upon the utility's position vis-a-vis the tax collector and rate-payer. A conservative financial structure with a large stock equity and low interest charges is relatively undesirable tax-wise, since bond interest is deductible in the federal income tax computation.<sup>58</sup> In unregulated enterprises the tax collector's share is sliced only from stockholder earnings. For utilities, however, the case is somewhat different since federal income taxes are normally considered an operating expense recoverable from consumers.<sup>59</sup> Thus in the case of utilities, the increased tax burden stemming from a conservative capital structure is shifted to the rate-payer.

Finally, where the SEC is conducting reorganization proceedings under Section 11 of the Public Utilities Holding Company Act, a large common stock equity in an operating subsidiary is probably desirable, since it fulfills the double purpose of protecting a subsidiary's bondholders while giving sound securities to senior claimants in the holding company.<sup>60</sup>

*Have FPC accounting orders been open to a contest on the merits? That is, have the utilities had an opportunity to litigate the prescribed accounting?*

Only a limited form of judicial review has been available to utilities contesting FPC accounting orders. The test almost universally em-

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58. INT. REV. CODE § 23(b).

59. *Georgia Ry. & Power Co. v. Georgia Ry. Comm'n*, 262 U.S. 625, 632 (1923); *Galveston Electric Co. v. Galveston*, 258 U.S. 388, 399 (1922); *Atlantic City Sewerage Co. v. Board of Public Util. Comm'rs*, 128 N.J.L. 359, 26 A.2d 71 (1942); cf. *Detroit v. Michigan Pub. Serv. Comm'n*, 308 Mich. 706, 14 N.W.2d 784 (1944). See generally Stockwell, *How Public Utility Rates are Affected by Federal War Taxes*, 22 TAXES 535 (1944).

60. For SEC interpretation of financial effects of prescribed accounting see 10 SEC ANN. REP. 99, 103-4 (1944); 12 SEC ANN. REP. 78 (1946).

ployed<sup>61</sup> is taken from *American Telephone and Telegraph Co. v. United States*,<sup>62</sup> wherein Justice Cardozo stated that in order to set aside an accounting order "[w]hat has been ordered must appear to be 'so entirely at odds with fundamental principles of correct accounting' . . . as to be the expression of a whim rather than an exercise of judgment."<sup>63</sup> When faced with conflicting expert testimony as to what is the "proper" or "best" accounting practice,<sup>64</sup> courts have chosen the easy road of affirming the accounting orders as accounting orders and nothing more. The FPC, in supporting its accounting orders, has contended that they were "merely" matters of accounting, and has thereby avoided detailed judicial review of those orders.

This is in sharp contrast with review proceedings of "actual legitimate original cost" determinations for licensees under Part I of the Federal Power Act. Such determinations have been recognized as having serious substantive consequences. For example, "actual legitimate original cost" furnishes the basis of recapture price should the United States at the expiration of the license period exercise its right to recapture the licensee's equipment. In review proceedings of "actual legitimate original cost" determinations, courts have been willing to go beneath the various transactions and examine in detail the disputed elements of cost,<sup>65</sup> because they recognize the substantive consequences

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61. *United States v. New York Tel. Co.*, 326 U.S. 638, 655 (1946); *Northwestern Electric Co. v. FPC*, 321 U.S. 119, 124 (1944); *American Power & Light Co. v. SEC*, 158 F.2d 771, 784 (1st Cir. 1946); *Pacific Power & Light Co. v. FPC*, 144 F.2d 602, 605 (9th Cir. 1945). *New England Tel. & Tel. v. United States*, 53 F. Supp. 400, 412 (D. Mass. 1943).

62. 299 U.S. 232 (1936).

63. 299 U.S. 232, 236-7.

64. The unsatisfactory nature of the "good accounting" test is dramatically illustrated where two regulatory agencies holding a joint hearing and interpreting practically identical accounting systems can come to differing conclusions as to what is "proper accounting": *Montana Power Company*, 56 P.U.R. (N.S.) 193 (Montana Power Commission 1944); same, 57 P.U.R. (N.S.) 193 (FPC 1945); same, 59 P.U.R. (N.S.) 58 (FPC 1945). See also the discussion of "accounting principles" in *Arkansas Power and Light*, 55 P.U.R. (N.S.) 129 (Ark. Dep't. of Public Util. 1944). These cases demonstrate that the motto *experto credite* is unavailing where the experts are at swords point. Moreover, and somewhat surprisingly, the experts have launched caustic *ad hominem* blasts at each other. See concurring opinion in *Montana Power Co.*, 57 P.U.R. (N.S.) 193 (FPC 1945) answered in Dohr, *Power Price Fixing*, 80 J. ACCOUNTANCY 111 (1945). For a mature resolution of the current dispute among accounting profession and regulatory agencies see Kripke, *supra* note 11, at 720-7.

65. *Pennsylvania Power and Light Co. v. FPC*, 139 F.2d 445 (3d Cir. 1943) (costs arising from transactions between affiliates; expenses of conforming to regulation); *Niagara Falls Power Co. v. FPC*, 137 F.2d 787 (2d Cir. 1943) (corporate merger as creating an additional cost); *Puget Sound Power & Light Co. v. FPC*, 137 F.2d 701 (D.C. Cir. 1943) (interest during construction; taxes during construction; contingent salaries); *Alabama Power Co. v. FPC*, 134 F.2d 602 (5th Cir. 1943) (option payments; discounts; excess land; bonuses to employees; fees to affiliates); *Alabama Power Co. v. McNinch*, 94 F.2d 601 (D.C. Cir. 1937) (asserted increased cost arising from corporate merger).

hinging on their decisions.<sup>66</sup> In the accounting cases, however, the FPC has been successfully playing the game of labels and tags.<sup>67</sup> This, of course, does not deny that these accounting orders may be quite justified and eminently sound. However, there would now seem to be a serious question of whether it is fair play to hold these innocuously styled accounting orders determinative in dividend litigation.

### Conclusions

On balance and consideration of all of the factors outlined above, it is the author's conclusion that for dividend purposes the FPC accounts should be held determinative. The public interest in uniform federal regulation of the financial activities of public utilities is sufficient to outweigh the serious objection of almost unlimited FPC discretion which has resulted from the negligible standard of judicial review. This judgment is premised on the consideration that the loss to stockholders is actually not overwhelming since it only amounts to forced reinvestment.

It should be pointed out, however, that utility *rates* are quite another matter and should not be controlled by this decision with respect to dividends. In this area FPC "original" cost accounting valuations should be scrutinized carefully by the reviewing court. Considerations of policy set forth in the now familiar *Hope* case<sup>68</sup>—that rates be set so as to yield a return which will cover operating expenses and maintain the financial integrity and credit position of the company—must supplant adherence to "sound accounting." The FPC has asserted that "original" cost figures appearing in the accounts should furnish the basis for rate making.<sup>69</sup> This may or may not be true, but until the

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66. See note 9 *supra*. A determination of "actual legitimate original cost" is a final administrative order and failure to seek timely review precludes a later contest. *Louisville Gas & Electric Co. v. FPC*, 129 F.2d 126 (6th Cir. 1942). After findings of "actual legitimate original cost" have been made, licensees have objected without success to conforming their accounts. *Louisville Gas & Electric Co. v. FPC*, *supra*; *Alabama Power Co. v. FPC*, 128 F.2d 280 (D.C. Cir. 1942); *Northern States Power Co. v. FPC*, 118 F.2d 141 (7th Cir. 1941). The "accounting" problem in the licensee cases is somewhat different because the finding of "actual legitimate original cost" furnishes a satisfactory objective basis for accounting valuations and the *American Telephone and Telegraph* test (see notes 61-3 *supra*) need not be employed. In the licensee cases prior to *Northwestern Electric Co. v. FPC*, circuit courts discussing the dividend question in dicta, however, came to seemingly opposite conclusions. *Louisville Gas and Electric Co. v. FPC*, *supra*, suggests strongly, and *Alabama Power Co. v. FPC*, *supra*, less strongly, that FPC "actual legitimate original cost" valuations are conclusive for dividend purposes, while *Alabama Power Co. v. FPC*, 134 F.2d 602 (5th Cir. 1943) deems them inconclusive.

67. See, *e.g.*, notes 28-32 *supra*.

68. *FPC v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).

69. The cases are well reviewed in Blachly & Oatman, *Actual Legitimate Cost as a Basis for Utility Regulation—The Experience of the Federal Power Commission*, 36 *Geo. L.J.* 487 (1948); see also 27 *FPC ANN. REP.* 66 (1947).

FPC is willing to litigate the accounting cases on this premise, there are strong equitable reasons for not allowing an administrative agency to do in two steps what it could not do in one. The only justification for such a procedure in the context of dividend legality is that the public interest<sup>70</sup> outweighs the relatively lesser loss to the shareholders.

#### "OFFICIAL ACCOUNTS" AND DIVIDEND LEGALITY

After the *Northwestern* case and its progeny,<sup>71</sup> it was apparent that utilities were likely to have little success in contesting the merits of FPC accounting orders. These cases made clear, too, that state jurisdiction over accounting would not oust FPC control. The courts also emphasized that utilities could keep other accounts if they wished, or if state law so required. But is there any virtue in having more than one set of books? And if more than one set is kept which should be controlling for the purpose of determining dividend legality?

Technically these questions are framed in terms of whether the FPC has jurisdiction over the "official" as distinct from other or supplementary corporate accounts.<sup>72</sup> The problem came to the fore in the *Northern States Power Company* case.<sup>73</sup> The company proposed accounting adjustments to the FPC coupled, however, with the reservation that "the accounting entries to give effect thereto, are submitted for the sole purpose of meeting the accounting requirements of Uniform System of Accounts prescribed by the Federal Power Commission as interpreted by the Commission, without recognizing or admitting the necessity or propriety of such accounting entries for any other purposes whatsoever. . . ." <sup>74</sup> The FPC approved the company's

70. The financial abuses of the holding company era are chronicled in the comprehensive Federal Trade Commission report, SEN. DOC. NO. 92, 70th Cong., 1st Sess. (1928), and the Splawn Report, H.R. REP. NO. 827, 73d Cong., 2d Sess. (1934).

71. *California Oregon Power Co. v. FPC*, 150 F.2d 25 (9th Cir. 1945); *Pacific Power & Light Co. v. FPC*, 141 F.2d 602 (9th Cir. 1944); cf. *United States v. New York Tel. Co.*, 326 U.S. 638 (1946); *American Power & Light Co. v. SEC*, 158 F.2d 771 (1st Cir. 1946).

72. The idea of "official" (or dominant, primary, and basic) corporate accounts is not altogether new. *New York Edison Co. v. Maltbie*, 244 App. Div. 685, 281 N.Y.S. 223 (1935), for example, alludes to accounts or memoranda disconnected from the books.

73. 64 P.U.R. (N.S.) 257 (FPC 1946).

74. *Id.* at 259, 260. The remainder of the reservation reads as follows:

"And such accounting entries, when made, shall not be construed as recognizing, admitting, effecting, affecting or establishing any value or values of the property of the company for rate making or any other purpose whatsoever, and are not regarded by the company as in any manner changing or affecting the value or values of such property as presently reflected on the books of the company or otherwise; and this reservation includes but is not limited to the right of the company at any time thereafter to maintain such Plant Acquisition Adjustments on its books of account for purposes other than the accounting requirements of the Federal Power Commission and to include such Plant

proposed adjustments but was firm in dealing with the reservation: "The question which may arise by reason of the language used in applicant's reservation is whether our accounting requirements control the fundamental or basic corporate books of account of a public utility or licensee." 75 After reviewing the legislative history 76 the Commission concluded that the company "is required to reflect the entries prescribed by our order herein on its fundamental corporate books of account, and we will consider any failure to do so a violation thereof." 77 The FPC thus asserted its control over the "official" books of companies under its jurisdiction.

In *Arkansas Power and Light Co. v. FPC* 78 an unsuccessful attempt was made by a utility to use the Federal Declaratory Judgment Act<sup>79</sup>

Acquisition Adjustments in the property of the company for rate-making purposes or otherwise."

75. *Id.* at 260.

76. The reasoning of the Commission in this regard is worth scrutinizing:

"A review of the legislative history of the Federal Power Act indicates clearly that Congress was fully cognizant of the fact that uniform and comprehensive accounting authority was not only desirable but a vital necessity to the effective regulation of electric utilities. It took positive steps to correct the abuses resulting from deceptive and unsound practices which were brought to light by the Federal Trade Commission's report on its investigation of the public utility industry and to prevent their recurrence.

"If public utilities and licensees are permitted to reflect in their basic corporate books of account entries at variance with those required under the Uniform System of Accounts prescribed by this Commission, or our orders issued with respect thereto, the way would be immediately opened for a return to the accounting abuses revealed by the Federal Trade Commission's investigation.

"Awareness of the foregoing fact caused Congress to provide that our accounting authority be comprehensive and extend to the basic books of accounts of public utilities and licensees. This authority is set forth specifically in § 301 of the Federal Power Act, *supra*, and is supplemented by other provisions of the act, including § 302, 16 USCA § 825a, which deals with the fixing of depreciation rates and accounting for depreciation, § 305, 16 USCA 825d, which prohibits the payment of dividends from funds includible in capital account, and the provisions of § 203, 16 USCA § 824b, dealing with consolidations and mergers. Frequently the most important question presented in consolidation and merger proceedings relates to the possibility of introducing inflation in the plants accounts and the capital structure, and this the Commission would be unable to prevent if the utility's basic corporate accounts are not kept according to its orders. In other words, if the corporate accounts in respect to the capital, surplus plant, and depreciation in particular, are not kept according to this Commission's requirements, important provisions of the Federal Power Act will be rendered nullities.

"Of course, public utilities and licensees may keep such other supplementary and memorandum accounts as well as subdivisions of the accounts prescribed in our uniform system, as may be necessary or appropriate, provided that the integrity of our uniform system, an essential element in the administration of the Federal Power Act, is not impaired." *Id.* at 261.

77. *Id.* at 261-2. *Accord*, *Arkansas Power and Light Co.*, 80 P.U.R. (N.S.) 193, 209-17 (FPC 1949).

78. 60 F. Supp. 907 (D.D.C. 1945) (complaint dismissed), *rev'd*, 156 F.2d 821 (D.C. Cir. 1946), *rev'd per curiam on other grounds*, 330 U.S. 802 (1947), on remand, 80 P.U.R. (N.S.) 193 (FPC 1949).

79. 28 U.S.C. § 400 (1946).

to determine where control of its "official" corporate accounts lay as between the FPC and Arkansas Public Service Commission. Both agencies asserted accounting jurisdiction and a conflict in "accounting principles" was almost certain. The point was never litigated because the case was finally decided on the ground that the company had not exhausted its administrative remedy. The question of jurisdiction over the "official" books, however, is not likely to be settled until it receives judicial interpretation.

In assessing this problem, the first inquiry is whether the hallmark "official" need be confined to any one set of corporate accounts. The court of appeals<sup>80</sup> in the Arkansas case clearly supports an affirmative answer:

"[A] public utility cannot keep more than one set of actual, official corporate accounts. Neither can any other corporation, for that matter. There must always be an official recording of figures to represent the *actualities* of the business, to constitute the genuine record of stewardship, the basis upon which representatives are made as to the *real* results of the utility's operations and its *true* financial condition in reports to stockholders and to the public, and in financial statements to be submitted to prospective investors to demonstrate its soundness, since any reasonable mind immediately perceives that *actual* transactions can be *truly* reflected by only one set of figures. A differing set shows only a hypothetical situation, demonstrating the distinction between what is, and what might have been." [emphasis added].<sup>81</sup>

But this conclusion, no matter how dogmatically asserted, is not persuasive. The recordation of business transactions is not analogous to an engineering measurement. Were two observers independently to place a yardstick against an object of fixed size, one reporting it to be 15 inches long, and the other finding it to be merely a foot in length, there would be justification for concluding that one or both measurements were in error. But when two accountants prepare statements reporting a different figure for net income, there is no warrant for holding that either is incorrect. This is true because while both may be attempting to measure what is often referred to as "true economic income," factors of judgment and choice among accounting conventions may and often do lead to different results.<sup>82</sup> Although it might

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80. 156 F.2d 821 (D.C. Cir. 1946), *rev'd per curiam on other grounds*, 330 U.S. 802 (1947).

81. 156 F.2d 821, 823.

82. For example, AMERICAN INSTITUTE OF ACCOUNTS RESEARCH BULLETIN No. 29, INVENTORY PRICING (July, 1947) states: "Cost for inventory purposes may be determined under any one of several assumptions as to the flow of cost factors (such as 'first-in, first-out', 'average', and 'last-in first-out'); the major objective in selecting a method should be to choose the one which, under the circumstances, most clearly reflects periodic income."

be theoretically true that "actual transactions can be truly affected by only one set of figures," there is no known way of determining this "one set of figures."

In view of this inability to reach a universally correct result, the best that can be done is to select certain data for certain purposes. There may be one computation of net income for tax purposes, another for dividend purposes and still a third for a bonus calculation. Similarly, asset valuations may differ depending on the purposes for which they are used. In this way judgments may be made and accounting conventions selected keeping in view the end to which the resultant figures will be put.<sup>83</sup> Such a process, disdained perhaps by the purist, is not intellectually offensive and at the present stage of accounting development is a practical necessity.<sup>84</sup>

Why then can the utilities not keep two or more sets of books, each "official" in its own sphere? The FPC books could be kept as the FPC directed and would be "official" for purposes of the Power Act. Any books required by the state commissions would be kept as the states required and be "official" for state regulatory purposes. This is approximately the current practice with respect to the Federal income tax. No one doubts that the records of "basis,"<sup>85</sup> although often differ-

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Selection of a different assumption as to cost flow would affect both balance sheet assets and net income. The permissible methods of inventory valuation set forth in this bulletin, it might be added, are not limited to these three nor is the area of judgment in accounting confined to inventories. See, e.g., ACCOUNTANTS' HANDBOOK 751 *et seq.* (3d ed., Paton, 1945) (differing methods of depreciation accounting); *id.* at 730 *et seq.* (treatment of absence); *id.* at 867 *et seq.* (going concern valuation); *id.* at 617 *et seq.* (accounting treatment of wasting assets); AMERICAN INSTITUTE OF ACCOUNTANTS RESEARCH BULLETIN No. 24, ACCOUNTING FOR INTANGIBLE ASSETS (Dec., 1944).

83. MAY, FINANCIAL ACCOUNTING 3, 4 (1943) after listing ten distinguishable uses of financial accounts goes on to say:

"General purpose accounts are not suitable in all of these cases; in some instances, special purpose accounts are called for. This has become increasingly recognized in respect of rate or price control and taxation, and it should also be recognized, for reasons which will be indicated later, in respect of information for new investors—or, in other words, for the prospectus—and also in some cases for the determination of the legality of a dividend. But even if these purposes are eliminated there remain at least six which are expected to be served by general purpose accounts.

"It is immediately apparent that any general purpose accounts cannot be expected to serve all the purposes equally well—indeed, if they are to be appropriate for the major use it is likely that they will not serve some other purposes even reasonably well. It becomes necessary to consider which are to be regarded as the controlling objectives, and the possibility of changes therein."

For stimulating discussion, consult Wienshienk, *Accountants and the Law*, 96 U. OF PA. L. REV. 48 (1947). This fact of course does not detract from the usefulness of published reports. In non-regulated enterprises, particularly, the independent certifying auditor will have the information available from which to prepare a report best suited to its purpose.

84. See note 82 *supra*.

85. INT. REV. CODE, §§ 113, 114.

ing from other valuations, are "official" for purposes of income tax computations. Once the ghost of universal validity is disposed of, the theoretical justification for insisting on one set of "official" accounts is gone.

The serious practical objection is that public reports containing multiple and contradictory financial statements are likely to be confusing.<sup>86</sup> Such confusion, however, is not necessarily unhealthy insofar as it emphasizes that financial facts of a public utility subject to joint state and federal regulation are indeed complex. Simplification resulting from omission of important data is at least as undesirable as the confusion stemming from a full disclosure. Furthermore, there is precedent for the publication of multiple statements in that many corporations include both individual and consolidated statements in their annual reports to shareholders.<sup>87</sup>

In the type situation illustrated by the *Arkansas* case the most sensible compromise would be to draw the statements from one set of books and use footnotes or similar devices to fill out the financial picture. This has the advantage of providing all pertinent information and calling attention to divergent accounting treatment where it exists. Whether the utility has one or more "official" set of books then becomes immaterial.

Recognition that there need be no one "official" set of books solves only the verbal problem of the *Arkansas* and *Northern States Power* cases. The basic issue within the context of dividend legality is not whether the FPC should control the "official" corporate books, but rather whether the accounts prescribed by the FPC should be "official" for dividend purposes. Manufacturing a concept of "official" corporate accounts is no more than a device for obtaining a judicial determination of the hierarchy of inconsistent and competing accounting systems. The one set of accounts securing preeminence is endowed with the characteristic of representing the "true" financial situation, while the other systems are relegated to being "merely supplementary" or "memorandum." Within the limits of this reasoning, the legality of all dividends would, perforce, be measured by the one "correct" set of accounts. Should it be desired to remove utilities from the ambit of FPC dividend regulation, Section 305 of the Power Act can effectively be emasculated by employing the concept of "official" books while

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86. The Montana Power Company, see note 64 *supra*, shows dual records; its "corporate" books conform to the Montana Power Commission system, while additional records are kept in accordance with the FPC system. MOODY'S PUBLIC UTILITIES 1170 (1947) reports both, giving prominence to the FPC accounts. The two systems show different figures for net income and earned surplus for both 1945 and 1946.

87. See, *e.g.*, Annual Reports to Stockholders of the following companies: American Tel. & Tel. (1947); Standard Oil Co. (N.J.) (1947), Consolidated Edison Co. of N.Y. (1947).



denying the FPC jurisdiction over those books. But if considerations of policy favor federal regulation of utility dividends, one need say only that the FPC accounts are "official" for all purposes of the Power Act, including Section 305, as representing the facts of valuation and income as found by the FPC.

Even if the FPC accounts are deemed "official" for purpose of dividend legality, they should not be endowed with the quality of being the exclusively "official" corporate accounts. To do so might give the FPC accounts greater substantive weight than they merit in view of the almost negligible judicial review that FPC accounting orders have received. Moreover, the Power Act contemplates joint federal and state regulation, and relegating state accounting systems to the role of "memorandum" records is logically something less than joint jurisdiction.

If this conclusion is adopted, we need decide only whether the published financial statements should be prepared from the FPC books with non-conforming explanatory data relegated to footnotes, or vice versa. This is not a momentous decision but it would seem preferable to construct the published statements themselves from the FPC books mainly because of the advantage to be gained in national uniformity and comparability.