1918

In the matter of the inquiry to determine prices for newsprint paper; Before the Federal Trade Commission, Washington, D.C., March 22, 1918: In the matter of the inquiry to determine prices for newsprint paper

United States. Federal Trade Commission

George Oliver May

BEFORE THE

FEDERAL TRADE COMMISSION

Washington, D. C., March 22, 1918

IN THE MATTER OF THE INQUIRY TO DETERMINE PRICES FOR NEWSPRINT PAPER

PRICE, WATERHOUSE & CO.

NEW YORK

BEFORE THE

FEDERAL TRADE COMMISSION

Washington, D. C., March 22, 1918

IN THE MATTER OF THE

INQUIRY TO DETERMINE PRICES FOR NEWSPRINT PAPER

PRICE, WATERHOUSE & CO.
NEW YORK

TESTIMONY BEFORE THE FEDERAL TRADE COMMISSION TO DETERMINE THE MAXIMUM SELLING PRICE OF NEWSPRINT PAPER

THE ANNEXED TESTIMONY was given before the Federal Trade Commission in a proceeding to determine the maximum selling price of newsprint paper, pursuant to an agreement which provided for the determination of the price by the Commission subject to a right of appeal to the Circuit Judges of the United States for the Second Circuit.

The Federal Trade Commission made no express findings on the questions covered by the testimony, and fixed a price on newsprint paper in carload lots of $3.10 per hundred pounds. Upon appeal the Circuit Judges fixed the maximum selling price at $3.50 per hundred pounds and in doing so made the following specific findings:

> In valuing the capital investment used in producing newsprint, prices before the present European War should be adopted.
>
> In ascertaining capital investment, *i.e.*, the present value of property actually used in paper production, we exclude timber lands whether owned or leased, also undeveloped or potential water power, *i.e.*, water rights; but include mill and town sites, terminal facilities, and improvements on or development of natural water powers, together with any investment by way of actual payment for power rights. The foregoing allowed elements of capital value are the "tangibles."
>
> A fair maximum return on said capital in a business of the hazards proven is 15% per annum.

The Judges found the depreciated present value of "tangibles" at pre-war prices to be $25,000 per ton of daily capacity and adding 10% for going value and $12,000 per ton for working capital arrived at an investment of $39,500 per ton. They applied their findings to a plant having a daily capacity of 100 tons as follows:

The capital invested is 39,500 × 100 =	$3,950,000
The fair annual return, 15% =	592,500
To be obtained by selling all of an annual production of 30,000 tons, or a profit per ton of	19.75

The testimony as printed in the record has been revised only to the extent of correcting a few obvious clerical errors in reporting.

G. O. MAY

RECALLED AS A WITNESS, HAVING BEEN PREVIOUSLY SWORN, TESTIFIED AS FOLLOWS:

Mr. Wise. Mr. May, how old are you?

Mr. May. Forty-two.

Mr. Wise. What is your occupation?

Mr. May. I am an accountant.

Mr. Wise. And how long have you been in the business of accountancy?

Mr. May. Well, including my apprenticeship, it is, let us say, 26 years, 5 years apprenticeship.

Mr. Wise. Where did you take your apprenticeship?

Mr. May. I took my apprenticeship in England in the country and then went to the office of Price Waterhouse & Company in London.

Mr. Wise. In England as a prerequisite to admission to your practice of accountancy there is a necessity for this apprenticeship?

Mr. May. Yes, sir.

Mr. Wise. You were with Price Waterhouse & Company some twenty odd years altogether?

Mr. May. Yes.

Mr. Wise. And you have been in the accounting business ever since?

Mr. May. Yes, I have been in Price Waterhouse & Company ever since.

Mr. Wise. How long have you been in this country?

Mr. May. A little over twenty years.

Mr. Wise. Always with Price Waterhouse & Company?

Mr. May. Yes.

Mr. Wise. Are you head of the firm now?

Mr. May. Yes.

Mr. Wise. Do you hold any positions now?

Mr. May. How do you mean?

Mr. Wise. For instance, in connection with the American Institute of Accountants?

Mr. May. Yes, I am Vice-President.

Mr. Wise. And you are, I believe, occupying some position with the Government at the present time?

Mr. May. Yes, I am a Treasury volunteer.

Mr. Wise. You are working for the Treasury Department?

Mr. May. Yes.

Mr. Wise. In the course of your work in accountancy, what has been the nature of the work you have had occasion to do?

Mr. May. Well, our practice is a very general practice. We have touched almost every line of work.

Mr. Wise. Have you worked for the National Government?

Mr. May. Yes, with the Postoffice Department, and have done various other things for the Government.

Mr. Wise. Have you worked for any of the State governments?

Mr. May. Yes, for several of the State governments, and cities.

Mr. Wise. Municipal governments?

Mr. May. Yes.

Mr. Wise. Have you had occasion to audit any of the accounts of the railroads of this country?

Mr. May. Well, I think, as a matter of fact, since I have been with the firm we have audited the accounts of about 35 or 40 per cent. of the railroad mileage of the North American Continent.

Mr. Wise. That includes the Dominion of Canada, the United States and Mexico?

Mr. May. Yes.

Mr. Wise. And what has been the extent of your experience in the industrial world?

Mr. May. Of course, that is the big thing of our practice. We are auditors of a lot of large corporations, like the United States Steel Corporation, but the great bulk of our business is with small manufacturing enterprises. That constitutes, the small manufacturers, as much as 40 or 50 per cent. of the total.

Mr. Wise. In your work as accountants do you have occasion to be consulted on the question of value of properties?

Mr. May. Well, we do not go into the field of valuation of properties, but we have a great deal to do with questions of value as affected by earning capacity.

Mr. Wise. Yes, and with earnings?

Mr. May. And with earnings.

Mr. Wise. Upon the value of the property?

Mr. May. Yes. We have acted for a great many people contemplating purchasing a business or selling a business, and they have frequently called on us for advice as to the wisdom of buying or selling property.

Mr. Wise. As a preliminary to that advice, I take it, you have to make an examination of the books of the properties to determine what is shown on those books?

Mr. May. Yes.

Mr. Wise. And in this work have you made a study of the question of the rate of return on invested capital?

Mr. May. The question of return on invested capital is a subject that I have given a great deal of consideration to for the last fifteen years.

Mr. Wise. As to industrial businesses?

Mr. May. Yes. Perhaps I may explain that I approached the question from an entirely different angle from Mr. Erickson.

I do not claim to have made an exhaustive study of the underlying theories that he has. My ideas are based on practical experience, and I came in from the standpoint, not originally, of rate cases or price fixing, but from an entirely different angle.

Up to about ten years ago I do not think my firm were ever engaged in a rate or price-fixing matter, and since then I do not think we have been engaged in more than one or, perhaps, two a year, and my interest in the matter has developed originally from the fact that there was a tendency to value assets, particularly mining properties, on the basis of estimating the future earnings and then discounting those values at a given rate of interest.

Now, we have always been advocates of conservatism in accounting and finance and were satisfied that people were using too low rates of return in those calculations, and, unfortunately, some of the States were supporting them—entirely for tax purposes—one of the most extreme cases being Minnesota which valued on the basis of estimating the future return, and discounting it at 4 per cent. I was convinced you could never get people to put money into any business of that kind on a 4 per cent. basis. I was originally interested in that subject largely for the purpose of convincing our clients it was not wise to establish any such theories, and later I became convinced that the same fallacy was being adopted in the regulation of rates, and I felt sure that the Commissions in fixing too low rates were flying in the face of an economic fact and going to do more harm in the long run to the public than to the railroads, and that is how I became interested in value—from this angle.

Mr. Wise. Now, in the past you have had occasion, I take it, to audit the books of a good many of the news print manufacturing concerns in this country?

Mr. May. Yes, we have done quite a number of them. More of the other paper than of news print, as a matter of fact.

Mr. Wise. In the recent past you have had occasion to make a special examination into the accounts of the companies involved in this particular proceeding, have you not?

Mr. May. Yes, we are doing that now.

Mr. Wise. And as a result of your studies in the whole field of accountancy and of your particular studies of the companies involved here, have you formed any opinion as to what is a proper rate of return upon the investment?

Mr. May. Well, to state what is a fair rate of return today is a little difficult question, and the immediate effect of war conditions is rather difficult to estimate accurately. Of course, the answer depends, in some measure, on how you value your property. If you in valuing your property take the highest point of the present costs you do not have to give the same liberality in return as you have if you take a lower level as the basis of value. Naturally the two are always linked up together, but I would say, based on pre-war conditions, a prospect of a return of 15 to 20 per cent. has always been necessary to attract capital into a business of moderate hazards. This, I would say, would certainly not be more than covered by those rates.

I think that property has to earn that in order to attract capital into the business. In saying that, I am basing it largely on my actual experience of cases where even that return has failed to attract purchasers. You would be surprised if you had seen as many cases as I have where earnings which showed approximately 15 per cent. had been turned down by people contemplating buying. I was surprised myself, because I approached it purely from the professional standpoint, earlier in my experience. I have seen so many now that I am convinced of the fact that that is so, and in recent years I have given a good deal of thought to the reasons.

I imagine Mr. Wise will want me to state some of the reasons I have for saying it, entirely from the practical standpoint of experience.

Commissioner Murdock. Let me follow that. Supposing I came to you and said, "Mr. May, I wish you would go out here to Podunk, Indiana, and look over a mill out there I want to buy." You go and look over the mill and come back and report to me and say, "They have got $100,000 in that mill supported by $10,000 earnings, but my advice is not to buy it."

Mr. May. I would say that, but I do not base so much on my advice as on the number of cases where I reported to people and they refused to buy.

Within the last sixty days I had a business in New York that was earning $100,000 a year which had between $600,000 and $700,000 of assets. Those people could not get a buyer for the property. Finally it was sold for $500,000. That is an actual case within the last sixty days. People who have not been through it do not realize it. That is why I have been concerning myself with trying to explain the phenomenon.

Commissioner Fort. Do you not consider that now that condition may be worse largely on account of the war?

Mr. May. As a matter of fact that particular plant had more opportunities during the war. During the war it will earn a great deal more than in normal conditions.

Commissioner Fort. You do not think conditions as to the uncertainty of business, owing to the war, had anything to do with it?

Mr. May. No, I do not think so.

Commissioner Murdock. As a matter of fact, the answer you would return to me in that case, Mr. May, would be this: If the facts were verified, showing it is a sure thing that there is $100,000 in that mill I have looked over, and I found this is the maximum earning for several years, but there seems to be an upward tendency in the mill and I think it is going to earn more in a few years. That is about the way you would report to me.

In other words, in surveying the property for me you would not take merely the present into your consideration, but you would take a survey of the past and just as near as you could form a survey of the future as you were able to in your report to me.

Mr. May. Of course, if I could put my finger on anything that was only earning 10 per cent. and I felt satisfied that it would earn 25 per cent. I would say, go ahead and buy it, but, of course, that is a rather different question from the proposition of fixing a maximum rate of return you are going to allow them to earn in the future.

Commissioner Murdock. I wanted to get it just as simply as possible.

Mr. May. The more questions you ask the better I will be pleased, because I do not want to leave any point that is not clear in your mind, if I can help it.

Mr. Wise. You say that 15 per cent. return is needed to attract capital into an industry of moderate hazards. What would you say of the paper industry? Does that come into the class of industrials where the hazards are moderate?

Mr. May. I would say it was an industry of moderate hazards although not one of the lowest of that group.

Mr. Wise. What would you regard as the hazards of the business?

Mr. May. Well, first of all, the uninsurable risks, and the second, which I think has regard to a large part of the industry, is the fact that it is engaged in a business in one country and selling its product largely in another country, and is, therefore, subject to the operation of the fiscal policy of the two different countries and to the elements of government control by two different governments whose interests may not always be identical; that is a distinct hazard in the business.

Then there is another equally important hazard in it, and that is the fact that it takes such a large return in proportion to the sales. If you have a business with sales of four or five times the capital you can always provide the return on capital by a reasonable percentage of the sales, and nobody would say this is an exorbitant return on your investment, but when you have to get a large percentage on your sales, people are always apt to say, "Why, half the selling price is profit, or 25 per cent. is profit; that must be too much." Whereas it is not at all necessarily so in an industry like this where the capital is large in proportion to the sales, and 20 per cent. or 25 per cent. profit on sales would not be anything like as remunerative as 2 or 3 per cent. profit is to John Wanamaker, Sears Roebuck, or Woolworth, or any of those people. Therefore, I always feel where they have to have a large investment in proportion to the sales it detracts from the attractiveness of the investment.

Mr. Wise. Well, what is the basis of your calculation for your return?

Mr. May. The investment value of the property. I noticed Mr. Erickson discusses the question to some extent from the standpoint of bonds and stocks, and, therefore, I would like to say that in my view of the case the controlling factor is the investment value, that is, the total present value of the investment, and the question whether capitalized by bonds or stocks does not enter into it in my view of the case at all.

Mr. Wise. Does it make any difference to you how many times the turnover in that business occurs in a year?

Mr. May. How do you mean?

Mr. Wise. Sales?

Mr. May. I think it does, in this way. The return must be based on the investment, but if the turnover is small, as I said, your percentage of profit to sales looks so high that there is always a tendency to cut it unduly; that is your hazard.

Mr. Wise. Are you speaking with the idea of only one turnover of capital per annum in a business?

Mr. May. In this business I suppose you do not turn over your capital once a year. Comparing the agricultural implement industry and the packing industry it is much more difficult for the agricultural implement industry to get a fair return on capital than the packers because the same rate of return would constitute something like eight or nine times the percentage of sales in the case of the agricultural implement industry that it would in the case of the packers.

Commissioner Murdock. Mr. May is speaking of the gross sales as contrasted with the capital. He is talking about the turnover.

Mr. May. Yes, the turnover. The turnover is the relation of sales to capital investment.

Commissioner Murdock. That is, the more rapid the turnover, the lower the rate of profit on the investment.

Mr. May. No, I do not say that. I say that theoretically they should be the same, but practically, because a given profit is a higher percentage of sales, you have more difficulty in getting it. That is one of the hazards of the business. That is the point I was trying to make.

Commissioner Fort. Well then, in your idea, the profit should be the same on every sale of a concern that has but one turnover per annum as the concern that has five turnovers per annum.

Mr. May. Percentage of investment.

Commisioner Fort. That may make quite a difference.

Mr. May. Of course the percentage of investment should be the same, although the percentage of sales would be much higher in the case of the company with a small turnover than the one with a big turnover.

Mr. Wise. Can you explain that any further?

Mr. May. No, I think that is all.

Mr. Wise. Now you stated, Mr. May, that as a basis of the return you take the investment regardless of how that investment is placed, whether it is in stocks, in bonds, or part in stocks and part in bonds?

Mr. May. Yes, sir.

Mr. Wise. In other words, it is no matter whether one company has a $50,000,000 and another a $5,000,000 outlay they are entitled to the same rate of return?

Mr. May. That is my feeling.

Mr. Wise. I wish you would go right ahead and explain your position here without my having to prompt you or question you at all, and testify as to your opinion for a rate of return on the basis that you have recited.

Mr. May. All right. I hope you will interrupt whenever you see fit.

In the first place, before I start to discuss reasons for the opinion I want to emphasize two points, first, that I take it what we are discussing is a maximum price and that there is no guarantee you are going to get that price, and that there is no guarantee of a minimum price. I think that is a fairly agreed upon point. In the second place, I want to emphasize the distinction between the profits that a business must earn and the profits which can be distributed to the investors in that business.

A large part of the earnings of every successful company has to be reinvested in that business, or, as Mr. Schwab put it once, a dollar for dividends and a dollar for plant, and it is curious how nearly accurate that is.

In preparing a brief for the Senate Finance Committee on the excess profits tax payment dealing with that point, I took at random forty companies, railroads, public utilities and manufacturing companies and miscellaneous companies, and when we checked all the figures back that were drawn at random it showed over a five-year period they would actually distribute in dividends almost exactly 50 per cent., within 1 per cent. of 50 per cent. of the total earnings in the five years. So if you happen to earn your 15 per cent. or 20 per cent. you won't be able to distribute year in and year out more than half of it. That is the first point.

Commissioner Murdock. Mr. May, I do not quite get that in my mind. What I would like to know is what you are feeding that 10 per cent. to. If you allow 20 per cent. to go in the business and give 10 per cent. to the stockholders, where does that other 10 per cent. go?

Mr. May. It goes to build up the business. Of course, it ultimately accrues directly or indirectly to the benefit of the stockholder. There is no doubt about that. As long as he gets only half distributed in cash he feels that the other half is going to build up the business. It may or may not. Some do get it.

Commissioner Murdock. The ordinary method, as I have observed it, is to divert that 10 per cent. which is not distributed as dividends into some reserve fund or surplus.

Mr. May. Yes, that is so, but my experience is that a man is attracted if he thinks he has a fair prospect of being able to get that 15 or 20 per cent. out of the business, half in cash and half in equities piling up for the future. That is the way he sizes it up, as far as my experience goes.

Commissioner Fort. That extra 10 per cent. is not distributed in dividends and you do not care whether it is carried in surplus or a sinking fund or put into new machinery as long as it is carried.

Mr. May. Yes.

Mr. Wise. It is a fact that it is never as such handed back to the stockholder.

Mr. May. Yes, he has got to leave it in to insure he is still going to have a cash dividend in the future.

Mr. Wise. He is simply switching his principal all the time to insure him of his return.

Mr. May. That is right. I have made some examination of the actual facts. Take the Report of the Commissioner of Corporations on the investigation of the Steel Industry. You will find that year in and year out he said that the price of $28 for steel rails was the fixed price and that it never varied for years, or that there were very slight fluctuations. That yielded a profit of 18 per cent. on the investment to the steel corporation, including 18 per cent. on the relative investment in ore properties and 18 per cent. on the relative investment in transportation facilities, taking ore properties, transportation, blast furnaces, mills, working capital, all along the line invested in turning out a ton of steel rails, that the price of $28 yielded a return of 18 per cent. on the entire capital, and yet, so far as my experience goes, nobody ever seriously questioned the fairness of the price of steel rails, and it remained unchanged for fifteen years, I suppose.

Commissioner Murdock. Of course, it has been traditional in the United States for thirty years that they sold cheaper abroad than at home.

Mr. May. That, I think, is one of the things that has often been said but has never been proven.

Then there is another report, taking the smaller companies. If you will refer to the Report of the Commissioner of Corporations on the investigation of Independent Tobacco Industry at the time it was being oppressed by the Tobacco Trust, as the report puts it. It shows for 48 independent companies—let me see, I have the exact figures here, I think—(referring to memorandum) an average profit of 15.9 per cent., and it is rather amazing to note that the Commissioner drew attention to that fact as evidence of oppression because the Tobacco Trust itself was earning 40 per cent.

Then there was another interesting thing that developed in the same connection some three or four years ago. In the course of a study of this question my firm took at random a series of records at our own offices. There were all kinds of businesses, largely small manufacturing companies, and we just took them as they came. We said to a man to go and pick out 200 reports, to take them straight out of the files, leaving out all public utilities and non-industrial concerns, pick them out and find out their capital, and we found the average of those 158 companies was 13.67 per cent. Those were accounts where we knew a proper provision had been made for salaries, depreciation and everything, so that we were dealing with reliable data, and they were just picked out at random. Those figures were published by one of my partners in the *American Economic Review,* and I will put that in, if I may, because I have something further bearing on that.

(The paper above referred to was received in evidence and marked Manufacturers' Exhibit No. 73, and is as follows:)

MANUFACTURERS' EXHIBIT NO. 73

THE AMERICAN ECONOMIC REVIEW

VOL. VI MARCH, 1916 No. 1

THE COMPARATIVE YIELD ON TRADE AND PUBLIC SERVICE INVESTMENT

What constitutes a fair return upon capital invested in a business enterprise? Recent efforts of the Interstate Commerce Commission and of the various state public service commissions to regulate rates (or more truly to regulate profits) have made this a vital question. Broadly, the answer is given that such rate of return must be allowed as will attract capital in sufficient volume to develop and maintain the particular industry. As a statement of a ruling principle this is doubtless correct, but it is not a practical answer for, What is the fair rate of return that will attract capital to the industry? It does, however, suggest the fundamental truth that the investor has a right of selection and is, therefore, the final regulator; and, though for those who have already invested, the choice has been exercised, the effect of regulation on the potential future investor is a question of paramount importance to the public.

The saving to the public which might result from reducing the limit of return on capital already invested in public utilities by, say, one or two per cent., considered by itself, is doubtless a notable sum, but it is insignificant if considered, as it should be, in relation to the value of attracting and inspiring with confidence the enormous further capital which requires yet to be invested in the extension of the facilities now established and the development of new ones if this country is to attain its full development and prosperity. So not only justice but self-interest dictates that the public should not restrict capital already invested to a rate of return too small to attract new capital.

Eventually, if rate regulation is applied consistently, experience will indicate with some measure of accuracy the rates that are adequate to attract capital to railroad and other public service securities. In the meantime, however, there is pretty sure to be much groping around with consequent damage to the public as well as to the investor. Evidence is not lacking that many investors are inclined, for the time being at least, to allow the regulating bodies to work out their experiments upon the other fellow, while they place their money either where it will be as nearly safe as may be, as in a savings bank or in high grade bonds, or invest it where it will yield a larger return than it is likely to yield if invested in enterprises subject to regulation.

Thus the question really turns upon the competition for money. And money has its law of attraction, operating as certainly as the law of gravitation. Every investor is seeking safety and return. One may attach greater value to safety, while another desires, if possible, a larger return even though attended with a somewhat higher degree of risk, thus taking the speculative or gambling chances; and much skill is displayed in devising types of securities that will appeal to the different classes of investors.

In the present uncertainty as to the maximum rate of return an investor in a public service corporation should be allowed to receive (and in passing it is important to note that it is nowhere proposed to guarantee even a minimum return), it would seem logical to inquire what return can be secured from investments in enterprises not subject to public regulation. Many attempts have been made in this direction with at best but incomplete or indifferent success. It must be remembered that there is a tendency among regulating bodies to fix a rate of return to be allowed on the amount actually invested in the business and that, substantially speaking, the intangible values, such as good-will, patents, etc., so frequently met with in industrial enterprises, and the so-called franchise and going concern values in public utility companies are to be eliminated from the capital sum upon which a company subject to regulation may earn a return. The inclusion of these intangible values, which has been almost universal until quite recent years, by both utility and industrial companies under the general heading of property or other equivalent title in corporation balance sheets, renders it impracticable to determine the rate of return upon the investment even in the case of corporations publishing reasonably full reports. Undoubtedly, the present tendency in the case of new industrial companies is to set out as a separate balance sheet item the investment in good-will or other intangible assets, but the number of instances where this is done is as yet relatively small. It is, therefore, not possible to compile from the published reports of corporations statistics that would be upon a basis permitting accurate conclusions to be drawn therefrom. In so far as these statistics are accessible, whether found in the form of corporation annual report or of prospectus issued in the flotation of securities, they show with remarkable uniformity a rate of return in excess of the maximum yet allowed in any representative case by any commission in determining rates.

It is true even of our national banks, than which no line of business is perhaps rightfully regarded as more safe. The Comptroller of the Currency reports that the net earnings upon the capital and surplus of all the national banks averaged 8.64 per cent. for the forty-five years ending June 30, 1914. In only two of the last seven years of this period have the earnings ranged below this general average, and then but slightly, while the average for the seven years is 8.98 per cent. It will be observed that this rate of earnings is upon the surplus as well as upon the capital and if it is objected that bank surpluses are frequently understated and that secret reserves commonly exist, it is sufficient to say in reply that in so far as this may be true, the profits must have been understated by an equal amount and therefore the rate of earnings stated by the Comptroller of the Currency should, if anything, be increased.

In an effort to supplement the meager data obtainable from published records, I have made a study of a number of audit reports prepared by my firm with a view to determining in each case, so far as could be done, the investment exclusive of intangible assets of the character above mentioned, the return, and the resulting rate. The reports were selected purely at random from our files, excluding only those upon enterprises subject to regulation or otherwise outside the field of inquiry, such as reports upon governmental bodies, charitable institutions and the like. It was necessary to discard a considerable proportion of the reports selected for examination principally because of their failure to disclose the measure of the intangible values included among the assets. This process of elimination, however, left 158 reports showing the amount of the investment and the profits, after payment of operating and management expenses, earned by enterprises engaged in a wide range of business activities and scattered throughout the United States. The contents of individual reports and the identity of the clients must, of course, be withheld, but certain group generalizations can be made without violation of professional confidence; and I trust they will throw some light upon the return earned by capital invested in lines of business open to competition but not subject to governmental regulation of rates or earnings.

It may be objected that an accountant's reports are likely to be confined to the more prosperous concerns and will not for this reason give a fair indication of general conditions. The premise here is correct only in part. Every important accounting firm is brought into contact, sometimes in bankruptcies and receiverships, sometimes through disputes between owners, sometimes to determine the efficiency of a management or to locate the reason for a falling off of earnings, with enterprises that are unprofitable. Even were the charge wholly true it would be relatively unimportant, inasmuch as the regulation of rates is merely an effort to limit the maximum earnings and does not concern itself with the failure of a given utility to earn that maximum.

The aggregate investment represented by the 158 audit reports was $406,829,358. This relatively small total for so large a group is attributable to the fact that reports upon the accounts of most of the very large concerns had to be set aside for reasons indicated above. The annual profits remaining for the enjoyment of this capital, after providing for all costs and expenses of operation and management, including depreciation of plant and equipment, were $55,613,659 or 13.67 per cent. The periods covered by these reports are not uniform, but in most instances the accounts are for the calendar years 1912 and 1913 or for fiscal years ending in 1913 or 1914, while in a few instances the period covered is a fiscal year ending in 1912. During this time business conditions have been generally unfavorable and some lines of trade have suffered considerable depression. It may, therefore, be assumed that the profits earned during the past two or three years have been not more than a fair average; furthermore, as the present study is confined to audited accounts, the results may be expected to be more accurate than statistics usually are.

A few of the concerns under review show an actual loss on their operations. Only four, however, fail to earn any part of their interest charges, and these have a total investment of only $1,527,914 and show an operating loss of $26,993. Nineteen more having an investment of $60,358,131 earned less than 6 per cent. and fourteen of these businesses earned less than 5 per cent. Of the entire group of enterprises, therefore, twenty-three, or 14½ per cent. in number, earned less than the usual legal rate of interest after paying the costs of operation and management.

A further analysis of the 158 reports under examination shows that upon the invested capital:

In	117	cases	8	per	cent.	or	more	was	earned
"	97	"	10	"	"	"	"	"	"
"	86	"	12	"	"	"	"	"	"
"	70	"	15	"	"	"	"	"	"
"	44	"	20	"	"	"	"	"	"
"	28	"	25	"	"	"	"	"	"
"	17	"	30	"	"	"	"	"	"
"	10	"	40	"	"	"	"	"	"

There appears to be a widespread belief that large corporations have crowded the small business man, if not to the wall, at least to the point where he finds increasing difficulty in making an adequate profit. Many intelligent persons sincerely believe this to be true and are deeply disturbed thereby. It is interesting and perhaps not without significance to find from the reports now being considered that fifty-nine of them relate to enterprises each having an investment of $1,000,000 or more and having an aggregate investment of $379,511,380 upon which the earnings amounted to $51,317,952 or 13.52 per cent. Only one of these concerns failed to earn any profits, and its loss for the year was only a fraction over 1 per cent. upon the investment of $1,200,000, so that its bearing upon the general average is unimportant. Twenty-five reports relate to businesses having an investment of $100,000 or less and may, therefore, be taken as indicating so far as they may go the situation of the so-called small business man. The total investment in these twenty-five cases was $1,156,827, while the profits are found to be no less than $324,114 or 28.02 per cent. Another compilation shows that the average return upon the investments of $500,000 or less was 16.67 per cent. The smallest investment shown by any of the reports is that of a retail store employing a capital of $9,250, upon which for the year 1913 it earned 34.27 per cent. The highest rate of return in the group is found in a little establishment having an investment of $13,000, while the second in rank employed slightly less than $51,000. Of the ten instances mentioned above as having earned over 40 per cent. each, five had an investment of less than $60,000 and all but two were below $200,000.

In determining the profits of a small business, the question of management salaries is relatively more important than in a large one and the thought may arise that a sufficient allowance for this expense might perhaps reduce largely the profits shown for the smaller enterprises. To this suggestion, two replies may be made; first, that a careful effort was made to exclude reports upon accounts which did not make reasonable provision for management salaries; and, second, that since 1909, when the corporation tax law was enacted, the tendency among the smaller corporations, where the officers are usually the principal stockholders, has been toward a liberal allowance for salaries and a consequent reduction of taxable profits. It is not necessary to imply, nor do I so imply, that by the use of this means there has been any extensive evasion of taxation; but the corporation tax law permitted a deduction to be made for management salaries and it has not been customary for corporations either to fail to claim the deduction or in fixing the amount to err on the low side.

In so far, therefore, as the statistics before us indicate, it is very clear that the day of the small business is not yet past. The initiative and enterprise of the man of moderate means still bring, as they deserve to bring, a reward far beyond anything that may reasonably be hoped for by the employers of great aggregations of capital. The figures given for the profits of small enterprises may seem surprising to many. If this is so it will be largely because public impressions are based upon profits divided rather than upon profits earned. In most growing businesses the difference is substantial, as it is seldom desirable or practicable to distribute the whole of the profits.

Incidentally, it may be pertinent to suggest that the ideal type of regulation should provide not only rates for the distribution of profits, but for rates of service that while not unduly burdensome upon the payers should not be reduced except where they provide a substantial excess over:

(a) a fair distribution of profits to the owners;
(b) a substantial sum for the betterment and surplus to be held subject to definite restrictions and to be deducted from the capital sum in any future calculation of return.

It should be borne in mind that the theory of governmental regulation is based largely upon the assumption that public service corporations, from their very nature, are or should be monopolies, or, at least, not subject to the same competition, quantitatively or qualitatively, as other enterprises; in other words, that regulation is, to a large extent, a substitute for competition as the prime factor in the attainment of reasonable rates. And yet, as indicated below, commissions have been exceedingly loath to grant to public service corporations a return comparable to that being earned by unregulated enterprises, even where the latter are exposed to intense and active competition.

Contrasted with the profits earned by businesses not subject to regulation, the maximum return thus far allowed by the various state commissions, is, so far as I have been able to ascertain, only 8 per cent. That is the most the owners can hope for and in some cases a smaller maximum is fixed. Among the states in which decisions upon this question have been rendered by courts or commissions, reference may be made briefly as follows:

Maximum return allowed by state commissions.
(per cent.)

	Telephone and Telegraph	Gas and Water	Street Railway
Illinois	8		
Kentucky	7		
Maryland	8		
California		8	
Iowa		8	
Washington			7
Missouri	6	7	
New Jersey	8	8	
New York	8	7½	
Nebraska	7		8

The United States Circuit Court held in the Northern Pacific case that 7 per cent. per annum was a fair return, while in the Arkansas rate case 6 per cent. with a possible 1½ per cent. additional in lean years was allowed. Both of these cases were decided in 1911.

In every comparison of the rates of return, recognition must, of course, be given to the difference in the conditions affecting business generally and those under which public utilities are operated, with the consequent greater measure of confidence displayed by careful investors in favor of the securities of companies in the latter field. At the same time it must be admitted that this margin of confidence in securities of utilities as against industrials is diminishing and the marked disparity of even less than ten years ago no longer exists.

Having in view the earnings of capital in businesses outside the field of public regulation and the increasing stability of such enterprises, it does not seem too much to say that nothing is definitely settled by the decisions thus far rendered in rate cases. The commissions and the courts have been feeling their way among issues too often befogged and possibly with eyes too constantly fixed upon interest rates and dividends and without giving sufficient consideration to the speculative element of profit that has made possible the rapid development of electrical and other utilities in recent years. It is the desire of every one that this process of development shall continue unabated. It cannot continue if capital finds greater attraction elsewhere. Not the only attraction but certainly one of the most important is the rate of profit capital may reasonably expect to earn under competent enterprising management.

It is my hope that the facts herein given, culled as they have been from a group of business enterprises at once too small to justify the drawing of final conclusions and yet a group much more extensive in variety of activity and in territory than, perhaps, has heretofore been subjected to a similar study in equal accuracy of detail, may prove suggestive; and, what is much more important, I trust what has been said may serve to incite a more comprehensive investigation of those business facts ordinarily stated in terms of profit and loss.

J. E. Sterrett.

Commissioner Murdock. That is 6½ per cent. to the stockholders and 6½ per cent. to the business?

Mr. May. Yes, sir.

Mr. Wise. Some of the companies made less than 6 per cent. altogether and others made as much as 24 per cent?

Mr. May. Some of them made a loss as the actual facts show. Out of the 158 cases there were 70 that earned over 15 per cent. Now these companies, as stated, were selected in 1913; they were not picked out but just taken at random in 1913. I thought that for this purpose it would be interesting to take as many of those same companies as I could find and find out what their last report showed. I was able to find in our office files the corresponding records for 86 of those 158 companies.

Commissioner Murdock. As of what year?

Mr. May. The year ending 1916 or 1917. Those 86 companies in the earlier period averaged 13.11 per cent., and the same companies in the later period averaged 20.37 per cent. I also have the percentage here of the individual companies showing the different ranges in the earlier period. There were 16 earning between 15 and 20 per cent. and 24 earning over 20 per cent. There are 40 earning over 15 per cent. today and there are 7 earning between 15 and 20 per cent., and 39 earning over 20, making 46 out of 86 that are earning from 15 per cent., and about 60 per cent. of those companies, between 50 and 60, are companies with a capital investment of under a million dollars. They are not big trusts, they are small and medium size corporations.

This is another light on the question, and I have prepared some figures which seem to me particularly illuminating in view of the fact many of the parties to this proceeding are Canadian corporations. Now, Canada's normal source of supply of capital is Great Britain, and, therefore, it seems to me that figures showing the return in industry in Great Britain, and in countries capitalized in Great Britain, would be relevant. The London *Economist,* which is the best known of the financial journals of London, gives each year a summary of the profits shown by corporations whose accounts are published in its columns during that year. I have prepared the figures from those summaries, by industries, leaving out the railways, public utilities, mines and financial companies like banks and trust companies. I have had them prepared under different groups and I have worked them out to show the percentage of profit to the total capital, whether borrowed capital or stock capital, during these years. The averages are as follows: the ending of the year June 30, 1914; the average of all companies is 11.25 per cent.; 1915, 10.32 per cent. That is where they felt the adverse effect of the beginning of the war: 1916, 12.65 per cent.; 1917, 13.27 per cent.

(The paper above referred to was received in evidence and marked Manufacturers' Exhibit No. 74, consisting of four tabulations, and is as follows:)

SUMMARY OF CAPITAL AND PROFITS OF ALL COMPANIES WHOSE REPORTS WERE PUBLISHED IN THE LONDON "ECONOMIST" DURING THE YEAR ENDING JUNE 30, 1914, EXCLUDING RAILWAYS, PUBLIC UTILITIES, MINES AND FINANCIAL COMPANIES SUCH AS BANKS

(Figures taken from The Economist of July 18, 1914)

	Number of companies	Debenture capital — Amount	Debenture capital — Average rate	Preferred capital	Ordinary capital	Profits after debenture interest	Add back interest on debentures	Profits before interest	Total capital	Per cent. of profit to total capital (borrowed and stock capital)
Breweries	90	£ 37,939,713	4.1	£ 24,464,987	£ 29,658,693	£ 4,656,316	£ 1,555,528	£ 6,211,844	£ 92,063,393	6.74
Iron, coal and steel.	73	22,996,539	4.3	22,693,326	45,003,174	9,438,754	988,851	10,427,605	90,693,039	11.49
Motor and cycle...	25	1,335,050	4.7	2,302,430	4,565,317	1,287,543	62,747	1,350,290	8,202,797	16.46
Nitrate	20	1,125,032	4.1	350,000	5,253,300	1,186,892	46,126	1,233,018	6,728,332	18.32
Oil	13	300,000	5.1	6,647,271	9,642,346	3,409,521	15,300	3,424,821	16,589,617	20.64
Shipping	29	14,239,160	4.4	10.601,665	16,153,399	5,547,255	626,523	6,173,778	40,994,224	15.06
Tea, rubber, etc....	152	1,413,462	5.5	5,212,597	19,097,152	4,016,390	77,740	4,094,130	25,723,211	15.91
Miscellaneous	255	59,795,289	4.3	84,384,285	116,143,506	25,389,872	2,571,197	27,961,069	260,323,080	10.74
Total	657	£139,144,245		£156,656,561	£245,516,887	£ 54,932,543	£ 5,944,012	£ 60,876,555	£541,317,693	11.25

SUMMARY OF CAPITAL AND PROFITS OF ALL COMPANIES WHOSE REPORTS WERE PUBLISHED IN THE LONDON "ECONOMIST" DURING THE YEAR ENDING JUNE 30, 1915, EXCLUDING RAILWAYS, PUBLIC UTILITIES, MINES AND FINANCIAL COMPANIES SUCH AS BANKS

(Figures taken from The Economist of July 17, 1915)

	Number of companies	Debenture capital — Amount	Debenture capital — Average rate	Preferred capital	Ordinary capital	Profits after debenture interest	Add back interest on debentures	Profits before interest	Total capital	Per cent. of profit to total capital (borrowed and stock capital)
Breweries	81	£ 32,163,057	4.0	£ 28,361,296	£ 21,916,026	£ 4,700,463	£ 1,286,522	£ 5,986,985	£ 82,440,379	7.26
Iron, coal and steel.	75	22,762,332	4.3	46,377,119	23,501,216	8,390,132	978,780	9,368,912	92,640,667	10.11
Motor and cycle...	27	510,900	4.7	5,797,161	4,027,694	1,369,232	24,012	1,393,244	10,335,755	13.48
Nitrate	18	1,197,425	5.1	4,303,300	410,000	811,185	61,069	872,254	5,910,725	14.76
Oil	11	494,092	5.8	8,260,482	3,510,000	2,714,973	28,657	2,743,630	12,264,574	22.37
Shipping	27	19,950,977	3.2	16,773,353	11,828,099	3,541,003	638,431	4,179,434	48,552,429	8.61
Tea, rubber, etc....	195	2,202,497	5.5	24,752,273	6,583,240	4,604,953	121,137	4,726,090	33,538,010	14.09
Miscellaneous	240	60,711,929	4.3	113,871,313	85,592,658	24,427,497	2,610,613	27,038,110	260,175,900	10.39
Total	674	£139,993,209		£248,496,297	£157,368,933	£ 50,559,438	£ 5,749,221	£ 56,308,659	£545,858,439	10.315

SUMMARY OF CAPITAL AND PROFITS OF ALL COMPANIES WHOSE REPORTS WERE PUBLISHED IN THE LONDON "ECONOMIST" DURING THE YEAR ENDING JUNE 30, 1916, EXCLUDING RAILWAYS, PUBLIC UTILITIES, MINES AND FINANCIAL COMPANIES SUCH AS BANKS

(Figures taken from The Economist of July 22, 1916)

	Number of companies	Debenture capital — Amount	Debenture capital — Average rate	Preferred capital	Ordinary capital	Profits after debenture interest	Add back interest on debentures	Profits before interest	Total capital	Per cent. of profit to total capital (borrowed and stock capital)
Breweries	77	£ 30,518,846	4.2	£ 25,341,589	£ 26,744,679	£ 4,853,452	£ 1,281,792	£ 6,135,244	£ 82,605,114	7.43
Iron, coal and steel.	67	15,330,126	4.5	18,494,578	32,982,051	7,516,704	689,856	8,206,560	66,806,755	12.28
Motor and cycle...	24	422,600	5.2	3,738,220	5,968,674	1,900,495	21,975	1,922,470	10,129,494	18.98
Nitrate	21	1,333,637	6.4	460,000	5,567,300	573,408	85,353	658,761	7,360,937	8.95
Oil	19	2,057,157	5.7	4,988,000	17,400,581	4,196,369	117,258	4,313,627	24,445,738	17.64
Shipping	30	21,907,032	4.6	15,625,365	18,913,987	8,755,390	1,007,723	9,763,113	56,446,384	17.29
Tea, rubber, etc....	205	1,486,600	5.9	5,607,490	23,308,607	7,133,309	87,709	7,221,018	30,402,697	23.75
Miscellaneous	248	65,510,623	4.4	106,836,913	117,770,373	30,794,583	2,882,467	33,677,050	290,117,909	11.61
Total	691	£138,566,621		£181,092,155	£248,656,252	£ 65,723,710	£ 6,174,133	£ 71,897,843	£568,315,028	12.651

SUMMARY OF CAPITAL AND PROFITS OF ALL COMPANIES WHOSE REPORTS WERE PUBLISHED IN THE LONDON "ECONOMIST" DURING THE YEAR ENDING JUNE 30, 1917, EXCLUDING RAILWAYS, PUBLIC UTILITIES, MINES AND FINANCIAL COMPANIES SUCH AS BANKS

(Figures taken from The Economist of July 14, 1917)

	Number of companies	Debenture capital — Amount	Debenture capital — Average rate	Preferred capital	Ordinary capital	Profits after debenture interest	Add back interest on debentures	Profits before interest	Total capital	Per cent. of profit to total capital (borrowed and stock capital)
Breweries	52	£ 29,786,939	3.9	£ 20,350,986	£ 25,915,416	£ 4,492,464	£ 1,161,690	£ 5,654,154	£ 76,053,341	7.43
Iron, coal and steel.	53	15,301,879	4.4	16,876,396	31,305,000	8,890,874	673,282	9,564,156	63,483,275	15.06
Motor and cycle...	13	407,600	4.9	1,779,206	2,982,352	809,811	19,972	829,783	5,169,158	16.05
Nitrate	21	1,112,789	4.7	460,000	5,513,300	1,214,910	52,301	1,267,211	7,086,089	17.86
Oil	15	1,527,198	5.5	2,518,000	10,936,749	2,108,772	83,995	2,192,767	14,981,947	14.63
Shipping	26	19,321,664	4.6	14,606,307	22,106,074	8,493,319	888,796	9,382,115	56,034,045	16.74
Tea, rubber, etc....	227	2,129,429	5.7	6,407,599	30,837,282	9,124,088	121,377	9,245,465	39,374,310	23.48
Miscellaneous	259	58,623,559	4.2	97,460,889	123,506,616	31,838,176	2,462,189	34,300,365	279,591,064	12.26
Total	666	£128,211,057		£160,459,383	£253,102,789	£ 66,972,414	£ 5,463,602	£ 72,436,016	£541,773,229	13.37

Mr. Wise. How many companies does that represent?

Mr. May. It represents about 650 companies with a total invested capital of about 550,000,000 pounds sterling.

Mr. Wise. Good, bad and indifferent?

Mr. May. All that are published. I will draw attention to the breweries, which come at the top. English breweries are notoriously overcapitalized. They were a very, very successful industry. They were capitalized on the basis of their earning capacity during their palmy days. Undoubtedly they are overcapitalized. If you leave out the breweries in any year it raises the average of the rest about one per cent. In my view they are extremely interesting and I think relevant as regards this proceeding.

Commissioner Murdock. That is on the aggregate of these industries, less the breweries, the rate would be for the year 1917, 14.37?

Mr. May. About that. 14.37, if you leave the breweries out. Breweries only earned 6.7.

Then there is another significant figure, that is, the earnings of our national banks. The reports of the Comptroller of the Currency show that the earnings of national banks in the last fifteen or sixteen years—it does not make much difference what period you take—they averaged 9.7 per cent. on the total capital and surplus invested. Now there is a really attractive industry, the national bank. Your capital is in there and you can take it out and liquidate it if you do not like that kind of investment. It is entirely different from locking up property in bricks and mortar. They are not any good unless they be put to some such use as you build them for. That has always seemed to me a very good index and it seems to me is entirely in line with the general conclusion that you reach from studying the industrial businesses because there cannot be any question as to the attractiveness of a national bank investment.

Commissioner Fort. Except in one respect, double liability on stock.

Mr. May. That is true.

Mr. Wise. What is the percentage of loss in that case?

Mr. May. I think that is the key to the explanation of the condition that I have been discussing, and what is the actual reason for that is significant. The actual losses are less than five-hundredths of one per cent. Yet one of the first things a man thinks of when he thinks of a national bank investment is the liability of it and the risks he is running and that influences his judgment as to the attractiveness of that investment far beyond the mathematical value of the risk, and that is the clue, I think. That is the clue to the whole thing.

Take fire insurance. Every man is considered lacking in all business prudence if he does not insure, yet he is paying double the mathematical value of the risk for the insurance. Not more than 50 per cent. of the premiums paid go to pay losses. I happened to be talking last week to a Mr. Graham Harding, who is an assessor for Lloyds in London. His firm have acted for Lloyds for 120 years and he was talking about this business that Lloyds do in insuring all sorts of extraordinary risks, and he said, of course, they make some spectacular losses, to be sure, but they are making all the time spectacular profits—because people are willing to pay many times the mathematical value of the risk.

I think that is the one factor more than any other that accounts for the high rate of return that you have got to give to attract capital into industry. I do not know of any single factor that is more potent. Now, of course, there is a suggestion that grows out of that, namely, that by our system of distributing securities you can spread your risks and therefore you do not sustain those losses. In our country there are two ways of financing industry, practically. One or two men or a group of men go in and put up all the capital and control the business or else it is distributed to the public. Now if a few men put it in they are the men who control it and if they go in the way they look at it is somewhat like this: Well, we have looked to make a certain profit and if we make more than that profit it will give us a little more income, but as we come up the value of the income is relatively less. If you have an income of $25,000 a year and increase it to $30,000, you have added $5,000, but you have not added 20 per cent. to the enjoyments you get out of life. It is just the same as building a steamer. When you get up to a 20-knot steamer it costs a lot more money to add a little speed. The higher you get the less in the way of additional speed you get for your money. That is the way we live, the more income you get the less you really get out of it for the additional income. On the other hand, if they should lose the whole thing, that is a loss that is far more felt than any small addition to their income, if successful. Therefore, only a prospect of getting a liberal return attracts them. On the other hand, if you are trying to distribute to small holders you come up against another factor, that is, the factor in the high cost of everything in this country, the high cost of distribution and the high profits of distributors, and that applies to securities and the selling of securities. In other words, it applies to the raising of money just the same as it does to the problem of distribution of commodities. There is the same difference between the prices that the farmer gets and the price that the consumer pays and between the cost of money to the industry and the return on the investment to the ultimate distributees of those securities. The discrepancy is almost as large in one case as in the other. And, of course, you have got to make things reasonably attractive to the individual small holder. In his case his risk is not quite as large. But there is another factor that operates far more with him than it does with the big investor. When a few men take hold of a business they do not worry much about the hazards of bad management. They are generally willing to admit that they can give good management, but the small investor has to take the risk of bad management as well as risks inherent in the business. He sees the possibility of loss from bad management. So that in the long run it does not make very much difference which way you go about getting capital into the industry because to make it attractive, you must give just about the same return in the one case as the other.

Commissioner Murdock. There must be some point, however, in your reasoning upon this proposition at which you come to the conclusion that the rate of return is unreasonably high. Where does that point arise in your mind?

Mr. May. When you say rate of return unreasonably high, that is a somewhat difficult question to answer in connection with competitive business. My thought is that regulation and protection ought to go hand in hand. If you do not give any protection you are not in a position to insist on regulation. If you give a minimum of protection you cannot insist on a maximum of regulation. If you fix a minimum return you can fix a maximum return. If you do not give any sort of protection at all it is rather difficult for me to see on what you may base any regulation of return other than a paramount public interest or something of that kind, of course. All I can see is that in so far as a regulative body can control the situation they would not do anything that was calculated to promote extravagantly high returns, and in the interest of the consumer, ultimately, just as much as of the producer, you have got to fix that fairly high if you are going to make it a maximum. Commissions may be the primary regulators but capital is the ultimate regulator because the necessity of attracting capital into enterprise and keeping capital in enterprise is, after all, the paramount consideration, and that, I think, is particularly true when you are dealing with an industry that is largely outside of your own jurisdiction, as you are in this case. You cannot compel capital to stay in news print in Canada by any proceeding in this case if you fix the return so low as to discourage them from staying in it.

Mr. Wise. You can compel them to stay in the United States?

Mr. May. By a gradual extension of the powers of the Government which might make the return in all industries unattractive. I mean by that that they would rather stay in the frying pan than jump into the fire.

Commissioner Fort. There is another situation there. You say the voluntary bringing of them into another jurisdiction. They may of necessity, if they wish to carry on their business, be compelled to bring them into another jurisdiction because they have not enough demand at home.

Mr. May. If you drive him out of the industry, he can go out of the industry and, of course, a lot of these water power companies could turn their service to other uses. They may have to come in here if they want to stay in the news print business. If they come into the United States and it should regulate the return in the industry they would be no better off. If they should go out of the industry they would go into something else in Canada.

Commissioner Fort. And make a profit?

Mr. May. Yes.

Mr. Wise. What I wanted to ask was this. Commissioner Murdock spoke of the return becoming too high. That is not a condition that can arise in a competitive field, is it, unless the competition is wiped out by combination?

It is a fair proposition that supply and demand is going to keep down any such abnormal conditions?

Commissioner Murdock. That law of supply and demand is occasionally repealed.

Mr. May. If I were a purchaser I would rather take my chance on having a fairly high maximum and relying on competition to keep prices down than I would run the risk of a low maximum and a consequent discouragement of capital from coming into the enterprise. I would rather take my chance on the first.

Commissioner Murdock. Would you stimulate production by high prices?

Mr. May. I should.

Commissioner Murdock. Then after you got a stimulated production how would you maintain your high prices?

Mr. May. You do not stimulate production by fixing high prices because you do not fix a price. All I would say is you can avoid discouraging production while preventing prices from going up to a point where they would be prohibitive.

Of course, the excess profits tax and the business profits tax in Canada operate to a considerable extent as levelers, and I do not know but what they level down in a way that is more equitable to the community as a whole than the regulation of prices. The point of view there, in the case of companies that make high profits, is that it comes to the whole community rather than to one group of consumers. I do not think it is any detriment to the consumers. I think it is to the interest of the consumers and the government in these times.

Mr. Wise. When the Government itself is in the market buying?

Mr. May. No, I do not mean that.

Mr. Wise. That is quite another proposition.

Mr. May. Yes, that is quite another proposition.

Mr. Wise. When the Government itself is buying an article and you put the price up high in order to get the tax back the consumer pays and not the Government. There is not much profit in that.

Mr. May. Within reasonable limits I believe it is a good policy of the Government for the psychological effect. However, that is a different proposition. The producer's handling the money adds a little encouragement.

Mr. Wise. He thinks he has it until the tax collector comes around.

Mr. May, have you given any consideration to the question of this price or this profit being applied, say, on the whole industry or on a part of the industry?

Mr. May. Well, that is, of course, one of the crucial problems; that is a very critical problem and it depends on a lot of factors which are particularly numerous just now, with the question of the curtailment of non-essential industries, which is very much in the air. The question of production is a factor there, but I would approach it from the standpoint of a return of between 15 and 20 per cent. to anybody who is within 80 per cent. of the production necessary to fill the demand. That is the way I would look at that question, but it is a fairly big question and involves so many considerations.

Commissioner Fort. Would you consider an allowance of 5 per cent. profit on an industry with two turnovers a year a fair profit?

Mr. May. No, I do not. Nothing but compulsion or patriotism, I think, would keep capital in that industry very long on that basis.

Mr. Wise. Have you given any particular thought in your work on the question of whether or not in figuring the investment there should be any item included for what is known as the going value?

Mr. May. Going value or good will?

Mr. Wise. I distinguish between good will and going value.

Mr. May. All right.

Mr. Wise. In fixing a price do you think that the good will of a business is to be considered?

Mr. May. Good will, as I see it, rests primarily on earning capacity. In determining what the earning capacity shall be you cannot predicate your action on the capital value of that earning capacity. I do not think good will enters into it at all. As to going value in the sense of the value of the developed industry as compared with the position of an industry that is just completed—a plant that is nothing more than a plant I think, within reasonable limits—that should be recognized as part of the investment on which a return should be figured, and in this particular case I do not imagine the publishers would dissent from that view. I recognize that the new excess profits tax law is one of the greatest hardships that these publishers are suffering from. Their going value is a great part of their value and the unfortunate terms of the excess profits tax are undoubtedly a very serious hardship to the publishers,

Mr. Wise. Do you mean if they have included in their statement good will, that when they come to make up their excess profits taxes it has to be included?

Mr. May. There is no recognition that the established value of a newspaper is invested capital under the excess profits tax law.

Mr. Wise. That is not good will. Take a newspaper subscription; it is not good will.

Commissioner Murdock. It is not. (Laughter.)

Mr. Wise. Not all.

Mr. May. I am sorry to say it is, for the purposes of the excess profits tax.

Mr. Wise. But they have spent money in building up, have they not?

Mr. May. Yes.

Mr. Wise. It represents an actual outlay?

Mr. May. I believe the Commissioner of Internal Revenue feels—

Mr. Plante. Has the Commissioner actually made a ruling on that?

Mr. May. I think what they are trying to do—

Mr. Plante. Has he made a ruling?

Mr. May. There is no official ruling on it as yet.

Mr. Plante. Why tell us about what somebody is threatening to do?

Commissioner Fort. It does not affect this case.

Mr. May. I apologize if I have gone off the subject.

Commissioner Murdock. Mr. May, what is your definition of going value?

Mr. May. I think, as far as going value should be recognized in a case of this kind, it would simply represent the reasonable cost or additional value resulting from the act of building up the plant from the point where the plant is completed to the point where it has a successful business going. It is a difficult thing to measure, I admit. In an industry where there is a big investment like this, of course there is the actual expense and loss of return during the preliminary period immediately following the completion of the plant. That is the best criterion of it that I think suggests itself.

Mr. Wise. Do you consider it to be a proper form of accounting for a manufacturer, in an industry such as this, to set up a charge for depreciation?

Mr. May. Why, yes.

Mr. Wise. How long has it been the custom with accountants in this country?

Mr. May. Well, it is a development. It is pretty hard to say. I know, in the early days of my experience here I lost a great deal of work because I refused to sign accounts as being correct unless they had provided for depreciation. But it is a development, more or less general, I should say, during the last ten or twelve years. I would say that the Federal Trade Commission itself has assisted the accountants a great deal in spreading the recognition of it, although, to be perfectly honest, I think perhaps the income tax has done even more to stimulate the practice.

Commissioner Murdock. It is growing all the time?

Mr. May. As the tax rate grows, you can rely on its growing.

Commissioner Fort. I did not suppose there was any question about setting up depreciation.

Mr. May. No; I do not think there is.

Commissioner Fort. Nor is there any question either, in good bookkeeping, as to setting up depletion—

Mr. May. No.

Commissioner Fort. (Continuing:) Where at the end of a specified period of time the industry may be depleted so that there is not any. Now, is there any other way to provide for the carrying of the repayment of the 10 per cent. to the stockholders, if you keep on paying dividends?

Mr. May. That is the point.

Commissioner Fort. Take the coal industry. Here is a coal field, say ten acres square. There is a vein running through it. The coal company is incorporated for a hundred thousand dollars. I make that figure because it is small. The stockholders put their hundred thousand dollars in there, and at the end of a period of twenty years you have exhausted your coal, and you have paid out your money in dividends, and by methods of various kinds, taking care of your machinery, and so forth, and when you get through your machinery is practically junk. Now, what are you going to pay your capital stock on, if you do not provide for depletion?

Mr. May. If you pay out all your current earnings, you are not, strictly speaking, paying dividends; you are paying out of capital, and it ought to be recognized as such.

Commissioner Fort. Then you would not get any interest on your capital.

Mr. May. You should get a fair return plus depletion.

Commissioner Fort. Six per cent. does not take care of your principal?

Mr. May. Oh, no.

Commissioner Fort. If you get six per cent., and at the end of a period of twenty years your coal vein is exhausted, how are you going to pay your stockholders back their money?

Mr. May. Charge it into the cost, and set aside a fund for depletion.

Commissioner Fort. Depletion; yes.

Mr. Wise. And they have not all done that?

Mr. May. No.

Commissioner Fort. The result of the investigations we made here as to the coal industry was that 60 per cent. of the coal mines of the United States charge neither depreciation nor depletion.

Mr. May. I can believe that is true.

Mr. Plante. They cannot eat the cake and have it, too.

Commissioner Fort. There is a larger percentage on depletion, but I take the average as to both.

Mr. May. There is one other point that I wanted to bring out, that I overlooked; that is when we were talking about the question of the capitalization not affecting the amount of return. In view of what Mr. Erickson said, there is one consideration that I would like to point out. That is the effect of the excess profits tax on that question. I am not discussing the question of allowing that excess profits tax in figuring a return, but I want to point out that the excess profits tax, which I think we must take to be a part of our fiscal system for a good many years to come, makes financing through bonds extremely expensive and almost impracticable. Suppose you had a company that had $1,000,000 investment, and was earning 20 per cent, on the whole thing, that is, $200,000. It had borrowed half that money at seven per cent. in interest and discount. Now, its excess profits tax on that basis would be $40,000, whereas if it were capitalized wholly by stock its excess profits tax would be only $26,500. Therefore, the additional excess profits tax resulting from capitalizing with bonds is 40 per cent. of the interest on the bonds; and whatever may have been the fact in the past, all the considerations based on the possibility of capitalizing with bonds as to the future have to be very substantially modified on that account. If the United States Steel Corporation today could retire a hundred millions of its bonds by an issue of stock, it would reduce its excess profits tax by $11,000,000.

Commissioner Murdock. They do not know that over in Wall Street yet, do they? (Laughter.)

Mr. May. It is because both here and in Canada it has been the deliberate policy of the law to base the excess profits tax on the invested capital after deducting the borrowed capital. It was deliberately done. It was not done without argument. There were briefs innumerable submitted on the question, and it was a deliberate action of Congress here and it is the action of Parliament in Canada, and in Canada the effect is even more marked than I have cited here, because the Canadian tax is more steeply graduated. Here they go up from 25 to 35; there they go up 25, 50 and 75; and I suppose if we stay in the war long enough we will get there too. So the whole policy of capitalizing with bonds has been fundamentally affected by the passage of that law.

Commissioner Murdock. That is likely to lead to a quite general retirement of bonds, is it not?

Mr. May. That is undoubtedly so. A number of our clients are retiring their bonds today, converting indebtedness in various forms into capital stock so as to get the benefit of the law.

Mr. Wise. So your conclusion on that is that in computing the return it should be on a flat rate upon the value of the investment, regardless of the investment?

Mr. May. Yes. The character of the capitalization; yes.

Mr. Wise. The capitalization.

You may cross-examine.

Mr. Plante. No cross-examination.

(The witness was thereupon excused.)

(Thereupon, at 4.30 p.m., the hearing was adjourned until Tuesday, March 26, 1918, at 2.30 o'clock p.m.)