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Book Reviews

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DEPRECIATION, a review of legal and accounting problems, by the STAFF OF THE PUBLIC SERVICE COMMISSION OF WISCONSIN. *Public Service Commission of Wisconsin*, 1933. Madison, Wisconsin. 1933.

What is there in the subject of depreciation which renders every writer on the subject (myself included), incapable of avoiding confused statements and unsound reasoning? At sundry times and in various places attention has been called to some of these, and it would have been gratifying if this latest treatise, prepared by a most highly competent body of experts, had avoided the pitfalls of their predecessors.

The authors define Depreciation, as "the consumption of investment in property" (p. 4) and this consumption of property (or more correctly of the value of the property) is said to be an expense, or even a loss (p. 14 *et saepe*). Accounting for depreciation therefore shows two facts or two aspects of one phenomenon: (1) that part of the original value of the machine has disappeared, and (2) that consequently there has been an expense, an offset against earnings. This the authors fully recognize and frequently state. How then can they speak of "the loss to be recovered by depreciation charges"? A charge recognizes and records a loss; it never can recover it. If the recovery of a loss is ever possible, which is somewhat doubtful, it is only by earnings sufficient to cover the loss.

Perhaps even more mystifying is the statement regarding the credit side of the entry: "If the reserve is less than necessary for preserving the investment owing to insufficient earnings it might be increased gradually by an enhancement of the annual depreciation allowance until . . . the reserve is sufficient" (p. 160).

What the authors mean is uncertain. What this says is that if earnings are insufficient to cover the expense, and thus preserve the investment, the deficiency can be remedied by showing a still further diminution of the value of the asset. It is similar to saying that if cash has been depleted by payment of expenses, and receipts have not been sufficient to bring the cash balance back to a safe figure, the remedy is to make an additional credit in the cash account, indicating a still further depletion of cash. Is it not an accepted statement that a credit to the reserve for depreciation (why do they still use "reserve" instead of "allowance" in the title?) is in fact the same as a credit to the asset account?

Again one reads that where depreciation amounting to $900 has been charged as an expense and credited to "reserve for depreciation," the utility would have on hand the sum of $900 (p. 23). This is a flagrant non sequitur. One might as well say that, because fuel is consumed or cash is paid, and expense is charged, therefore the utility has an equivalent on hand. All that these credit entries show is that the fuel and cash are no longer on hand. Whether something else is on hand, replacing these, is an entirely separate question. Perhaps it is assumed that the rates allowed a public utility will be high enough to reimburse all expenses. But this is a false assumption. One need only look at the recent income accounts of railroads and other public utilities to see that despite the allowing of liberal rates, earnings have not fully reimbursed for wages paid or for depreciation of plant. The Wisconsin railroad commission knows this perfectly well. Why then put forth so careless a statement?

The authors decry the "absurdity" of saying that the expense of heating a boiler is measured by the present value, not by original cost, of the fuel consumed. This is a debatable question. There are certainly many respectable accountants, headed by Professor Schmidt of Frankfort, who vehemently argue that it is precisely the present value of the fuel that measures the expense. And while I have not sworn allegiance to that school of thought, I can recognize that it deserves at least careful consideration and should not be rejected by the cavalier method of calling it "absurd." Put the case that a ten-dollar bill is paid for some expense. That particular bill might have been inherited or found or stolen or procured in exchange for ten silver dollars. Would the Wisconsin commission assert that only in the last-named case is the expense to be stated at ten dollars, but in all the other cases the expense is to be reckoned as zero, for that represents the cost of obtaining the bill in question? Surely the present value of the bill parted with determines the amount of expense involved. Is it, then, inherently "absurd" to hold that, if coal actually worth $5.00 a ton is consumed in manufacturing, the expense involved is measured by the value consumed, rather than by an antecedent cost?

Nor is the phrase "providing for depreciation" (pp. 147 and 38) felicitous. Depreciation is a lamentable fact—it means that something has been consumed, perhaps by wear and tear. One may provide for a future expenditure, as one puts cash into a Christmas fund, to provide for the purchase of presents. But one does not provide for the wear and tear due to the gnawing tooth of time. It comes of itself.

The statement: "the payment of common [why not 'preferred' as well?] dividends at the expense of adequate depreciation" is somewhat worse than meaningless as an expression relating to accounting. One may spend his wages for whiskey "at the expense" of shoes for his children. The more whiskey the less shoes. But paying dividends certainly does not lessen depreciation. Depreciation it is to be remembered *is* "the consumption of property," and what have dividends to do with that?

A final criticism is of the statement that the reason "why" depreciation is booked is that unless this is done, the investors will be "left with no useful property." This in itself need not be a serious hardship. If the investment has been returned to them, from year to year, they are in the position of fortunate investors in a mine, who have been reimbursed through dividends. But that is a minor criticism. The objection is that the authors do not give the correct reason why depreciation must be reckoned.

Coal has been consumed, cash has been diminished because of payroll, and the accountant must show (1) the diminution of the asset value and (2) the consequent expense. In the case of depreciation, part of the service value of the machine has been consumed. The accountant likewise must show this and the correlated expense—the former by crediting reserve for depreciation, the latter by debiting an expense account called "depreciation." The accountant shows these not to replace, not to reimburse, not because he amiably desires that the investor shall have something on hand (perhaps he will not) but simply because a significant business event has occurred, which, by the ethics of his profession, he is bound to record with as high a degree of accuracy as is possible.

It is fair to recall that the work is written by those intimately associated with the regulation of rates by public utilities. To such, depreciation may seem to have a function different from that which it has in competitive industry. But the difference is superficial.

So much for fault finding. The criticisms made are in regard to matters of theory and the expression of general principles. From the practical viewpoint the work is admirable. The summary of legal doctrines, the discussion of methods of estimating and allocating depreciation are indeed valuable. Especially commendable is the denial of the opinion implied in many statements by engineers that so long as a car runs smoothly it has not depreciated. For this, thanks.

Henry Rand Hatfield

FUNDAMENTALS OF ACCOUNTING, by Harry H. Wade. *John Wiley & Sons, Inc.*, New York. 281 pages. 1934.

I have read *Fundamentals of Accounting* with care. It is well written, the ideas contained in it are clearly expressed; it is well printed and well bound; yet it leaves one cold.

The author says that "the purpose of this text is to acquaint students with terminology and with basic principles," the material having been developed through his teaching. In other words, the book is a handbook to accompany his lectures. For this purpose it is well adapted. While the basic principles are set forth clearly, the work is from its very nature elementary; no new ideas are advanced and the contents are similar to those contained in many of the similar works now offered, which may be of use to students but are of little value to the practising accountant.

While there is no fault to be found with the principles laid down, some of the definitions given are drawn with a boldness and a brevity which perhaps rob them of some value, and some important elementary ideas receive little recognition.

For example: the reader may gather the impression that a balance-sheet is a statement as definite in character as is an "account rendered." The fact that it is almost invariably—in part, at least—an expression of opinion is not mentioned. Consequently, there is no suggestion that the value of a balance-sheet depends upon the ability of him who draws it and on the soundness of his opinions.

Again, of the several balance-sheets shown there is nothing on their face to indicate the basis on which the inventories are valued.

The author states that "recently the practice of accounting has become a profession." Opinions may differ as to what is meant by "recently"; but I fancy that some of our old Scots accountants would wriggle in their graves if they heard such a statement; and while recognition is recent in this country, accountancy has been recognized as an honorable calling in London for over a century, while its literature runs back for three or four times as long.

In the matter of terminology there appears to be a disregard of the present usage among leading members of the profession; as is indicated in the title, for the word "accountancy" is, I believe, generally preferred to "accounting." It is doubtful if accountants will accept the author's suggestion to substitute "estimate of uncollectible accounts" for the generally used term "reserve for bad debts"; nor do I think that "estimated liability for federal income tax" and for state and local taxes will be accepted. As a matter of fact, when a balance-sheet is prepared, these amounts are usually definitely determinable and are not "estimates."

Depreciation is defined as "the difference between the cost of a fixed asset and any salvage value which it may have at the end of its useful service life"—which strikes me as being not incorrect, but not complete. It is unnecessary to give other examples of phraseology which most accountants would criticize adversely.

In general the book strengthens the fear which crops up from time to time in the course of one's reading, that there is a real and present danger arising from the fact that two languages are being applied to accountancy: that of the practitioner and that of the preacher, and it seems to me that every effort should be made to bring these two into closer communion. No one is more alive to the deficiencies of *Accounting Terminology* than myself; but I do feel that it is the nearest approach we have had to obtaining uniform terminology, and I think that it is worthy of consideration before new and comparatively unknown terms are suggested for use.

This book also causes another fear to thrust up its ugly head; and that is that all of us in this country, both preachers and practitioners of accountancy, are inclined to write too much. I say this knowing that I am among the guilty; but have we not too many books on generalities and perhaps too few on specific branches? Sometimes I have thought it would be well if we would practice in authorship something analogous to birth control. It might result in a reduction of the number of books, but I think it might also increase the value of those which did appear.

Walter Mucklow

CORPORATION FINANCIAL STATEMENTS, by Mortimer B. Daniels. *University of Michigan*, Ann Arbor. 131 pages. 1934.

Another instructive book in the "Michigan business studies" was published in January, 1934, by the bureau of business research of the university of Michigan, entitled *Corporation Financial Statements*. The author, Mortimer B. Daniels, is assistant professor of accounting. He says in his introductory note that Professor W. A. Paton, who is well-known to the readers of The Journal, gave him aid and advice. It is stated that the primary aim of the study is to present a brief critical survey of financial statement practice. This book comes at a time when the subject has the attention of the financial world and of the public accountants. The study is based upon a detailed examination of the published annual reports of 294 corporations, the catalogue of which is included in an appendix. A summary and 19 conclusions are given on the first four pages of the book. "Published reports constitute the only means available to investors to judge for themselves the success of the enterprise in which they have made investments," Professor Daniels says. He clearly presents the information necessary in such reports.

After reading the conclusions in the first part of the book, I feel sure the reader will continue to the end. The first chapter is an explanation of the underlying structure of financial statements, followed by chapters on clarity, adequacy and accuracy in financial statements. A discussion of valuation principles, comprising valuation of plant, goodwill, investments, liabilities and proprietorship, is then given.

The chapter on "valuation of liabilities" deals with bonds sold at a premium or discount and the expenses incident to the issue. I heartily support the statement that "practice could be improved by a considered endeavor to separate bond discount and bond expense in the accounts and on the balance-sheet." To combine them is improper, and further, "bond discount is invariably treated as an asset on the ground that it represents prepaid interest. However, there can be no prepaid interest." I doubt, though, if the accountants will change the prevailing method of stating unamortized bond discount in the balance-sheet as a deferred charge. The author shows that "in every one of 96 appearances, bond discount is listed as an asset, usually under the title 'bond discount and expense'." This method, while undoubtedly an expediency, seems to bear the authority of long usage.

The chapter on "income and the income sheet" is instructive. The author says that "practice could be improved if depreciation were always included in operating expenses," and that "parenthetic expressions are simple devices" to disclose the amount. The author seems to favor the practice, which is becoming more popular, of including the surplus reconcilement as a part of the year's income account.

I believe it important for independent auditors to consider Professor Daniels' comments about hesitating or refusing "to show in the income sheet items which the board of directors has duly 'resolved' should be charged (or credited) to surplus." The author properly seems to disapprove of such hesitancy "evident in published reports certified to by independent auditors."

In view of recent discussions by accountants, the chapter on treasury stock, treasury bonds and reserves is interesting and educational. Accountants should consider the conclusion that "treasury stock and treasury bonds are often incorrectly listed as assets on the balance-sheet. They are not assets, but reductions of proprietorship and liabilities, respectively."

The last two chapters are on the general considerations and specific problems of consolidated statements. Consolidated financial statements are called "synthetic statements" of no legal corporation, and it is said that "reports to stockholders should contain not only the usual consolidated financial statements but the legal statements of the parent company as well." I wish public accountants would insist upon that. "The importance of the legal financial statements of holding companies has been lost sight of in the United States."

Abandonment of the technical form of financial statement and the use of the descriptive form seems to be favored, as "it seems to be admirably suited to the needs of an annual report to stockholders."

I know, as all accountants do, that the preparation of corporation financial statements is an intensely practical task. On it depends the basis of confidence in the public accountants' signature thereto, and I likewise know that such confidence can only be sustained by showing the public that the accountant is trustworthy and competent. Otherwise the court of public opinion will turn from us.

Corporation Financial Statements is not a text-book. It is too deep for the understanding of students, but I believe it should be used as a base for the preparation of lectures for accountancy courses. I recommend it particularly to public accountants and hope that corporation accounting officers will also read it.

WILL-A. CLADER