Depreciation in Public-utility Income Accounts

By George Shiras Call

The writer believes that the accountancy profession can render a great service to the public by working for the revision of public-utility income statements and for the adoption of a form of statement that will present all the facts and will in no way tend to mislead the public or to conceal the true state of affairs of the company concerned.

Early in the year 1927 a salesman representing an investment banking house presented a pamphlet describing a security that was said to be "on the bargain counter." The offering in question was the class A common stock of an electric-light and power company and, according to the salesman, the market price of the stock was very low in comparison with the net earnings per share.

The writer looked over the income account of the company for the year 1926 and inquired whether the net earnings as shown were before or after depreciation. It developed that depreciation had not been deducted in arriving at net earnings and the salesman had no data concerning the depreciation allowance for the year. He was asked why depreciation was not taken off before the net earnings were shown and the answer was, "Well, you see, that goes back into the property." Just how the depreciation allowance goes back into the property was something that the salesman could not explain satisfactorily, as his idea of the methods and procedure of calculating and recording depreciation was somewhat hazy. After some discussion the writer continued to hold his former opinion that the depreciation allowance represented the amount that comes out of the property rather than something which goes back into it.

The income account of the company mentioned above for the year 1926 was substantially as follows:

Gross earnings	$2,400,000.00
Operating expenses, maintenance and taxes	1,330,000.00
Net earnings	1,070,000.00
Interest	415,000.00
Preferred dividends	260,000.00
Balance	$395,000.00

After deduction from the balance of net earnings shown of $144,000 for depreciation, representing 6 per cent. of the gross earnings, the remainder came to $251,000 or $2.28 a share of common stock, in comparison with a figure of about $3.60 a share before depreciation. The percentage of 6 per cent. probably represents a fair deduction for depreciation for the average electric-light and power company, inasmuch as it is usually considered that an allowance of from 12 per cent. to 15 per cent. of gross earnings should be made for total maintenance and depreciation, and the maintenance charges alone should be approximately 7 per cent. or 8 per cent. of gross. A smaller provision should be made in the case of a water company, and a street-railway system would require a larger allowance.

A short time after the salesman's visit there was received from the same investment house a circular recommending the same class A stock and comparing it with the common stock of half a dozen other public utilities. The table showing the seven stocks under comparison included data as to the market price and the ratio of market price to earnings per share. The class A stock recommended was shown to have earnings of $3.60 for the year 1926 and the ratio of its market price to earnings was 7.3. These figures, the writer knew from previous calculations, were based on the net earnings before depreciation, although the circular contained no information on that point.

The earnings per share given for the other six common stocks were the amounts applicable after depreciation, and the group average showed a ratio of market price to earnings of 11.6. Apparently the stock recommended was indeed a bargain, for the circular contained no information to make the casual reader aware that the different bases used for the class A stock and for the other six made the comparisons not only valueless but utterly misleading. It is hard to believe that the statisticians who compiled the circular could have been ignorant of the flaws in their bases of comparison.

A few months ago one of the popular financial magazines contained a list of estimated earnings per share of common stock of a number of public utilities. In this list also two different bases of comparison were used—some of the earnings shown were before depreciation and others after the deduction of that charge.

During the year 1927 the writer has clipped at random from the daily papers of various dates twenty-two advertisements of

preferred stock or bonds of public-utility companies. Of these twenty-two, seventeen show net earnings before the deduction of depreciation; of the remaining five advertisements four show net earnings after the deduction of a fixed percentage for depreciation for which provision was made in the bond indenture or trust indenture, and only one shows the net after the depreciation charges recorded by the company itself.

No attempt was made to obtain a complete file of advertisements of utility securities, but the twenty-two that were studied probably are representative of the general average in terminology and arrangement. It is interesting to note the forms of income accounts and the diversity in terms. What the writer prefers to call "operating revenues" are also variously named "gross revenues", "gross earnings" and even "gross income." From the operating revenues are deducted operating expenses, maintenance and taxes other than federal income taxes, and the remainder is frequently called "net earnings." Sometimes the more explicit term "net earnings available for interest, depreciation and dividends" is used and in other advertisements the word "balance" alone appears. Then, in the case of a bond issue, the annual interest requirements are shown and the public is informed that earnings are more than 2½ times the interest requirements, or whatever the ratio may be. At this point the word "depreciation" drops out of sight, never to reappear—except in the surplus accounts of the various companies.

The depreciation allowances must evidently be charged to operating expense, or else treated as appropriations of net income or of surplus, and this brings us to the question, what is a surplus charge? It is usually considered that a charge to surplus should be made only to cover some cost or expense of a prior year for which provision has not been made during the proper period, or else for some extraordinary expense or loss that is in no way related to the usual business of the company concerned. In the case of public-utility companies it has been a common practice to treat the yearly allowances for depreciation as surplus charges, although it can hardly be maintained that these charges represent some extraordinary expense or loss. The usual argument given for treating depreciation as a surplus charge is that the determination of the proper amount is exceedingly difficult and can not be estimated with even approximate accuracy. Although that contention is probably true there seems to be no justification for

omitting from operating expenses an item for which, even public-utility operators admit, provision should be made year after year. In the accounts of manufacturing companies depreciation is treated as a proper charge to operating expense as a matter of course, and why should the depreciation provision of a public utility be veiled with secrecy and mystery and held out from its proper place among the operating expenses? That is to say, it is so treated in the published reports to stockholders and in advertisements of securities, but in rate cases the companies involved never fail to claim their depreciation allowance "above the line", together with the other normal and necessary operating expenses.

The writer does not believe that any one method of calculating depreciation must be followed slavishly. Among public-utility operators the theory of the retirement-loss-equalization reserve is probably the most popular and the writer feels that such a reserve, if carried at a balance sufficiently large to provide for any retirement losses during the year, will serve just as satisfactorily as a reserve set up on the straight-line method. Whatever the method may be, it is certain that some allowance should be made each year and it is difficult to see the logic of charging to surplus an item which recurs year after year with regularity. Occasionally, there may be found public-utility companies that make a practice of charging surplus account with legal fees and other expenses and costs of prior periods for which some provision should have been made by means of accruals. Almost all accountants would condemn surplus charges of that nature and yet it has become common practice to prepare statements for clients in which the depreciation charge is deducted from surplus.

The decrease in the net earnings per share of common stock after depreciation is deducted is particularly noticeable in the case of a holding company, as in such a company the margin remaining for the common stock in proportion to the gross earnings of the consolidated group is much smaller than in an operating company. For example, one of the large holding companies reported in its consolidated income account for the year 1926 net income of approximately $8,500,000, available for retirement reserve and dividends on the holding company's common stock. The provision for depreciation amounted to about $3,400,000 and, after deducting this allowance, there remained a balance of only $5,100,000, available for common-stock dividends and surplus. In other words, the provision for depreciation was equivalent to

about 40 per cent. of the total amount available for dividends and depreciation, and the net earnings on the common stock came to $4.13 a share after depreciation, as against $6.90 before that deduction.

The average investor knows little of the methods of determining depreciation and of recording the allowances on corporation books. He probably has a vague idea that physical property depreciates in value over a period of years, but he is not sufficiently versed in corporation accounting to understand the significance of depreciation in public-utility income accounts, or to realize that the advertisements showing interest earned two and a half times before depreciation really mean that interest charges may, perhaps, be earned only one and a half times after provision for depreciation is made. Neither does the average holder of common stock of public utilities understand the meaning of the annual reports sent to him. He struggles over the consolidated income account if he is of an inquisitive turn of mind, and, after many trials and considerable mental anguish he calculates that the "net income available for retirement reserve and dividends" amounts to some $6 a share of common stock. This will be a pleasing discovery, perhaps, for he will expect to receive a large portion of the net income in the form of dividends over a period of years—50 per cent. to 75 per cent., let us say. But, unfortunately, he has not discovered the whole truth. Concealed in the surplus account there is a "provision for retirements." Whether it is placed in the income account or the surplus account is not a matter of great importance from the point of view of dividends. If included in operating expenses it will reduce the earnings on the common stock from $6 to less than $4, perhaps. If included in surplus it will diminish the amount available for dividends just as effectively. In other words the "poison" is still there, although the sugar coating applied by the immersion in surplus account may conceal it for the time being.

To sum up the situation, it is certain that, no matter what the intent of the bankers may be, the usual form of income account used for advertisements of public-utility securities is misleading. Many securities have been sold on the strength of the "before depreciation" form of statement that would have had scant appeal to buyers if all the facts had been presented. It is dangerous practice to bolster up weak securities by means of statements that tell the truth but not the whole truth.

Accountants are not, of course, responsible for the statements prepared by bankers, yet the name of the accountants shown in a bond circular or advertisement suggests to the public that the income statement was prepared and certified by the accountants themselves.