[Journal of Accountancy](https://egrove.olemiss.edu/jofa)

Volume 62 | Issue 2 Article 8

8-1936

Book Reviews

Herbert C. Freeman

W. H. Lawton

Norman G. Chambers

Maurice E. Peloubet

Book Reviews

PUBLIC UTILITY FINANCING, 1930–35, by MERWIN H. WATERMAN. *University of Michigan*, Ann Arbor. 144 pages. 1936.

Public Utility Financing 1930–35, which is one of the series of "Michigan business studies," published under the auspices of the bureau of business research of the school of business administration of the University of Michigan, does not deal with matters of accounting. Its interest to the accountant is necessarily from the broader aspect of the familiarity with matters of finance and business procedure which is essential to the exercise of accountancy as a profession. The volume must, accordingly, be examined from that point of view.

At the outset let it be frankly said that the present reviewer is an executive of one of the larger public-utility holding companies. His viewpoint is in consequence somewhat subject to the limitations imposed by first-hand knowledge of the problems confronting the industry during the several years just passed. He has perhaps been rendered a little sensitive on certain points by the undiscriminating attacks directed against the industry during the past few years, which have so greatly increased its difficulties in emerging from the effects of the industrial depression. Professor Waterman must not, therefore, take it amiss if his contribution to the study of public-utility financing, which reads in many parts like an echo of the unsound philosophy underlying the public-utility holding company act of 1935, is criticized from that viewpoint, more particularly where it appears somewhat gratuitously to go beyond the scope of the study which was undertaken, to delve into some other aspects of the holding-company situation and condemn the soil as being neither fertile nor auriferous.

The volume consists of five chapters: purpose and motivation (of the public-utility financing during this six year period); characteristics of security contracts; capital costs and methods of security distribution; holding companies and public-utility finance; and holding-company diversification. The fourth and fifth chapters are those in which Professor Waterman's conclusions with regard to the lack of usefulness of holding companies are chiefly elaborated, but the first three chapters do not entirely ignore this aspect of the matter.

Professor Waterman has assembled information of a financial and statistical character useful as a record of utility financing during the period following the peak of expansion in general business at the end of 1929 down to the end of 1935 when previous peaks in kilowatt-hour output had already been exceeded and the electric industry, if unencumbered by the federal legislation of 1935 and free from the threat of destructive federal competition and subsidies in aid of artificially fostered municipal competition, would have been in a position to enter upon a new period of plant expansion and development.

Of great significance are the figures presented in the tables prepared by Professor Waterman, setting forth the facts as to the decline in public-utility security offerings from $2,381,781,152 in 1930 to $92,731,478 in 1933, with a subsequent increase to $1,294,421,747 in 1935; but more significant still is the fact that while in 1930 the security offerings made for the purpose of expansion amounted to $1,916,794,855, or 80.5% of the total offerings, in 1935 only $17,659,109, or 1.4% of the total, was for this purpose, the remaining 98.6% being for funding, refunding and refinancing. Of further significance is the fact that only 2.2% of the offerings in 1935, or $28,990,847, represented preferred and common stock, while 32.2%, or $766,822,152, fell under these categories in 1930. Of this latter total $410,000,000 represented common stock of telephone companies, but the balance remaining for other utilities is still a very substantial amount, representing many times the corresponding amount for 1935.

A detailed table of the public-utility bond redemptions which occurred in 1935 is given, the totals of which show that the new money rate, calculated after bankers' commissions but before other expenses of issue, averaged 3.39% against an average interest rate of 5.14% on the issues called. Out of the savings in interest, there must be amortized in some manner the premium paid, which averaged 4.69%, upon the call of the old issues. Professor Waterman's first chapter discusses this transition period in an effective manner.

In the second chapter dealing with characteristics of security contracts, Professor Waterman shows a tendency, which is apparent in other chapters of this volume, to fall into the error of attacking human devices, which represent the best that can be done in a changing world, because those devices do not afford perfect protection under all conditions. There is little to be gained in criticizing the desire of timid capital for that degree of security afforded by first mortgage bonds, on the ground that the mortgagee faces an almost inevitable loss if the mortgaged property loses its earning power. Financial institutions and the legal profession will continue to regard a first mortgage obligation as preferable to a debenture or preferred stock. From the point of view of the borrowing company, the modern form of open-end mortgage does not represent an unreasonably restrictive device for the securing of senior capital at the lowest interest cost. In some respects there is an advantage in setting that class of creditor, who seldom contributes more than 50% of the total capital required, apart from other capital groups, who in consideration of a somewhat higher return on their capital are willing to accept a subordinate position from the standpoint of security and must be prepared to permit considerable flexibility and independence of judgment to the management. It was to be expected that in the greater part of the period covered by this study, mortgage bonds would represent the required medium for financing.

Professor Waterman makes a somewhat surprising statement as to what he regards as a growing demand for retirement provisions with respect to senior securities. On the basis of his study, he finds that 84% of the bond offerings in 1934 and 82% of those in 1935 contain "some sort of provision for debt retirement" (page 33). Professor Waterman does not agree that this is a desirable tendency as applied to utility securities and this reviewer is in entire agreement with him on that point. The results of his study, however, may somewhat exaggerate the tendency. There is a vast difference between a sinking fund which calls for the extinguishment of debt by annual retirements and a purchase fund which must be applied to the purchase in the market of bonds up to a specified amount if they are available below a stipulated price. If the bonds are not so available, the purchase fund is inoperative and does not have to be set aside. This is a common provision in indentures, but it should not be treated as equivalent to a sinking fund. Another type of retirement provision, which calls for the application to the purchase or redemption of bonds of the amount remaining from a certain percentage of operating revenue after provision for maintenance, replacements and new construction, or some combination of these three factors, also hardly ranks as more than a protective provision for the upkeep of the mortgaged property. It is possible by simple inspection to extract from the list of bond redemptions in 1935 an amount substantially greater than 18% of the total offerings in 1935 which do not provide for any retirement provisions other than of the types just indicated. There have been cases during this period of the issuance of securities with serial maturities, obviously for the purpose of securing the very low money costs at which such securities could be sold under the abnormal conditions prevailing, but these together with the cases in which true sinking funds have been provided for appear on the basis of an analysis of over 85% of the security issues to amount to less than 25% of the total offerings in 1935.

In the chapter dealing with capital costs and methods of security distribution, the significance of the volume of financing done by direct placement with financial institutions can be easily overemphasized. It reflects a somewhat abnormal investment situation, accentuated by the premium placed on this type of financing by its freedom from the requirement of registration under the security act. As a general principle, however, it may be doubted whether it is desirable, either from the point of view of the financial institutions or of the utility companies, that undue proportions of single issues of individual companies should be absorbed by such institutions, and it seems unlikely that bankers are suffering any permanent impairment of their usefulness to their clients in the placing of securities. Professor Waterman's discussion of costs of registration and of bankers' spreads is interesting, although one can not agree with certain of his conclusions. He believes that experience with registration procedure tends to a material reduction in such expenses and points to the relatively high cost of the Detroit Edison registration (1%) as being no doubt due, in part at least, to the fact that its offering represented the company's first contact with registration requirements. This is carrying deductive reasoning rather too far. An examination of the registration statement of Detroit Edison shows that of the $491,000 of expense of the issue, $294,000 represented state of Michigan fee and mortgage tax on bonds, of which $245,000 was to be paid under protest. The balance of the expenses represented less than 4/10ths of 1% of the amount of the issue.

The time element involved in registration requirements is ignored as a potential cost of financing. During this extraordinary bond market, the time element has operated as a rule in favor of the borrower, but there have been periods in the past when the reverse would have been the case, and we have all of us lived through periods when the interval of time required for registration would have rendered financing, intrinsically sound, entirely impossible. Perhaps, however, we must regard such potential casualties as some of the eggs which must be broken to make good omelets. Professor Waterman's statement that bankers' margins were much lower than they had been prior to the days of regulation and its accompanying publicity appears to point to a conclusion which may not be well founded. Bankers' margins have undoubtedly been substantially affected by the volume of capital seeking investment and by the fact that by far the greater part of the offerings which have been made have been of the highest type, appealing to insurance companies and other financial institutions. Publicity may not affect the situation when money rates harden and bankers are called upon to do a real selling job in order to place securities.

In view of Professor Waterman's feeling with regard to the lack of real security afforded by mortgage bonds, it is interesting to see his comment (page 77) to the effect that the economic condition of a company or an industry can be about as accurately forecast for fifty years as it can for twenty. There are, of course, limits to human foresight, but given stable political conditions, it is surely not rash to assume that the trends in a great industry, essential in character, can be projected conservatively over a twenty-year period. The purchasers of bonds have evidently concluded that these trends can be adequately projected over a thirty-year period, but they have shown a reasonable disposition not to go beyond that. The electric industry, after all, is hardly more than fifty years old, counting even from its feeble beginnings, and to assume that we can just as well anticipate the developments of another fifty years is going too far.

Coming now to chapters four and five which deal more particularly with the relationship of holding companies to the industry, we find the tendency referred to before to assume that perfection is claimed for the holding company form of ownership in its financing, in its relation to investors and in all its ways,—a perfection so far exceeding ordinary human attainments that no other form of utility ownership can conceivably match it. Having shown that this degree of perfection does not exist, Mr. Waterman proceeds to condemn the institution itself. This, it is submitted, is neither logical nor fair.

In the chapter dealing with holding companies and public-utility finance, Professor Waterman gives some instances in which the holding company has been of service to subsidiary companies by rendering financial assistance when it was sorely needed, but he goes to greater lengths in an attempt to show that the holding companies have been in part responsible for the need of their subsidiaries for additional capital, owing to their having received dividends from these same companies. The fact that holding companies are investors in their subsidiaries, and as such are entitled to a return on their investments in order that they may be in a position, in turn, to make distributions to the investors in their own securities, frequently seems to be overlooked by critics of the industry. No holding company, so far as this reviewer knows, has undertaken to pose as Santa Claus. They do for the most part claim to have acted in a reasonable and rational manner towards the companies in which they were investors and towards which they assumed a protective attitude. If, however, it is to be assumed that the needs of operating companies for additional capital required that investors in those companies, whether holding companies or other investors, should not withdraw earnings in the form of dividends, then obviously no utility company would ever have paid any dividends, until possibly the last three or four years, the requirements for new capital having constantly exceeded the amount available for dividends until that time.

In making his point Professor Waterman sees no obstacle in some cases to arriving at the requisite aggregate of dividends by including dividends paid subsequent to the period when the need for the loan arose and, in at least one case, subsequent to the time when the subsidiary had permanently financed its requirements. The consideration of the proper timing of a security issue by an operating company must not be overlooked. It may be undesirable to do financing during the progress of a large construction project, and it is at such times, particularly, that the assistance of the holding company may be most valuable.

Professor Waterman's arguments otherwise suggest that holding company sponsorship is undesirable unless it can be shown that the subsidiaries of holding companies can finance on better terms than independent companies. This argument is entirely fallacious. It is, of course, not possible to say what any of the subsidiaries of holding companies would have been able to do in the way of financing had they remained independent. A comparison on these lines with what was actually accomplished might have some validity. It must be remembered that some of the companies not under holding-company sponsorship are among the strongest companies in the country. This will be seen by reference to the table given by Professor Waterman on page 86. These companies could not have been expected to do much better had they been included in holding-company systems. It may be asserted with some degree of confidence, based on comparable companies which are included in holding-company systems, that they would not have done any worse. The real question is: Would some of the weaker companies which are under holding-company sponsorship have done as well had they been independent? Some of them, it is safe to predict, would have fared considerably worse.

Professor Waterman presents a table (page 90) in support of his statement that "in the matter of supplying new capital to meet the financial needs of the utility industry during the years 1930 to 1935, the holding company failed miserably." The table, however, shows only the security offerings made by parent companies, sub-holding companies and operating companies. It does not show the amount of equity securities of operating companies taken by parent companies; neither does it reflect the fact, to which attention has already been drawn, that since 1931 the capital requirements of operating companies have been almost entirely for refunding purposes and that there has been no occasion, except in rare instances, to furnish additional equity capital for expansion purposes. Further on in this chapter, Professor Waterman dismisses as of no consequence the fact of very real assistance given to their subsidiaries by Commonwealth & Southern Corporation, by United Gas Improvement and others, by pointing to the fact that these companies were simply reinvesting revenue which they had received from their investments in those and other subsidiaries. This is open to the same criticism as that already made, namely, that investors look for a return upon their investments. The nature of the business of a holding company is to collect revenue in the form of interest and dividends and to pay interest and dividends to the investors in its own securities. That they have been able to meet these latter obligations and at the same time extend financial assistance to their subsidiaries speaks well for the conservatism which these companies have exercised with respect to their own working capital positions.

The most that can be said for Professor Waterman's argument in this chapter is that the holding companies have developed their subsidiaries to a point at which they have become largely independent of the kind of assistance which the holding companies have been able to extend to them in the past. He actually says (page 97), ". . . holding companies will be left with just one financial function; namely, to support uneconomic and essentially unprofitable situations." In an industry which is still growing as rapidly as the electric industry, it is a hardy character who would undertake to say that the time when even the strongest companies may welcome financial assistance is past. Even if this were so, however, a case does not seem to have been made against the holding companies which would justify their being deprived of their rights as investors to enjoy the legitimate returns from sound investments well made and carefully fostered.

Professor Waterman makes one rather naïve suggestion in support of his theory that the holding company is of little use to its subsidiaries in matters of financing. He speaks (page 87) of "the admittedly important service of giving advice regarding type of contract or indenture to be used in connection with a given piece of financing," but goes on to say, "Such service is one which the investment banker is paid for, and he certainly is in a position to give advice and counsel that will be as good, and more unbiased than, advice from the officials of a public-utility holding company." The investment banker's advice is, of course, useful and is sought by the officers of both operating and holding companies when financing is being done, but the banker is after all not entirely unbiased, and even if he were, the company's interest must be safeguarded by officers who are admittedly biased in favor of the company. Many provisions of modern mortgages which are distinctly of service to the company, and often in the long run to the investor in the securities issued under the mortgage, would never have been adopted without benefit of forceful advocates speaking for the company. On the other hand, this opposition of ideas leaves the banker free to press for more stringent conditions which will facilitate his sale of the securities to the most exacting investors, who will nevertheless buy a good security with less onerous conditions if the company is able effectively to maintain its side of the argument.

Critics of the holding company recognize that a strong argument can be made for the existence of such companies as a means of affording diversification of investment to their security holders. Having set out to show that the extension of financial assistance by holding companies to their subsidiaries has become a dead issue, Professor Waterman next proceeds, in his last chapter, to show that the principle of diversification never was a live issue; that it is in fact a myth. Unfortunately for Professor Waterman's argument, all the facts which he has assembled not only fail to support his contention, but definitely contradict it. Professor Waterman, however, starts by assuming an utterly impossible and unattainable objective, namely, that diversification should permit an American investor to escape entirely the effects of a worldwide depression which culminated with particular severity in this country. If the principle of diversification which has governed investment policy, whether of individuals, investment trusts, insurance companies, banks or holding companies, is to stand or fall by such a test, then there is no argument. One might as well invest all one's funds in a single enterprise doing business on a single street corner. Only the investor who so far diversified his activities as to take the short side of the market after the boom was over, could meet the standard set by Professor Waterman.

The interesting fact is that all the figures and charts prepared by Professor Waterman show that the ownership of properties in various parts of the country and possessing varying characteristics did smooth out the hills and valleys of fluctuating earnings. Professor Waterman, in fact, admits this several times in his text. The index of variation from a moving five-year average which he has prepared for a number of holding-company situations shows conclusively, as it could indeed hardly fail to show, that the variation for the group combined was substantially less than for the individual units. There are examples in which the index of variation for the group does not even lie between the maximum and minimum variations of the component parts, although Professor Waterman suggests in discussing deviations from secular trend (page 137) that this must necessarily be the case. It is not the case, because the variations are computed from a moving average or straight-line trend, as the case may be, and expressed, quite properly, as positive values. The figures do not show, nor will the figures for any group of investments, commodities or activities of any kind show, that diversification had any magic power to avert the disastrous consequences of the depression. The utilities simply suffered less than many other industries and the holding companies showed less violent fluctuations than their constituent companies taken individually. Professor Waterman himself brings out the fact that utilities in different sections of the country were affected in varying degrees and at different times during the period covered by his study.

It is, of course, the desire of every investor to select those investments which will yield the best results. It is unfortunately not possible for an individual, or even for a holding company, to make these selections with infallible accuracy. A holding company does not afford the same degree of flexibility of investment as an investment trust specializing in utility securities, and the latter in turn is less flexible than a general investment trust. On the other hand, the holding company offers an investor in utility securities an opportunity to spread his risk over a known and substantially fixed group of properties. He might fare better as an investor in a single one of the group. That, however, would be a matter of judgment and possibly of price. On the other hand, he might fare measurably worse as an investor in some other property in the group. Professor Waterman makes this abundantly clear in the figures which he presents and his rejection of the value of diversification in the face of his own evidence is, to say the least, a departure from the scientific method of approach.

In case any one should disagree with Professor Waterman's handiwork, he adopts the defensive attitude of quarreling with his tools. He suggests that, "The real significance of these results is difficult to determine because of the fact that little faith can be placed in the year-by-year profit figures of operating utilities" (page 110). Auditors of operating companies, please note! Even were Professor Waterman's sweeping statement to be taken seriously, it is rather obvious that for the most part the controllable factors in the accounts would be made to minimize rather than exaggerate yearly fluctuations, although Professor Waterman mentions one or two instances which have come to his attention which, without further investigation, appear to create greater divergency of results.

Professor Waterman utters a note of rebuke (page 132) to certain holding companies which have permitted apparently hopeless situations in certain of their subsidiary companies to be worked out through the medium of default and reorganization. Again we are faced with the thought that some other critic of the industry would probably condemn these same companies for having persisted too long in trying to bolster up a hopeless situation. It is permissible to suggest that a holding company is not an eleemosynary institution.

Professor Waterman very gracefully summarizes his conclusions with regard to holding companies by the time-honored statement that, "You can't make a silk purse out of a sow's ear" (page 133). One is reminded of the prisoner about to be sentenced for a crime which the judge said had been committed in a highly skillful and intelligent manner, who begged his honor not to descend to flattery.

Extended comment in a review may be out of place. That is, perhaps, why there are too many unsuspecting purchasers of books which dissemble their real purpose. As to the present volume, therefore, may it be said in brief that it contains some interesting tabulations and presentations of figures, but that for the conclusions to be drawn from those figures, the reader must rely on his own intelligence.

HERBERT C. FREEMAN.

AUDITING LABORATORY SET, by THOMAS W. BYRNES and K. LANNEAU BAKER. *The Ronald Press Co.*, New York. 1936.

As a unit of the Columbia university accounting series, edited by Professor Kester, *Auditing Laboratory Set* is an attempt to solve the problem of supplying to students of auditing procedure practical material for laboratory work. It consists of some 300 sheets in type-script containing completely written up accounts as they would be found in a set of books, with full supporting data such as vouchers, cheques, bank statements, confirmation letters, invoices, excerpts from minutes, etc. Working conditions are fairly imitated even to the inclusion of errors, irregularities and defalcations. With these before him the student is led step by step through an orderly program of audit as prescribed by any of the standard authorities.

As far as it goes this is an eminently practical method for laboratory work. It is open to the criticism that it deals with one type of business, textile production and selling. Much of it would not be applicable to other types, such as banking, real estate, farming, etc., but at least the student gets practice in applying theory systematically. Also, as a matter of technique, one may doubt perhaps the advisability of using the long list of code-marks on the books (sheet ii). No tidy bookkeeper likes to see his books all marked up, and, if I am not mistaken, most modern practitioners prefer to make analyses of pertinent accounts on their working papers.

Altogether it is a bit of practical work that reflects credit on its authors. Its effectiveness in training students will be watched with interest by accounting instructors and by the profession generally.

W. H. LAWTON.

INTRODUCTION TO FEDERAL TAXATION, by GEORGE T. ALTMAN. *Commerce Clearing House, Inc.*, New York. 166 pages. 1936.

Introduction to Federal Taxation is, I believe, the first definite attempt to state in simple narrative form the underlying principles of the federal revenue laws.

Perhaps fifty years from now a work of this character could attain the position of an authoritative work of reference. The present volume, however, deals with a subject not yet sufficiently molded into its final form and is of no more than passing interest, except to the student desiring to become well grounded in the development of our revenue laws from their inception up to date.

The book is well written and logical in its presentation and, if properly understood as being only an introduction to federal taxation as stated in the title, should cause the student reader to desire more up-to-date information to be found only in one of the standard tax services.

NORMAN G. CHAMBERS.

NEW YORK STOCK EXCHANGE, Committee on Public Relations, New York Stock Exchange, April, 1936. 40 pages. 1936.

STOCK EXCHANGE PROCEDURE, by BIRL E. SHULTZ, New York Stock Exchange Institute, March, 1936. 102 pages. 1936.

These two excellent manuals would seem to be required reading for anyone who has an interest, direct or indirect, in the work of the New York stock exchange. Both of them are clearly written and well illustrated. The section dealing with the work of the "specialist" is particularly valuable, as it gives a clear statement of what is to many a complicated and mysterious function.

The short history of the exchange and its efforts, largely successful, to persuade corporations to publish adequate information, and its constant endeavor to raise and maintain the standard of ethics among its own members are interesting not only to men in Wall street, but to accountants, credit men and all others whose work lies in the preparation or interpretation of financial statements.

Without laboring the point, in fact without referring to it specifically, it is made clear that the exchange had, at the time of the passage of the securities exchange act, gone a long way towards the goal to which that act gave it a forcible and somewhat uncomfortable propulsion. The exchange authorities state what everyone, I believe, admits to be the fact, that they have been and are endeavoring to coöperate so far as lies within their ability with the securities and exchange commission.

These two little books contain information which should be in the possession of every practising accountant, but more particularly those who have to deal with personal income taxes, investments, estate work and the many other parts of an accountant's practice which have to do with the statement and verification of securities and security values.

MAURICE E. PELOUBET